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Tax Planning for the Professional Athlete and the Impact of the Tax Reform Act of 1986

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I. INTRODUCTION

The Tax Reform Act (TRA) of 1986 sets forth some of the most sweeping changes to the federal income tax system since its inception in 1913.[1] By simplifying the tax structure through reducing the rates and number of tax brackets, deductions, credits, and exemptions, taxes are now abolished or sharply curtailed.[2] For the professional athlete who has significant earnings only during the early stages of his income-producing life, an adequate tax planning strategy, although important before, now becomes imperative.

The Act's goals of fairness, efficiency, and simplicity[3] may have harmful results for those athletes who have been reducing much of their taxable income through bona fide tax shelters. Opportunities do remain, however, for a farsighted athlete who seeks competent advice to significantly reduce income tax liability. This paper will focus on the TRA's effect on the typical financial goals of a professional athlete. These generally include reducing current

1. S. REP. No. 313, 99th Cong., 2d Sess. 3 (1986). Note: The Tax Reform Act of 1986 renamed the Internal Revenue Code of 1954 as the Internal Revenue Code of 1986. Any cites to the old Code will refer to the 1954 I.R.C. All other cites will refer to the new code as enacted in 1986.

2. *Id.*

3. *Id.*

year taxes, establishing future retirement security, and providing for a family member.

Many traditional ways exist for the athlete to reduce his taxes and still meet his other goals. The athlete and advisor may consider incorporating the athlete or forming a personal holding company. Deferred compensation arrangements may be established through contract negotiations. After negotiations, sheltering the earned income through real estate ventures and other methods can be effective. Other considerations include the income-averaging technique, the alternative minimum tax, and general tax planning advice such as individual retirement accounts and Keough plans.

Part I of this paper concentrates on the assignment of income doctrine and the possibilities of providing for a family member. Part II examines the incorporation technique and the resulting tax advantages and problems. Part III looks at tax shelters and the impact that the TRA of 1986 will have in this area. Parts IV and V discuss the alternative minimum tax and deferred compensation, respectively. Part VI explores a variety of other items including income averaging, employee business expenses, investment tax credits, individual retirement accounts and interest-free loans. Finally, Part VII summarizes the areas discussed and presents a general tax-planning strategy.

II. Assignment of Income Doctrine

An initial way for the athlete to reduce his taxable income is to use the assignment of income doctrine. This fundamental principle of tax law is not codified but is well supported by case law.[4] The basic theory behind the doctrine involves shifting taxable income from a high bracket individual to a family member or other beneficiary in a lower bracket.[5] The overall tax paid on the same income is then reduced. An athlete earning $200,000 a year is in the 33% bracket[6] and can expect to pay income taxes of approximately $60,000. If $50,000 of the income is shifted to his parents, who are in a 28% bracket, the athlete reduces his personal taxes to about $40,000. The parents' tax bill rises by $14,000, but there is a $6,000 tax savings overall. An athlete can thus provide his parents

4. Lucas v. Earl, 281 U.S. 111 (1930); Harrison v. Shaffner, 312 U.S. 579 (1941); Helvering v. Eubank, 311 U.S. 122 (1940); Helvering v. Horst, 311 U.S. 112 (1940).

5. *See Lucas*, 281 U.S. at 113-14; *Harrison*, 312 U.S. at 579-80; *Eubank*, 311 U.S. at 124-25; *Horst*, 311 U.S. at 114.

6. Beginning in 1988, the top tax bracket was increased from 28% to 33%. I.R.C. § 1 (1988).

with a share of his income, while at the same time reducing the total tax paid.

The case which set out the general rule is *Lucas v. Earl.*[7] Justice Holmes held that anticipatory agreements, in which "the fruits are attributed to a different tree from that on which they grew" will not be upheld.[8] Thus, if an athlete assigns part of his salary to his parents in order to take advantage of their lower bracket, the assignment will be disallowed and the athlete taxed on the income. If he desires to donate a sum of his after-tax income, there are no income tax consequences. However, gift tax implications must then be considered.[9]

Careful planning of the transaction may still lead to the desired results. Two cases, with contrasting results, demonstrate what steps must be taken to use this tax reduction method. In *Cecil Randolph Hundley, Jr. v. Commissioner*,[10] the athlete, Randy Hundley, signed with the San Francisco Giants in 1960 and received a substantial bonus. Instead of including the entire amount of the bonus as income, Randy paid half of the bonus to his father pursuant to an earlier oral agreement and reduced his gross income.[11]

The case turned on the validity of the prior agreement which was entered into in 1958 when Randy was a sophomore in high school. The contract provided that the father would get one-half of any of Randy's bonus in exchange for performing certain services. These services included training and coaching his son and negotiating a contract with a professional team.[12] The court held that the father earned the income due to the substantial services rendered and a legitimate basis existed for the son to exclude it from his income.[13]

In *Richard A. Allen v. Commissioner*,[14] the court would not allow the purported assignment of income. Dick Allen, a major league baseball player, could not claim the same legitimate basis that Hundley did. Allen tried to deflect the tax consequences of a large signing bonus in the same manner as Hundley.[15] The recipi-

7. 281 U.S. 111 (1930).

8. *Id.* at 115.

9. These are outside the scope of this paper. The primary focus here will be on income tax consequences. *See generally* I.R.C. §§ 2501-24 (1986).

10. 48 T.C. 339 (1967).

11. *Id.* at 341-42.

12. *Id.* at 340.

13. *Id.*

14. 50 T.C. 466 (1968).

15. *Id.* at 468.

ent, his mother, produced neither a previously signed agreement nor evidence of training, coaching or negotiating as Hundley's father did. Instead, arguments focused on the fact that the mother was responsible for the bonus by her "hard work, perseverance and seeing that Allen did the right thing."[16] The court felt these intangibles alone did not constitute a legitimate basis for exclusion of the income.[17]

For the farsighted athlete with adequate tax planning advice, income reduction is possible through assignment of income. A contract must be entered into prior to the income being earned which allows for the lower bracket recipient to provide substantial, legitimate services to the athlete. If these services are indeed performed, compensation may then be directed not from the team to the athlete but, in effect, from the team to the beneficiary.

III. Incorporating the Athlete

An extremely effective way of meeting the athlete's financial goals involves incorporation. Earned income initially flows into the corporation. Before being disbursed to the athlete, it will be subjected to a number of beneficial deductions available because of the new entity.[18] Although, in theory, the threat of double taxation[19] is present with the addition of another taxable entity, proper planning can reduce the corporation's taxable income to zero and thus avoid this drawback.

In order to successfully incorporate in this context, a number of obstacles presented by the Code and case law must be overcome. Among these are reality of the corporate structure, assignment of income and tax avoidance problems, reasonableness of employee/athlete compensation, the personal holding company tax, and a cost/benefit analysis of forming, running and using the entity.[20]

Some benefits available from the corporate structure are using before-tax dollars to establish and fund a qualified retirement plan, a medical reimbursement plan, and health, medical and

16. *Id.* at 468.

17. *Id.* at 477-78.

18. The new entity will allow deductions for compensation paid to the athlete, medical or life insurance benefits, and qualified retirement plan contributions.

19. The same income is being taxed twice if it is recognized by both the individual and the corporate entity.

20. *See, e.g.*, Treas. Reg. § 301.7701-2(a)(1) (corporate structure), Lucas v. Earl, 281 U.S. 111 (1930) (assignment of income doctrine), I.R.C. § 482 (1988) (tax avoidance and reasonableness of compensation), I.R.C. §§ 541-47 (personal holding companies).

group term insurance.[21] Without a corporate entity, an athlete would normally fund many of these benefits with after-tax dollars. After incorporation, they may be obtained with before-tax dollars, thereby reducing taxes owed.

The first obstacle the athlete faces involves the corporate structure of the new entity. If there is a lack of evidence to the contrary, the Internal Revenue Service (IRS) may determine that the entity is a sham, has no real economic substance, and was formed primarily to avoid taxes.[22] If the corporate entity is deemed a sham, it will not be recognized for tax purposes and the athlete will bear all the usual tax consequences of his income.[23]

Certain steps must be taken in order to avoid this problem. First, the corporation must be carefully organized to comply with applicable state laws. For example, it should apply for and receive its own tax identification number. Additionally, the corporation should draw up bylaws, name officers and directors, maintain minutes of periodic board meetings, and issue stock. Second, a separate bank account should be established and office space leased in the corporate name. Finally, the athlete should serve on the Board of Directors and may act as an officer or president of the company. Since the athlete will be deemed an employee of the corporation, he provides the ability to incur deductions. If possible, all income producing amounts earned as a result of the athlete's performance should be funnelled through the corporation. Although several sports do not address corporations in their standard player contracts,[24] this form of tax benefit is still available to athletes that play in these leagues. Any ancillary income from endorsement contracts, speaking engagements, or other sources should flow through as corporate income so that the athletes playing in these leagues may still take advantage of these tax benefits. The corporation should negotiate all of the income-producing contracts. The corporation also must enter into an agreement with its employee, the athlete, for him to provide services, allowing the athlete to be compensated with a salary deductible to the corporation and includible

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21. *See, e.g.*, I.R.C. §§ 401-17 (1986) (qualified retirement plans), §§ 105-06 (medical reimbursement and other fringe benefits).

22. The requirements needed to support the corporate status include an objective to carry on a business, continuity of life, centralization of management, limited liability, and free transferability of interests in the corporation by the shareholders. Treas. Reg. § 301.7701-2(a)(1) (1986).

23. *See* Floyd Patterson, 25 T.C.M. (CCH) 1230 (1966).

24. The leagues that do not deal with the corporate entity in their standard player contracts are the National Football League, the National Basketball Association and Major League Baseball.

to the athlete. This scheme is necessary because the corporation must "perform some meaningful business function in order to gain recognition as a separate entity for tax purposes" to avoid being labeled a sham by the IRS.[25]

The tax avoidance rule[26] of section 482 poses another hurdle for the athlete and the corporation. The IRS may allocate gross income among business entities owned or controlled by the same interests if it determines that allocation is necessary to prevent tax evasion.[27] The broad language of this section gives the IRS a tool which is more powerful than the corporate sham theory. An IRS determination that income should be reallocated to the athlete will usually be upheld where little or no actual services are performed by the corporate entity on the athlete's behalf.[28] No reallocation will take place if the corporation performs legitimate services for the athlete.[29]

Another problem the athlete and the corporation face is how to distribute income left over at the fiscal year's end. Prior to the TRA, deferral benefits were available in the initial year if the corporate fiscal year was different from that of the athlete's.[30] These benefits are now eliminated.[31] Distribution questions must still be answered.

Basically, four choices exist. The corporation may hold the income, distribute it to the athlete as a dividend, distribute it as a salary, or use any combination of these.[32] The first alternative may present personal holding company tax problems.[33] If a corporation qualifies as a personal holding company, then its undistributed income may be subject to a penalty tax.[34] A personal holding com-

25. Floyd Patterson, 25 T.C.M. (CCH) at 1234.

26. I.R.C. § 482 (1986).

27. *Id.*

28. Borge v. Commissioner, 405 F.2d 673 (2d Cir. 1968), *cert. denied*, 395 U.S. 933 (1969).

29. *Id.*

30. Individual athletes generally report all income and expenses on a calendar year basis with December 31st as the year end. If the corporation adopts a January 31st year end, 11 months of income (February through December) will be deferred and reported by the athlete during the second calendar year.

31. I.R.C. § 441(i)(1) (1986).

32. The I.R.C. does not mandate what corporations must do with their accumulated income unless it reaches excessive levels. It is essentially a management decision. The corporation may either hold or pay out the income. If it is paid, it may be a dividend under I.R.C. § 301, some other expense, such as a salary under I.R.C. § 162, or any combination of the two.

33. I.R.C. § 541-547 (1986).

34. I.R.C. § 541 (1986).

pany is defined as a corporation where at least 60% of its income is personal holding company income and more than 50% of the outstanding stock is owned by five or fewer individuals.[35] The personal service contract entered into by the corporation with a team or marketing organization creates a personal holding company.[36] The stock ownership test is generally met because the athlete would not want to lose control of his corporation and thus would normally retain at least 50% control.

The penalty tax had been as high as 70% but the TRA reduces this to 38.5%.[37] This tax is in addition to the regular tax rates which the corporation, as a separate tax entity, ordinarily must pay. As corporate tax rates are somewhat lower than individual rates, the athlete may desire to leave all possible income in the corporation.[38] For example, under the tax rates effective for 1988, an individual earning $100,000 would pay $28,522 in tax with any additional income over $100,000 taxed at 33%.[39] A corporation, however, would pay $22,500 with an effective rate of 34% for income over $100,000.[40] Unfortunately, the penalty tax on personal holding company income wipes out this incentive. Fifty percent of the undistributed income, or $50,000, is taxed at 38.5%, or $19,250.[41] Thus, leaving the income in the corporation is not a viable alternative. Paying a dividend does not solve the problem because they are not deductible items to the corporation.[42] They are, however, includible income to the recipient.[43] Double taxation would occur here because both tax entities would pay tax on the same income.

The only real alternative is to distribute the income as a salary to the athlete. The IRC presents a challenge here because only a

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35. *Id.* §§ 542(a)(1), (2).

36. *Id.* § 543(a)(7).

37. *Id.* § 541.

38. Corporate tax rates are 15% for the income bracket encompassing up to $50,000, 25% for the $50,000-$75,000 income bracket and 34% for income over $75,000. I.R.C. § 11(b) (1986). Individual tax rates are 15% for income up to $17,850, 28% for income up to $43,150 and 33% above this. I.R.C. § 1 (1986).

39. The amount is calculated as follows: the first $17,850 is calculated at 15% for a total tax of $2,678; the next $25,300 (up to $43,150) is figured at 28% and nets a total tax of $7,054; the remaining $56,850 is calculated at 33% and nets a tax of $18,760 for a total of $28,522 in tax liability. I.R.C. § 1 (1986).

40. The amount is calculated as follows. On the first $50,000 at 15%, the tax is $7,500. The next $25,000 at 25% brings a tax of $6250. The final $25,000 at 34% brings a tax of $8750 or a total of $22,500. *Id.*

41. I.R.C. § 541 (1986) (effective as of 1987).

42. *Id.* § 301(c).

43. *Id.* § 61(a)(7).

reasonable allowance for salaries, or other compensation for personal services actually rendered, is deductible.[44] If the IRS determines that the amount is unreasonable, it will be classified as a distribution of profits or dividend and taxed as such. This determination is unlikely, however, because corporate income is based solely on the athlete providing services. Without these services, there would be no corporate income at all. Thus, theoretically, all the income could be distributed as salary. A lesser amount, after paying the deductions such as pension and insurance, would almost certainly be reasonable.

After the corporation has been properly established, tax avoidance and assignment of income questions resolved, and the final distribution issues addressed, the real benefits of the corporate entity may be explored. The most important benefit is the ability to establish a corporate retirement plan which fulfills several of the athlete's financial goals. First, it allows earned income to be placed into a qualified plan that reduces income to the corporation.[45] This is the primary income-reducing benefit of the corporate entity. Second, it provides for the athlete's financial security through the forced savings feature of the corporation's contributions. In addition, income earned in the retirement plan is not taxable until withdrawn.[46]

The corporation may choose from three different options: a defined benefit plan; a defined contribution plan; and a profit sharing plan. The defined benefit plan offers the least amount of tax deferral because the total amount of benefits that can be paid out annually is the lesser of either $90,000 or 100% of the athlete's average compensation for the highest three years of earnings.[47] The $90,000 amount is adjusted for a cost of living allowance.[48] A key restriction imposed on a young athlete by the TRA is a ten percent reduction of benefits allowed to be withdrawn for each year less than ten years that the athlete did not participate in the plan.[49] This may pose a serious problem for athletes with short careers.

A more generous retirement plan is the defined contribution plan. No limit exists on benefits to be paid to the athlete but there is a limit on allowable contributions. These are the lesser of

44. *Id.* § 162(a)(1).
45. *Id.* § 404.
46. *Id.* § 501(a).
47. *Id.* § 415(b)(1).
48. *Id.* § 415(d).
49. *Id.* § 415(b)(5).

$30,000 or 25% of the athlete's compensation.[50] A combination of defined benefit and contribution plans may be used, but the limitations still may not be exceeded.[51]

The profit sharing option is the most flexible of the three plans. It has the same maximum limits on contributions as a defined contribution plan,[52] but, unlike the defined contribution plan, it allows benefits to be paid to the athlete prior to retirement age upon illness, disability, retirement, death or severance of employment.[53] Profit sharing plans also have specific limits on amounts that the corporation may deduct. Fifteen percent of the compensation paid to the participants in the plan is the deductible limit if one plan is established.[54] Twenty-five percent or an amount that meets the minimum funding standard under Section 412 is deductible if more than one plan is in place.[55] In addition, profit sharing plans need not make contributions if there are no profits or funds in a particular year.[56] This discretionary feature may prove to be the key feature of all the plans.

Before adoption of one of these retirement plans, consideration must be given to the non-tax aspects of these transactions. The athlete's specific cash flow needs and savings ability must be analyzed. Adequate tax planning does not necessarily mean paying the lowest overall level of tax. The client's needs should be the paramount consideration. If there is a need for immediate cash, locking away funds in a corporate retirement plan may not be the best alternative. Honest evaluations are necessary to achieve all of the athlete's goals. The adoption of the plan must also consider the possible loss of league-provided pension benefits.[57]

Another benefit resulting from establishing a corporate entity is the fringe benefits available to the employee athlete. Items such as a medical expense reimbursement plan or health and group term insurance are deductible items to the corporation as ordinary and necessary business expense and are excludable by the athlete.[58] The medical expense reimbursement may be significant to individuals because there is a current 7.5 percent floor of expenses

50. *Id.* § 415(c)(1).
51. *Id.* § 415(e).
52. *Id.* § 415(c)(1).
53. Treas. Reg. § 1.401-(1)(b)(1)(ii).
54. I.R.C. § 404(a)(3)(A)(i).
55. *Id.* § 404(a)(7)(A)(i), (ii).
56. *Id.* § 404(a)(3)(B).
57. The league may not allow the player to enjoy its pension benefits if the player has his own plan.
58. I.R.C. §§ 105, 106.

that is nondeductible.[59] All amounts may be deductible after coming through the corporation. Any protection beyond $50,000 from group term life insurance benefits is taxable.[60]

IV. Tax Shelters

The TRA impacts the tax planning of the professional athlete the most in the real estate tax shelter area. Congress acted to curb abusive practices and tax incentives which led to excessive construction and record vacancy rates.[61]

Tax shelters have been an extremely popular way to reduce taxable income. In general, they allow tax losses to be realized where, in reality, no economic loss has occurred.[62] Depreciation, a non-cash expense, is the primary tool for this purpose. Athletes are subjected to this treatment because their long term contracts are depreciated over a short term period, providing team owners with significant write-offs.

For example, if an owner spends $1,000 for a bona fide nondepreciable expense such as office supplies, the net cash outlay will be the $1,000 disbursed minus the tax savings caused by the deduction. If an owner is in the highest bracket of 33%, taxes owed at year end will be $330 less because of the office supply deduction. Thus, the net cash outlay is $670.

If an owner depreciates a capital asset, such as a computer, for $1,000, the net cash outlay for the same period is a negative amount, or in effect, tax savings. The owner did not actually disburse the $1,000 deduction taken. Yet, the deduction's tax benefits are still available and a tax savings and cash intake of $330 is realized.

An incentive thus exists to broaden the gap between the allowable tax loss and the actual economic loss. Historically, real estate has been a popular investment area for shelters as it is likely to give steady asset appreciation.[63] An additional benefit is that as the write-off ratio[64] tends to be lower, IRS scrutiny focuses on other areas.

59. *Id.* § 213(a). The TRA increased this from 5%.

60. *Id.* § 79.

61. S. Rep. No. 313, 99th Cong., 2d Sess. 7 (1986).

62. Depreciation, a noncash expense, is allowed under I.R.C. § 167 regardless of whether there has been an economic loss.

63. American Law Institute/American Bar Association Committee On Continuing Professional Education, Foreign Investment In U.S. Real Estate (1981).

64. This ratio is defined as depreciable losses to investment. Generally, real estate ventures have ratios of 3:1 or 4:1. Other shelters such as oil and gas may have 7:1 or 8:1. *Id.*

For the athlete unable or unwilling to avoid receiving taxable income, shelters had been a common way to reduce tax liability. The TRA shifts the importance of tax planning away from real estate tax shelters and into other areas such as incorporating the athlete and deferred compensation arrangements.

The most radical change in the tax law concerns the limitation on allowable "passive" loss deductions. By defining another class of expenses,[65] Congress's passive loss requirements reduced available shelter losses to a maximum of $25,000. If an athlete is engaged in rental real estate activities, actively participates in the investment as defined by the IRS, and meets the adjusted gross income test, then the maximum deduction is possible.[66]

For tax years beginning after 1986, passive losses may only be used to offset passive income.[67] The rule applies to individuals, closely held corporations, and personal service corporations.[68] Passive losses cannot be used to offset active income, such as wages or salary earned, but they may be carried forward to offset future passive income.[69]

A "passive activity" is generally defined as one that involves conduct of a trade, business, or investment activity in which the taxpayer does not materially participate.[70] "Material participation" is defined as being involved in the activity's operations throughout the tax year or on a regular, continuous and substantial basis.[71] Periodic consultation as to general management decisions does not satisfy the material participation test.[72] A highly relevant factor in determining this status is how frequently the taxpayer is present at the place where principal operations are being carried on.[73]

Rental activities involving real estate or equipment leasing are always treated as passive activities without regard to whether the taxpayer materially participates or not.[74] Active participation is achieved if the athlete owns ten percent or more of all interests in the activity.[75] The adjusted gross income test calls for the $25,000

65. Prior to enactment of the TRA, expenses could be categorized as trade or business (§ 162), portfolio (§ 212), and hobby (§ 183) costs.
66. I.R.C. § 469 (1986).
67. *Id.*
68. *Id.* § 469(a)(2).
69. *Id.* § 469(b).
70. *Id.* § 469(c)(1).
71. *Id.* § 469(b)(1).
72. S. REP. No. 313, 99th Cong., 2d Sess. 732 (1986).
73. *Id.* at 733.
74. I.R.C. § 469(c)(2) (1986).
75. *Id.* § 469(i)(6)(A).

maximum deduction to be reduced by 50% of adjusted gross income over $100,000.[76] Thus, for the athlete with significant earnings, this whole area involves little tax benefits. Other tax deferral devices may reduce the athlete's income, thus bringing into play these provisions.

Transition rules alleviate some of the harshness of these changes. A five year phase-in period allows some losses on interests held on or before date of enactment.[77] In 1987, only 65% of any losses were allowed.[78] In subsequent years, the percentage of allowable losses decreases to 40%, 20%, 10% and finally zero.[79]

For the athlete who must devote significant time to his current occupation in order to generate an extremely large salary, material participation in a venture is a high standard to achieve. Not achieving the standard of active participation leaves the athlete with a maximum $25,000 writeoff.

There are other ways in which the TRA restricts available tax benefits to the athlete. It increases the write-off period of both residential and non-residential real property from 19 years to 27.5 and 31.5 years respectively.[80] This reduces the available depreciation by almost one-half. For the athlete who purchases a luxury automobile,[81] the already small depreciation deductions are further reduced. Prior to the TRA, $3,200 multiplied by the business use percentage was allowable as a first year write-off.[82] After the first year, this limit was increased to $4,800.[83]

The new Act lengthens the depreciation period from three to five years and places the amounts available for deduction at $2,560, $4,100, $2,450, and $1,475 for years one through four and beyond.[84] The requirement that recapture of excess ACRS deductions be made if business use declines below 50% is still in effect.[85]

Besides the new passive loss limitations and longer depreciation periods, the TRA extended the "at risk" rule to real estate.[86]

76. *Id.* § 469(i)(3)(A).
77. *Id.* § 469(l).
78. *Id.*
79. *Id.* § 469(l)(1).
80. *Id.* § 168(c).
81. A better tax strategy would have the personal holding corporation purchase the auto and then allow the employee athlete to use it. This ensures additional deductions for the corporation.
82. I.R.C. § 280F (1954).
83. *Id.*
84. I.R.C. § 280F(a)(2)(A) (1986).
85. *Id.* § 280F(b)(3).
86. *Id.* § 465(c)(3).

Generally, a taxpayer is only allowed to deduct losses not in excess of his actual economic involvement or the amount he was actually at risk.[87]

Non-recourse financing provides the principal means for allowing the taxpayer to invest in a development project and not be liable for that portion of income invested in the project. Eager sellers, aggressive banks, investment companies, and others seeking to lend money in the competitive development market will offer to assume the risk of a project over a certain level in order to make the loan. For the developer, this form of financing offers the necessary capital without the inherent risk of the project going sour. A consequence of this type of financing is inflated land values.[88] A tax shelter-oriented investor with a large non-recourse line of credit actually has an incentive to overbid for the property to generate higher depreciation losses. This is especially true where the goals of a tax shelter partnership are to provide tax losses. The developer may simply walk away from the project at any time, leaving the lender with the property and avoiding any future liability.

Prior to the TRA, real estate was not subjected to the "at risk" rules and the above scenario was likely to occur.[89] The new act extends the "at risk" rule to real estate except for "qualified non-recourse financing,"[90] which means financing secured by real estate from any federal, state, or other local government body or other qualified person.[91] This last term means any person who is actively and regularly engaged in the business of lending money.[92] The problem of overvaluation of property can be eliminated with the availability of non-recourse financing to the seller. If an athlete with significant disposable income can develop a relationship with a qualified lender to obtain non-recourse financing, tax benefits may be available.

A common real estate venture prior to the TRA was rehabilitation investment. When the purchased structure met certain requirements, 15% and 20% credits against tax were allowed to encourage this investment.[93] If the property was a certified historic

87. *Id.* § 465.

88. S. REP. No. 313, 99th Cong., 2d Sess. 748 (1986).

89. Section 503(a) amended § 465(c)(3) so as to include real property within the "at risk" rule.

90. I.R.C. § 465(c)(3) (1986).

91. *Id.* § (b)(6)(B).

92. *Id.* § 46 (c)(8)(D)(iv).

93. I.R.C. § 46(b)(4) (1954).

structure, a 25% credit was allowed.[94] These percentages are now reduced to 10% generally and 20% for historic structures. This reduction will likely have a negative impact on the desirability of this investment.[95]

V. Alternative Minimum Tax

Prior to the new act, a separate tax base subjected certain taxpayers to an additional tax, as well as all other tax liabilities.[96] The purpose of the "alternative minimum tax" was to ensure that taxpayers with substantial economic income could not completely avoid taxation through various exclusions, deductions, and credits provided by the Internal Revenue Code.[97] Though each benefit has a worthy goal, grouping them together to completely eliminate tax liability may become counterproductive.[98]

Congress believed that the alternative minimum's purpose was not being met by existing law because it did not effectively measure economic income.[99] Accordingly, the new Act created an alternative minimum tax for corporations and changed the old one for individuals.[100] If an athlete creates a corporation, that entity will now be subject to this tax. The scope of the calculation is also broadened for individuals.[101]

VI. Deferred Compensation Arrangements

A common way for an athlete to reduce tax liability is to defer earned compensation until subsequent years. Taxes are not ultimately avoided, but income will be recognized at a later time when the applicable tax bracket may be lower than at present.

Since the primary change of the TRA was elimination of the numerous tax brackets, this benefit was sharply curtailed.[102] However, deferred compensation packages are still attractive as tax laws could change again and install higher brackets. In addition, delaying payment of taxes provides time value of money benefits as well as the possibility of future deductions to offset the future

94. *Id.*
95. I.R.C. § 46(b)(4) (1986).
96. *Id.* §§ 55-58.
97. S. Rep. No. 313, 99th Cong., 2d Sess. 518 (1986).
98. *Id.*
99. *Id.* at 519.
100. I.R.C. § 55(a) (1986). The complexities of this tax are beyond the scope of this paper.
101. *Id.* §§ 55-57.
102. *Id.* § 1.

income. Once the tax is paid, an individual cannot utilize tax deductions which arise later, unless an amended return is filed.

Prior to the new Act, the Code provided for fourteen progressive tax brackets ranging from a low of 11% to a high of 50%.[103] The TRA of 1986 will phase-in over a period of time and provide two brackets of 15% and 28% applicable to those with low or moderate incomes.[104] For athletes and other high-income taxpayers with incomes over $43,150, there is a third bracket of 33%. Thus, after all sheltering and other tax planning devices are used, an athlete with net taxable income of $100,000 would pay $28,522 in taxes.[105] If the athlete was able to defer $100,000 of his salary by spreading it out over a number of years, his current tax would be zero and the future income taxes on the same income would be at 15% or a total of $15,000.

Some initial caveats must be considered. Initially, determining if there is excess disposable income should be considered. If all other agreeable sheltering options and tax planning devices such as forming a personal holding corporation, are not used, the athlete needlessly runs the risk of not collecting his future income. His deferred compensation risks are twofold. First, the team or owner may go bankrupt and second, the present value of receiving his money in the future may be less than the amount received today.

This latter risk is one to be negotiated during contract talks. Typically, if an owner is agreeable to deferred plans, a percentage rate is negotiated to be applied to all income not currently received. For the benefit of not paying the athlete currently, the owner must set aside and pay interest on the original salary being deferred. If the interest rate negotiated is too low, the athlete runs the risk of receiving far less than anticipated. The opposite may occur but a gamble is taking place and the athlete should be aware of these risks.

The athlete's cash flow need must also be considered. Deferring may be the best way to avoid taxes but may not leave the athlete with sufficient cash to maintain a necessary lifestyle. Also, the long term security of deferred compensation may affect the athlete's performance. Consideration should be given to this factor as well.

Finally, the creditworthiness of the borrower, in this case, the owner, must be considered. If an athlete belongs to a relatively new

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103. I.R.C. § 1 (1954).

104. I.R.C. § 1 (1986).

105. *See supra* note 30 and accompanying text.

league or with a new owner without a proven history of creditworthiness, deferred compensation may not be the best strategy. One possible alternative is to have the debt personally guaranteed by the owner, regardless of the team's financial condition.

There are three possible ways of deferring compensation. The first is a collectively bargained pension agreement where the owners deposit an agreed sum into a plan which then distributes benefits to the players at set times.[106] Except for his voice in the union, the athlete has little control over this arrangement and therefore the individual tax planning possibilities are limited.

The second method is deferral by contractual agreement. In order to achieve desirable results, the "constructive receipt doctrine" must not be a problem. This doctrine states that if the athlete constructively receives income through access to the funds, setting apart of the money, or because the funds are otherwise made available to him, the IRS will view the income as taxable in the current year.[107] Thus, unless the taxpayer's control of the income is subject to substantial limitations or restrictions, taxation will occur in the current year. This will happen even though the taxpayer may not have access to the taxed funds in order to pay the tax. In *Ray S. Robinson v. Commissioner*,[108] the Tax Court identified what must occur to avoid taxation: there first must be a binding contractual agreement, no third party may be allowed to control and distribute the funds to the athlete, and finally, the athlete must be placed in a position of a general, not specific, creditor to the other party involved in the agreement.[109] As the IRS does not provide advance letter rulings giving advice as to whether particular contract arrangements meet the "constructive receipt doctrine," the athlete must assess the risk that the doctrine applies as well as the risks inherent in being a general creditor before attempting this maneuver.[110]

A third way of deferring compensation is through receipt of substantially nonvested property. This alternative elevates the athlete above the level of general creditors. To accomplish this tax deferral method, substantially nonvested property is immediately transferred to the athlete. Income need not be recognized if the

106. All major sports leagues with collective bargaining agreements provide pension benefits to the players.

107. Treas. Reg. § 1.451-2(a); Rev. Rul. 72-25, 1972-1 Cum. Bull. 127.

108. 44 T.C. 20 (1965).

109. *Id.*

110. Internal Revenue Bulletin 1987-2, Announcement 87-3.

property stays nonvested.[111] "Nonvested" means the property must be subjected to a substantial risk of forfeiture and would revert back to the owner if there is a forfeiture.[112] A provision requiring the athlete to return the property if the athlete terminates his services within a specified time would qualify as a substantial risk of forfeiture.[113] Real property, personal property, and capital stock are allowed to be transferred, but cash or an unsecured promise to pay deferred compensation are excluded.[114] A provision can be made in the contract for periodic lapsing of the restrictions and periodic inclusion of income.[115] Care must be taken to avoid having the control of forfeiture rest with someone other than the athlete. The principle IRC sections outlining deferred compensation arrangements are section 451 for constructive receipt and section 83 for substantially nonvested property. No parts of the TRA amend or affect these sections.

VII. Other Alternatives

There are a number of areas where the TRA severely curtails potential tax benefits to the athlete in order to achieve its goal of simplification. Included among these are income averaging, individual retirement accounts (IRA's), employee business expenses, and the investment tax credit.

A. *Income Averaging*

Income averaging was formerly an extremely useful tool for the athlete with high income. The purpose of income averaging was to alleviate the harshness caused by the combination of the progressive tax structure and the annual accounting requirement.[116] Where a taxpayer had little or no income for several years and then earned substantial income, the IRC allowed a distribution of income over the years.[117] As a result, the taxpayer was able to avoid the higher progressive rates. In order to qualify, the athlete would have to show that he supported himself during the income years.[118] The need for income averaging no longer exists because of

111. I.R.C. § 83(a).
112. *Id.*
113. Treas. Reg. § 1.83-(3)(c)(1).
114. Treas. Reg. § 1.83-(3)(e).
115. Treas. Reg. § 1.83-(3)(c)(4)(ex. 3).
116. I.R.C. §§ 1301-05 (1954).
117. *Id.*
118. I.R.C. § 1303(c) (1954).

the significantly flatter rate structure under the TRA.[119] Consequently, this once useful tool was repealed effective January 1, 1987.[120]

B. *Individual Retirement Accounts*

IRAs formerly offered a possible tax deduction of $2,000 for an individual taxpayer.[121] The savings may have been small, especially in light of potential multimillion dollar athletic or endorsement contracts. However, solid, aggressive tax planning strategy before 1986 would certainly have included this technique.

The TRA presents two hurdles the athlete must overcome to attain this deduction. First, a determination must be made whether the athlete is an "active participant" in an employer-maintained retirement plan.[122] An "active participant" means either a vested or a nonvested participant in a qualified pension, profit sharing, or stock bonus plan, all of which include an exempt trust.[123] Other plans are available to which the participant may belong, but these are less popular.[124] Most team players belong to a union-organized pension plan; athletes who are members of the union would be considered "active participants."[125] Individual athletes such as golf or tennis players may not belong to such plans and therefore may not be "active participants."

The second hurdle relates to the amount of income the athlete earns. For active participants, the $2,000 maximum deductible limit must be reduced by an amount which bears the same ratio to $2,000 as the amount of the taxpayer's adjusted gross income minus the applicable dollar amount bears to $10,000.[126] The applicable dollar amount for a married individual is $40,000.[127] For "active participants," the allowable deduction decreases from $2,000 to $0 as adjusted gross income reaches $50,000.[128] Beyond this, no deduction is allowed. Non-active participants are allowed the full

119. S. REP. No. 313., 99th Cong., 2d Sess. 45 (1986).

120. I.R.C. § 141 (1986).

121. *Id.* § 219(b)(1)(A).

122. *Id.* § 219(g)(5).

123. *Id.*

124. Other available plans include qualified annuities, United States government employee plans, tax sheltered annuities for employees of tax-exempt organizations, simplified employee pensions, and certain trusts created before June 25, 1959. *Id.* § 219(g)(5).

125. A union-organized plan meets the definition of a qualified pension plan. Athletes participating in the union plan thus would be considered active participants.

126. I.R.C. § 219(g)(2)(A).

127. *Id.*

128. *Id.* § 219(2)(A).

deduction of $2,000 up to $40,000 for married athletes and $25,000 for single athletes;[129] a partial deduction is allowed for income between $40,000 to $50,000 ($25,000 to $35,000 if single)[130] and no deductions exist for income in excess of $50,000.[131] Thus, for the high income athlete, IRA's no longer afford even a modest tax benefit.

C. *Employee Business Expenses*

Employee business expenses are another area where the TRA eliminates a tax benefit for the sake of simplicity. Expenses that are ordinary and necessary and are a result of carrying on a trade or business are generally deductible to the extent the athlete is not reimbursed for them by the employer.[132] Where an expense is not a mere personal expense but is incurred due to the business activity, the athlete may deduct it.[133] Adequate record keeping is essential in this strategy as any expense which justifiably falls within the broad language of "ordinary and necessary" may be deductible. Expenditures for traveling, dues, meals, lodging, entertainment, professional fees, telephone, physical conditioning, coaching, or other tools to improve performance may be deductible.[134]

The TRA imposes a floor of two percent of adjusted gross income on employee business expenses.[135] Thus, where an athlete has a legitimate expense and is not reimbursed by the employer, he may not get a deduction for the first two percent of his adjusted gross income. Thus, an athlete with a $100,000 salary loses a deduction on the first $2,000 of legitimate employee business expenses. The policy behind the TRA is to relieve taxpayers of the burden of record keeping unless they expect to incur expenditures in excess of the floor.[136] It also enhances IRS audit efficiency because the IRS will be relieved of examining these miscellaneous items.[137]

D. *Investment Tax Credit*

Another provision repealed by the TRA is the investment tax

129. *Id.* § 219(g)(3)(B).
130. *Id.* § 219(g)(2)(A).
131. *Id.*
132. *Id.* § 162(a).
133. *Id.* § 162.
134. *Id.*
135. *Id.* § 67(a).
136. I.R.C. § 46 (1954).
137. H.R. REP. No. 426, 99th Cong., 1st Sess. 110 (1985).

credit (ITC).[138] This incentive-oriented credit, designed to promote and spur investment, has undergone periodic enactment and repeal.[139] For the athlete with significant disposable income prior to 1986, investments in tax shelters, particularly equipment leasing, offered significant tax benefits from investment tax credits.[140] Generally, ten percent of the amount invested would be available as a credit, not a deduction, against the tax liability.[141] Future reenactment is possible given its past history.

E. Interest Free Loans

A common tax planning technique prior to 1984 involved the use of interest free loans. The athlete would negotiate and obtain a sum from the owner which would be repaid at some future time without interest. Economic reality dictated that an unstated amount of interest was being received by the athlete. Nevertheless, the form, and not the substance of the transaction prevailed, and no interest income was reported. Provisions of the Tax Reform Act of 1984,[142] further supported by the 1986 reform,[143] stopped this practice and required income to be recognized immediately. For example, if an athlete was given $100,000 to be repaid at face value in five years, the loan amount essentially was the present value of the face amount ($100,000) discounted over five years.[144] In other words, the owner really lent the athlete about $90,000 and gave him $10,000 in ordinary income. The Tax Reform Act of 1954 required that market rates of interest be used to give support to the substance of the transaction.[145]

The tax advantages of obtaining an interest free loan are greatly reduced. No longer will income be able to be deflected through what the owner and athlete call a loan. Instead, the only benefit to the athlete will be a business one, that of greater access to a source of capital, albeit at a market price of interest.

VIII. SUMMARY

The financial goals of an athlete are to reduce current taxes

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138. I.R.C. § 211 (1986).

139. The investment tax credit has been repealed and enacted a number of times in the past fifteen years.

140. I.R.C. § 46.

141. *Id.*

142. I.R.C. § 483 (1954).

143. I.R.C. § 1803(b)(1) (1986).

144. *Id.* § 1272.

145. I.R.C. § 483 (1954).

owed, create retirement security, and provide for family members. A general strategy dealing with the TRA and achieving these goals may be summarized as follows.

First, if possible, the athlete should enter into a contractual agreement with a family member to provide services for a fee. Substantial and legitimate services must be performed by the family member. When the athlete begins earning income, he must pay the family member to ensure the deduction.

Second, the athlete should form a corporation prior to negotiations, with the most common choice being a personal holding corporation. If possible, all income should be directed through the corporation. At a minimum, all ancillary income should be funnelled through this entity. Care must be taken to follow all required formalities and ensure the corporate structure remains separate and distinct from the individual. Once the entity is established, one or more of the qualified retirement plans should be formed in anticipation of the deductible contributions to be funded to them. A medical reimbursement plan and other cost effective insurance plans may be established.

Third, a determination must be made if any tax shelter opportunities exist for the athlete and whether the athlete can devote sufficient time to actively manage an investment which will provide tax losses for him. A review of available investment opportunities should also be done.

Fourth, the athlete's cash flow needs must be analyzed before negotiations begin. Possible taxes owed must be calculated and the alternative minimum tax, if any, must be considered. With all this information assembled, a contract may now be negotiated with the emphasis on deferred compensation for any excess income the athlete would like to defer. The risks inherent in the two types of arrangements should be considered.

If additional capital is required to fund certain investments, deferred compensation may not be required. Instead, the athlete may use the owner as a source of capital and negotiate an interest free loan. The retirement security goal may still be achieved without deferred compensation through the corporate retirement plan.

With the elimination or practical elimination of income averaging, investment tax credits, individual retirement accounts, and most tax shelters, the planning problems of the high income athlete are acute. However, as described above, a number of options still exist and the possibility of meeting the financial goals of an athlete is present with careful tax planning.

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