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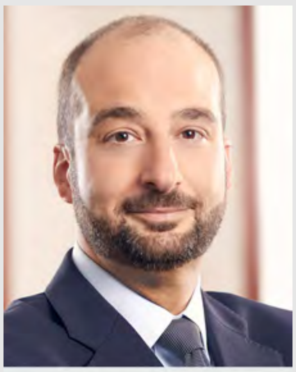

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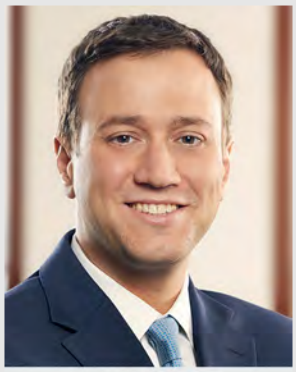

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In this Thoughts in Brief, Teti and Katz summarize the federal and state income tax law on deferred compensation as it relates to Los Angeles Dodgers player Shohei Ohtani's contract, and they discuss the potential of similar structures in the corporate setting.

Shohei Ohtani dominates baseball as both a pitcher and hitter like no player since Babe Ruth. In December 2023 Ohtani signed a $700 million contract with the Los Angeles Dodgers — the most lucrative free agent contract in sports history. Perhaps more interesting than the contract's total value is the fact that approximately $680 million will be deferred and paid to Ohtani over a 10-year period starting in 2034. The stated reason for the deferral was that it provided the team with more flexibility to acquire other talented, high-priced players by spreading out the cost and helping the Dodgers minimize baseball's special "luxury tax." It has been speculated, however, that avoidance of California state income taxes may have been another reason for the contract's unique deferral feature. This writing summarizes the federal and state income tax law on deferred compensation and the potential of similar structures in the corporate setting.

Individual taxpayers operate on the cash method of accounting for tax purposes, meaning that amounts that are "earned" currently but not "paid" until a future year generally are not taxed until the future years in which the amounts are paid.[1] State tax laws generally follow the federal rules for purposes of determining what year the income should be taxed.

A more complicated question, however, is which state has the right to tax the income when the individual lives in one state where the income is paid (and therefore taxed) but lived in another state when the income was earned. This is a common situation, of course, for retirees who move to states with low or no state income tax (for example, Florida, Texas, or Washington) during retirement. In part to prevent the chaos of various states taxing the same income, federal law prohibits states from taxing certain types of retirement income paid to nonresidents.[2] Retirement income is defined for this purpose as income from a variety of qualified pension plans and annuities and, importantly for Ohtani, deferred compensation plans under which the payments are made in a series of substantially equal periodic payments over the life of the

[1] 26 U.S.C. section 446. There are, however, several doctrines, such as constructive receipt and economic benefit, that are aimed at preventing taxpayers from abusing these rules to defer taxes inappropriately.

[2] 4 U.S.C. section 114. "[N]o State may impose an income tax on any retirement income of an individual who is not a resident or domiciliary of such State (as determined under the laws of such State)."

recipient or designated beneficiaries or over a period of 10 years or longer.

As a result of this federal prohibition, California law excludes these types of payments from the reach of its state income tax. This means that Ohtani can become a nonresident of California after his retirement[3] and thereby avoid California income tax on the deferred portion of his contract. At the current California rate of 12.3 percent, a deferral would save him $83.6 million in absolute-dollar terms and approximately $20 million in present-value terms (2024 dollars).[4] Some have argued that this result deprives California of tax revenues related to Ohtani's services performed as a California resident and therefore is inappropriate. As noted above, however, this result is compelled by federal law for these sorts of arrangements; California cannot change it unilaterally. The same issue faces other high-tax states (for example, New York, New Jersey, and Connecticut) when retirees move away with generous deferred compensation arrangements.

Indeed, the Ohtani contract highlights a very typical deferred compensation state planning opportunity on a grand scale. It is very common for businesses to sponsor deferred compensation plans under which executives and other highly compensated employees defer compensation until their retirement. These plans often offer a menu of distribution options such as a lump sum distribution upon retirement, periodic payments over several years, or payment upon death or disability. Typically, these plans do not provide for payment structures that meet the federal exclusion rule discussed above, but they could easily be adapted to do so. Today's world is increasingly mobile, and relocation is common.

With enough foresight and planning, companies and employees may be able to structure their deferred compensation plans to achieve substantial tax savings. Professional ballplayers may not be the only taxpayers who can hit these kinds of home runs. ■

[3] Ohtani could still spend time in California and even keep one or more homes there, so long as he does not trigger the rules for maintaining or reestablishing tax residency.

[4] Assumes tax savings of $8.36 million over 10 years beginning in 2034 and at a 10 percent discount rate.