
Wealth Management

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# Signing bonus planning for sports professionals

When an athlete enters into a contract to play on a professional sports team, the contract often includes a signing bonus. When the player receives a signing bonus it will be subject to tax in the country where the player is resident for tax purposes. If the signing bonus is paid by a professional sports team located in a different country, that country may also impose tax on the payment of the bonus. With proper planning it may be possible to significantly reduce the overall tax to which a player is subject on receiving a signing bonus.

This article will discuss some tax planning tips which may help to maximize the tax savings when structuring a signing bonus with a Canadian or U.S. based team.

The information provided in this article is based on the tax law in effect at the date of this article. The information is not intended to provide legal or tax advice. You should obtain professional advice from a qualified tax advisor before acting on any of the information in this article, to ensure that your own circumstances have been properly considered and that action is taken based on the latest information available.

## Understanding the taxation of signing bonuses

### Tax in the country of residence

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For Canadian tax purposes, the signing bonus will be taxable in the province where the player is a resident at the end of the calendar year. For U.S. state tax purposes, provided the professional sports contract is structured properly the signing bonus will be taxable in the state the player is a resident. Otherwise, the signing bonus may need to be allocated to each state where the services are performed and the allocated amount may be subject to tax in that state. For discussion purposes, this article assumes for U.S. state tax purposes the signing bonus is subject to tax based on the state of residence.

A player may be able to significantly reduce the overall tax they pay on receiving a signing bonus if they implement proper planning.

If the player is a U.S. citizen living in another country, the signing bonus they receive will be subject to U.S. federal tax (no U.S. state tax) at graduated tax rates (i.e. increasing tax rates on increasing levels of taxable income) even if the player is also subject to tax in another country. For example, if a U.S. citizen who lives in Canada receives a signing bonus, they will be subject to taxation in both Canada and the U.S. However, it is generally possible to avoid double taxation due to the system of foreign tax credits and the ability to claim the foreign earned income exclusion on the player's U.S. income tax return.

### Tax in the country where the sports team is located

When a player receives a signing bonus from a professional sports team located in a country other than the player's country of residence, the signing bonus may be subject to tax in that other country. For example, a signing bonus paid by a U.S.-based team to a Canadian-resident player is subject to U.S. tax and a signing bonus paid by a Canadian-based team to a U.S.-resident player is subject to Canadian tax.

However, Article XVI(4) of the Canada-U.S. Income Tax Treaty (the "Treaty") provides that the tax levied by the country where the sports team is located will be limited to 15% when paid to a player who lives in the other country.

### Avoiding double taxation

When a signing bonus is subject to tax in two different countries, it is generally possible to avoid double taxation by using foreign tax credits. Overall, the tax rate that usually applies is the higher of the two tax rates charged by the countries in question. For example, if a player is a resident of Canada with a Canadian marginal tax rate of 46% and the player is subject to a 15% flat U.S. tax on a signing bonus received from a U.S.-based team; the overall tax they pay is unlikely to exceed 46% (the higher of the tax rates applicable in the two countries). The player will generally be subject to 31% Canadian tax (i.e. 46% Canadian tax less a 15% foreign tax credit for the U.S. tax) plus the 15% U.S. tax for a total overall tax of 46% (31% Canadian tax plus 15% U.S. tax).

**Table 1:** PCountry where player is resident when signing bonus is received and country where sports team is based

| | Canadian resident signing with a U.S.-based team | Canadian resident signing with a Canadian-based team | U.S. resident signing with a Canadian-based team | U.S. resident signing with a U.S.-based team |
|---|---|---|---|---|
| Taxation of signing bonus | Canada – Fully taxed (graduated Canadian tax rates) but may be reduced or eliminated by any U.S. tax paid<br>U.S. – 15% tax rate (*) if not a U.S. citizen | Canada – Fully taxed (graduated Canadian tax rates)<br>U.S. – No tax if not a U.S. citizen | Canada – 15% tax (*)<br>U.S. – Fully taxed (graduated U.S. tax rates) but may be reduced by any Canadian tax | Canada – No tax<br>U.S. – Fully taxed (graduated U.S. tax rates) |
| Signing bonus planning consideration | Receive bonus as a Canadian resident and become a U.S. resident by end of year | If possible, become a resident of a lower-tax Canadian province at year-end | Receive bonus as a U.S. resident (may depend on U.S. state of residence) | If possible, receive bonus as a resident of a lower-tax U.S. state |

(*) Pursuant to Article XVI (4) of the Canada-U.S. Income Tax Treaty

## Signing bonus planning strategies

A player may be able to significantly reduce the overall tax they pay on receiving a signing bonus if they implement proper planning. This should include a review of their taxation based on their residency status at the time they receive the signing bonus. It should take into consideration whether the professional sports team paying the bonus is based in Canada or the U.S. and the use of foreign tax credits. For example, a Canadian resident who signs with a U.S. team may only have to pay an overall tax of 15% on a signing bonus if they implement proper planning before the contract is signed.

Table 1 summarizes the tax rules and the potential planning opportunities that may be available under different circumstances relating to receipt of a signing bonus. This table assumes for U.S. state tax purposes that the signing bonus is subject to tax based on the player's state of residency

**Table 2:** Canadian and U.S. after-tax income based on residency status when signing bonus and salary are paid

| | B.C. resident entire year | Arizona resident entire year | Dual-status resident (resident of B.C. on receipt of signing bonus, resident of Arizona from September) |
|---|---|---|---|
| Signing bonus | $300,000 | $300,000 | $300,000 |
| Salary | $425,000 | $425,000 | $425,000 |
| Total compensation | $725,000 | $725,000 | $725,000 |
| Canadian federal and B.C. tax | $110, 479[1] | N/A | NIL[2] |
| U.S. federal tax | $170,051 | $227,909 | $170,051 |
| Arizona state tax | $20,282 | $35,402 | $20,282 |
| Total tax payable | $300,812 | $263,311 | $190,333 |
| After-tax income | $424,188 | $461,689 | $534,667 |

Assumptions:

- Player is single and is not a U.S. citizen or green-card holder. Receives a signing bonus of $300,000 from an Arizona-based team. Base salary is $425,000 from September to December while playing in Arizona.
- US$1=Cdn$1 and 2005 tax rates used.

Notes:

1. Canadian federal and B.C. tax on $725,000 of income is $300,812. However, a foreign tax credit of $190,333 for the U.S. taxes paid on the signing bonus ($45,000 tax) and the base salary ($145,333 tax) can be used as a foreign tax credit to reduce the Canadian tax to $110,479 [$300,812 - $190,333].
2. Only the $300,000 signing bonus is subject to Canadian tax of $115,548. However, the U.S. taxes paid on the signing bonus ($45,000 tax) and the base salary ($70,548 tax) can be used as a foreign tax credit to eliminate the Canadian tax.

## Canadian resident signing with a U.S. team

This scenario is perhaps the most common. It also presents a significant tax saving opportunity relating to the signing bonus. In this case, the signing bonus is paid by a U.S. team to a player who is still a Canadian resident. That player then plays for a U.S. team during the year and, by the end of the year, is considered a U.S. resident.

As previously mentioned, pursuant to the Treaty, the player will pay only 15% U.S. tax on the signing bonus because they were a Canadian resident at the time it was paid. The signing bonus will be fully taxable at the player's Canadian marginal tax rate due to the fact that they received the signing bonus while they were a Canadian resident. However, if the player has become a U.S. resident by the end of the year (referred to as a "dual-status resident"), then they can use the 15% U.S. tax they paid on the signing bonus, plus any U.S. tax paid on the player's salary during the year, as a foreign tax credit in Canada to offset the Canadian tax paid on the signing bonus (does not apply for Quebec residents).

To illustrate the potential tax savings, Table 2 reproduces a numerical example taken from the article titled "Taxation of Professional Athletes: Cross-Border Perspectives" written by Bruce Sprague, Tax Partner, Ernst & Young LLP, Vancouver in the 2006 Volume 54, No 2 Canadian Tax Journal, Canadian Tax Foundation. The table illustrates the Canadian and U.S. tax payable under three scenarios: the player is a British Columbia (B.C.) resident throughout the year, an Arizona resident throughout the year, or a dual-status resident. A dual-status resident is a person who is a resident of Canada for part of the year and a resident of the U.S. for the remainder of the year.

A Canadian resident signing with a U.S. team pays the least amount of tax as a dual-status resident.

The table shows that the player pays the least amount of tax as a dualstatus resident. In other words, the player receives the signing bonus while the player is a Canadian resident and pays U.S. tax of only 15% on the signing bonus pursuant to the Treaty. The player then ceases Canadian residency and becomes an Arizona resident from September onwards, during which time they receive the base salary. This way the player avoids Canadian tax on the base salary but they can use the U.S. tax they pay on the signing bonus (15% tax) and the base salary as a foreign tax credit in Canada to eliminate the Canadian-resident tax on the signing bonus.

Note that Arizona has relatively low state income tax rates. Although some states, for example Florida and Texas, have no state tax, other states, such as California and New York, have high state tax rates. The tax savings by filing as a dual-status resident will vary depending on the U.S. state where the player is resident for the latter half of the year.

In the case of a Canadian player who signs with a U.S. based team, it is a good idea to have the player's tax advisor prepare a similar comparative analysis to determine the potential tax saving in the player's particular circumstances.

## Canadian resident signing with a Canadian team

Under the dual-status resident scenario, the player would pay total tax of $190,333 using the assumptions in the above example. However, if the player was a Canadian resident throughout the year, then the total tax they would pay would be $300,812. There is quite a significant difference in the tax they would pay. One potential strategy to reduce Canadian tax is to be a resident of a lower-taxed province, such as Alberta, on December 31. That is, the provincial tax payable depends on the province where the player is considered resident on December 31st of that year. A player's province of residence is based on their

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facts and circumstances, but they are generally considered to be resident in the province to which they have the most significant residential ties on December 31st.

If we assume that the highest combined federal and provincial tax rates in the provinces where the major Canadian professional sports teams are based are B.C. (45.8%), Alberta (39%), Ontario (49.5%) and Quebec (50%), a resident of Quebec who signs with an Alberta-based sports team stands to save up to 11% tax on their signing bonus by becoming a resident of Alberta on or before December 31 in the year they receive the signing bonus rather than remaining a resident of Quebec.

Similarly, an Alberta resident who signs with a Canadian-based sports team located in a province outside Alberta could consider taking steps to remain an Alberta resident for tax purposes to minimize the Canadian provincial tax they will pay on their signing bonus and salary.

## U.S. resident signing with a Canadian team

If a U.S.-resident player is signing with a Canadian sports team, the player's tax advisor should determine the tax impact of receiving the signing bonus as a U.S. resident or as a Canadian resident and which residency scenario would result in the least amount of tax on the signing bonus. This calculation can help the player determine if they should take steps to maintain U.S. residency or become a Canadian resident at the time they receive the signing bonus.

If the player receives the signing bonus as a U.S. resident, then pursuant to the Treaty, the Canadian tax rate on the bonus would be 15%. The player will also pay U.S. federal and state tax on the signing bonus; however the 15% Canadian tax can be used as a foreign tax credit against U.S. federal tax to reduce the U.S. tax on the signing bonus. Some states (such as Arizona) also allow a foreign tax credit.

If the player receives the bonus as a Canadian resident, then the player will pay tax at full Canadian marginal tax rates on the bonus. If the player is a U.S. citizen resident in Canada, they will also have to report the bonus on their U.S. tax return; however the U.S. tax can be reduced or eliminated through foreign tax credits.

Depending on the U.S. state where the player lives and the province where the Canadian team is located, it may be preferable, in many cases, to receive the signing bonus as a resident of the U.S. before moving to Canada, to avoid potentially higher Canadian marginal tax rates on the signing bonus.

A review of the potential tax and residency planning strategies that relate to receiving a signing bonus as part of a player's contract may present opportunities to save significant tax dollars.

## U.S. resident signing with a U.S. team

In this scenario, there are no Canadian tax considerations. For U.S. tax purposes, the signing bonus is fully taxed for U.S. federal tax purposes. If the contract is structured properly to qualify for state taxation based on state residency, the signing bonus is typically taxed in the U.S. state where the player is living when they receive it. Therefore, depending on the residency rules in that state and the differing state tax rates, it may be possible to minimize the U.S. tax on the signing bonus if the player can reside in a U.S. state that has lower tax rates or no state tax (e.g. Florida, Texas, etc).

## Before you finalize the contract

It is important for players to consult a qualified tax advisor who is familiar with both Canadian and U.S. tax laws before finalizing a contract and related signing bonus terms. A review of the potential tax and residency planning strategies that relate to receiving a signing bonus as part of a player's contract may present opportunities to save significant tax dollars.

If you have any questions or require clarification of any of the issues discussed in this document, do not hesitate to contact your RBC advisor or discuss them with your own tax advisor.

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