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SPORTS ALERT

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MICHELLE WONG-HALABI
614.227.2075
mwong-halabi@porterwright.com

Tax hits for professional athletes

On Sept. 13, 2021, the U.S. House of Representatives Ways and Means Committee released its tax proposal (the Proposal). The Proposal will be considered as a part of the budget reconciliation bill to be negotiated by Congress in the coming days and weeks. If passed, the Proposal can significantly impact active and retired professional athletes, as well as individuals of high net worth.

A one-two punch: Increasing income taxes and capital gains can affect professional athletes

It is no secret that the IRS will look to tax every penny of one's earnings. But with this Proposal, earnings could be subject to even higher taxes. Whether a professional athlete's income is earned from a team affiliation, sponsorship or endorsement deals, or even personal business activities, the Proposal could subject earnings to a higher income tax rate.

If passed, the top marginal income tax rate would be increased to 39.6% from 37%. There is also a proposed 3% surtax (an additional tax on something already taxed) on individuals with adjusted gross income of over $5 million. This means if someone is a high earner or in some cases, receives a large signing bonus, they could face a federal tax rate of 42.6% in addition to the income taxes imposed by their home state.

But it's not just earnings that are being targeted by the Proposal. Investments in capital assets, like stocks or real estate, can also be subject to higher capital gains tax rates upon sale. If someone earns over $400,000, their capital gains tax rate could increase from 20% to 25%. They could also be subject to an additional 3.8% for the existing Affordable Care Act tax on investments, which would mean a potential 28.8% federal capital gains rate. And again, someone's home state may impose additional capital gain tax.

Playing the long game: Proposed changes to death taxes

Aside from income tax, the Proposal also seeks to make significant changes that could result in large tax consequences upon death. And while statistically one might anticipate a long life expectancy, failing to plan for the future can be a costly mistake in the long run.

Many professional athletes aim to leverage earnings during their playing years to provide financial stability after retiring from the game. This planned growth is intended to support not only the athlete but also their family, which may include a spouse, children, parents, siblings and other loved ones. However, estate taxes imposed at death could cost the athlete's family millions of dollars in taxes, leaving less funds available for their care and needs.

The current estate tax exemption is $11.7 million, with slight increases each year for inflation. However, this historically high exemption is not permanent and is scheduled to reduce to $5 million (adjusted for inflation) on Jan. 1, 2026. But if the Proposal should pass, the scheduled reduction will be accelerated to Jan. 1, 2022.

Many of the traditional strategies that would allow tax professionals to reduce death taxes may also be hamstrung by the Proposal unless strategies are implemented this year. The smart play is to take advantage of the current exemption amount now before it is gone.

The game plan: Don't drop the ball

While income taxes are unavoidable, there are strategies that can reduce one's overall tax liability. Although the clock is running down, estate tax savings strategies can be implemented now to protect future growth and earnings from estate taxes. Aside from the tax savings, these strategies can provide long-term asset protection, financial privacy from potential creditors and protection to loved ones during and after a professional athlete's lifetime. However, the most important thing to do is to take action now before time runs out.

If you have questions or would like to explore which tax-savings options are right for your circumstances, please contact Michelle H. Wong-Halabi.