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Phone: (800) 668-6481 | customerservice@lexisnexis.ca

A beginner's guide to cross-border tax issues for professional athletes: Part two

By **Ian Spiegel and Dylan Romero-Marshall**

Law360 Canada (August 21, 2024, 1:55 PM EDT) -- In part one of this series (see below for the link), we began looking at some of the main tax issues being faced by Canadian athletes who compete in the United States. Part one put a particular emphasis on residency for tax purposes in both Canada and the United States and alluded to the impact the *Convention Between Canada and the United States of America* (the Treaty) has on residency and the ultimate tax burden of an athlete.

Ian Spiegel

In part two, we will focus on the Treaty, how it can assist with determining the tax residency of an athlete and what that means for the imposition of tax on the athlete by both Canada and the United States. We will then discuss one of the most common retirement savings tools used by athletes and other high-net-worth individuals and how those savings are eventually taxed.

Dylan Romero-Marshall

Convention between Canada and the United States

Athletes and their advisers must consider the Treaty and how it can impact Canadian athletes competing in the United States. It addresses the taxation of income earned by athletes from their activities in a Contracting State (i.e. Canada and the United States) other than their own, as well as providing some clarity on residency issues where an athlete may be a resident of both Canada and the United States. It should be noted that the Treaty generally relates to federal tax rather than provincial/state and municipal tax.

Residency tiebreaker rules

Where an athlete could be considered a resident of both Canada and the United States (See part one, "Residency status" and Income Tax Folio S5-F1-C1, "Determining an Individual's Residence Status"), the Treaty provides the following tiebreaker rules that generally apply in the following order:

1. individuals are deemed to be residents of the Contracting State in which they have a permanent home available to them; if they have a permanent home available to them in both States or in neither State, they shall be deemed to be residents of the Contracting State with which their personal and economic relations are closer (centre of vital interests);
2. if the Contracting State in which they have their centre of vital interests cannot be determined, they shall be deemed to be residents of the Contracting State in which they have a habitual abode;
3. if they have a habitual abode in both States or in neither State, they shall be deemed to be residents of the Contracting State of which they are a citizen; and
4. if they are a citizen of both States or of neither of them, the competent authorities of the Contracting States shall settle the question by mutual agreement (Treaty, Article IV).

These tiebreaker rules will, in most cases, assist an athlete and their advisers in determining the residency of the athlete.

Taxation of income

The Treaty also provides guidance on how Canada and the United States can tax the earnings of athletes where they perform their services (e.g., compete in events, play games, make appearances, etc.) in both Contracting States:

1. Athletes that are resident in one Contracting State (e.g., Canada) can be taxed in the other Contracting State (e.g., the United States) in which they perform if their gross income, including reimbursed expenses, exceeds $15,000 in a year (Treaty, at Article XVI, para. 1).
2. If an athlete's income is paid to another person or entity, the income may still be taxed in the Contracting State in which the activities occurred, unless the athlete can prove they or related parties did not benefit from it (Treaty, at Article XVI, para. 2).
3. Team athletes who play in leagues with games in both Canada and the United States are governed by Article XV of the Treaty (Income From Employment) rather than Article XVI (Artists and Athletes) and may be exempt from source Contracting State tax if their earnings are below $10,000, they spend fewer than 183 days in the source state and their income isn't paid by a resident or permanent establishment in that State (Treaty, at Article XVI, para. 3 and Article XV, at paras. 1–2).

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When discussing Canadian professional athletes competing in the United States and resident in Canada, it is unlikely that U.S.-source income will be under the $15,000 threshold for individual sportspersons (though it is possible if participating in only a single event and not advancing beyond the first round in certain tennis, golf or similar tournaments) or the $10,000 threshold for team athletes. Assuming an athlete earns above the threshold for U.S.-sourced income, the income will be taxed in the United States. Worldwide income will be taxed in Canada, with the availability of foreign tax credits for amounts taxed in the United States.

Taxation of bonuses

Signing bonuses have become a popular contract structure in professional sports. Bonuses related to the services performed (e.g., performance bonuses or signing bonuses related to services) are taxed as employment income (CRA Technical Interpretation 2020-0869441I7). That generally means that bonuses would be taxed in the Contracting State in which they were sourced, assuming they surpass the thresholds noted above.

Signing bonuses paid as an "inducement to sign an agreement related to the performance of services" are treated differently. While they can still be taxed in the Contracting State of source, the tax rate is limited to 15 per cent (Treaty, at Article XVI, para. 4). An athlete who receives a signing bonus as an inducement typically pays taxes in the Contracting State where they are considered a tax resident at the time of receiving the bonus.

Assume there is a Canadian athlete who signs a contract with a US-based team, and the contract includes an “inducement to sign” signing bonus. For Canadian tax purposes, the signing bonus will be taxable in Canada. The signing bonus will also be subject to a 15 per cent tax in the United States. Taxes paid in Canada will be available to use a foreign tax credit in the United States to offset the double taxation.

However, whether a signing bonus is in fact an “inducement to sign” has recently been questioned by the Canada Revenue Agency (CRA). The Toronto Maple Leafs’ John Tavares signed a seven-year contract worth US$77 million on July 1, 2018, after having spent the previous nine seasons with the New York Islanders. Tavares received a signing bonus of US$15.25 million the same day as part of his compensation.

Maple Leafs Sports and Entertainment withheld 15 per cent of the signing bonus amount and remitted it to the CRA in accordance with the Treaty, and Tavares paid taxes on the signing bonus in the United States as a resident of the United States for tax purposes. However, the CRA issued a Notice of Reassessment to Tavares, denying him relief under the Treaty and assessing Tavares for approximately $8 million in additional tax and interest charges. The CRA appears to have taken issue with the structure of the contract wherein Tavares receives the majority of his compensation in the form of a “signing bonus” and only a minimal amount as actual salary. The CRA claims that the entirety of the signing bonus on July 1, 2018, was in fact remuneration from the duties of employment for services.

While the Tavares situation is the reverse of the example given above, the Internal Revenue Service could similarly challenge the signing bonus structure. So, for Canadian athletes receiving a signing bonus as an “inducement to sign” in the United States, athletes should be cautious that they may be fully taxed on the signing bonus in both Canada and the United States.

Taxation on retirement savings

A popular retirement savings tool used by high-income earners such as athletes is the Retirement Compensation Arrangement (RCA). An RCA is a plan or an arrangement under which an employer, former employer and, in some cases, an employee makes contributions to a person or partnership, referred to as a custodian. The custodian holds the funds in trust with the intent of eventually distributing them to the employee, former employee or other beneficiary on, after or in contemplation of an employee’s retirement or an employee’s job loss.

Contributions to the RCA are not considered taxable income for the athlete in Canada. However, 50 per cent of the contributions must be paid into a Refundable Tax Account with the CRA. This 50 per cent refundable tax acts as a prepayment and is refunded when distributions are made from the RCA, meaning only half of the funds are available to be invested. The refundable tax does not earn income.

The RCA structure offers significant tax advantages, particularly for athletes who become nonresidents of Canada after having competed/played in Canada, especially if they move to a country where RCA distributions are either untaxed or taxed at a very low rate.

Distributions from an RCA are fully taxable in Canada. If the athlete is a Canadian resident at the time of receiving payments, the income is reported as “other income” and taxed at their marginal rate. If the athlete is a nonresident when receiving distributions, Canadian nonresident withholding tax applies, typically at a rate of 25 per cent (ITA, para. 212(1)). If the payments out of the RCA qualify as “periodic pension payments,” the tax treaty between Canada and the other country may reduce the rate of withholding tax. For example, the Treaty would reduce the withholding tax to 15 per cent (Treaty, Article XVIII).

While it might be tempting to allocate all compensation beyond living expenses into an RCA, contributions should remain reasonable and focused on retirement funding. Excessive contributions could lead to the RCA not being classified as a pension plan, thus negating the RCA’s tax benefits. For example, the CRA has reassessed Jose Bautista, denying approximately $16 million in RCA contributions made while he was a member of the Toronto Blue Jays based on the contributions being unreasonable (*Bautista v. The King*, 2022-2718(IT)G). The case has not yet been heard by the Tax Court of Canada.

Conclusion

The goal of this series is to provide some insight into the complicated cross-border tax issues experienced by professional athletes.

In part one, we discussed the concept of residency for tax purposes and why determining residency is vital for athletes competing across the Canada-U.S. border. In part two, we took an in-depth look at the Treaty and how it impacts residency determination and the imposition of tax as well as discussed a common retirement savings method favoured by athletes in Canada.

Athletes should seek professional advisers in both Canada and the United States to ensure that they are properly aware of, and reactive to, the tax issues they face.

This article has been prepared for general information only and should not be considered personal tax advice. Specific professional advice should be obtained regarding any topic discussed in this article.

If you have any questions about the above information, please contact a member of the Gardiner Roberts LLP’s experienced tax and estates planning group.

Ian Spiegel is an associate at Gardiner Roberts LLP and practises in the areas of tax and estate planning, business and corporate commercial law and nonprofit and charities law. He advises on tax and estate planning, corporate reorganizations and general corporate and commercial matters, including for charities and not-for-profits operating in Canada and internationally. Dylan Romero-Marshall is a third-year law student at Western University. He will return to complete his articles with Gardiner Roberts LLP in the summer of 2025.

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