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The Untaxed King of South Beach: LeBron James and the NBA Salary Cap

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TABLE OF CONTENTS

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I. INTRODUCTION

The National Basketball Association (NBA) salary caps, including an overall cap for the team and an individual cap for each player, are designed to maintain competitive balance in the league by blocking the richer clubs from outspending the poorer ones for free-agent players. Yet, in the "biggest free-agent market,"[1] the Miami Heat were able to sign not only LeBron James, arguably the game's top player,[2] but also re-sign Dwyane Wade, generally recognized as the game's current third-best player and second-best available free agent.[3]

And if that were not enough, Miami also simultaneously signed Chris Bosh, the third-best available free agent, to supplement the dynamic James-and-Wade duo. Then, to make matters even worse, despite initial reactions—even hopes—that Miami would have insufficient remaining cap room to obtain the supporting players required for a championship run,[4] Miami later was able to entice a number of quality role players to sign with it as well.[5]

So how can we explain Miami's incredible windfall? This Article focuses on one key contributing factor: the lack of a state or local income tax in Florida and Miami. Because the NBA salary cap amounts are not adjusted for state and local income taxes, Miami essentially had higher after-tax cap amounts to work with than the other competing teams, including the Chicago Bulls, Los Angeles Clippers, New Jersey

1. *League's Biggest Free-Agent Market Opens Its Doors*, SEATTLE TIMES, July 1, 2010, at C2, *available at* http://seattletimes.nwsource.com/html/nba/2012250328_nba01.html?syndication=rss.

2. A frequent debate today is whether LeBron or Kobe Bryant is the game's current best player. *See, e.g.*, Michael Framball, *Best NBA Player—Kobe or LeBron?*, EZINE ARTICLES (Jan. 2, 2010), http://ezinearticles.com/?Best-NBA-Player---Kobe-Or-LeBron?&id=3511789. Although LeBron has won the last two regular season most valuable player (MVP) awards, Kobe has led the Los Angeles Lakers to the past two NBA championships while taking home the last two play-off finals MVP awards. *See Most Valuable Player*, NBA.COM, http://www.nba.com/history/awards_mvp.html (last visited Mar. 29, 2011); *NBA Finals: All-Time Champions*, NBA.COM, http://www.nba.com/history/finals/champions.html (last visited Mar. 29, 2011).

3. *See, e.g.*, Scott Tully, *Dwyane Wade Is the Third Best Player in the NBA*, BLEACHER REP. (Aug. 14, 2008), http://bleacherreport.com/articles/47717-dwyane-wade-is-the-third-best-player-in-the-nba.

4. As has been often highlighted, even the great Michael Jordan could not win a championship until he was surrounded by a proper "supporting cast." *See, e.g.*, Hubie Brown, *Hubie Brown on Jordan*, NBA.COM, http://www.nba.com/jordan/hubieonjordan.html (last visited Mar. 29, 2011) ("Now, [Jordan] had the supporting cast to help transform individual success into team success.").

5. The Heat subsequently signed quality supporting players, such as Mike Miller, Udonis Haslem, Eddie House, Mike Bibby, Zydrunas Ilgauskas, James Jones, and Erick Dampier. *Transactions: 2010–11 Season*, NBA.COM (Mar. 24, 2011, 4:19 PM), http://www.nba.com/news/transactions/2010_11/. For the Heat's full roster, see *Heat Roster*, NBA.COM, http://www.nba.com/heat/roster/ (last visited Mar. 29, 2011).

Nets, and New York Knicks. Miami utilized its tax attractiveness to its advantage, thereby undermining the cap's promise of a level playing field.[6]

Furthermore, this is not the first time that a Florida team has capitalized on its no-tax advantage under the salary cap. The Orlando Magic acquired two highly-sought-after free-agent superstars during the 2000 off-season: Tracy McGrady and Grant Hill.[7] Although injuries derailed the hoped-for Magic juggernaut, the Magic's success provided the early warning signs for the latest Florida coup.

After Part II of this Article expands upon the problems with the current salary cap, Part III then proposes an appropriate response to the highlighted problem: an income tax adjustment to each team's salary cap amounts in order to restore the promise of a level playing field and prevent future occurrences of this unbalanced result. Part IV will then respond to potential objections, such as the possible argument that highly compensated athletes are not influenced by state tax concerns. As discussed below, however, even the wealthiest athletes, such as Tiger Woods, have shown that they pay attention to state tax differences.[8] Part IV similarly refutes other arguments that the proposed adjustment goes too far, highlighting how the tax benefits might extend to endorsement income as well. As such, deeper analysis instructs that the proposed adjustment, if anything, might be too modest.

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6. *See, e.g.*, Jeff Ostrowski, *By Choosing Miami Heat, LeBron James Saves Millions in State Income Taxes*, PALM BEACH POST, July 10, 2010, at 4B, *available at* http://www.palmbeachpost.com/money/by-choosing-miami-heat-lebron-james-saves-millions-794079.html; Dennis Brennan, *LeBron James, Dwayne Wade and Chris Bosh Choose Miami and Avoid Illinois Taxes*, EXAMINER.COM (July 8, 2010, 11:18 PM), http://www.examiner.com/x-45736-Illinois-Political-Buzz-Examiner~y2010m7d8-Lebron-James-Dwayne-Wade-and-Chris-Bosh-choose-Miami-and-avoid-illinois-taxes; Peter C. Pappas, *Tax Advice for LeBron: Move Your Domicile to Miami*, FORBES.COM (July 9, 2010, 6:15 PM), http://www.forbes.com/2010/07/09/lebron-james-state-tax-domicile-ny-ohio-personal-finance-move-home-miami.html.

7. *All-Time Transactions*, NBA.COM, http://www.nba.com/magic/news/AllTime_Transactions-155422-808.html (last visited Mar. 29, 2011).

8. *See infra* note 52 and accompanying text.

II. UNDERSTANDING THE PROBLEM WITH THE CURRENT SALARY CAP

A. NBA Salary Cap: Basic Operation and Goals

Let us consider first the reasons behind the overall NBA salary cap (overall cap), which limits the total amount that each team can spend for all of its players. This overall cap is designed to

> maintain competitive balance in the league. Without a salary cap, teams with deeper pockets can simply outspend the remaining teams for the better free agents. The basic idea is that a team can only sign a free agent if the total payroll for the team will not exceed the salary cap. So a team with deep pockets is playing on a level playing field with every other team.[9]

In addition to the overall cap, there is also a limit on how much any team can spend on any one free-agent player (players' cap).[10] The players' cap generally is the same amount for each team for similar reasons as the overall cap. There is one noted exception to the players' cap, however: the incumbency rule. The incumbency rule allows the current team to offer a higher salary over time than the other bidding teams.[11] This incumbency rule promotes the goal of greater player stability and competitive balance.[12]

Taken together, the overall and players' caps serve the salary cap goals in two main ways. As to the superstar players, the overall and players' caps amounts can block one team's ability to obtain one or more of those stars simply by outbidding the next-best offer. The overall cap also has a more subtle impact on supporting-role players whose talents are not great enough to run into the individual maximum salary amounts. The overall cap can limit a team's ability to surround superstar players with higher quality role players because the hefty superstar salaries can limit the money available under the cap to round out the roster.

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9. LARRY COON'S NBA SALARY CAP FAQ, http://members.cox.net/lmcoon/salarycap.htm (last updated July 8, 2010).

10. *See id.*

11. *See* Ira Winderman & Harvey Fialkov, *Heat Ready To Offer Brand $82.2m*, SUN-SENTINEL, July 16, 2003, at 1C, *available at* http://articles.sun-sentinel.com/2003-07-16/news/0307160015_1_heat-offer-elton-brand-pat-riley ("NBA rules sharply favor incumbent teams . . . . [O]utside teams may only offer 10-percent annual raises in offer sheets, while incumbent teams may offer 12.5-percent raises.").

12. *See* Sam Goldaper, *Salary Can Help Reshape N.B.A.; Commissioner Optimistic*, N.Y. TIMES, Oct. 26, 1984, at A25, *available at* http://www.nytimes.com/1984/10/26/sports/salary-can-help-reshape-nba-commissioner-optimistic.html (discussing the NBA salary cap goals of ensuring the financial stability of all teams, fostering competitive balance, and keeping the smaller market teams "from simply becoming farm teams for the larger teams"); LARRY COON'S NBA SALARY CAP FAQ, *supra* note 9 (justifying the NBA's "soft" cap as a way "to promote players' ability to stay with their current teams").

B. Lack of State Tax Adjustment Undercuts the Cap Goals

Let us consider now how the current failure to adjust the overall cap amounts for state income taxes can undercut, and sometimes even reverse, the above-stated goals. As a quick starting point by way of analogy, first consider currency differences between teams in different countries. For illustration, let us assume that the Toronto Raptors pay their players in Canadian dollars.[13] If so, we probably would agree without much fanfare that Toronto's cap amounts should be increased to take into account the currency difference between the U.S. and Canadian dollars.[14] Otherwise, Toronto would be placed at a competitive disadvantage because its Canadian dollar cap would be lower than the U.S. teams' U.S. dollar cap.[15] By analogy, a team in a state with high taxes is like Toronto in the weaker currency jurisdiction. As such, and as expanded upon below, an adjustment for state tax differences appeals for the same reasons as a currency adjustment.[16]

Expanding upon the currency analogy, perhaps the most fundamental lesson from the study of tax law is the critical importance of focusing on after-tax amounts rather than pretax amounts. As a classic example, consider a municipal bond, which pays interest exempt from federal and state income tax.[17] Although the municipal bond's pretax interest rate is lower than the rate on comparable taxable bonds, well-informed, wealthy investors purchase the municipal bond because of the higher

13. In actuality, the NBA avoids this potential problem by paying players on the Toronto Raptors in U.S. dollars. *See* Jason Fleming, *Mid-Day Report: The Canadian Dollar Issue*, HOOPSWORLD (Oct. 10, 2008, 1:36 PM), http://www.hoopsworld.com/Story.asp?story_id=10221.

14. *See* Yankem, Comment to Message Board for *NBA 2K9: How Do the Toronto Raptors Get Paid?*, GAMEFAQS, http://www.gamefaqs.com/boards/946535-nba-2k9/46277622 ("[T]he Raptors switched to paying U.S. dollars some years ago . . . . [I]f they actually paid in Canadian dollars, the Raptors would have to have their own separate salary cap and league luxury tax, and they [would] have to go through the contract of every player they acquire and change every dollar amount.").

15. Due to exchange rate variations over time, the Canadian currency has been stronger than the U.S. dollar at certain times. Recent history evidences times, though, when the U.S. dollar has been significantly stronger than the Canadian dollar. For instance, $1 bought C$1.6125 in January 2002. *US$/CAN$ Closing Rate Summary*, BANK CAN., http://www.bank-banque-canada.ca/en/rates/can_us_close.html (last visited Mar. 29, 2011).

16. Unlike the currency situation, high-tax teams cannot avoid the problem by paying in a way that avoids the higher tax cost.

17. I.R.C. § 103 (2006).

after-tax return.[18] In similar fashion, a lesser or equal salary from the Miami Heat can provide a higher after-tax return to an NBA player than a higher or equal salary from teams located in jurisdictions with state and local income taxes, such as the other teams actively chasing LeBron this past off-season—Cleveland, Chicago, Los Angeles, New Jersey, and New York.[19]

By focusing solely on pretax salary amounts, the overall cap limits for each team can undercut the competitive balance and player stability goals. The same cap amounts for each team irrespective of income taxes artificially slant the playing field in favor of teams in jurisdictions without state income taxes. By offering the maximum individual amount to any one player, the no-tax team effectively offers a higher after-tax salary than its taxed competitors.

Alternatively, similar to municipal governments, the no-tax team can offer less than the maximum salary amount, which will provide an equal or greater after-tax return than a higher pretax offer from its taxed competitors. Returning to the currency analogy, it is as if the no-tax team can offer the same dollar amount in a stronger currency.

In this regard, note how the no-tax team then has two advantages when it comes to surrounding the star players with a quality supporting team. First, if the no-tax team can obtain the star players for less than the maximum individual amount, there will be more room left under the overall cap. Second, any amounts offered under the remaining cap amounts will be higher on an after-tax basis compared to salaries offered by taxed competitors. Recall Miami's recent success as an example of these points. Miami lured three superstar players at a little less than the maximum amount and also was able to successfully recruit a number of established supporting-role players.

As a more dramatic illustration of the problem, let us now turn to the incumbency rule. The incumbency rule permits the incumbent team to offer an additional year and a higher annual percentage salary increase. As noted above, the incumbency rule is designed to foster player stability. But as noted by the *New York Times* during Jason Kidd's free-agency courtship by the San Antonio Spurs during his New Jersey Nets days, the incumbent team's maximum offer can be less than the outside suitor's on the all-important after-tax basis when the incumbent is highly

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18. Assume, for example, that a municipal bond pays 8% interest and a taxable corporate bond with similar risk pays 10% interest. An investor subject to tax at a rate above 20%—say 30%—would receive a higher after-tax return from purchasing the municipal bond—8% on the municipal versus only 7% after tax on the corporate bond.

19. *See* LARRY COON'S NBA SALARY CAP FAQ, *supra* note 9 ("Since the [income] tax rate is different in the different states and Canada . . . teams in a more 'tax friendly' state have an advantage over the other teams.").

taxed and the suitor is tax free![20] Under these circumstances, the salary cap perversely works in direct opposition to its stated goals.

In the absence of any salary cap, the highly taxed incumbent team could counteract the tax disadvantage when facing competition from a no-tax suitor by fully grossing up the pretax offer amount to cover the extra tax cost. But the salary cap blocks this full gross up even with the extra incumbency allowance because the extra allowance can effectively be less than the extra tax cost.

Along these same lines, and as will be discussed in greater detail below, the overall cap can have similar perverse results regarding the competitive balance goal. For instance, the Florida teams have a no-tax advantage over other teams given Florida's more attractive climate, especially during the winter basketball season. Without the salary cap, other teams could counteract the appeal of South Beach by offering more money. Again, though, the salary cap blocks this ability, and in a perverse double whammy, the incorrect use of equal pretax salary amounts means that the Florida teams can offer higher after-tax salaries in addition to their sunny days.[21] As such, the current cap rules can enhance, rather than decrease, a team's competitive advantage.

III. THE PROPOSED STATE TAX ADJUSTMENT IN RESPONSE

Based on the above analysis, this Article proposes the following simple adjustment to the salary cap amounts: First, determine the highest combined state and local income tax rate for each team's jurisdiction.[22] Then, reduce each team's pretax cap amount to the extent its tax rate is less than the highest taxed team. For example, assume a $1-million-per-year cap on any one player's salary, and further assume that the highest

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20. *See* Liz Robbins, *As Kidds Visit Spurs, Nets Wait*, N.Y. TIMES, July 6, 2003, § 8 (Sports), at 6 (discussing how Jason Kidd would earn more from the Spurs' lower pretax offer than under the incumbent New Jersey Nets' higher pretax offer due to the combination of high New Jersey taxes and zero Texas income tax).

21. For a discussion on "taxing" sunny days, see Michael S. Knoll & Thomas D. Griffith, *Taxing Sunny Days: Adjusting Taxes for Regional Living Costs and Amenities*, 116 HARV. L. REV. 987 (2003).

22. This simplifies matters to the extent of a progressive rate structure. That is, some income could be subject to lower rates under a progressive structure. This simplification is justified, however, because most of the NBA salaries would be taxed at the highest rates. In addition, some states, such as New York, remove the benefit of lower rates on lower income levels as the salary increases above certain thresholds. *See* N.Y. TAX LAW § 601(d) (McKinney 2006). Accordingly, although some adjustment could be made for lower progressive rates, it is probably not worth the effort.

taxed team has a 10% tax rate. The $1-million-per-player cap amount for each no-tax team simply would be reduced by 10% down to $900,000. As such, the no-tax team could offer only $900,000 of after-tax salary, same as the team with the 10% tax.[23] Accordingly, in addition to the per-player limits, a similar decrease should be made to each team's overall cap.

Alternatively, the inverse of this adjustment could be utilized to address possible concerns that lowered cap amounts for no-tax teams might create a cap violation.[24] Under this scenario, the regular cap amount could apply to the no-tax teams with an appropriate multiplier increase for the high-tax teams.[25] Because either alternative does the trick, there is much flexibility in choosing between the options. Thus, the NBA can balance the varying interests, such as the possible cap violation concern under the first cap-reduction approach versus possible concerns over higher spending under the second cap-increase approach.[26] In this regard, the following middle-ground approach might appeal: maintain the current cap amounts for teams with the average tax rate and then adjust other teams' cap amounts up or down to the extent their rate is higher or lower than the average tax rate.

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23. The tax would be $100,000—10% x $1,000,000. The $1,000,000 pretax salary less the $100,000 tax would leave $900,000. The player, of course, would have less after considering the impact of federal income taxes. Federal taxes have been ignored at this point because players generally face the same federal tax burden regardless of their team, and only one current team—the Toronto Raptors—is located outside the United States. The impact of federal taxes on the state income tax deduction is considered *infra* at Part IV.B.1.

24. One might have some concern that a low-tax team close to or at the current overall cap could fall into a cap violation. In addition to the response suggested in the text, this potential concern might be ameliorated because the adjustment would be made starting only in subsequent years and the cap limits generally are increased each year. Any residual concerns could be addressed by "grandfather-type" rules.

25. The multiplier would be the following percentage: $T/(1 - T)$ if T equals the tax rate in the team's jurisdiction. Returning to the textual example, the no-tax team would keep the $1-million-per-player cap while the team with the 10% tax would receive an 11.1% increase, thereby raising its maximum allowable offer to $1,111,000—.1/(1 - .1) = .1/.9 = .111 rounded, and $1,000,000 x 1.111 = $1,111,000. The 11.1% adjustment exceeds the 10% state income tax rate because state tax would be due on both the unadjusted $1 million and the state tax increase. Restated, a salary of $1,111,000 would leave a player with $1,000,000 after payment of state income taxes at a 10% rate—$1,111,000 - (.1 x $1,111,000) = $1,111,000 - $111,100 = $1 million, ignoring rounding impact.

26. For example, under the second approach, high-tax teams would have to spend more than the current cap amounts to compete with the no-tax teams.

IV. RESPONSES TO POSSIBLE OBJECTIONS

Having laid out the core argument in favor of the state tax adjustment above, this Part now considers, and refutes, possible objections to making the proposed adjustment. As shown below, there are compelling responses to each potential objection. Part IV.A first demonstrates why an adjustment just for taxes makes sense even though jurisdictions have other differences as well, such as weather. Part IV.B then shows why the full tax adjustment should be made even though state taxes can be deductible on federal tax returns and players on no-tax teams incur some state tax when visiting other states as road-team players. Part IV.C then refutes the notion that state taxes are not significant enough to impact the decisions of wealthy players. Finally, Part IV.D considers possible collusive manipulation concerns arising out of differing cap amounts for each team.

A. How Do Income Taxes Differ from Other State Costs and Benefits?

Adjusting the cap solely for state income tax costs might seem too narrow a focus because each state provides a different basket of costs and benefits. For instance, why adjust the salary cap for state income taxes while ignoring other potential costs, such as state sales taxes or above-average housing costs? Conversely, why decrease the cap amount for no-tax states but ignore the potential benefits provided to residents of high-tax states?[27] Restated, if we really wanted to adjust the salary cap for state differences, it might seem that we should make that adjustment based on the aggregate net balance of all in-state costs and amenities that differ from the national average.

In response, several key points justify a cap adjustment for state and local income taxes. Part IV.A.1 will first highlight how state income taxes typically will have a significantly greater impact on an NBA player than other state costs and amenities. This results because players generally remain subject to the state's income tax regardless of their savings and consumption choices. Second, as discussed in Part IV.A.2,

27. *See* Knoll & Griffith, *supra* note 21, at 987, 989–91 (addressing whether the federal income tax base should adjust for differences in regional living costs or amenities). State taxes may be treated the same as other state costs for purposes of such analysis. *See id.* at 989. The article expands the analysis to include state amenities such as weather and public schools. *Id.* The article also discusses cost differences on housing due to local demand and on other products due to unusual shipping costs. *Id.* at 990–91.

it is more practical to adjust for income taxes than other state costs and amenities. Third, as discussed in Part IV.A.3, the current "no regional adjustment" approach cannot be justified on grounds that higher tax costs are offset by extra attractive in-state amenities for the players. Finally, as discussed in Part IV.A.4, the NBA salary cap blocks the usual free market ability of employers in locales with a below-average net balance of amenities and costs to offset that relative unattractiveness through higher salaries.

1. *Income Taxes Are Less Avoidable*

Even if he resides in the state while employed, an NBA player avoids state amenities and costs other than income taxes in three main ways. First, the saved portion of an NBA salary generally does not implicate in-state costs and amenities unless the player remains a resident of the state after he is employed by the team. Second, part of a resident player's current-year consumption occurs outside his home state: an NBA player typically spends about 30% of the season on the road.[28] Third, a resident player can avoid particular state costs and amenities through his in-state consumption choices. For example, a player uninterested in good public schools at this stage in his life can "avoid" them and any associated property tax cost by choosing where to live within the state.

In addition to the three points above for in-state residents, state costs and amenities are further avoided if the player resides out of the state during either the season or off-season. Taken together, the four above points for resident and nonresident players are particularly significant because the NBA work year is limited to about six months, and about 30% of that work period is spent on the road. In contrast, a player generally cannot avoid the home state income tax by saving some salary or through his consumption choices.[29]

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28. For a discussion of how out-of-state location affects tax allocation, see *infra* text accompanying note 49.

29. There might be a limited exception for qualified retirement savings. This results because the states generally follow the federal calculation of gross income, and the federal income tax code provides a limited exception for wages invested in a qualified retirement plan. *See* I.R.C. § 402(b)(1) (2006) ("Contributions to [non-qualified plans] shall be included in the gross income of the employee . . . ."). However, some states attempt to enforce their income tax on these amounts upon later withdrawals even if the taxpayer resides in another state at that time. Also, players might have a very limited ability to avoid tax on the portion of income allocated to no-tax road jurisdictions if they reside out of state. Consistent with this analysis, local taxes should be added to the state income tax calculation to the extent the player cannot avoid those taxes through his consumption choices.

2. Income Tax Adjustment Is More Practical

As shown above, the income tax adjustment is pretty straightforward: increase the cap amount by the stated formula. A more general adjustment for aggregate state costs and amenities presents much greater difficulties. In theory, the adjustment could be based on regional salary differences because locales with less favorable costs-and-amenities packages generally need to offer higher salaries to compensate for their lesser attractiveness.[30] Regional salary differences capture the aggregate costs-and-amenities balance better than cost-of-living differences because the latter ignore amenities.[31] Unfortunately, the data on regional salary differences are less reliable than living costs data, which also have some practical difficulties.[32] As such, practical difficulties seem to restrict the real options to either an income-tax-only adjustment or no adjustment at all. The latter possibility provides the link to the third key point.

3. Higher Taxes Not Offset by Better Amenities

We could safely choose to ignore regional differences if locales with higher taxes provided offsetting higher benefits. Unfortunately, this is just not the case even at a very general level of analysis—and even ignoring the above point that players are impacted more by income taxes than other items given the itinerant nature of their jobs.[33] As noted in Part I, Miami is particularly well situated under the current no-adjustment approach because it provides both low income taxes and better amenities.[34] For further elaboration, contrast Miami to New

30. Knoll & Griffith, *supra* note 21, at 1008.
31. *See id.* at 1012–13.
32. *See id.* at 1019–20 (discussing the difficulties with relative salary differentials and regional living cost differences). As to relative salary differentials, individuals with the same title and even same years of experience might have different levels of proficiency. *Id.* at 1019. In addition, regional salary differences might reflect different work effort in the region. *Id.* at 1020. As to regional living cost differences, the authors note that there are "more than a dozen different methodologies for comparing living costs in different regions." *Id.* at 1019. Finally, note how some law firms, for example, pay the same salary to all of their associates in different offices regardless of location.
33. *See id.* at 1012 (finding that disregard of costs and amenities for federal tax purposes is appropriate to the extent above-average amenities are reflected in above-average costs).
34. *See, e.g.*, Jeffrey L. Krasney, *State Income Taxation of Nonresident Professional Athletes*, 2 SPORTS LAW. J. 127 (1995) (discussing various methods of state taxation of a nonresident and the effect of state and local taxes on nonresident professional athletes).

Jersey. Miami has both the more attractive climate and the income tax advantage.[35] In addition, Florida's 6% sales tax rate is close to New Jersey's 7% sales tax rate,[36] and its housing costs generally are lower than in New Jersey and the surrounding areas.[37]

4. Salary Cap Blocks Usual Free Market Adjustments

As highlighted above, some locales provide a less attractive package of costs and amenities, although employers in these locales generally can counteract their lesser attractiveness by offering higher pretax salaries.[38] But the NBA salary cap, by its limits, interferes with the usual free market correction. Accordingly, after introducing that interference, the NBA cannot rely on market forces to correct the unintended consequences and perverse incentives. In particular, the very terms of the salary cap block teams from paying players more to compensate for above-average income tax costs. The potential response that a player can avoid the lack of such a "tax gross up" by choosing teams in low-tax states highlights the current problem.[39] This bias in favor of teams in low-tax states seems quite contrary to the NBA salary cap goal of a level playing field.

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35. New Jersey had an 8.97% state income tax rate for residents making over $500,000 in 2010. N.J. DEP'T OF THE TREASURY, DIV. OF TAXATION, N.J. TAX RATE SCHEDULES 2010, http://www.state.nj.us/treasury/taxation/pdf/other_forms/tgi-ee/njtaxratesch_10.pdf (last visited Mar. 29, 2011).

36. FED'N OF TAX ADM'RS, STATE SALES TAX RATES AND FOOD & DRUG EXEMPTIONS (AS OF JANUARY 1, 2011) (2011), *available at* http://www.taxadmin.org/fta/rate/sales.pdf.

37. As to housing costs, a recent state-by-state listing shows that New Jersey has a significantly higher average current listing price and median sales price from August to October 2006 than Florida does. *US Home Prices and USA Heat Map*, TRULIA, http://www.trulia.com/home_prices/ (last visited Mar. 29, 2011) (noting New Jersey's current listing price of $441,060 versus Florida's $364,135 and New Jersey's listing price in August through October 2006 as $342,000 versus Florida's $236,000). This provides a good estimation of the point, even though it obviously does not take into account pricing variations within the state. Note that other states without income taxes have sales tax rates similar to New Jersey—6.25% in Texas and 6.5% in Washington. FED'N OF TAX ADM'RS, *supra* note 36. Although localities within Florida, Texas, and Washington can add on additional sales tax—up to 1.5% in Florida, 2% in Texas, and 3% in Washington—these rates are relatively low and can be minimized by the player's choice. *See Sales Taxes in the United States*, WIKIPEDIA, http://en.wikipedia.org/wiki/Sales_taxes_in_the_United_States (last modified Mar. 30, 2011, 10:36 PM). As to housing costs in other states without an income tax, Texas, for example, shows even lower housing costs than Florida, with a $265,531 current average listing price and a $144,900 median 2006 sales price. *US Home Prices and USA Heat Map*, *supra*.

38. *See* Knoll & Griffith, *supra* note 21, at 1009 tbl.6A.

39. From the player's perspective, the player might not have a real choice depending on, for example, which teams have salary cap room at the time of the player's free agency. This is a separate point, though.

5. Summary

In a theoretically ideal world, the best approach would be an adjustment for income taxes as well as some other state costs and amenities. But because this "first-best" solution is not practical, we need to examine matters more closely. Under the classic "second-best theory," we should not necessarily assume that making one improvement is desirable if other imperfections remain because two imperfections might offset each other.[40] As such, the second-best theory instructs that deeper consideration is required to ascertain whether the practical improvement under consideration remains desirable after taking into account any remaining imperfections.

Drawing upon the above points, adjusting the NBA salary cap only for income taxes successfully meets this higher hurdle. As evidenced by the most recent free-agent class, the failure to adjust for income taxes can exacerbate, rather than offset, the failure to adjust for amenities because some teams have both below-average income taxes and above-average amenities. Given the lack of any discernable reason to intentionally favor teams like Miami and Orlando, changes should be made to deal with the unfair and unjustified advantage.[41] Finally, the case for the income-tax-only adjustment becomes even more compelling upon recognizing that state income taxes are more certain to have an impact on players than the other state items, and that the NBA salary cap, by its very terms, blocks the usual ability of employers to compensate employees for their lesser attractiveness through higher wages.

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40. Second-best theory posits that correcting only some imperfections, while leaving others intact, does not necessarily improve the status quo. R.G. Lipsey & Kelvin Lancaster, *The General Theory of Second Best*, 24 REV. ECON. STUD. 11, 12 (1956).

41. Although the salary cap was designed in part to help small-market teams against the large-market teams, there does not seem to appear to be any real link between teams located in low income tax states and those teams in small markets or otherwise suffering financial difficulties. A few teams in states without income taxes might satisfy the small-market label—Memphis and San Antonio. Other teams in states without income taxes, however, seem better categorized as either middle- or even large-market teams—Houston, Dallas, Miami, and Orlando. Similarly, some teams in states with high income taxes might satisfy the large-market label—Portland, New York, New Jersey, Los Angeles Lakers, Washington Wizards—but other teams in states with high income taxes might well be categorized as small-market teams—Utah, Minnesota, and Milwaukee. For a chart on state income taxes, see FED'N OF TAX ADM'RS, STATE INDIVIDUAL INCOME TAXES (TAX RATES FOR TAX YEAR 2011—AS OF JANUARY 1, 2011) (2011), *available at* http://www.taxadmin.org/fta/rate/ind_inc.pdf.

B. Excess Adjustment due to State Tax Deduction and Road Tax?

Adjusting by the top state tax rate as suggested above might seem excessive because (1) state income taxes can be deducted on the federal tax return, and (2) athletes can be taxed by outside states when they enter to play games on the road—the road tax. This Part will analyze these two points in turn, demonstrating why a full state tax adjustment appeals notwithstanding some merit to these points. In particular, although these points might seem to cut in favor of scaling back the proposed tax adjustment, the very real prospect of additional tax-favored endorsement income supports an increase to the proposed adjustment. Keeping the full adjustment as proposed above provides a nice balancing of these competing points.

1. State Tax Deduction on Federal Return

State income taxes generally can be deducted on the federal tax return.[42] As such, the proposed state tax adjustment might seem wrongheaded in that it ignores that deductibility. But even assuming full deductibility, the appropriate response should be to then reduce the proposed state tax adjustment by a percentage equal to the federal tax rate—and not to just ignore the state tax like the current regime does. This results because even a full federal tax deduction saves the player just a percentage of the state tax cost equal to his federal tax rate. For example, assume a player pays $100,000 of state income tax and is subject to the top federal rate of 35%. A $100,000 federal deduction for the state tax would save the player $35,000. As such, although the player still bears the majority of the state income tax cost even assuming a full federal deduction, the current regime fails to take that into account.

Beyond that, there are good reasons to base the cap tax adjustment on the full state tax rate, rather than a lowered percentage—65% of the state rate in the above example. First, the deduction for state income taxes can be limited or even eliminated under the federal tax code due to the alternative minimum tax (AMT), which was designed to prevent wealthy taxpayers the benefit of excessive deductions. In particular for our purposes, the state income tax deduction is disallowed for AMT purposes.[43] So players caught by the AMT net might lose some or all of

42. I.R.C. § 164(a)(3) (2006).

43. The AMT requires a separate tax calculation that denies certain deductions, including state income taxes. *Id.* § 56(b)(1)(A)(ii). The AMT then applies a lower rate, maxing out at 28%. *Id.* § 55(b)(1)(A)(i)(II). Taxpayers effectively pay the higher of (1) the AMT calculation—lower tax rate, higher taxable amount—or (2) the regular tax

the state tax deduction, and this likelihood increases as the state tax amount increases.[44]

Finally and very importantly, the state tax savings from signing with a no-tax team can extend beyond the player's salary to other income, such as endorsement revenue and investment income. In this regard, it has been reported that by choosing Miami over New York or Los Angeles, "James could save many millions [of state taxes] on just his salary, and potentially tens of millions [of state taxes] on his salary plus endorsements. . . . James, it appears, had done his homework on the tax implications."[45] Although a player might attempt to minimize this impact by establishing his tax residency in another state, this raises its own costs and difficulties.[46]

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calculation—higher tax rate, lower taxable amount. The AMT accordingly can reduce, and in extreme cases eliminate, the value of the state income tax deduction for federal purposes depending on the taxpayer's regular tax rate, the taxpayer's other deductions, and the state income tax rate. At one extreme, the AMT would eliminate all the value if other significant disallowed deductions subject the taxpayer to the AMT even without regard to the state income tax deduction. At the other extreme, the AMT would not reduce the value at all if the taxpayer claims no deductions other than the state income tax.

44. All else being equal, higher disallowed deductions increase the likelihood of the AMT's application because, as discussed *supra* note 43, the AMT provides a lower rate to an increased taxable amount. As such, a taxpayer gets pulled into the AMT only when the AMT taxable income is sufficiently higher than the regular taxable income—due to enough disallowed deductions—so as to overcome the lower AMT rate.

Furthermore, even if the player is outside the AMT, a special provision under the regular tax code might limit the deductions. Section 68 can reduce certain itemized deductions, including state income taxes, for high-income taxpayers by up to 80% of those amounts. *See* I.R.C. § 68(a) (2006) (reducing certain itemized deductions by the lesser of 80% of such deductions or 3% of the taxpayer's excess adjusted gross income). The application of § 68 has been suspended for 2009 through 2012. Absent further legislation, though, § 68 would return to force for 2013. *See* STAFF OF THE JOINT COMM. ON TAXATION, 111TH CONG., TECHNICAL EXPLANATION OF THE REVENUE PROVISIONS CONTAINED IN THE "TAX RELIEF, UNEMPLOYMENT INSURANCE REAUTHORIZATION, AND JOB CREATION ACT OF 2010" SCHEDULED FOR CONSIDERATION BY THE UNITED STATES SENATE 6–7 (Comm. Print 2010), *available at* www.jct.gov/publications.html?func=startdown&id=3716.

45. John Seiler, *Are Sports Stars Shunning California?*, CALWATCHDOG (July 13, 2010), http://www.calwatchdog.com/2010/07/13/new-are-sports-stars-shunning-california/ (quoting Kelly Phillips Erb, *Did Saving $25 Million in Taxes Fuel LeBron James' Miami Heat Pick?*, WALLETPOP (July 9, 2010, 9:20 AM), http://www.walletpop.com/2010/07/09/did-saving-25-million-taxes-fuel-lebron-james-miami-heat-pick/).

46. As a general proposition, it seems that states typically assert tax rights to their home-team athletes' endorsement revenue via claims that the athlete is a resident within the state. *See, e.g.*, Kara Fratto, *The Taxation of Professional U.S. Athletes in Both the United States and Canada*, 14 SPORTS LAW. J. 29, 46–47 (2007) (analyzing, for example, Maryland's taxation of Brady Anderson and other Orioles baseball players); William Ahern, *Derek*

In sum, even if the full proposed adjustment is a little high on the stated salary due to the possible federal deduction, any such excess might help offset the extra tax benefits on nonsalary income. On balance, if anything, an even higher state tax adjustment seems appropriate.

2. The Road Tax

The proposed state tax adjustment might be similarly critiqued on two other grounds. First, some states tax visiting road team players when they perform in state. Second, most states grant tax credits for these "road income taxes."[47] By granting the credit, the home-team state effectively cedes primary taxing jurisdiction to the road-team state. As such, the home-team tax rate might seem to lose its significance.[48] But tracking the above analysis regarding the federal tax deduction, several factors mute the impact of this critique. This, in turn, supports the state tax adjustment.

First, only a minor portion of an NBA salary faces the same state income tax regardless of the player's home team because (1) the salary portion allocated to road games is less than 50% due to nongame work

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Jeter Tax Case Distinct from "Jock Tax" Controversy, TAX FOUND. (Nov. 16, 2007), http://www.taxfoundation.org/blog/printer/22757.html (analyzing New York's recent assertion that Derek Jeter had established tax residency in New York). This might suggest that NBA players could avoid the home-team tax on their endorsement revenue by setting up their tax residency in a no-tax state. Such avoidance is not so easily accomplished, however. First, establishing tax residency in another state is not without additional costs, especially if neighboring states also have state income taxes. In this regard, consider especially an athlete who has school-age children. Beyond just duplicative housing costs and family disruption, great care must be taken in trying to establish the strongest tax position on residency. *See, e.g.*, Fratto, *supra*, at 46. Also, an athlete who tries to minimize local taxes via an out-of-state residency might face adverse publicity. *See, e.g.*, Mark Zeigler, *Anderson Fights a Baltimore Chop*, SAN DIEGO UNION-TRIB., May 25, 1997, at C15 (discussing Brady Anderson being labeled a "tax evader" and "deadbeat"). In addition, the athlete must take care not to film endorsements within the athlete's home team state. For taxation where the actual endorsement activity occurs in state, see *Dionne Warrick*, N.Y. Tax Rptr. (CCH) ¶ 99-629 (Aug. 4, 1972). Finally, it is possible that a state might assert taxation of the endorsement revenue on grounds that it relates to the in-state athletic performance. *See, e.g.*, WALTER HELLERSTEIN ET AL., STATE AND LOCAL TAXATION 374 (9th ed. 2009) (raising a question whether athletes' endorsement revenue should be taxed according to the same formula as their salary). In this regard, the United Kingdom has asserted a right to tax endorsement revenue of foreign athletes under a similar theory. *See* Robert Watts & Kevin Dowling, *Taxman Scares Off Top Sport Stars*, SUNDAY TIMES (London), Jan. 17, 2010, http://www.timesonline.co.uk/tol/money/tax/article6991066.ece.

47. For a general discussion of the road income tax, see, for example, Richard Hawkins et al., *Play Here, Pay Here: An Analysis of the State Income Tax on Athletes*, 26 ST. TAX NOTES 551 (2002).

48. Note that a player can still face extra tax if the home-team rate exceeds the imposed road tax rate. This is a relatively minor point because, as discussed *infra* note 50, high-tax states have been most aggressive in asserting the road tax.

days—practice and meeting days[49]—and (2) the road tax is not imposed on road games in states without any income tax. A reasonable estimate would be that only about 15%–18% of the salary is taxed the same regardless of the home-team locale.[50]

Second, although the road-tax point might indicate scaling back the state tax adjustment by this low 15%–18%, recall the very real possibility that the player will have nonsalary endorsement or investment income that might also benefit from a lowered home-team rate. Like above, a full state tax adjustment therefore appeals because it provides a moderate balance between the competing possible reductions and increases to the adjustment. Finally, providing the link to Part IV.C, a full state tax adjustment also appeals from a perception perspective, apart from the substantive reality.

C. Disregard State Tax Differences as De Minimis?

Expanding upon the analysis of Part IV.B, it might seem that the state tax difference is not significant enough to be taken into account. One variant of this critique might take the following form: "Do we really believe that LeBron would have chosen differently if Florida had a state

49. *See, e.g.*, Joseph Barry Carroll, 39 Cal. State Bd. of Equalization 166, 167 (Apr. 7, 1987) (allocating 70% of an NBA player's income to California in a year in which he played about 50% of his games in that state). Virtually all jurisdictions allocate based on a "duty days" method—taking into account total work days, including practices and meeting days—rather than just games played. Hawkins et al., *supra* note 47, at 553.

50. As discussed above, *see supra* note 49, about 70% of the salary is "allocated" to the home-team state, leaving about 30% allocated to road jurisdictions. The 30% figure needs to be further reduced because (1) some states that house NBA teams do not have an income tax—Texas, Florida, Washington, and Tennessee—and (2) some other states do not actively enforce the road team tax. *See* Hawkins et al., *supra* note 47, at 551–52. As somewhat of a detail, the actual percentage varies slightly because teams can play different amounts of road games in different jurisdictions. *See, e.g.*, *Scores & Schedule*, NBA.COM, http://www.nba.com/gameline/ (last visited Mar. 29, 2011). It is also possible that the player could avoid the home team's tax rate on another 12%–15% of the salary by residing out of state—the 30% allocated away from the home-team state less the 15%–18% already subject to the road income tax. Even as to this 12%–15%, though, the player generally will have more difficulty avoiding the state income tax through an out-of-state residence than other regional costs. Consider again the New Jersey Nets. Even as to the 12%–15% portion, a Nets player will have difficulty matching the zero rate because all states within reasonable proximity to New Jersey have a state income tax. In other words, if a Nets player chooses a zero-income-tax state as his residence, he is likely to incur excess traveling and other costs. For a similar discussion regarding endorsement income, see *supra* note 46.

income tax?" The twofold response to these de minimis critiques emphasizes the joining together of substance and perception.

Let us consider first the substantive reality. Although LeBron stated that his decision was about winning rather than money, the money obviously mattered too. Although LeBron took less than the maximum salary, he signed for the very significant salary amount of about $110 million over six years.[51] If it truly were solely about winning, why not take even less money so that the Miami Heat would have a greater ability to sign an even better supporting cast? Further recall the earlier discussion of LeBron's very significant tax savings, especially given all of his endorsement income.

Beyond just LeBron, other athletes with significant financial empires have shown sensitivity to state tax differences. For example, it has been reported that Tiger Woods relocated from California to Florida due to Florida's tax advantages on his golf winnings, endorsement revenue, and investment income.[52] And this occurred before the potential hit to his financial empire because of marital issues. Back to the basketball world, recall Orlando's 2000 success with Tracy McGrady and Grant Hill.[53]

Finally, apart from the impact of finances on mega-millionaire LeBron, recall how Miami's tax-free status allows it to offer more after-tax money to supporting players who might not have LeBron's financial flexibility. In this regard, Derek Harper, a former player of the Dallas Mavericks, reportedly "once nixed a potential trade to the L.A. Clippers in part because it would have cost him six figures in income taxes to California."[54]

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51. Ric Bucher et al., *Heat Stars Sign Six-Year Deals*, ESPN.COM (July 10, 2011, 1:37 PM), http://sports.espn.go.com/nba/news/story?id=5368003.

52. *See* Shane Goldmacher, *Natalie Doesn't Live Here Anymore*, NEWSREVIEW.COM (July 28, 2005), http://www.newsreview.com/sacramento/content?oid=43505 ("The state's best-known golfer, Tiger Woods, abandoned California for the tax-free confines of Florida when he signed a lucrative $40 million endorsement deal with Nike in 1996."); *see also* Joel Fox, *Rotten "Low Hanging Fruit,"* FOX & HOUNDS DAILY (Dec. 7, 2009), http://www.foxandhoundsdaily.com/blog/joel-fox/5992-rotten-%E2%80%9Clow-hanging-fruit%E2%80%9D (refuting California Tax Reform Association's claim that "[s]tate income taxes have no impact on the location of the wealthy" (internal quotation marks omitted)). Fox refutes the claim by stating that "[p]erhaps CTRA never heard of the tennis playing Williams sisters who grew up in Compton and now call no-income tax Florida home. Maybe they [have] heard of California native and Stanford grad Tiger Woods." *Id.*

53. *See* Andrew Feinstein, *Magic vs. Nuggets: Another Opponent, Another Possible Melo Destination . . .*, DENVER STIFFS (Dec. 13, 2010, 10:17 PM), http://www.denverstiffs.com/2010/12/13/1875034/magic-vs-nuggets-another-opponent-another-possible-melo-destination (explaining that McGrady and Hill signed with Orlando because they liked "the weather" and "Florida's favorable tax rates").

54. *See* Seiler, *supra* note 45 (quoting Interview with David Kline, Vice President of Commc'ns & Research, Cal. Taxpayers Ass'n).

Second, perception backs up the problematic reality. As evidenced by much commentary,[55] there is a widespread perception that no-tax teams like Miami have an advantage over their taxed competitors. This perception is problematic for two reasons. First, to the extent that players believe there is a real tax advantage, their decisionmaking could be impacted by the current lack of a tax adjustment. Second, the NBA's goodwill and its level-playing-field mantra are undercut to the extent that fans believe the system contains a meaningful tax bias. If that perception were divorced from reality, a more difficult case would be presented. In such a case, one might prefer a reeducation of players and fans if they mistakenly perceived a nonexistent tax distortion. But if the perception comports with the reality, as shown to be the case in this Article, perception then lends further support to correcting the underlying wrong.

D. Possible Abusive Manipulations

Different overall cap amounts for different teams might raise the specter of abuse. For instance, concern might arise that a no-tax team might conspire with a high-tax team to have the high-tax team sign a player under its higher per-player limit and then trade the player to the no-tax team. Any of those concerns should not override the favorable case for the cap adjustment set forth above. First, existing rules generally prohibit a team from signing a free agent and then trading the player right away.[56] In addition, existing aspects of the NBA cap also lead to possible abuse, but the NBA polices such end-run attempts.

For instance, the NBA punished the Minnesota Timberwolves in 2000 for a salary cap violation involving Joe Smith. The Timberwolves successfully recruited Smith as a free agent even though the salary cap prevented the team from paying him his full market value. The NBA concluded that Smith went to the Timberwolves based on the team's secret promise of additional money even though the money was disallowed under the cap.[57] Any attempted manipulations of the differing cap amounts

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55. *See supra* notes 6, 45 and accompanying text.

56. *See* LARRY COON'S NBA SALARY CAP FAQ, *supra* note 9 ("Generally, a player cannot be traded until three months after signing a contract or December 15th of that season, whichever is later."). There is a limited exception if the incumbent team re-signs its player as part of a "sign-and-trade." *See id.* This sign-and-trade exception could be handled easily by using the recipient team's salary cap amount.

57. *See Smith Is Signed and Sealed, and Pistons Look To Deliver*, N.Y. TIMES, Nov. 21, 2000, at D2.

could be policed in similar fashion, much like how the tax law polices abuses under the sham, economic substance, and substance-over-form doctrines.[58]

V. CONCLUSION

The time is ripe to finally make the necessary salary cap adjustment for state taxes. In retrospect, the possible inequities have been visible at least as far back as Orlando's success in the 2000 market. Unforeseen injuries to Orlando's good fortune helped delay any public outcry. But now Miami's recent way-over-the-top haul has brought the issue to unavoidable crossroads, infuriating numerous fans outside the favored no-tax inner circle of teams.[59]

Miami's incredible bonanza has exposed, once and for all, the unintended and perverse consequences of a cap that ignores tax differences between the states. Absent the cap, high-tax teams could offset their tax disadvantage by paying higher salaries. Yet, although the cap itself purports to provide a level playing field, it places the high-tax teams on an uphill-sloping treadmill by blocking the necessary adjustment! Fortunately, the cap's goal of protecting small-market teams can be achieved relatively easily without throwing high-tax teams under the bus: just reduce the cap amounts of the no-tax teams by a percentage equal to the tax rate faced by other players in the highest tax jurisdiction.

This Article also has refuted possible objections that differences in state tax rates do not matter or do not matter enough to justify the change. First, as discussed above, even mega-millionaire superstar athletes have shown that they pay close attention to state tax differences. Along these lines, the potential tax benefits to the star players might extend beyond just salary to lucrative endorsement and investment income. As such, if anything, the state tax adjustment on maximum player salaries arguably should be even greater than that proposed above. In addition, with an unadjusted overall cap, the benefits to the no-tax teams extend beyond the star players to the necessary role players as well because the no-tax teams essentially have more overall cap room with which to work.

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58. For recent codification of the economic substance doctrine under the tax code, see I.R.C. § 7701(o) (Supp. 2010). Also compare how the National Hockey League (NHL) recently rejected the New Jersey Devils' seventeen-year contract with free-agent Ilya Kovalchuk on grounds that extra years were added to the contract—until the time when Kovalchuk would be forty-four—to gain an advantage under the NHL's salary cap. *NHL Rejects Kovalchuk's 17-Year Deal with Devils Because of Cap Violations*, THERECORD.COM (July 20, 2010), http://news.therecord.com/Sports/article/748688.

59. *See* LARRY COON'S NBA SALARY CAP FAQ, *supra* note 9 (discussing how state taxes give some teams an advantage).

Finally, public perception comports with the actual problematic realities above. Miami's latest success has contributed to the widespread perception that the unadjusted cap unfairly benefits certain limited teams while penalizing many others. For reasons of both actuality and perception, then, the NBA salary cap should be adjusted for state taxes in order to further the cap's promise of a level playing field.