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An 'Expensive' Trade? Taxation of Nonresident Professional Athletes Playing in Canada

by Marie-France Dompierre

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In this article, Dompierre provides an overview of Canada's tax treatment of nonresident professional athletes, especially those playing in North American sports leagues.

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Professional athletes who play all over the world are subject to a multitude of tax regimes. Attracting athletes to Canada is sometimes easier said than done for one simple reason — income taxes. Canada's marginal tax rate for individuals is one of the highest in the world, and the corporate income tax rate, albeit more competitive, is also high. Moreover, given the complex and ever-changing global tax landscape, tax compliance has become increasingly onerous. Add the new sports environment created by the COVID-19 pandemic to the mix, and together these factors create challenging tax scenarios that most income earners never have to consider.

Likewise, Canada's high income tax rates can deter professional athletes from joining teams based in Canada that compete in major North American sports leagues. For many, high rates may tip the scales in favor of playing for U.S.-based teams, making it arduous for Canadian teams to attract and recruit top talent to their rosters.

Although differential tax rates between Canada and other jurisdictions create disparities in after-tax income earned by professional athletes, these inequalities can be mitigated to help bridge the gap. This article canvasses the general Canadian income tax considerations for nonresident professional athletes and, particularly, for professional athletes who participate in North American sports leagues.

Taxation of Nonresident Pro Athletes

There is no special tax regime in Canada applicable to nonresident professional athletes — they are subject to the same tax rules as other nonresidents. Unlike in the United States, "jock taxes" do not exist in Canada. Constitutionally, there are two orders of government in Canada: federal and provincial/territorial. Both the federal and the provincial/territorial governments levy income taxes and sales taxes, with some provinces, including Québec, having their own tax authorities.

Nonresidents of Canada are generally subject to source-based taxation in Canada on income earned from specific sources, such as:

- a business carried on in Canada;[1]
- an office or employment performed in Canada; and
- gains realized on the disposition of specific types of property with a Canadian situs.[2]

This is the essence of subsection 2(3) of the Income Tax Act (Canada), which sets out the scope of Canada's jurisdiction to tax nonresidents. At the provincial level, nonresidents may also be liable for provincial (or territorial) source-based taxation. For example, U.S. resident players on the Montréal Canadiens hockey team of the National Hockey League (NHL) are liable for income tax in Québec on their income earned within the

[1] Under many of Canada's tax treaties, business income is subject to Canadian taxation only to the extent that it is attributable to a permanent establishment in Canada through which the business is carried on.

[2] Canadian withholding tax is also imposed on some types of passive income received by nonresidents from Canadian residents.

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province. There is no de minimis filing threshold — nonresidents are consequently liable for tax from the first dollar they earn on Canadian soil. Nonresidents who are subject to tax in Canada are generally required to file a Canadian income tax return and compute their taxable income earned in Canada on the same basis as residents. Therefore, in computing income, nonresidents are also entitled to the deductions available to residents.

Specific payments made to nonresidents are subject to withholding taxes. These apply to "salary, wages, or other remuneration" (generally applicable to employees) and to "fees, commissions, or other amounts for services" (generally applicable to independent contractors).[3] The withholding rate will vary depending on:

- the nature of the payment;
- the employment status of the nonresident; and
- any relevant tax treaties.

The withholding requirements are usually unaffected by any applicable tax treaty exemptions; payers must remit these amounts unless the Canada Revenue Agency issues a "withholding tax waiver."[4] Nonresidents can claim a credit for any tax that is withheld against their ultimate tax liability when their Canadian income tax return is filed.

To complicate matters, athletes may also be taxed on their worldwide income by their country of residence or citizenship. This could raise issues of double taxation. For example, the United States taxes based on U.S. citizenship, regardless of whether an individual resides in the United States. Resident aliens — including noncitizen green card holders and persons who meet the "substantial presence" test — are also taxed on their worldwide income in the United States. This can lead to double taxation by the United States and Canada.

Double taxation can usually be resolved by the foreign tax credit regime, which reduces athletes' domestic tax liability in their country of residence (or citizenship) by the amount of tax paid in Canada and elsewhere. Tax treaties may also play a role in reducing the amount of Canadian taxes for which a nonresident athlete may be liable.

Source of Income: Employment or Business

A primary issue in the taxation of nonresident professional athletes playing in Canada is whether they are employees or are considered to be carrying on a business (independent contractors). The distinction between employment income and business income is important for the availability of deductions. Employee deductions are more restrictive than the deductions available to an athlete considered to be carrying on a business. However, some tax treaties may provide tax relief for employee athletes playing in North American sports leagues, but do not provide the same relief for athletes considered to be independent contractors.

Generally, athletes who play in professional sports leagues, such as the NHL, the National Basketball Association (NBA), and Major League Baseball, are considered employees. On the other hand, individual sportspersons such as tennis players, golfers, and boxers, are often considered independent contractors.

Nevertheless, an athlete's status as an employee or independent contractor remains a question of fact, largely depending on the notion of control: The more control one person exercises over another person with respect to the manner in which a service is rendered, the more the relationship will resemble that of employer-employee.[5] The CRA can challenge a sportsperson's status when the relationship between an individual and a team or organization does not align with that of the reported relationship. For example, in *Royal Winnipeg*

[3] Paras. 153(1)(a) and (g) of the ITA, respectively.

[4] Interestingly, in 2018 the CRA introduced a simplified process for nonresident athletes (and entertainers) earning no more than C $15,000 for performances in Canada during a calendar year to obtain a tax waiver from withholding obligations that does not require advance approval from the CRA.

[5] Pierre Archambault, "Contrat de travail: Pourquoi *Wiebe Door Services Ltd.* ne s'applique pas au Québec et par quoi on doit le remplacer," in *L'Harmonisation de la législation fédérale avec le droit civil québécois et le bijuridisme canadien: deuxième recueil d'études en fiscalité* 2:1 (2005) (in French).

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Ballet,[6] the Federal Court of Appeal found that ballet dancers with a full season contract with a ballet company were independent contractors, not employees, primarily on the basis that the parties did not intend an employment relationship to result from the contract.

The outcome will depend not only on the terms of the athlete's contract but also on common law or civil law factors.[7] Tax law in Canada is an "ancillary system," which means that tax consequences will flow from determinations made at private law. For example, in Québec, before the tax consequences of a situation can be determined, the Civil Code of Quebec[8] will be considered regarding matters of private law that are relevant to the application of the ITA and the Taxation Act (Québec).[9]

Allocation of Income: Who Gets What

Nonresidents are required to compute income on a source-by-source basis and must allocate expenses to each source on a reasonable basis. Unless sportspersons are resident in Canada, they should be taxable only to the extent of the services performed in Canada or the income earned from a business carried on in Canada (and subject to the provisions of an applicable tax treaty). This apportionment of income must be done on a reasonable basis. The ITA does not provide any specific rules in this regard.

Over the years the CRA has issued contradictory administrative statements addressing the territorial allocation of income for nonresident athletes.[10] These statements ranged from the number of days the athlete was required to spend in Canada in a year (including, and then excluding, playoffs) to the percentage of games played in Canada in a year. Moreover, the CRA has taken the position that the same allocation should be used for salary and bonuses, despite the fact that these bonuses could be earned entirely in a foreign jurisdiction, and thus have no situs in Canada. Sportspersons who participate in individual sports will be taxable in Canada on any prizes earned in Canada.[11]

In any event, administrative statements are not law and have been challenged before Canadian courts. The determination of the correct method of allocating income earned in Canada and elsewhere is a question of fact and reasonability. For example, Toronto Blue Jays players will generally allocate income on a 60-40 proportion between the United States and Canada on the basis of the location of performance of services such as training camps and games. In the recent case of *Nonis*,[12] which involved a former general manager of the Toronto Maple Leafs, the CRA had reassessed David Nonis to include in his income for Canadian tax the amounts he received under his employment contract after his termination. Nonis had returned to the United States after his termination. The Tax Court of Canada held that he did not perform any services in Canada after his return to the United States. Therefore, the payments he received during the remaining term of his employment contract were not taxable in Canada.

Another interesting case (while not sports related) on the allocation of income is *Sumner*,[13] which involved the allocation of employment income earned by Gordon Sumner (better known by his stage name Sting) from a North American concert tour, which included several performances in Canada. Sumner provided his services through Roxanne Music Inc., a U.S.-resident loan-out corporation with no permanent establishment in Canada. Sumner had allocated 2.5 percent of his salary from the tour to services performed in Canada on the basis that only six concerts out of the assumed 240-day period of the tour occurred in Canada. The CRA asserted that 9.11 percent of Sumner's salary should be allocated to Canada because this was the percentage of the overall gross revenue of the tour that was generated by the Canadian concerts. The

[6] *Royal Winnipeg Ballet v. MNR*, 2006 FCA 87.

[7] Two different legal regimes coexist in Canada: English common law and French civil law.

[8] RLRQ, c CCQ-1991.

[9] RLRQ, c I-3.

[10] CRA Doc. No. 9601625 (May 28, 1996); CRA Doc. No. 9819311 (Aug. 11, 1998); CRA Doc. No. 2001-0087644 (July 18, 2001).

[11] Some commentators have speculated on whether sportspersons would also be taxable on a portion of any annual prizes or bonuses they earn down the road for points earned over the course of an entire season — of which some were earned in Canada.

[12] *David Nonis v. The Queen*, 2021 TCC 31 (TCC).

[13] *Sumner v. The Queen*, 2000 DTC 1667 (TCC).

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Tax Court of Canada upheld the CRA's reassessment on the basis that Sumner did not demonstrate that the per diem method he used was more accurate than the gross revenue method used by the CRA.[14]

The question of allocation is likely to continue to be the subject of many disputes, especially considering the suspension of regular seasons because of the COVID-19 pandemic and the creation of "bubbles," which required members of sports teams to reside in, as well as play at, a particular location. For example, the 2020 NBA bubble was situated at Walt Disney World in Bay Lake, Florida. Twenty-two out of 30 NBA teams were invited to attend. Likewise, the NHL bubbles that were created in two Canadian cities — Toronto and Edmonton — hosted the 2020 NHL Stanley Cup playoffs. Twenty-four teams, and the league and club personnel, stayed in these two bubbles. These contingencies may indeed skew any historical allocation of income for professional athletes in those leagues.

In light of the intricacies involved in allocating income to a particular source, jurisdictions may disagree on the appropriate allocation. In these cases, full relief of double taxation may be unattainable. For example, if Canada allocates less tax to the foreign country than the foreign country assesses for domestic tax, the Canadian FTC will not provide full relief for the foreign taxes paid. The taxpayer will therefore be subject to double taxation on the portion of income tax paid that exceeds the FTC.

Taxation of Nonresident Employees

If considered employees, nonresident athletes must include in their income, for tax purposes, all remuneration in connection with their employment, including salaries, wages, appearance fees,[15] performance bonuses, fees, allowances and reimbursements related to personal expenses, nondeductible fees such as agent fees,[16] and any other benefits such as benefits related to the free use of an automobile.

A signing bonus paid to an employee is also deemed to be remuneration for services rendered during the period of employment and is included in income when received, notwithstanding that a signing bonus is an inducement to sign an agreement concerning services rather than a payment for actual services.[17] Most tax treaties allow a reduced rate for the taxation of signing bonuses. For example, Article XVI(4) of the Canada-U.S. tax treaty limits Canada's right to tax a signing bonus to 15 percent of the total amount of the bonus paid to a U.S. resident sportsperson playing for a team with regularly scheduled games.[18] The CRA considers a signing bonus to be a payment to induce a player to sign an employment contract.[19] As a result, players who receive signing bonuses in relation to their employment contracts will be subject to a lower income tax rate on their signing bonuses than on their employment income — 15 percent when compared with 53.53 percent.[20]

Nonaccountable allowances, including those used for travel expenses, are also included in income. However, reasonable allowances paid in the context of professional activities, board and lodging during training or tryout periods, would not be included in income unless an athlete traveled from home to a tryout location.[21] Athletes who are employees cannot deduct fines imposed by a league, agent fees or legal fees incurred in the negotiation of player contracts. The cost of equipment is generally not deductible to an employee.[22]

[14]In reaching this conclusion, the Tax Court of Canada noted that Roxanne Music Inc. had deducted 9.11 percent of Sumner's salary from its gross Canadian revenue in computing its taxable income earned in Canada, and that Sumner determined his U.S. taxable income on a gross receipts basis.

[15]CRA Doc. No. 9506595 (May 9, 1995).

[16]*Pavel Bure v. The Queen*, 2000 DTC 1507 (TCC).

[17]Subsection 6(3) ITA.

[18]Typically, league rules limit the amount of a signing bonus that can be paid.

[19]CRA Doc. No. 9819311 (Aug. 11, 1998).

[20]The province of Ontario's top combined marginal tax rate on employment income for 2022.

[21]*Id.*

[22]A deduction is allowed for "the cost of supplies that were consumed directly in the performance of the duties of the office or employment, and that the officer or employee was required by the contract of employment to supply and pay for." This provision has been interpreted narrowly to the extent that it would not allow a deduction for the cost of most "equipment," which the courts distinguish from "supplies."

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Carrying On a Business and 'Other Income'

The tax applicable to "other income" depends on the nature of the payments as well as the relationship between the nonresident recipient and the payer. Athletes who are employees may also earn other types of income, such as income derived from the use of image rights, from endorsements, and from public appearances. This income is not typically considered employment income, even if the athlete is otherwise an employee. Rather, it is generally considered business income.

An athlete who is considered an independent contractor will usually be entitled to deduct reasonable expenses incurred to earn income from the business. For example, an independent contractor can deduct legal fees, agent and advertising fees, accommodation and transportation expenses, as well as fees incurred to purchase equipment or clothes used in the practice of the sport.

Application of Treaties

Another complexity in relation to the taxation of professional athletes is the application of tax treaties. Although income earned by an athlete playing a sport in Canada would be considered taxable in Canada under domestic law, many of Canada's tax treaties provide a limited exemption from Canadian taxation for employment income earned in Canada by a nonresident. While an exhaustive review of Canada's tax treaties goes beyond the scope of this article, the Canada-U.S. tax treaty warrants some discussion.

Canada's tax treaties contain a provision similar to article 17 of the OECD's model convention[23] concerning income derived from the personal activities of an entertainer or athlete. Accordingly, nonresident entertainers and athletes will not usually be entitled to rely on other articles of the treaty to exempt their income from a business or employment from Canadian taxation. The Canada-U.S. tax treaty differs in this respect. It contains several provisions that are unique. Article XVI(1) permits Canada to tax U.S. resident athletes' (and entertainers') income earned for a performance in Canada insofar as the gross receipts derived by the person exceed C $15,000.

In this regard, a special carveout is provided in Article XVI(3) of the Canada-U.S. tax treaty for athletes who compete in regularly scheduled games in both Canada and the United States. This carveout also applies to sports teams. As a result, a U.S. resident player or team is typically exempt from Canadian tax, while a U.S. resident employee of a Canadian team will be subject to tax on the portion of their salary that is attributable to Canada. For example, the New York Yankees and its players are generally not taxable in Canada when they play against the Toronto Blue Jays in Toronto. This provision of the Canada-U.S. tax treaty has been the target of criticism — it is perceived as unfair to Canada because U.S. residents rely on this exemption to a greater extent than Canadians. The treatment is afforded only to U.S. resident athletes who are not physically present in Canada for more than 183 days in a given tax year. For U.S. athletes considered to be independent contractors, all income earned from performances in Canada is taxable, regardless of the time spent in Canada.

Income Tax Mitigation Strategies

A common issue encountered by athletes in North American sports leagues is that they earn substantial amounts of income as employees with massive tax implications. The issue is central to most negotiations between Canada-based sports teams and the nonresident athletes they covet. The ability to defer tax is often at the forefront of these discussions because this may permit Canadian teams to attract talent by reducing income tax rates to a level similar to those enjoyed by members of U.S.-based teams.

Employees are usually taxed on remuneration or benefits when they are received. Commonly used tax deferral plans afforded to Canadian taxpayers, such as registered retirement savings plans, have limited use for professional athletes because of the low contribution threshold of these plans relative to the high income athletes earn. Instead, these athletes and their employers rely on other arrangements to benefit from tax deferral opportunities. The ITA is replete with provisions aimed at preventing the abuse of income deferral

[23] OECD, Model Tax Convention on Income and on Capital 2017 (2019).

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plans. However, some of these income deferral provisions expressly exclude professional athletes playing in major North American sports leagues.

Retirement compensation arrangements (RCAs) are interesting compensation deferral plans for athletes. RCAs allow employers to set aside funds to provide retirement benefits and defer the income recognition for the employee.[24] In essence, contributions made to an RCA bear a 50 percent refundable tax that is withheld from the athlete's salary at source. These contributions must be reasonable.

From a U.S. perspective, U.S. residents will be taxed on their full salary earned in the year without a carveout of any amount diverted to the RCA. This tax is then refunded when the funds are distributed to the athlete on, after, or in contemplation of:

- any substantial change in the services rendered by the athlete;
- retirement of the athlete; or
- loss of employment by the athlete.

[24] Subsection 248(1) ITA.

The athlete is then subject to whichever tax consequences arise from the distribution (for example, withholding tax if distributed to a nonresident or inclusion into taxable income if distributed to a resident of Canada). This can be quite an attractive deferral plan if an athlete is a nonresident at the time of the distributions because any payments out of the RCA would not be taxable in Canada. It could, however, lead to FTC timing mismatches.

Conclusion

The foregoing discussion provides a high-level overview of the Canadian tax treatment of nonresident professional athletes, with a focus on those playing in North American sports leagues. It demonstrates the complexity associated with playing and paying tax in countries around the world. Additional complexity arises in the Canadian context by virtue of the scrutiny Canadian tax authorities exercise over these tax matters. ■

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