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Is Shohei Ohtani's Contract a Smart Play?

The biggest news in sports this past week is Shohei Ohtani's $700 million, 10-year contract with the Los Angeles Dodgers. Aside from the fact that the deal breaks previous records, it's also uniquely structured. Ohtani will earn $2 million a year during the 10 years while he's playing for the Dodgers. After which, he will 'retire' and is scheduled to receive $68 million each year for 10 years. Ohtani's deal defers $680 million in payments until retirement.

Deferring the payments and designating them as 'retirement income' has some risks and benefits. From a federal tax standpoint, there is no advantage and potentially a risk to delaying income. Federal tax rates are scheduled to increase in 2026 and could even be higher in 2033. Another risk is inflation. The value of receiving payments over the next 10 years is greater than starting the payments ten years from now. There's also an opportunity cost associated with investing. By delaying the proceeds of the contract 10 years from now, Shohei potentially loses ten years of investment returns.

However, there is a clear benefit to deferral, and that's the potential to save on California state income taxes. If Ohtani moves out of California at the end of his Dodgers contract, he could avoid paying CA state income taxes on his deferred salary in retirement. California has the highest marginal income tax rates of any state: 13.3% today and the highest rate increases to 14.4% next year.

California taxes the worldwide income of its residents. The state also taxes non-residents on income that is sourced in CA. So how could Ohtani avoid paying CA taxes? The federal government passed a law in 1995 that prohibits states from taxing *non-resident retirement income*. Ohtani's tax attorneys likely understood this when they negotiated to label the bulk of the contract as 'retirement income'. If Ohtani avoids paying California state income taxes, he will save approximately $100 million. However, the California Franchise Tax Board (FTB) is known for clawing back income on taxpayers who move to other states. It remains to be seen how this will transpire in 10 years, but one can imagine that the FTB will aggressively pursue the 'retirement income'.

While playing for the Dodgers, Ohtani will still owe taxes on his $2mm/year salary in California, as well as in most states that he plays games. Earlier this year, we wrote about the entertainer's tax. It's also known as a "jock tax" because professional athletes are frequently impacted. The entertainer's tax applies to non-residents who perform or play in a state, and rates vary by city and state. The entertainer or player pays tax on the portion of income from events in the non-resident state at its marginal income tax rates. Note that Ohtani will avoid entertainer's tax on the bulk of his $700 mil contract by deferring most of the payments to retirement.

Ohtani's contact does draw upon a strategy of deferring income and moving to a lower tax state in retirement. Some highly compensated executives have access to salary deferral and non-qualified compensation plans. Typically, the plans allow one to reduce taxes over time by controlling when income is received. Before negotiating compensation, it's important to model out the alternatives and determine which strategy will meet the taxpayers' objectives based on current and future circumstances.

It is unclear whether the potential $100mm in CA state and entertainment tax savings outweighs the value lost to inflation, the opportunity cost of investing, and the risk of higher federal taxes in the future. Ohtani has placed his bet, and we will see how it works out.

Please reach out to your Wealth Manager with any questions about tax deferral.

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Disclosures