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# Structured Legal Fees and Ohtani's $700 Million Tax Plan

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In this installment of Woodcraft, Wood and Brown examine Generic Legal Advice Memorandum AM-2022-007 and its effect on structuring legal fees. This discussion is not intended as legal advice.

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Plaintiff lawyers who represent clients on a contingent fee basis can generally structure their legal fees to be paid in installments over time. Generally, they can do so in a way that allows the funds to grow on a tax-deferred basis until the fees are paid out. There are many restrictions and requirements, of course, but the practice is common. The key tax authority is *Childs v. Commissioner*.[1]

The IRS never acquiesced in *Childs*, but the IRS cited the decision repeatedly in private letter rulings and seemed comfortable that lawyers could do this. But in December 2022, the IRS took aim at *some* structured legal fees in the controversial Generic Legal Advice Memorandum AM-2022-007 (GLAM).[2] The GLAM is not binding on any taxpayer and is not considered to be published authority on which taxpayers can rely. Yet it seemed reasonable to assume that the GLAM might have a chilling effect on lawyers deferring their fees.

However, plaintiff attorneys generally seem to be structuring legal fees anyway, with some reports suggesting that the GLAM increased the pace, rather than the reverse. Few people seem to have cut back, and some providers of structured fees have reported an uptick.[3]

## Structure, Then Move

One topic that seems to get little attention is lawyers who structure fees and then move states. Some lawyers may be contemplating retirement and may be eyeing the well-publicized tax plan of baseball star Shohei Ohtani. The question for lawyers is whether they can structure fees while living in a high-tax state such as California and then move to a zero- or low-tax state. They might move before the series of structured payments begins or after some — but not all — payments have been made.

The state tax question is whether California can still tax the payments, even though the lawyer would be collecting them while living in Texas or

[1] 103 T.C. 634 (1994), *aff'd without opinion*, 89 F.3rd 856 (11th Cir. 1996).

[2] *See* IRS General Legal Advice Memorandum AM 2022-007 (Dec. 9, 2022).

[3] *See* Robert W. Wood and Alex Z. Brown, "Lawyers Are Structuring Fees Despite IRS Attack," *Tax Notes Federal*, Jan. 22, 2024, p. 675.



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Florida. The general consensus appears to be that moving should not change a taxpayer's California income tax exposure concerning payments received for services performed in California. California imposes tax on a nonresident's California-source income.[4] The task of deciding what is considered California-source income is generally delegated under the California Revenue and Taxation Code to the Franchise Tax Board.[5]

Under this authority, the FTB has long held that income received by nonresidents for services performed while in California is California-source income taxable in California.[6] This California rule is consistent with the federal definition of U.S-source income, which also treats non-U.S. persons as subject to U.S. income tax on compensation for personal services performed while in the United States, even if they collect payment at a time when they reside abroad.[7]

But are these rules different in the case of retirees, who routinely move states when they retire? Particularly for taxpayers who may move states many times during their professional lives, it would seem like a nightmare to apply state tax rules if taxpayers had to figure out how much of their 401(k) or IRA income was on account of compensation for services they performed in different states potentially decades in the past. Thankfully, California offers a reprieve, one that was forced on all states by a federal law enacted in 1996.[8]

## Retirement Living

The California Revenue and Taxation Code contains an exception for "qualified retirement income," which is deemed *not* to be California-source income even if the retirement income relates to services previously performed exclusively in California.[9] For taxpayers with qualified retirement income, they can leave California when they retire. They can then begin collecting retirement income payments, and they can safely pay the FTB nothing on the qualifying payments.

However, the definition of qualified retirement income is rather limited and includes the usual list of qualified retirement programs created under federal tax law, including 401(k) plans, IRAs, 403(b) plans, and so forth. Yet that is not the complete story. After the list of the usual retirement plans, there is a catchall for "nonqualified" plans for retiring employees and partners in partnerships who meet certain requirements.

The requirements for this nonqualified catchall seem to be drafted to ensure that the plan is a bona fide retirement plan, rather than other deferred compensation. For example, the nonqualified plan must be in effect immediately before retirement begins. It must involve "substantially equal" periodic payments made at least annually for at least 10 years or for the life or life expectancy of the retired partner or employee (which can include the life or life expectancy of their designated beneficiary).

Despite the multiple references to retirement, and perhaps the intention that this catchall provision be limited to retirement plans, there appears to be a gap in the California language, which matches the language in the federal law exactly, that allows some ostensibly nonretirement-motivated deferred compensation arrangements to also escape California income tax if received after the employee has left California. To see the gap (some might even say "loophole"), one needs to parse the California and federal language closely.

Let us use Cal. Rev. & Tax. Code section 17952.5(b)(9) as our reference, which contains the nonqualified catchall to the qualified retirement income exclusion. The first, flush language of the section provides that to qualify for the nonqualified catchall, an arrangement must *either* be described in section 3121(v)(2)(C) of the federal Internal Revenue Code *or* be a plan to provide retirement payments to retiring partners in a partnership. The retiring partner provision more clearly references that the plan must relate to retirement, or at least that may be reasonably inferred from the use of the terms "retirement payments in recognition of prior service to be made to a retired partner."

[4] Cal. Rev. & Tax. Code section 17951(a).

[5] Cal. Rev. & Tax. Code section 17954.

[6] Cal. Code Regs. tit. 18, section 17951-5.

[7] *See* IRC section 861(a)(3).

[8] 4 U.S.C section 114.

[9] Cal. Rev. & Tax. Code section 17952.5.



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One might *assume* that the cross-reference to section 3121(v)(2)(C) in the IRC also addresses retirement income. However, it is not so limited, and section 3121(v)(2)(C) merely contains the definition for "nonqualified deferred compensation plan." The federal code section defines a nonqualified deferred compensation plan to include "any plan or other arrangement for deferral of compensation" other than the types of plans generally considered "qualified" retirement plans (for example, 401(k)s, IRAs, and so forth). By citing this federal definition *without* limiting it to retirement plans that are nonqualified deferred compensation plans, the federal law (and the California law that cannot be narrower than the federal law) has created an opening for deferred compensation plans not related to retirement to qualify for the qualified retirement income exception.

The remainder of subsection (9) does little to close the door that is opened by the federal cross-reference to nondeferred compensation plan. There is a requirement in the flush language of subsection (9) that the plan must be in effect immediately before retirement begins, but the language is not worded clearly enough to make unambiguous whether that requirement applies to *both* the arrangements that satisfy the federal definition of nonqualified deferred compensation plan *and* the partner retirement plans, or just the latter. In any event, it seems easy enough to make sure a deferred compensation plan is entered into before retirement (so that it is effective, at the latest, immediately upon retirement), so this requirement hardly seems an encumbrance to the taxpayer.

Nevertheless, satisfying this first set of either-or requirements is not sufficient for a nonqualified deferred compensation plan to escape California taxation. Subsection (9) contains a second either-or test that must be satisfied. Congress (and by extension California) had a second chance with this second either-or test to make sure that only retirement plans (and not other deferred compensation) could qualify as qualified retirement income.

Just as with the first either-or test in subsection (9), they appear to have gotten it half right, if their goal was not to let nonretirement income qualify as qualified retirement income. The second qualifying situation requires that a plan be "maintained solely for the purpose of providing retirement benefits" in excess of the federal or state contribution limits for qualified retirement plans (often called SERP plans).

Also mirroring the first either-or test in subsection (9), it is the first option that drops the ball for ensuring that the qualified retirement income is limited to retirement income. The first option is satisfied by any payment stream that involves:

> a series of substantially equal periodic payments (not less frequently than annually) . . . made for either of the following: (i) The life or the life expectancy of the recipient (or the joint lives or joint life expectancies of the recipient and the designated beneficiary of the recipient) [or] (ii) A period of not less than 10 years.

Imbedded in the catchall's language for the *third* time is yet another either-or test. Here, however, it is the first option that at least has some bearing to a dedicated retirement plan, since it would require that the employee or retiring partner agree to spread out payments over their entire life expectancy. But why bother doing that when the second option is equally good at satisfying the requirement, and much more flexibly only requires that payments be spread out over a period of not less than 10 years? For the third time in the same definition, only half of the either-or test has been limited to retirement income.

Putting these three either-or tests together, it seems that to have nonretirement income treated as qualified retirement income, one must simply structure the compensation to pick the three nonretirement-focused options. That is, a certain worker may need to structure compensation he intends to receive after leaving California to be:

- a nonqualified deferred compensation plan, which essentially means not being a qualified retirement plan identified under federal law, entered into before retirement;
- one that provides for substantially equal periodic payments that are made no less frequently than annually; and
- one that provides for payments paid over 10 years or more.



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It may come as little surprise that structured legal fees are not on the list of qualified retirement income. Under current commercially available structured legal fee arrangements, an attorney who structures fees for legal work in California and who then moves should still be on the hook to California for each payment received through the structure. However, is there a way to refigure a structure fee arrangement to shoehorn it into a nonqualified retirement plan for retiring partners that qualifies for the carveout?

### Ohtani's Tax Plan

As it turns out, Ohtani's contract appears to be nonqualified deferred compensation under federal law that involves payments paid at least annually over at least 10 years. What a nice coincidence that is if he should be a nonresident of California when he receives the larger payments. The baseball phenom's record-shattering $700 million contract is notable from every angle. Even paid out the regular way, it would be big news. But what made the story even bigger was the peculiar nature of the grand-slam-size payout.

Ohtani reportedly deferred most of his salary under his 10-year contract with the Dodgers. His compensation provides for $2 million each year for 10 years, followed by annual payments of $68 million for each of the next 10 years. Does having the same payment amount for 10 years, and then a new amount for the next 10 years satisfy the "substantially equal periodic payments" language in section 17952.5? Should the tax result under the statutory language be different if he signed *two* contracts, one for $2 million per year for 10 years (that is, with exactly equal payments over its full term) and a second contract for $68 million per year for the 10 years after that (that is, also with exactly equal payments over its full term)?

Would it matter if the $2 million payments and the $68 million payments were compartmentalized in formally separate sections of the same overall contract, rather than treated as a single income stream? One thing seems safe to assume: California would probably prefer for its right to tax the $68 million payments each year to not come down to such esoteric questions.

Of course, if the arrangement does meet the statutory definition of qualified retirement income, and he receives some of the payments after leaving California, some sources say it cleverly avoids California's 13.3 percent state income tax, which rose as high as 14.4 percent in 2024, if the star moves out of state before the big money starts rolling in.

Even if California finds a hook to avoid qualified retirement income status, Ohtani may have a tax-related backup position based on a benefit that most professions, including lawyers, do not have: Ohtani travels for work *a lot*. Indeed, he travels more even than most taxpayers who think they travel for work a lot. For the 2023 baseball season, the Dodgers played 162 games, and 81 of them were away games. Although some of those away games may have been to other teams in California, most of them were out of the state. Moreover, the Dodgers' spring training camp is in Glendale, Arizona.[10]

As a California resident, Ohtani is subject to California income tax on his worldwide income.[11] As a result, 100 percent of his paychecks are taxable in California, even if he is being paid for playing baseball in Texas, New York, or Florida. But, to the extent he gets paid after he is no longer a California resident (and assuming he does not qualify for the blanket exclusion for qualified retirement income), he still gets to carve out the work he did outside California. The FTB's residency and sourcing manual, available online,[12] has multiple sections specifically on sourcing the income of professional athletes, at sections 3980, 3985, 3990, and 3995.

The FTB's sourcing manual generally provides that the FTB will look at the athlete's "duty days" during the season, which are all the working days on which a player practices, travels, or plays during the season. That starts with the first day of official preseason training and runs through the team's last game. For determining the

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[10] In addition to the Dodgers and the local Arizona Diamondbacks, the Chicago Cubs, Chicago White Sox, Cincinnati Reds, Cleveland Guardians, Colorado Rockies, Kansas City Royals, Los Angeles Angels, Milwaukee Brewers, Oakland Athletics, San Diego Padres, San Francisco Giants, Seattle Mariners, and Texas Rangers are all Arizona-based teams for spring training as part of the "Cactus League." The other half of baseball's major league teams can be found spring training each year in Florida's "Grapefruit League."

[11] Cal. Rev. & Tax. Code section 17041(a)(1).

[12] California FTB, "Residency and Sourcing Technical Manual" (rev. Nov. 2022).



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percentage of duty days spent in California for allocating the athlete's compensation to California, each duty day is given equal weight.

Therefore, each of the 21 or so days of spring training spent in Arizona each year is given equal weight to 21 home games in Los Angeles. The same is true for each date of traveling outside California between away games. The sourcing manual also provides that endorsement income received by athletes is California-source income to the extent the athlete is required to wear the sponsored items at an event located in California.

Since this apportionment ratio would be applied to nine-digit compensation figures, the tax savings created by being able to apportion his compensation are staggering.

### Backloaded Pay

Ohtani's backloading of his compensation maximizes his possible benefits. For the next 10 years, when he is more likely to still be a California resident, he will receive a total of $20 million ($2 million per year) under the contract. But for the 10 years thereafter, when he may be less likely to be a California resident, he will receive $680 million (*34 times* the amount he will receive over the next 10 years under the deferral). Consequently, he will receive most of his income under his contract when he has the better arguments to reduce or avoid California income tax on that income. It may not matter exactly why this was done, although some reports say that the deferred payout was so the Dodgers could acquire lots of other talent, avoiding baseball's so-called luxury tax. The luxury tax is not a tax in the normal sense, and it is not paid to any governmental entity.

According to Major League Baseball, each year clubs that exceed a predetermined payroll threshold are subject to a competitive balance "tax," commonly referred to as a luxury tax. Those who carry payrolls above that threshold pay to the league a tax on each dollar above the threshold, with the rate increasing based on the number of consecutive years a club has exceeded the threshold. Some say that the luxury tax motivated Ohtani and the Dodgers in striking their unusual deferred pay deal. Others suggest that state tax rates are a bigger play. Time is money and, in this case, there is no interest payable on the deferred pay. Therefore, one could say that a sizable amount of the deferred $680 million is really interest. The tax law (both state and federal) routinely recharacterizes some payments as interest, even if deferred payments do not explicitly involve interest payments, as is occurring here.

In any event, given how (relatively) little Ohtani is being paid now at only $2 million a year, the back end of his contract is huge. It is not hard to imagine California arguing that the timing of the payments in his contract does not fairly reflect the timing of when he provided the associated services, while he will be a resident of the state. To take an even more extreme example, suppose that you agree to be paid nothing for years while you work in California. But you and your employer agree to pay you all your accrued salary and bonuses after you have retired and moved to Florida.

That could require a lot of trust on your part regarding your employer's ability to pay that amount, as well as access to other sources of income and wealth to live off until payday finally comes. Perhaps your employer might pay the accrued salary into a trust to set the funds aside for future payments, resembling a so-called rabbi trust arrangement (because the first taxpayers to request a private letter ruling on the arrangement were a congregation providing deferred compensation for its rabbi). Yet if it goes beyond mere bookkeeping, setting funds aside and protected from the employer's creditors can trigger the economic benefit doctrine, which can trigger immediate income tax to you on the funds set aside for your future benefit.

But let's say that you avoid tripping the economic benefit and other antiabuse doctrines through careful planning. The Golden State may ask if it is fundamentally fair for services performed while a resident of California to be principally or entirely taxed under the more favorable nonresident rules as a result of a significant deferral in the timing of the payment date. It seems California is saying it is not fair, but it is also not clear what rules prevent taxpayers from trying.

*The Athletic* wrote that Ohtani's salary deferral reduces the present value of his contract to $460 million, not the nosebleed figure of $700 million.



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*The Athletic* suggested that only $46 million a year will count toward the Dodgers' luxury tax calculations, instead of $70 million.

## Goodbye California

Will Ohtani's state tax gambit work under California law? I'm sure the star player has big-time tax lawyers, so we are speculating here. It looks to us like Ohtani's tax play has a good chance of working, either under the somewhat more aggressive qualified retirement income position (somewhat weakened by the 34x increase in payments halfway through the payment schedule arguably not being "substantially equal" in amount), or the less aggressive income sourcing rules for services performed outside California. Beyond that, it is unclear. One can argue that California already has the tools to go after Ohtani if he starts collecting the payments after he leaves California.

Nevertheless, California's reaction so far suggests that state tax officials might not be so sure. California has been known to change the law to send tax revenues its way, sometimes even retroactively, such as the 2023 law to retroactively tax certain trusts.[13] However, California appears to be assuming that to collect taxes on deferred pay deals similar to Ohtani's, it would need a change to *federal* tax law, not just state.

In the wake of the Ohtani contract news, California Controller Malia M. Cohen already announced that she wants Congress to change the tax code to cap deferred payments. Cohen's complaint has found a sympathetic ear in the California Senate, which on this past Tax Day passed Senate Joint Resolution 14 calling on Congress to amend the federal legislation that section 17952.5 mirrors, and which section 17952.5 cannot be more limited than, to create a "reasonable cap" on deferred compensation that qualifies under this exception, specifically to avoid the possible tax results of Ohtani's contract. In the joint resolution, the California Senate referenced that Ohtani's contract may qualify under the 10-year deferred compensation arrangement provision as qualified retirement income that could be excludible from Ohtani's California income once he is a nonresident.

By limiting how much compensation for *current* services can be deferred until a post-residency year, more compensation would be taxed while the taxpayer is still a California resident. Cohen and the California Senate asked for Congress to step in over the $700 million Dodgers player contract that awards his whopping $680 million payout for 2034 through 2043. Even without a change in the law, it is possible that California could attack the pay deal as unrealistic for Ohtani's services and as artificially backloaded.

For now, Cohen seems to agree with Ohtani's tax lawyers that the $680 million may slip through California's tax net, and with so many away games, spring training, and travel days to count against California-source income, perhaps a great deal of it. "The absence of reasonable caps on deferral for the wealthiest individuals exacerbates income inequality and hinders the fair distribution of taxes. We would urge Congress to take immediate and decisive action to rectify this imbalance,"[14] Cohen said in a statement.

The Golden State tends to dispute what is sourced in California: when you arrived, when you left, and so on. But with some issues, federal law trumps California, and that is where Ohtani's tax plan might kick in. There were many disputes about retirement pay for decades. For years, people earned a good living in California but left for other states to retire only to find that the FTB was chasing them for California taxes. The federal law effective in 1996 made retirement pay more mobile.

## Are Structured Legal Fees Similar?

Structured legal fees sound awfully boring compared with a baseball star's contract, but is there a way to structure legal fees to piggyback on Ohtani's tax plan? It is hard to find authorities that specifically address the California income tax treatment of structured legal fees. However, there are many examples of income that represent compensation for services where the FTB has

[13] *See* Wood, "Trusts to Avoid California Tax Are Outlawed, Moving Away Still Works," *Forbes*, Aug. 14, 2023.

[14] State Controller Malia M. Cohen, "Controller Cohen: Statement Regarding Ohtani Contract," California State Controller's Office (Jan. 8, 2024).



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enunciated a clear position. They suggest that California generally treats compensation for services performed in California as California-source income, regardless of when and where it is paid, apart from the qualified retirement income exception imposed on California by federal law.

California continues to tax income for the performance of services in California that is paid much later, even after the death of the person who rendered the services.

Given the potential stakes, it may be worth investigating whether a structured legal fee could be designed with California income tax savings in mind. Because many attorneys are partners in their firms, one avenue to consider would be whether a structured fee could be designed to qualify for the nonqualified retiring partner arrangement definition for the qualified retirement income exception in section 17952.5. Because the structured fee is not being paid by the partner's firm, this may be difficult to do — if possible at all.

Of course, Ohtani's contract, and California's near panic about it, suggests the easier route for attorneys would be to try to qualify under the nonretirement-based provisions. That is, it does not seem difficult to imagine a structured legal fee also being a form of nonqualified deferred compensation that can involve substantially equal payments paid at least annually over at least 10 years. If Ohtani's contract is proven to satisfy this set of requirements, one can imagine structured legal fees being similarly tailored to meet these not particularly difficult requirements. If California believes that congressional action would be needed to stop Ohtani's contract from avoiding California income tax once Ohtani is no longer a resident, then, at least in the current political climate, that suggests the qualified retirement income strategy may be viable indefinitely for attorneys, too, if it is confirmed that it is already viable for Ohtani.

Still, a more modest alternative would be to rely on income sourcing. Although an attorney may be a resident of California, they may practice law in other jurisdictions and have trials in other jurisdictions. Even for California trials, depositions and other discovery work may be conducted on-site outside California. By deferring recognition of the fee income until the attorney is a nonresident, the attorney may be able to allocate some of the fee income away from California.

Cal. Code Regs. (CCR) section 17951-5 provides rules for allocating wages, salaries, and other compensation received by employees for services performed within California. For attorneys, accountants, doctors, and so forth, CCR section 17951-5(a)(3) provides that fees and other compensation received for services performed in California are California-source income. If the structured fees were received for services performed both within and outside California, income would be allocated to California based on the ratio of the number of days services were performed in California divided by the total number of days services were performed.[15]

If structured legal fees are considered as earned by a passthrough entity law firm rather than by an individual attorney, the tax treatment of the income flowing through to the individual attorney is California-source income if the income is California-source income at the law firm level. Therefore, if the law firm receives fees for services the law firm provided in California, then the fees would be considered as California-source income to the firm's partners, even if a partner receiving allocations of the income is a nonresident or if the firm were not considered to be a California business.

CCR section 17951-4(a) provides that the net income from a nonresident's business, trade, or profession carried on wholly within this state is California-source income. Conversely, if a business operates entirely outside California, then none of its income is considered California-source income.[16] For a business that operates partially within California and partially outside California, California uses market-based sourcing, which it calls the "single sales factor" method to apportion many types of business income, including compensation for services.

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[15] *Paul L. and Joanne W. Newman v. FTB*, 208 Cal. App. 3d 972 (Cal. Ct. App. 1989).

[16] CCR section 17951-4(a).



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### Unitary and More

Consistent with this rule, CCR section 17951-4(d) provides that if a nonresident is a partner in a partnership that carries on a unitary business, trade, or profession both within and outside California, the partner's distributive share sourced to California is comprised of business income apportioned and nonbusiness income allocated to California. This framework essentially means that law firms that have at least some operations or employees based outside California may be able to allocate some of their income outside California based on the single-sales-factor allocation rules.

Under the single-sales-factor allocation method, a business's compensation for services is sourced to California if the purchaser of the service (that is, the firm's client) receives the benefit of the services in the state.[17] Therefore, if the law firm has non-California clients and/or if the litigation occurs outside California, some law firms allocate their income. A law firm that must allocate its income may be able to assert that some of their fees related to clients who received the benefit of their services outside California.

These allocation rules seem moot if the partner picking up the income is a California resident when they pick up the firm's income. Nevertheless, if the firm can defer receiving payment for their services until the partner is a nonresident, these allocation rules can help the nonresident partner shave off the portion of the income allocation from the firm that is allocable outside California.

### Statutes of Limitation

Some taxpayers who move out of California may feel comfortable ceasing to file returns and running the risk of audit, particularly if they have no other California-source income that requires reporting. A taxpayer who is already filing a nonresident return that reports some California-source income may perceive more risk. It is also generally more difficult for the FTB to attack the reasonableness of a specific allocation amount than it is for the FTB to attack a taxpayer's reporting who reports nothing as California-source income. And all tax returns must be signed under penalties of perjury.

The IRS statute of limitations is generally three years after you file a tax return. In California, the FTB is allowed a minimum of four years to audit. But if you never file a California return for a particular year, there is no statute of limitations. If you leave California and stop filing returns, the FTB can audit with no time constraints. It can examine your residency status and whether you have California-source income that you failed to report. All these reasons can make filing a nonresident return reporting California-source income a smart move.

It is common knowledge that California regularly audits people who leave, especially if they collect a big payday shortly thereafter. Moving in the same year as the payday is particularly likely to attract FTB attention. A part-year tax return will show the California income before the move and the balance of the income post-move. If there is a spike in income — say a big capital gain on which California is not collecting — the FTB may inquire further into the timing and bona fides of the move.

### Later Payments, Ceasing Business

As described above, the sourcing of business income depends on where the business is conducted, either entirely within California, entirely outside California, or partially both. But what if a law firm or a solo attorney ceases to do business in California between when the fee is earned and when the fee is paid? If the sourcing is determined at the time the income is earned (while the firm or attorney does business in California), then the fees would be subject either to the rule regarding business conducted entirely within California or the rule for business conducted both in or outside California.

Either of those usually means at least some California income. However, if the sourcing for business income is determined at the time the firm receives the fee, then it is possible the fee should not be considered California-source income. If the firm or attorney does not do business in California at that time, then perhaps the fee should not be California-source income under CCR section 17951-4(a).

[17] Cal. Rev. & Tax. Code section 25136(a)(1).



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There appear to be no authorities applying these rules to structured legal fees. But analogous and related authorities suggest that the source of fee income is determined at the time the fees are earned, not at the time the fees are paid. These authorities indicate that structured fee payments for legal services provided in California would retain their characterization as California-source income, even if the payments are received once the firm was no longer doing business in California.

For example, California regulations provide that:

> nonresident attorneys . . . even though not regularly engaged in carrying on their professions in [California], must include in gross income as income from sources within this State the entire amount of fees or compensation for services performed in this State on behalf of their client.[18]

This regulatory language specifically addresses legal fees received by nonresident attorneys for services performed in California. It indicates that the location where the services were performed takes precedence over the attorneys' residency status.

California also taxes the installment proceeds received by a nonresident if the income from the sale was from a California source, even if payments are received while the recipient is nonresident. For intangible property like intellectual property, California regulations provide that the source of gains and losses from the sale or other disposition of intangible personal property is determined at the time of the sale or disposition of that property.[19]

Additionally, California continues to tax income for the performance of services in California, later paid as a royalty to a nonresident. One case says that California can continue to tax California-source income even after the death of the person who originally rendered the personal services.[20]

One context in which compensation for services performed in California is received after a taxpayer leaves California is the context of deferred and equity compensation plans. For example, a California employee may be granted nonqualified stock options while working in California but not exercise those options until after moving to another state. When the options are exercised, the employee must generally recognize compensation income equal to the difference between the strike price for the option and the fair market value of the underlying equity on the exercise date.[21]

For California purposes, when the nonresident exercises the option, the resulting compensation must be allocated between California and other jurisdictions based on where the taxpayer performed the services for which the stock option was intended to compensate the employee.[22] That is often done by comparing the working days spent in California versus other jurisdictions for the period between the date of grant of the option and the date the option was exercised.[23] Similar allocation rules have been applied to other deferred compensation plans, including employee stock purchase plans[24] and restricted stock options.[25]

Payments to employees from nonqualified deferred compensation plans, such as performance incentive plans, long-term incentive plans, and deferred bonus plans (including stock appreciation rights and phantom stock) are also considered compensation for services under Rev. & Tax. Code section 17071. California does not distinguish between the portion of a payment from a deferred compensation plan that is deemed to be distributed from employer contributions and funds from the plan earnings.[26]

These authorities take the view that deferring compensation for services performed in California until the taxpayer is no longer a California resident is generally ineffective for

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[18] CCR section 17951-5(a)(3).

[19] *See* CCR section 17952(d).

[20] *Appeal of the Estate of Marilyn Monroe, deceased*, 1975-SBE-032 (Apr. 22, 1975).

[21] *See* Treas. reg. section 1.83-7.

[22] *Appeal of Charles W. and Mary D. Perelle*, 1958-SBE-057 (Dec. 17, 1958).

[23] *Matter of Sullivan*, Case No. 610943 (Feb. 26, 2014).

[24] *Matter of Gene L. Clothier*, Case No. 27809 (June 30, 2000).

[25] FTB Chief Counsel Ruling 2014-01.

[26] *See* Residency and Sourcing Technical Manual, section 3225.



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avoiding characterization as California-source income. However, as Ohtani reminds us, the same is not true for services performed outside California but while a California resident or for "qualified retirement income."

Rev. & Tax. Code section 17952.5 provides that gross income of a nonresident from sources within the state does not include "qualified retirement income" received on or after January 1, 1996, even if the taxpayer worked entirely in California to earn the qualified retirement income. Nevertheless, the nonqualified plan catchall in the definition of a qualified retirement income seems to allow payments from certain retirement-related (and notably here, arguably nonretirement-related) *nonqualified* plans to also avoid California tax when received by an employee or retired partner.

## Conclusion

Timing is critical in many tax matters. And particularly in the context of residency and sourcing issues, that is especially true. Looking past the vast amount of Ohtani's compensation, the main feature of his contract is a change in timing. Yet Ohtani's agreement to be paid later was sufficient to cause representatives of California's government to express public frustration and calls for federal action.

We do not know the precise reason Ohtani's compensation was structured the way it is. But it serves as a reminder that even if compensation is fully taxable in California when received now as a California resident, the outcome may be different if the compensation is not received until after leaving California. There is inevitably some line-drawing, and there are likely some people who move out of California and fail to report California-source income.

But for someone who manages to qualify, it is alluring to avoid California income tax altogether if the compensation is received as part of a qualifying (but formally "nonqualified") retirement plan. For taxpayers in the fortunate situation of not needing immediate payment for pressing necessities, patience and thoughtful planning can pay dividends — or even be a home run. ■

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