

Tax Concepts Affecting the Foreign Athletes and Entertainer

Performing in the United States

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In August 2007, the I.R.S. and the Treasury issued a comprehensive report entitled “Reducing the Federal Tax Gap: A Report on Improving Voluntary Compliance.”¹ The report included a recommendation to initiate a project on foreign entertainers and athletes to ensure appropriate reporting and sourcing of income as part of a program to address cross border compliance risks.

In October 2007, the I.R.S. announced the launching of a compliance initiative aimed at foreign entertainers and athletes working in the U.S. The I.R.S. website states that the initial focus will be on those engaged in tennis, golf and music as these individuals and those associated with arranging their appearances in the U.S. and managing their financial affairs are typically high-income taxpayers. The I.R.S. withholding program manager is reported to have said that the I.R.S. is concerned that foreign entertainers

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and athletes are not paying their fair share of withholding tax and fail to comply with the proper reporting for earnings in the United States.

In these days of globalization, other nonresident professionals such as accountants, architects and lawyers can also derive big paychecks from the performance of personal services in more than one country. So why does the I.R.S. have entertainers and athletes firmly in their sights? The answer would seem to be that entertainers and athletes can earn huge amounts of diverse types of income related to the services they perform as entertainers and athletes. They are some of the most mobile individuals in the business world. These individuals can earn substantial amounts of money in a country within a short period of time without ever establishing a fixed base in that country. Since many international athletes and artists live in low-tax or no-tax jurisdictions but earn their money in higher taxed countries, the latter jurisdictions want to stop any tax leakage. Instead, the goal is to tax all the income earned within their respective borders because they know that the income may not be subject to tax in any other jurisdiction.

For the tax adviser to the foreign entertainer or athlete, the combination of these initiatives and reliance on the “old way” of doing things can be problematic. This paper will address the various issues that an adviser to a foreign entertainer or athlete must consider when sitting down to begin tax planning on behalf of a foreign entertainer or athlete in connection with an event or a tour in the U.S.

Determination of Residence Status Under Domestic Law

The starting point for any discussion regarding foreign entertainers and athletes is whether the individual is actually foreign. In other words, has the individual been in the U.S. for enough time to be considered to be a U.S. resident under the substantial presence test. For persons who make movies in the U.S., or who are on tour, such as professional golfers and tennis players or musicians, triggering resident status is not difficult under the objective standard of current law. If tax residence exists, the entire set of tax paying and reporting rules applicable to residents may apply, including:

- The Subpart F rules,
- The foreign grantor trust rules,
- The information reporting rules and accompanying penalties for failure to comply, and
- The foreign financial account reporting rules.

Hence, the starting point must focus on whether the foreign entertainer or athlete has stumbled into U.S. tax residence.

There are two tests for determining U.S. residence for income tax purposes. These are the “substantial presence” test and the “green card” test. If an individual meets the conditions of either test, he will be considered to be a resident for income tax purposes.² For most foreign entertainers and athletes, the green card test is irrelevant. Thus, we focus on the substantial presence test.

Under the substantial presence test, a foreign individual is treated as a U.S. resident for income tax purposes if he or she is present in the U.S. 183 days or more during a rolling 3-year period. The period begins anew for each year and comprises the second preceding year, the immediately preceding year, and the current year.³ The individual must also be present for at least 31 days in the current year.⁴

An individual is treated as being present in the U.S. on any day that he or she is physically present at any time during the day. It does not matter how short a period is involved. In computing the days present in the U.S., a weighting formula is applied under which days in the current year are given greater weight than days in the earlier two years. Days in the current year are fully weighted, days in the first preceding year are afforded a one-third weight, and days in the second preceding year are afforded a one-sixth weight.

² Code §7701(b)(1)(A).

³ Code §7701(b)(3)(A)(ii).

⁴ Code §7701(b)(3)(A)(i).

In determining whether a foreign individual meets the substantial presence test based on days present in the U.S., certain days are excluded and are not counted as days present in the United States. These are days on which the individual is an “exempt individual.”⁵ Certain athletes can qualify as exempt individuals under a special rule directed principally at golfers. An exempt individual includes, *inter alia*, an individual who is a “professional athlete who is temporarily in the U.S. to compete in a charitable sports event described in section 274(l)(1)(B)” of the Code. This section refers to any sports event:

- That is organized for the primary purpose of benefiting an organization that is described in Section 501(c)(3) and exempt from tax under Section 501(a) (e.g., a qualified charitable organization);
- All the net proceeds of which are contributed to such organization; and
- That uses volunteers for substantially all the work performed in carrying out such event.

For purposes of computing the days of presence in the U.S., only days on which the athlete actually competes in a charitable sports event are excluded. Thus, days on which the individual is present in the U.S. to practice for the event, to perform promotional or other activities related to the event, or to travel between events are included for purposes

⁵ Code §7701(b)(3)(D)(i).

of calculating whether that individual is present in the U.S. for 183 days over the applicable measuring period, *viz.*, the rolling three-year period ending with the year in issue.

An alien individual who excludes days of presence in the United States as a professional athlete must file Form 8843 (Statement for Exempt Individuals and Individuals With a Medical Condition). The form is due with tax return for the year. Failure to file the form may cause the days to be counted toward residence under the substantial presence test. On the form, the athlete must attach a statement to the form verifying that all of the net proceeds of the sports events are contributed to the charitable organizations listed. No comparable exclusion exists for foreign entertainers.

A foreign entertainer or athlete who meets the substantial presence test may nevertheless be considered to be a nonresident with regard to the current year if he or she can demonstrate that closer connections are maintained to another, single, foreign country.⁶ To come within this exception, three conditions must be satisfied.

- First, the individual must be present in the U.S. for fewer than 183 days in the current year. Thus, this exception applies to persons who are in the U.S. for more than 183 days during the rolling 3-year period, computed in light of the weighting rules discussed above, and who are present for up to 182 days in the current year.

⁶ Regs. §301-7701(b)-2(a).

- Second, the individual must maintain a tax home in a foreign country during the year. The concept of a tax home originated in the context of the deduction of travel expenses incurred while away from home. While there is no uniform definition in the Court cases, and the view of the I.R.S. is somewhat different from that of many Courts, in broad terms a “tax home” is the place where a person generally should live in light of his employment responsibilities. Thus, if a person works in New York, it is reasonable for him to have a home in the New York area; expenses incurred in New York ordinarily would not be deductible. Living expenses incurred while temporarily outside New York would be deductible. However, if a person generally works in Los Angeles, but takes a short-term assignment in New York that is scheduled to last for less than one year, it ordinarily would not be reasonable for him to permanently move to New York. His “tax home” ordinarily would continue to be Los Angeles. Expenses incurred while in New York temporarily then would be deductible. As a general rule, a person does not have a tax home if an assignment in a new location exceeds one year.⁷ Finally, if a person merely moves from job-to-job, staying at each place only temporarily, his “tax home” would be wherever he happened to be at the time.⁸

⁷ Code §162(a)(2).

⁸ See I.R.S. Publication 17 (Your Federal Income Tax for Individuals), Chapter 26 (Car Expenses and Other Employee Business Expenses).

- Third, the individual must have a closer connection during the year to a single foreign country in which he or she also maintains a tax home than the connections maintained to the U.S. In some circumstances, the closer connection may be with more than one country during the year, if for example, the individual's tax home is changed.

To meet the last requirement, the individual must demonstrate that he or she has maintained more significant contacts with the foreign country than with the U.S. The regulations look to the following factors:

- The location of the individual's permanent home;
- The location of the individual's family;
- The location of personal belongings, such as automobiles, furniture, clothing and jewelry owned by the individual and his or her family;
- The location of social, political, cultural or religious organizations with which the individual has a current relationship;
- The location where the individual conducts his or her routine personal banking activities;

- The location where the individual conducts business activities (other than those that constitute the individual's tax home);
- The location of the jurisdiction in which the individual holds a driver's license;
- The location of the jurisdiction in which the individual votes;
- The country of residence designated by the individual on forms and documents; and
- The types of official forms and documents filed by the individual, such as Form 1078 (Certificate of Alien Claiming Residence in the United States), Form W-8BEN (Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding) or Form W-9 (Payer's Request for Taxpayer Identification Number).

A filing requirement is a condition of coming within this exception to residence under the substantial presence test.⁹ Form 8840 (Closer Connection Exception Statement for Aliens) is used to claim the closer connection exception. Because no single factor is controlling, the closer connection test is a relatively touchy-feely test that generally fails to eliminate uncertainty as to residence. As a result, it is possible that tax return preparers

⁹ Regs. §301-7701(b)-2(g).

will insist that full disclosure of the inherent uncertainty must be made in connection with the preparation of Form 8840 in order to avoid a tax return preparer's penalty under Code §6694. That section was recently amended in a way that grafts many of the concepts of FIN 48 onto the tax return preparation process.

The Small Business and Work Opportunity Tax Act of 2007 ("the Act"), Pub. L. No. 110-28, 121 Stat. 190, amended several provisions of the Code to, *inter alia*, alter the standards of conduct that must be met to avoid imposition of a preparer's penalty for preparing a return that reflects an understatement of liability and to increase the amount of the penalty. For undisclosed positions, the Act replaced the "realistic possibility" standard with a requirement that there be a "reasonable belief" that the tax treatment of the position would more likely than not be sustained on its merits. For disclosed positions, the Act replaced the "nonfrivolous standard" with the requirement that there be a "reasonable basis" for the tax treatment of the position.

A tax return preparer is considered to reasonably believe that the tax treatment of an item is more likely than not the proper tax treatment if – without taking into account the possibility that the tax return will not be audited, or that that an issue will not be raised on audit, or that an issue will be settled – the tax return preparer analyzes the pertinent facts and authorities and, in reliance upon that analysis, reasonably concludes in good faith that there is a greater than fifty percent likelihood that the tax treatment of the item will be upheld if challenged by the I.R.S.¹⁰

¹⁰ See proposed §10.34 of Circular 230 dealing with the obligation to disclose positions that are not more likely than not to succeed. See also Regs. § 1.6662-4(d)(3)(ii) regarding the process for determining whether a reasonable belief

Hence, when the factors listed in the text at n.6 are looked at, it is possible that a tax return preparer may question whether there is more than a fifty percent possibility that a closer connection will exist with a foreign country, especially if the preparer does not often deal with these issues. In these circumstances, reliance on a tiebreaker test of an income tax treaty to determine the residence of an entertainer or athlete may provide greater certainty.

Determination of Residence Under Treaty

In many instances, an individual contends that an income tax treaty obligation of the U.S. mandates a result that is more favorable than U.S. tax law. Where this contention arises, the first obligation of the tax adviser is to determine whether the claim of residence is valid. The failure to do so proved fatal for a heavy weight boxing champion who contended that he was a resident of Switzerland.

Johansson v. United States,¹¹ involved the residence of a foreign athlete, Ingemar Johansson, who fought three times in the U.S. during the middle part of the 20th Century. Mr. Johansson was a citizen of Sweden and had significant contacts in that country. Nonetheless, he moved to Switzerland to obtain favorable tax treatment and obtained a

exists that a position is more likely than not to succeed and its application to Code §6694(a) as a result of Notice 2008-13 in lieu of the need to file a Form 8275 in certain circumstances.

¹¹ 336 F.2d 809 (5th Cir.1964), affg. *United States v. Johansson*, (Docket No. 10,588-M, SD Fl., Dec. 14, 1961) reported unofficially at 62-1 USTC Para 9130, and 8 AFTR 2d 6001.

ruling from the Swiss tax authorities that he was properly treated as a resident of Switzerland. On that basis, he claimed benefits under the Switzerland-U.S. Income Tax Treaty then in effect which would have eliminated his U.S. tax. The Appeals Court confirmed a District Court's opinion that Mr. Johansson was not a resident of Switzerland within the meaning of the treaty. In pertinent part, the Courts evaluated his facts under U.S. standards and found his claim of residence to be lacking credibility. The Appeals Court stated as follows on this point:

In the year and a half between the date Johansson claims to have moved to Switzerland and March 13, 1961 [the date of the boxing match in the U.S.], the record shows that he spent only 79 days in that country as compared with 120 days in Sweden and 218 days in the United States. Except for his activities in the United States during this period, his social and economic ties remained predominantly with Sweden. Indeed, the summary of Johansson's ties with Switzerland presented in his brief to this Court cites only his maintenance of an apartment and bank account there, his self-declaration of residence, and two acts by the Swiss government that may well have been predicated entirely upon his self-declaration of residence.

Once residence in Switzerland was ignored, Mr. Johansson found that his boxing winnings were taxable in the U.S. because the treaty benefit was inapplicable.

If the U.S. tax adviser is satisfied that an individual is a resident of a treaty jurisdiction, the individual will be entitled to all the benefits provided under the treaty. Although the substantive tax benefits of an income tax treaty will be discussed below in the context of an entertainer or an athlete, one administrative benefit is that the treaty may override U.S. domestic tax rules applicable to residence of aliens. As a result, even though a foreign individual may be deemed to be a resident of the U.S. under domestic U.S. tax law, the individual may, nonetheless be taxed as if he were a nonresident with regard to the U.S., if so mandated by treaty in light of the circumstances presented.

With limited exception, the income tax treaties of the U.S. now in effect contain a residence provision that establishes the standard for determining the residence of individuals and corporations. Residence status is important because only residents qualify for the benefits provided by the treaty.

Ordinarily – and subject to the holding in *Johansson* – if an individual is taxed as a resident of a treaty country for purposes of the domestic tax laws of that country, the individual will be treated as a resident of that country for purposes of the income tax treaty. Where, under the respective domestic tax laws of the treaty countries, the individual is treated as a resident, he or she is potentially subject to double taxation of

income. This type of individual is commonly referred to as a “dual resident.” The residence article of an income tax treaty generally contains a tiebreaker provision under which the dual resident individual is classified as a resident of one, and only one, country for purposes of the income tax treaty.¹² In that way, the tiebreaker provisions of an income tax treaty overrides U.S. domestic law.¹³

Under the tiebreaker provision, a series of tests is applied in a specific order to the particular facts and circumstances of the dual resident. Once the individual’s residence is determined under a particular test, there is no need to proceed to another test. Thus, the tiebreaker rule of a treaty provides greater certainty than the closer connection test of domestic law.

In general, exclusive residence is determined by applying the following tests in the following order:

- First, the individual is deemed to be a resident of the country in which a permanent home is available;
- If the individual has a permanent home in both countries or in neither country, he will be deemed to be a resident of the country with which his

¹² See, for example, Article IV (Residence) of the Canada-U.S. Income Tax Treaty and Article 4 (Residence) of the U.K.-U.S. Income Tax Treaty.

¹³ H.R. Rep. No. 432 (Part 2), 98th Cong., 2d Sess. 1528 (1984).

personal and economic relations are closer -- this is known as the center of the individual's vital interests;

- If the closer economic relations cannot be determined, the individual will be a resident of the country in which he has an habitual abode; and
- If he has an habitual abode in both countries or in neither one, he will be deemed to be a resident of the country of which he is a national.

If the issue cannot be settled by the application of these tests, the competent authorities of both countries will decide by mutual agreement the country of which the individual will be considered an exclusive resident.

Because the tiebreaker test is applied in specific order, it provides greater certainty than the closer connection test. Moreover, where an individual has contacts in both countries and is present for significant time periods in both countries, the final test based on nationality is often determinative.

Compensation Income of Nonresident Alien Individuals

The United States taxes nonresident entertainers and athletes in the same manner as other nonresidents on U.S. source income. A nonresident alien may be subject to tax in two ways. First, income that is effectively connected with a trade or business in the United

States is subject to ordinary income tax at the same graduated rates and alternative minimum tax that apply to U.S. citizens and resident aliens. Second, U.S. source income that is not effectively connected with a trade or business is taxed at a flat rate of 30 percent, a rate that may be reduced by an applicable income tax treaty.

Code §§861(a)(3) and 862(a)(3) generally treat income from labor or personal services as having a source in the place in which the services are performed. The theory underlying this source rule is that the place in which the services are performed is the situs of the economic activity giving rise to the income. Thus, income from services performed within the U.S. is generally U.S. source income. Similarly, income from services performed outside the U.S. is generally foreign source income. The identity or residence of the payor, the location of the payroll, and the residence of the service provider are not relevant factors in determining the source of compensation income. In general, income derived from the performance of services is treated as U.S. source income to the extent the services are performed while the service provider is physically present in the United States.¹⁴

The Code provides an exception to the source rule for service income in the context of persons temporarily present in the United States and earning a *de minimis* amount of income in the U.S. Under Code §861(a)(3), income from services performed in the United States is not treated as income from U.S. sources if:

¹⁴ Code §861(a)(3) .

- The income is derived by a nonresident alien individual temporarily present in the United States for one or more periods not exceeding 90 days during the taxable year;
- The total income does not exceed \$3,000; and
- The services are performed as an employee of, or under a contract with:
 - A nonresident alien, foreign partnership, or foreign corporation not engaged in a U.S. trade or business; or
 - For a foreign office of a U.S. citizen, resident, domestic partnership, or domestic corporation.

Code §864(b)(1) provides a parallel exception with regard to the U.S. trade or business status of a nonresident alien employee or independent contractor under which the nonresident alien individual performing temporary services is not considered to be engaged in a U.S. trade or business by virtue of the performance of such services.

The Code exception has limited application for obvious reasons. In particular, in the case of nonresident entertainers and athletes, the \$3,000 limitation may not be enough to cover a suite at the Waldorf for one night, excluding breakfast. The exemption falls away entirely if the income exceeds \$3,000, whether or not received in the year that the

services are provided,¹⁵ or if the individual is present in the United States for more than 90 days during that taxable year.

It can be seen that a nonresident entertainer's salary, fees, wages, compensation, bonuses, or in the case of an or athlete, prize winnings received for performances in the United States will generally constitute effectively connected U.S. source income which will be taxed at the applicable Federal graduated rates. Deductions will be allowed to the extent allocable or apportionable to the U.S. source effectively connected income. If a nonresident alien performs services inside and outside of the U.S., deductions for expenses incurred may be apportioned between U.S. source taxable income and foreign-source tax-free income. Allocation of income is discussed below.

Comparable provisions exist in U.S. income tax treaties for dependent personal services, albeit with greater thresholds that must be achieved before compensation can be taxed. Thus for example, Article 14 (Employment Income), Paragraph 2 of the U.K.-U.S. Income Tax Treaty provides as follows in pertinent part:

[R]emuneration derived by a resident of a Contracting State in respect of an employment exercised in the other Contracting State shall be taxable only in the first-mentioned State if:

¹⁵ Regs. §1.864-2(b)(3), Ex.2 .

- a) the recipient is present in the other State for a period or periods not exceeding in the aggregate 183 days in any twelve-month period commencing or ending in the taxable year or year of assessment concerned;
- b) the remuneration is paid by, or on behalf of, an employer who is not a resident of the other State; and
- c) the remuneration is not borne by a permanent establishment which the employer has in the other State. [Emphasis supplied.]

Similarly, Article XV (Dependent Personal Services) of the Canada-U.S. Income Tax Treaty provides as follows:

Notwithstanding the provisions of paragraph 1, remuneration derived by a resident of a Contracting State in respect of an employment exercised in a calendar year in the other Contracting State shall be taxable only in the first-mentioned State if:

- (a) Such remuneration does not exceed ten thousand dollars (\$10,000) in the currency of that other State; or

- (b) The recipient is present in the other Contracting State for a period or periods not exceeding in the aggregate 183 days in that year and the remuneration is not borne by an employer who is a resident of that other State or by a permanent establishment or a fixed base which the employer has in that other State.

However, these provisions generally do not apply to entertainers or athletes resident in a treaty jurisdiction because treaties generally have provision that specifically address the taxation of these individuals. Thus, Article XVI (Artistes and Athletes) of the of the Canada-U.S. Income Tax Treaty, provides that the compensation of an artiste or athlete is taxed if it exceeds \$15,000 measured in the currency of the relevant country, and Article 16 (Entertainers and Sportsmen) of the U.K.-U.S. Income Tax Treaty, provides that the compensation of entertainers and sportsmen is taxed if it exceeds \$20,000 or its equivalent in U.K. funds. The 2006 U.S. model treaty provides an exempt amount of U.S. earnings for artists and sportsmen of \$20,000 per taxable year. The entertainers and athletes provisions in U.S. income tax treaties apply only to those persons who receive compensation from the performance of services as an entertainer or an athlete. Directors, producers, technicians, managers, coaches, cameramen, and the like are covered by the personal services articles of a treaty.

Allocation of Compensation Income

Where a foreign individual such as an entertainer receives income from a series of events, such as a North American tour that has venue sites both in the U.S. and foreign countries,

the income from the performance of services must be allocated between U.S. and foreign sources. Only the former is taxable.

In general, if an individual performs labor or personal services as an employee, the source of the individual's compensation is generally determined on a time basis, with certain fringe benefits sourced on a geographic basis. An individual may determine the source of his or her compensation under an alternative basis if it is established to the satisfaction of the I.R.S. that, under the facts and circumstances of the particular case, the alternative basis more properly determines the source of the compensation.

This was the situation in the case of *Stemkowski v. Commissioner*.¹⁶ In this case, the Court held that the salary paid to a nonresident alien Canadian professional hockey player who worked under a one-year contract with a club located in the United States was allocated to sources both within and without the United States on the basis of the number of days in the regular season of play plus the number of days spent in training camp and the number of days spent in the play-offs. The player's contract was held not to cover the off-season period. Thus, the formula for gross U.S. source income was (1) number of regular season, training camp, and play-off days spent in the U.S., divided by 365 days less the off-season period, multiplied by (2) the total contract compensation. The allocation of income provisions set out by the court in this case were later adopted by the I.R.S. in Rev. Rul. 87-38¹⁷ which also involved a Canadian hockey player.

¹⁶ *Stemkowski v. Commissioner*, 690 F2d 40 (2d Cir. 1982).

¹⁷ Rev. Rul. 87-38, 1987-1 CB 176.

Recently, the I.R.S. proposed regulations designed to require the apportionment on an “events basis”¹⁸ in an attempt to modify the allocation formula used in *Stemkowski*. The proposed regulations establish a general rule that the location of the event and the revenue generated at the event will control the source of the income of the entertainer. In conflict with the holding in *Stemkowski*, neither pre-season time nor post-season time is taken into account in determining the source of income of an athlete from compensation for the regular season. Extra payments for pre-season or post-season are sourced by the events performed in each separate time period. For an entertainer, preparation time is irrelevant for determining the source of income derived from a performance.

The proposed regulations also provide that, for an entertainer who receives a fixed amount for the tour, the number of events is not relevant to determining the source of the compensation income. Rather, the relative amounts of revenue generated from U.S. and foreign events will be controlling. This emphasis on revenue appears somewhat inconsistent with the general concept of the “events basis” because it goes beyond a time apportionment or even an events apportionment and adopts a “gate” apportionment. Because of this inconsistency, a foreign tax authority may not accept the position in the proposed regulations in the context of a performer’s compensation that is fixed. In such case, the source of the revenue in a treaty context may ultimately be determined through competent authority relief.

¹⁸ Proposed Regs. §1.861-4(b)(2)(ii)(G) and (c) Examples 7 through 10, proposed on October 17, 2007.

Taxation of Endorsement Income

Of course, not all income received by a foreign entertainer or athlete will fall into the categories of salary, appearance fees, wages, compensation, or bonuses. Many top foreign stars will receive the majority of their earnings from endorsement or sponsorship deals.

Endorsement income arises when a payment is received by a foreign artist or athlete from a manufacturer or service provider in return for the use of the entertainer's or athlete's name or image in the marketing of a product or service. In the U.S., sponsorship income arises when there are payments made to a foreign entertainer or athlete under a sponsorship contract related to a period when the foreign entertainer or athlete performs in the United States. For example, it occurs when a golfer appears at the U.S. open wearing a cap bearing the name of a sponsor, or using the sponsor's make of golf clubs. The total sponsorship income received from the sponsoring entity worldwide must be apportioned to the time the artist or athlete spends in the U.S. and that U.S. portion of the sponsorship fee will normally be subject to U.S. income tax. Presumably, this computation is made on a time apportionment basis; however, there is no reason why the I.R.S. may not decide to track the sponsor's sales in the U.S. and abroad for purposes computing U.S. source income. That type of approach would be consistent with the events basis of the proposed regulations.

Not all endorsement income is covered by the entertainers and athletes provision of an income tax treaty. In Field Service Advice 199947027, the Office of the Associate Chief Counsel (International) considered the status of a model and actor under an income tax treaty. The issue was whether the individual was covered by the entertainers and athletes article under which relevant income would be taxable in the U.S. or under by another article that could exempt the income. The advice concluded that the individual was not an entertainer and accordingly the independent personal services article was applicable.

The individual was a model and actor. She was engaged as an image spokesperson for a U.S. corporation in connection with the “advertising, marketing, promotion, publicizing, merchandising, and distribution” of products. Under the terms of the engagement, she was required to appear in the media and be associated with the product. She was required to meet with senior corporate managers for orientation sessions every year.

She filed a U.S. tax return in which her occupation was listed as “actor.” She claimed an exemption from taxation in connection with the fees received from the U.S. corporation on the grounds that the income was a royalty that was exempt under applicable treaty. As will be seen later, this contention is common among famous persons who receive income because of their fame.

The I.R.S. approached the issue by first determining whether the income in issue was properly characterized as income of an entertainer or athlete from the performance of services in that capacity. Looking to the explanation of the O.E.C.D. Model Convention

for the Avoidance of Double Taxation and Fiscal Evasion, the advice concluded that the activities of an entertainer must have “entertainment character.” Entertainment value was missing from the taxpayer’s arrangement with the U.S. corporation. The primary purpose of the individual’s activities was to promote, market, and sell products. Merely because the contract referred to the individual as a model and performer did not change the primary purpose of the contract. When this position is taken to its extreme, it could mean that actors in industrial videos and actors in television advertisements may not be receiving compensation covered by the entertainers and athletes provision of a treaty because of the absence of entertainment value.

Having reached the conclusion that the payment was not made to compensate the recipient for entertainment, the advice indicated that the fees likely constituted independent personal services for which the individual could be taxed only if a fixed base existed in the U.S. The fee did not constitute royalties.

Compensation Based on Sales

The characterization of income streams received by foreign entertainers and athletes is not always clear cut. When characterizing endorsement and sponsorship income, the distinction between royalty income and personal services income may become somewhat blurred. Royalties are payments made to compensate for the right to use intangible property such as the goodwill in an individual’s name, likeness, or signature. It is not

made as compensation for the performance of personal services.¹⁹ Royalties for the use of intangible property are sourced where the property is used. Contracts, under which the entertainer or athlete is required to render services like playing in a tennis tournament or turning up in the U.S. for the launch of a new product will be personal service income for U.S. tax purposes. This will be effectively connected U.S. income that is subject to U.S. income tax at applicable rates after the allowance of deductions for ordinary and necessary business expenses. If the income is classified as royalty income, it is subject to tax at a flat 30 percent rate on the gross amount paid or at a reduced rate under an applicable income tax treaty.

Just what type of income an entertainer or athlete is in receipt of can come down to an analysis of the sponsorship or endorsement contract. This point is well illustrated by the case of *Boulez v. Commissioner*.²⁰ In that case, Pierre Boulez, the well-known orchestra conductor, who was not a U.S. citizen but was a German resident, contracted with CBS Records to make recordings of orchestral works, some of them in the United States. The contract provided that all recordings would be the property of CBS Records, which was to pay Boulez an amount based on a percentage of sales receipts. This amount was described as “royalties” in the contract.

¹⁹ See Rev. Rul. 81-178, 1981-2 C.B. 135, which establishes the principle in the context of a tax exempt organization. The principle, however has wider application. See for example Chief Counsel Advice which applies the ruling in the context of amounts paid to an accountant. See also Field Service Advice 199947027, discussed above.

²⁰ *Boulez v. Commissioner*, 83 TC 584 (1984).

The I.R.S. claimed that compensation paid to Boulez was for personal services while Germany claimed that the payment represented royalties that were exempt from tax under Article VII of the U.S.-Germany Income Tax Treaty. The issue reached the U.S. District Court which held that payments received by recording artists who had no ownership rights in the master recordings constituted compensation for services rendered. The payments were referred to as “royalties” in the document. However the contract language indicated that the contract was for the personal services of the artist and that the artist had no ownership interest in the masters being created. Notwithstanding the way payments were measured, the contracts had “work for hire” clauses. It is believed that after the case was decided, the German government provided Mr. Boulez with a refund of German tax.

A similar decision was reached in an earlier case involving a heavy-weight boxing champion. In *United States v. Johansson*,²¹ the taxpayer was a professional boxer. In connection with a bout held in the U.S., amounts were paid to a Swiss company he owned to purchase certain broadcast rights covering countries in Europe. He was to receive a royalty from the Swiss company. He contended that this was foreign source royalty income because the broadcast rights that were exploited were outside the U.S. However, the Court held that no part of the amounts received was a royalty within the meaning of an applicable income tax treaty. As in the *Boulez* case, the taxpayer did not have any proprietary interest in any of the non-Scandinavian movie, radio, or television rights and that the use of the amounts received from these rights was but the method of

²¹ *United States v. Johansson*, (Docket No. 10,588-M, SD Fl., Dec. 14, 1961) reported unofficially at 62-1 USTC Para 9130, and 8 AFTR 2d 6001, affd. 336 F.2d 809 (5th Cir 1964) .

computing the taxpayer's personal service income. The Swiss company was formed or availed of merely to reduce U.S. tax and was viewed to be a sham.

Withholding Tax

One of the I.R.S.'s problems with highly paid foreign entertainers and athletes is that it is not uncommon for them to earn significant sums in the U.S., but to spend very little time in the U.S. In those circumstances, collecting the U.S. tax due is potentially problematic. The U.S. government has solved this problem by enforcing strict withholding requirements on anyone making payments to foreign entertainers and athletes.

Compensation received by a foreign entertainer or athlete may be subject to either wage withholding in the case of an employee,²² or 30 percent withholding tax in the case of a non-employee.²³ Payments to a foreign entertainer for the performance of services as an employee within the United States are subject to wage withholding. Payments to a foreign entertainer or athlete for services performed within the United States as an independent contractor, acting on his or her own behalf, are not "wages," and therefore are not subject to wage withholding but they are subject to a 30 percent withholding on account of U.S. income tax.²⁴ Examples of an athlete that is an independent contractor include a professional golfer and a professional boxer. An example of an entertainer that is an independent contractor is a recording artist on tour.

²² See Code section 3402(a)(1)

²³ See Code sections 871(a)(1) and 1441(a)

²⁴ See Code section 1441

When withholding tax is imposed at the rate of 30 percent of the gross amount paid to a nonresident alien, it is not unusual for the withholding tax to exceed the net income tax that is ultimately due. The reason is that entertainers and athletes typically travel with an entourage and have obligations to compensate their managers and booking agents. Presumably, those costs are ordinary and necessary business expenses.²⁵

Excessive withholding can be avoided if the foreign entertainer or athlete enters into a central withholding agreement with the I.R.S. This allows the withholding agent to prepare an estimate of net income after expenses and to withhold based on the projected tax imposed on that net income. In order to enter an agreement, the budget for the event must be demonstrated, including revenue and expense, and a projection of the net income before tax is calculated using graduated rates and taking into account income U.S. source net income previously derived for the year.²⁶ This is not inconsistent with the income tax regulations, which provide that compensation for personal services of a nonresident alien individual who is engaged during the taxable year in the conduct of a trade or business within the United States may be wholly or partially exempted from withholding if an agreement is reached between the I.R.S. and the alien individual with respect to the amount of withholding required.²⁷

²⁵ Such costs may also include state income taxes where the only reason for the imposition of the tax is the generation of income within the state.

²⁶ Rev. Proc. 89-47 89-2 CB 598.

²⁷ Treasury Regulation Section 1.1441-4(b)(3).

Rev. Proc. 89-47 provides guidance for nonresident alien entertainers and athletes who wish to enter into a central withholding agreement with the I.R.S. Under Rev. Proc. 89-47, nonresident alien entertainers and athletes who wish to apply for a central withholding agreement must provide the following information:

- A list of the names and addresses of the foreign individuals to be covered by the agreement (“the covered aliens”);
- Copies of all contracts that have been entered into regarding the time period and performances or events to be covered by the agreement (including contracts with agents and promoters, exhibition or performance halls, persons providing lodging, transportation or advertising, and accompanying personnel such as band members or trainers);
- An itinerary of dates and locations of all performances or events scheduled during the period to be covered by the agreement;
- A proposed budget with supporting documents containing itemized estimates of all gross income and expenses for the period and the name, address, and telephone number of the person to be contacted for additional information; and
- The name, address, and employer identification number of the central withholding agent who will enter into a contract with the I.R.S. This

typically is the person who receives contract payments, keeps books of account for the covered aliens, and pays their expenses.²⁸

If the I.R.S. accepts the validity of the estimated budget and identity of the central withholding agent, a withholding agreement is signed by the parties involved, *viz.*, the central withholding agent, the covered alien, and the Assistant Commissioner (International). The central withholding agent undertakes to withhold income tax from payments received on behalf of the foreign entertainer or athlete and to pay over the withheld tax to the I.R.S. on the dates and in the amounts specified in the agreement and to file appropriate tax forms. The time period for payment is typically ten days.

Loan-out Arrangements

No discussion of entertainers and athletes would be complete without a discussion of loan-out arrangements. The loan-out was a tax planning technique that was popular in a different age for entertainers and athletes. It attempted to shift personal service income to a related corporation that maintained no permanent establishment in the country in which the venue site was located. At the same time, the foreign entertainer or athlete received a moderate salary that was reported to the tax authorities, leaving the bulk of the income either retained in the corporation, or as part of a deferred compensation arrangement, or as royalty income in an offshore company. The intended goal was to defer the income recognition event for the entertainer or athlete until he or she retired to Monaco or a similar jurisdiction.

²⁸ Rev. Proc. 89-47 89-2 CB 598.

The loan-out arrangement first came under attack in the mid 1970's in Rev. Rul. 74-330.²⁹ There, the I.R.S. reviewed several factors that typically indicated an employer-employee relationship between the entertainer and the loaning-out company, and concluded that they typically are absent in a loan-out arrangement. In essence, the I.R.S. concluded that the entertainer controlled his employer and not *vice versa*. This suggested the absence of an employer-employee relationship, which is the underpinning of the loan-out arrangement.

While not formally ruling that the typical loan-out arrangement should be disregarded as a sham, the I.R.S. concluded it could be attacked under two basic theories of U.S. tax law. First, it could be attacked under "assignment of income" principles – the individual could be considered as earning the income directly from the event rather than as an employee of the loan-out entity. Second, the income of the loan-out entity could be reallocated to the foreign entertainer or athlete pursuant to the arm's length transfer pricing rules of Code §482. As most tax advisers know, Code §482 permits the I.R.S. to reallocate items of income, deduction, and credit between or among related persons if necessary to clearly reflect income or to prevent the avoidance of U.S. tax.

Several years ago, the Three Tenors – Luciano Pavarotti, Placido Domingo, and Jose Carreras – were investigated for possible tax fraud in Germany arising from a loan-out arrangement involving a controlled licensing company. According to the allegations raised by the prosecutor, each of the Three Tenors received \$1.5 Million for each concert in a series of ten concerts that took place across Europe, the U.S., and Asia. Their

²⁹ Rev. Rul. 74-300, 1974-2 CB 278

manager arranged a loan-out agreement in which the \$1.5 million from each concert for each tenor was divided between a \$500,000 payment to perform and a \$1.0 million license fee paid to Tenor Trademarks Ltd., an Irish company that was controlled by the singers. The company owned the trademark “Three Tenors.” The plan fell apart when the manager was arrested for tax fraud in Germany. Ultimate settlements were reached and the manager was convicted for evading tax on \$10 million. He was sentenced to 5 years and 8 months in prison, but the term was reduced to reflect his pre-conviction detention, a feature of German criminal tax law.

Today, loan-out type arrangements are precluded through special provisions of the entertainers and athletes provisions of U.S. income tax treaties. The U.S. typically includes a provision in its income tax treaties that will impose tax on income that accrues to a person other than the performer when the performer or a related person participates directly or indirectly in the profits of the other person. If this provision applies, tax can be imposed in the country of the venue site without regard to the treaty provisions dealing with business profits and permanent establishments or income from employment. Examples are Article 16 (Entertainers and Sportsmen), Paragraph 2 of the U.K.-U.S. Income Tax Treaty and Article XVI (Artistes and Athletes) and Paragraph (2) of the Canada-U.S. Income Tax Treaty. In each case, the company accruing the profits has the burden of proof to demonstrate that neither the entertainer or athlete nor a person related to the entertainer or athlete participates directly or indirectly in the profits.³⁰

³⁰ See also Article 17 (Artistes and Sportsmen), Paragraph 2 of the O.E.C.D. Model Convention With Respect To Taxes On Income And On Capital (2005).

On the other hand, Article 16 (Entertainers and Sportsmen), Paragraph 2 of the 2006 U.S. Model Income Tax Treaty provides a less drastic rule. If the person accruing the income has the right to designate the individual who is to perform the personal activities involved in the event, the anti-abuse rule is not applicable. This rule is based on the U.S. domestic law provision regarding personal service contracts in the context of foreign personal holding company under Subpart F. The premise is that where a performer is using another person to circumvent tax, the site promoter would insist on having the performer named and designated to perform the services. If instead the person accruing the income is allowed to designate the individual who is to perform the services, a tax abusive situation is likely not present.

According to the O.E.C.D. Commentary and the 2006 U.S. Model Treaty,³¹ payments received on the cancellation of a performance generally are outside the scope of the entertainers and athletes article, apparently because they are not paid for an actual performance. They may fall under the Independent or dependent personal services articles or the business profits article, depending on the situation and the relevant treaty. However a sponsorship fee paid by a business in order to attach its name to the performance would be considered as so closely associated with the performance that the fee would fall under the entertainers and athletes article.

Conclusion

³¹ O.E.C.D. Commentary on article 17(9) and 2006 Treasury Technical Explanation on Article 17(1).

The I.R.S. compliance initiative aimed at foreign entertainers and athletes working in the U.S. is a wake-up call for the U.S. tax adviser representing a foreign entertainer or athlete. The issues that are faced reflect the sum of the issues faced by all foreign persons entering the U.S. marketplace. However, the sums involved are huge and the downside can be substantial for the entertainer or athlete who fails to comply. In a worst case scenario, a foreign entertainer or athlete can unknowingly achieve tax resident status through continuous presence at a movie shoot or the participation in a full season as an athlete who participates in a professional league that has a six-month season. This brings with it problems that go beyond the taxation of compensation in the U.S. Nonetheless, if residence can be avoided, other issues must be faced, including the amount of income that is taxed and the matching of withholding taxes to the actual income tax liability. To that end, recent changes in penalty provisions for tax return preparers and changes in proposed regulations regarding the source of income may combine to impair planning opportunities. All this must be carried out in the context of a client who likely participates in discussions with offshore friends and advisers who may urge the foreign entertainer or athlete to consider loan-out schemes that have little chance of success when considered on a fully disclosed basis.

It is hoped that this paper enables the adviser to navigate through this minefield to legitimately reduce the taxable income and the income tax of the client.