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Tax Concepts Affecting the Foreign Entertainer or Athlete Performing in the United States

by Stanley C. Ruchelman, Esq.[*]
The Ruchelman Law Firm
New York, New York
and Ian Shane, Esq.[**]
Golenbock Eiseman Assor Bell & Peskoe L.L.P.
New York, New York

On August 2, 2007, the IRS and the Treasury issued a comprehensive report entitled ''Reducing the Federal Tax Gap: A Report on Improving Voluntary Compliance.'' The report included a recommendation to initiate a project on foreign (i.e., nonresident alien) 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 IRS announced the launching of a compliance initiative aimed at foreign entertainers and athletes working in the United States. The IRS website states that the initial focus is on those engaged in tennis, golf, and music, as these individuals and those associated with arranging their appearances in the United States and managing their financial affairs are typically high-income taxpayers. The IRS withholding program manager is reported to have said that the IRS is concerned that foreign entertainers and athletes are not paying their fair share of withholding tax and fail to report properly their income in the United States.

In these days of globalization, other foreign professionals, such as accountants, architects, and lawyers, may also derive big paychecks from the performance of personal services in more than one country. So why does the IRS 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 es-

[*] Stanley C. Ruchelman is a member of The Ruchelman Law Firm in New York City where his practice concentrates on cross-border transactions. He is a frequent lecturer and author on topics related to U.S. taxation of international transactions.

[**] Ian Shane is of counsel to Golenbock Eiseman Assor Bell & Peskoe L.L.P. in New York City. His practice concentrates on the taxation of cross-border mergers and acquisitions.

TAX MANAGEMENT INC.
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tablishing a fixed base in that country. Because many international entertainers and athletes 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. The goal of these jurisdictions 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 advisor to the foreign entertainer or athlete, the combination of these IRS initiatives and a taxpayer's reliance on the ''old way'' of doing things can be problematic. This article will address the various issues that an advisor to a foreign entertainer or athlete should consider when sitting down to begin tax planning on behalf of a client in connection with an event or a tour in the United States.

DETERMINATION OF RESIDENCE STATUS

The starting point for any discussion regarding foreign entertainers and athletes is whether the individual is actually foreign.

Determination of Residence Status Under Domestic Law

In determining resident status under domestic (U.S.) law, the key question is whether the individual has been in the United States for enough time to be considered a U.S. resident under the substantial presence test. For persons who make movies in the United States, or who are on tour, such as golfers, tennis players, and musicians, triggering resident status is not difficult under the objective standard of current law. If tax residence exists, the entire set of tax 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 be 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 or she will be considered a resident for U.S. income tax purposes.[1] 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 United States 183 days or more during a rolling three-year period. The period begins anew for each year and comprises the second preceding year, the immediately preceding year, and the current year.[2] The individual must also be present for at least 31 days in the current year.[3]

An individual is treated as being present in the United States 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 United States, 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.

In determining whether a foreign individual meets the substantial presence test based on days present in the United States, 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.'' [4] Certain athletes can qualify as exempt individuals under a special rule intended principally to benefit professional golfers. An exempt individual includes, *inter alia*, an individual who is a ''professional athlete who is temporarily in the United States to compete in a charitable sports event described in §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 §501(c)(3) and is exempt from tax under §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 United States, only days on which the athlete ac-

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[1] §7701(b)(1)(A). Unless the context indicates otherwise, all ''§'' references are to the U.S. Internal Revenue Code of 1986, as amended (''the Code''), and all ''Regs. §'' references are to the regulations issued thereunder (and set forth in 26 CFR).

[2] §7701(b)(3)(A)(ii).

[3] §7701(b)(3)(A)(i).

[4] §7701(b)(3)(D)(i).

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tually competes in a charitable sports event are excluded. Thus, days on which the individual is present in the United States to practice for the event, to perform promotional or other activities related to the event, or to travel between events are included for purposes of calculating whether that individual is present in the United States for 183 days during 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 the 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.[5] To come within this exception, three conditions must be satisfied. First, the individual must be present in the United States for fewer than 183 days in the current year. Thus, this exception applies to persons who are in the United States for more than 183 days during the rolling three-year period, computed in light of the weighting rules discussed above, and who are present for up to 182 days in the current year.

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 case law and the view of the IRS 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 would then be deductible. As a general rule, a person does not continue to have the previously established tax home if an assignment in a new location exceeds one year. 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.[6]

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 United States. In some circumstances, the closer connection may be with more than one country during the year if, for example, the individual's tax home changes.

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 United States. The regulations [7] look to the following factors, albeit on a nonexclusive basis:

- 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).

[5] Regs. §301.7701(b)-2(a).

[6] *See* IRS Publication 17 (*Your Federal Income Tax for Individuals*), Chapter 26 (*Car Expenses and Other Employee Business Expenses*).

[7] Regs. §301.7701(b)-2(d)(1).

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Meeting a filing requirement is a condition of coming within this exception to resident status under the substantial presence test.[8] 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 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 §6694.

The Small Business and Work Opportunity Tax Act of 2007 (''the Act'')[9] 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 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 50% likelihood that the tax treatment of the item will be upheld if challenged by the IRS.[10]

Hence, when the factors related to the closer connection requirement are reviewed, a tax return preparer may question whether there is more than a 50% 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 tie-breaker test of an income tax treaty to determine the residence of an entertainer or athlete may provide greater certainty.

Determination of Residence Status Under a Treaty

In many instances, an individual contends that an income tax treaty of the United States mandates a result that is more favorable than that under U.S. domestic law. The individual may claim that a treaty determines residence in a way that differs from U.S. domestic law or provides that compensation income of a resident of one country is not taxed in the other. Where residence in a treaty partner of the United States is claimed, the first obligation of the tax advisor is to determine the validity of the claim. Failure to do so may be fatal, as illustrated in a case involving a heavyweight boxing champion who claimed to be a resident of Switzerland.

Johansson v. U.S.[11] involved the residence of a foreign athlete, Ingemar Johansson, who fought three times in the United States 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 ruling from the Swiss tax authorities that he was properly treated as a resident of Switzerland. On that basis, he claimed benefits under the U.S.-Switzerland Income Tax Treaty then in effect, which would have eliminated his U.S. tax. The appeals court confirmed the U.S. 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 United States], 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.

[8] Regs. §301.7701(b)-2(g).

[9] P.L. 110-28.

[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 exists that a position is more likely than not to succeed and its application to §6694(a) as a result of Notice 2008-13, 2008-3 I.R.B. 282, in lieu of the need to file a Form 8275 in certain circumstances.

[11] 336 F.2d 809 (5th Cir. 1964), *aff'g*, 62-1 USTC ¶9130 (S.D. Fla. 1961).

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Once residence in Switzerland was ignored, Mr. Johansson found that his boxing winnings were taxable in the United States because the tax benefit under that treaty was inapplicable.

If an individual is in fact a resident of a treaty jurisdiction, the individual will be entitled to 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 that appears in virtually all treaties is that the treaty may override U.S. domestic tax rules applicable to the residence of aliens.[12] As a result, even though a foreign individual may be deemed to be a resident of the United States under U.S. domestic tax law, the individual is, nonetheless, taxed as if he were a nonresident with regard to the United States.

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 of each country, 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 tie-breaker 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.[13] In that way, the tie-breaker provision of an income tax treaty may override U.S. domestic law.

Under the tie-breaker 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. The matter is settled. 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 personal and economic relations are closer — this is known as the center of the individual's vital interests;
- If the center of vital interests 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 the mutual agreement procedure which country is the individual's exclusive residence. Where an individual has contacts in both countries and is present for significant periods of time in both countries, the final test based on nationality is often determinative.

TAXATION OF COMPENSATION INCOME

Taxation Under Domestic Law

The United States taxes foreign entertainers and athletes in the same manner as other foreign individuals. A foreign individual (also referred to here as a nonresident alien) is subject to tax in two ways. First, income that is effectively connected with a trade or business in the United States is generally subject to ordinary income tax (at the same graduated rates) and alternative minimum tax in the same way as income derived by U.S. citizens and resident aliens. Second, U.S.-source income that is not effectively connected with a U.S. trade or business is taxed at a flat rate of 30%, a rate that may be reduced by an applicable income tax treaty.

Sections 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 United States is generally U.S.-source income. Similarly, income from services performed outside the United States 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.

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

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

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

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- The income is derived by a nonresident alien 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 (including a foreign trust or foreign estate), a foreign partnership, or a foreign corporation not engaged in a U.S. trade or business; or
  - For a foreign office of a U.S. citizen, U.S. resident, domestic partnership, or domestic corporation.

Section 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 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 foreign 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,[14] 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 foreign entertainer's or athlete's salary, fees, wages, compensation, bonuses, or prize winnings received for performances in the United States will generally constitute effectively connected U.S.-source income (whether derived as an employee or an independent contractor), and will be taxed at the applicable graduated rates. Deductions will be allowed to the extent allocable or apportionable to the effectively connected income (which will generally consist only of U.S.-source income). If a nonresident alien performs services inside and outside of the United States, deductions for expenses incurred may be apportioned between U.S.-source taxable income and foreign-source tax-free income.

Taxation Under a Treaty

Comparable provisions exist in U.S. income tax treaties for dependent personal services (relating to services performed by an employee), albeit with greater thresholds before compensation can be taxed. Thus, for example, Article 14 (Employment Income), Paragraph 2, of the U.S.-U.K. 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:
>
> 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 U.S.-Canada 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. Thus, Article XVI (Artistes and Athletes) of the U.S.-Canada 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.S.-U.K. 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 sports-

[14] Regs. §1.864-2(b)(3) *Ex. 2.*

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men of $20,000 per taxable year. The entertainers and athletes provisions in U.S. income tax treaties apply only to compensation for the performance of services as an entertainer or an athlete. Compensation for the performance of services as a director, producer, technician, manager, coach, cameraman, or the like is typically covered by the dependent personal services article.

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 United States and foreign countries, the income from the performance of services must be allocated between U.S. and foreign sources. As mentioned above, only the former is taxable by the United States.

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 IRS 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 *Stemkowski v. Comr.*[15] In that case, 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 on which services were performed in the United States, (2) divided by the total number of days for which services were performed, whether in or out of the United States, and (3) multiplied by the total contract compensation. Because services were performed in a pre-season training camp and post-season playoff games, they were taken into account in the computation approved by the appellate court. The allocation of income by the appellate court in this case was later adopted by the IRS in Rev. Rul. 87-38,[16] which also involved a Canadian hockey player.

[15] 690 F.2d 40 (2d Cir. 1982), *rev'g* 76 T.C. 252 (1981).

[16] 1987-1 C.B. 176.

Recently, the IRS proposed regulations designed to require the apportionment on an "events basis" [17] 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.[18] 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 on tour who receives a fixed amount for the tour, the number of events is not relevant in determining the source of the compensation income. Rather, the relative amounts of revenue generated from U.S. and foreign events will be controlling. This latter application of the rule 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, foreign tax authorities may not readily accept the position in the proposed regulations where the performer's compensation is fixed. In such case, the source of the revenue in a treaty context may ultimately be determined through competent authority relief.

Characterization of Income

Of course, not all income realized by a foreign entertainer or athlete will fall into the categories of salary, wages, fees, and 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 entertainer 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 United States, sponsorship income arises when there are pay-

[17] Prop. Regs. §1.861-4(b)(2)(ii)(G) and (c) *Exs. 7* through *10*, proposed as part of REG-114125-07, 72 Fed. Reg. 58787 (10/17/07).

[18] *See* Rev. Rul. 76-66, 1976-1 C.B. 189, rejected in *Stemkowski* and revoked by Rev. Rul. 87-38; Rev. Rul. 2004-109, 2004-50 I.R.B. 958 (noncompetition "sign-on" fee is subject to U.S. federal social security and unemployment taxes as renumeration for employment even though fee does not in fact require or depend on performance of any services, revoking Rev. Rul. 74-108, 1974-1 C.B. 248, and Rev. Rul. 58-145, 1958-1 C.B. 360, to the contrary).

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ments 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 entertainer or athlete spends in the United States and that U.S. portion of the sponsorship fee will normally be subject to U.S. income tax.

Not all endorsement income is covered by the entertainers and athletes article of an income tax treaty. In Field Service Advice (FSA) 199947027, the Office of the Associate Chief Counsel (International) considered the status under an income tax treaty of a famous model and actress. The issue was whether the individual was taxable by the United States under the artistes and athletes article of an applicable income tax treaty. The FSA concluded that the individual was not an entertainer and, accordingly, the independent personal services article was applicable.

The individual was a model and actress. 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. income 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 the applicable treaty. As will be seen later, this contention is common among famous persons who receive income attributable to their fame.

The IRS first determined 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 Commentary on the OECD Model Convention for the Avoidance of Double Taxation and Fiscal Evasion, the FSA 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.

Having reached that conclusion, the FSA advised that the fees likely constituted independent personal services, for which the individual could be taxed only if a fixed base existed in the United States, but did not constitute royalties.

Thus, the characterization of income realized 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 get foggy and is by no means always straightforward. Royalties are payments for the right to use items like the entertainer's or athlete's name, likeness, or signature, and not 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 United States for the launch of a new product, will be personal services income for U.S tax purposes. This will generally be effectively connected U.S. sourced income and therefore subject to U.S. income tax at graduated rates. If the income is classified as royalty income, then it is subject to tax at a flat 30% rate, or such lower rates as may be provided by an applicable income tax treaty.

Just what type of income an entertainer or athlete has received can come down to an analysis of the endorsement or sponsorship contract. This point is well illustrated by *Boulez v. Comr.*[20] In that case, Pierre Boulez, the well-known orchestra conductor who was a German resident and not a U.S. citizen, 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 amounts, described as ''royalties'' in the contract.

The IRS claimed that the compensation paid to Boulez was for personal services, while Germany claimed that the payment represented royalties which 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. Although the payments were referred to as ''royalties'' in the document, 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. Also, notwithstanding the way payments were measured, the contracts had ''work for hire'' clauses.

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[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* FSA 199947027, discussed above.

[20] *Boulez v. Comr.*, 83 T.C. 584 (1984).

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A similar decision was reached in *U.S. v. Johansson,*[21] discussed earlier, involving a heavyweight boxing champion who contracted to receive certain percentages of receipts from the non-Scandinavian movie, radio, and television rights related to his boxing matches (as well as certain percentages of receipts from the Scandinavian movie, radio, and television rights to those fights). The boxer contended that this was royalty income. However, the court held that no part of the amounts received was a royalty within the meaning of the applicable income tax treaty. As in *Boulez*, the taxpayer did not have any proprietary interest in any of the non-Scandinavian movie, radio, or television rights and the use of receipts from these rights in computing the taxpayer's compensation was but the method of computing the taxpayer's personal services income.

According to the OECD Commentary and the 2006 U.S. Model Treaty,[22] payments received on the cancellation of a performance generally are outside the scope of the Artistes and Athletes article, apparently because they are not paid for an actual performance. They may fall under the Independent or Dependent Personal Services article (or, if not derived by an individual, 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 so closely associated with the performance that the fee would fall under the Artistes and Athletes article.

Withholding Tax

One of the IRS's problems with highly paid foreign entertainers and athletes is that it is not uncommon for them to earn significant sums in the United States, but to spend very little time in the United States. 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,[23] or the 30% withholding tax, in the case of an independent contractor.[24] Payments to a foreign entertainer or athlete 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 generally regarded as subject to 30% withholding on account of U.S. income tax,[25] although the individual is arguably engaged in the conduct of a trade or business within the United States and, therefore, subject to the required filing of an income tax return and payment of U.S. income tax on net income at graduated rates. Examples of independent contractors may include athletes, such as a professional golfer or a professional boxer, and entertainers, such as recording artists on tour.

Applying the standard withholding rate of 30% to the gross income derived by an entertainer or athlete for services performed in the United States would often result in the foreign entertainer or athlete paying too much U.S. tax. The reason is that these people typically travel with an entourage. They also are responsible for paying managers and booking agents. Presumably, those costs are ordinary and necessary business expenses.[26]

The excess withholding can be avoided if the foreign entertainer or athlete enters into a central withholding agreement with the IRS. In order to enter into an agreement, the budget for the event must be demonstrated, including revenue and expenses, and a projection of the income tax is calculated, using graduated rates and taking into account income derived from earlier events in the year.[27] This is not inconsistent with the income tax regulations, which provide that compensation for personal services of a nonresident alien 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 IRS and the individual with respect to the amount of withholding required. [28]

Rev. Proc. 89-47 provides guidance for nonresident alien entertainers and athletes to request a central withholding agreement that reduces the amount of U.S. withholding tax. 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'');

[21] *U.S. v. Johansson*, 62-1 USTC ¶9130 (S.D. Fla. 1962), *aff'd*, 336 F.2d 809 (5th Cir. 1964) .

[22] OECD Commentary on Article 17(9) and 2006 Treasury Department Technical Explanation of the U.S. Model Treaty, Article 17(1).

[23] *See* §3402(a)(1).

[24] *See* §§871(a)(1) and 1441(a).

[25] *See* §1441.

[26] 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.

[27] Rev. Proc. 89-47, 1989-2 C.B. 598.

[28] Regs. §1.1441-4(b)(3).

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- 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 IRS. This typically is the person who receives contract payments, keeps books of account for the covered aliens, and pays their expenses.[29]

If the IRS 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(s), 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 pay over the withheld tax to the IRS on the dates and in the amounts specified in the agreement. 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 services 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, as part of a deferred compensation arrangement, or as royalty income paid to 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.

The loan-out arrangement first came under attack in the mid-1970s in Rev. Rul. 74-330.[30] There, the IRS reviewed several factors that typically indicate the existence of an employer-employee relationship between an entertainer and a company, and concluded that they often are absent in a loan-out arrangement. In essence, the IRS 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 IRS 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 §482. As most tax advisors know, §482 permits the IRS to reallocate items of income, deduction, and credit between or among persons or businesses owned or controlled directly or indirectly by the same interests if necessary to reflect clearly income or to prevent the avoidance of U.S. tax.

Several years ago, the New York Times [31] reported that the Three Tenors — Luciano Pavarotti, Placido Domingo, and Jose Carreras — were investigated for possible tax fraud in Germany arising from a loan-out-type agreement 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 United States, and Asia. Their 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. Ultimately, settlements were reached by the tenors, but the manager was reported to have been convicted of evading German 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 ath-

[29] Rev. Proc. 89-47, 1989-2 C.B. 598.

[30] 1974-2 C.B. 278.

[31] N.Y. Times, Sept. 1, 1999.

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letes provisions of U.S. income tax treaties. The United States 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 include the second paragraph of Article 16 (Entertainers and Sportsmen) of the U.S.-U.K. Income Tax Treaty and of Article XVI (Artistes and Athletes) of the U.S.-Canada 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.[32]

On the other hand, Article 16 (Entertainers and Sportsmen) 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 income under Subpart F. The premise is that where a performer is using another person to circumvent tax, the site promoter would insist that the performer be named to perform the services. If instead the person accruing the income is allowed to designate the individual who is to perform the services, an abusive tax situation is likely not present because a direct or indirect control group of U.S. shareholders of the person would be required to include the income for U.S. income tax purposes under Subpart F.

In some circumstances, rules attacking loan-out companies can result in double taxation. This typically can occur where the entertainer or athlete enters into a central withholding agreement with the IRS that covers a production company in which he or she has an interest, and the base for the tax imposed on the entertainer or athlete under the central withholding agreement includes the production company's profits. Assuming the production company is resident in a jurisdiction that taxes the company on its profits, the loan-out company will compute its tax in its country of residence but will not be able to produce proof that it paid tax in the United States (because the U.S. tax was imposed on the individual). From the viewpoint of the country of residence, there is a misassignment of income by the IRS and the problem rests with the United States.

CONCLUSION

The IRS compliance initiative aimed at foreign entertainers and athletes working in the United States is a wake-up call for the U.S. tax advisor representing a foreign entertainer or athlete. The issues that are faced reflect 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 participation in the full season of a professional athletic league. This brings with it problems that go beyond the taxation of compensation in the United States. If residence can be avoided, issues must be faced regarding the amount of income that is taxed and the rate at which the tax is collected. 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. Finally, discussions with offshore friends and advisors may entice the foreign entertainer or athlete to consider loan-out schemes that have little chance of success on a fully disclosed basis.

It is hoped that this article enables the advisor to navigate through this minefield to reduce legitimately the taxable income and the income tax of his or her client.

[32] *See also* Article 17 (Artistes and Sportsmen) of the 2005 OECD Model Income Tax Convention.

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