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Fundamental Issues In U.S. Taxation of Foreign Entertainers and Athletes

Part One of a Two-Part Article

By **Robert M. Jason**

This article is Part One of a two-part article. Part Two will appear in our July 2016 issue.

The United States taxes its citizens and resident aliens on their worldwide income; nonresident aliens are taxed on their U.S. source income and income that is effectively connected with a trade or business in the U.S. These seemingly simple terms — "citizen," "resident," "nonresident," "U.S. source," "effectively connected with a trade or business in the U.S." (well, this last term doesn't seem so simple) — have spawned volumes of regulations, rulings, cases and articles, the essence of all of which is to determine who is subject to tax in the U.S., and on what.

Layer on top of this the impact of income tax treaties, estate taxes, estate tax treaties and state taxes, and you have an exceedingly complex patchwork of rules to navigate. This article introduces the U.S. federal income tax issues.

Citizens

A basic principle of U.S. federal income taxation is that U.S. citizens are taxable in the United States on their worldwide income, a principle that distinguishes the U.S. from almost all other countries, and not in a good way. Tax regulations define "citizen" to include "every person born or naturalized in the United States and subject to its jurisdiction." Treas. Reg. §1.1-1(c). The same regulation cross-references the Immigration and Nationality Act for additional definitions of "citizen."

This rule seems like it is not worth even mentioning in an article on "foreign" entertainers and athletes, but our experience suggests otherwise.

For example, we have a client who was born in the United States and shortly after birth was whisked away by his parents to Northern Europe, where he has resided for all of his 37 years. He became a moderately successful European actor. When he began to try to leverage his European successes into a U.S. film career, he learned that the fact that he was a U.S. citizen meant that he had been obligated to file and pay tax to the United States ever since he began earning money, even though he had never set foot in the United States.

This is a topical issue because it has been reported that nonresident citizens are giving up their U.S. citizenship in record numbers, largely to put a stop to this very issue.

Resident Aliens — In General

Similarly, and more logically, resident aliens are taxed in the United States on their worldwide income, while nonresident aliens are not. Obviously, it is important to be able to tell a resident alien from a nonresident alien.

Residency issues tend not to be important for most athletes or entertainers who perform or compete in the U.S. and then go back home. They typically are not in the United States long enough to become resident aliens. U.S. tax residence is primarily determined based on spending many days in the United States. (See below).

More and more, though, our foreign entertainment and music clients are staying in the United States longer and longer. They feel that they need to be here in order to develop relationships and obtain employment in their particular fields. This raises the specter of tax residency.

Resident Aliens — Green Card Test

One way of being treated as a tax resident of the United States having nothing to do with counting days is the green card test, which treats an individual as a resident alien if at any time during the year the individual is "a lawful permanent resident of the United States." I.R.C. §7701(b)(1)(A)(i). For most tax purposes, a green card holder is treated exactly the same as a citizen; in particular, green card holders are taxed in the United States on their worldwide income.

But even a green card holder can be treated as a nonresident alien if under a tax treaty with another country the holder is treated as a resident of that country. (More on treaties in Part Two of this article.) While in appropriate circumstances this is perfectly legitimate, taking the tax position that a green card holder is a nonresident alien under a tax treaty gives the immigration lawyers fits because this position might cause the U.S. Customs and Immigration Service to conclude that the individual does not have the proper "immigrant intent" necessary to maintain a green card. Immigration lawyers worry that the tax position may put the green card at risk.

Resident Aliens — Counting Days — The 'Substantial Presence Test'

The substantial presence test (I.R.C. §7701(b)(3)(A)) is the day-counting test that is the guts of tax residency determinations. Under this test, an individual is a resident alien in a year if he or she is present in the United States on at least 31 days in that year, and if the sum of: 1) the number of days the individual is present in the United States in that year, plus 2) one-third of the number of days the individual is present in the first preceding year, plus 3) one-sixth of the number of days the individual is present in the second preceding year, equals or exceeds 183. In general, an individual is present in the United States on a day if he or she is physically present in the country at any time during such day, no matter how briefly.

Here is an example:

Suppose T was in the United States 142 days in 2016, 90 days in 2015, and 60 days in 2014. Is T a U.S. resident in 2016? Well, 142 + (1/3 of 90) + (1/6 of 60) = 142+30+10 = 182, so T would not be a resident alien in 2016.

If T stayed in the United States for one more day in 2016, for a total of 143 days, the three-year weighted total would be 183 and he would be a resident alien in the United States in 2016. This highlights how critical it is to obtain an accurate day count.

Counting days is not always easy. In times past, we had interesting conversations with our clients about the number of days they were in the United States in the years pertinent to the substantial presence test. We'd ask the clients to provide their day counts; they'd consult their calendars, their travel receipts, their managers … and come back to us with numbers that we had no easy way to verify.

Now the uncertainty is largely gone (with some exceptions) because of a Department of Homeland Security website that, when certain simple security tests have been passed, provides a detailed list of dates and ports of entry and departure: https://i94.cbp.dhs.gov.

But sometimes a day is not a day. Simply counting days may do a disservice to a client because there are scattershot provisions that allow certain days on which an individual is physically in the U.S. to be ignored.

For example, a day doesn't count if an individual is unable to leave the United States that day because of a medical condition that arose while the individual was present in the country (I.R.C. §7701(b)(3)(D)(ii)). Days in the United States are also not counted for certain foreign government-related individuals, teachers or trainees, students or professional athletes temporarily in the country to compete in certain charitable sports events. (I.R.C. §§7701(b)(3)(D)(i) and 7701(b)(5)). Note that, as is typical with the Internal Revenue Code, many words whose meanings you think you know (such as "student") have their own definitions that may not comport with yours.

Other days not counted include commuting days to the United States for workers resident in Canada or Mexico, or a day present in the United States if the individual is in transit between two points outside the United States and is physically present in the United States for less than 24 hours. There are additional rules as well.

In many cases, these tweaks to the day-counting rules are not important because the individual's three-year weighted U.S. day count is either significantly over or significantly under 183. But in close cases, these day-count exceptions can make the difference between residency and nonresidency.

The residency test rules are extremely intricate and have numerous exceptions and exceptions to exceptions. Some of these can provide for some unique planning opportunities.

For example, consider the special rule for the first year of U.S. residency for a (formerly) nonresident alien.

As mentioned above, and as will be discussed in Part Two of this article, nonresident aliens are taxed in the United States (primarily) on their U.S. source income. Unlike resident aliens, nonresident aliens are not taxed in the United States on their worldwide (i.e., foreign source in this case) income.

If it appears that a nonresident alien is going to become a resident alien, a useful strategy may be for the individual to generate much of his foreign source income before becoming tax resident in the United States. That income will not be subject to tax in the United States. This makes it extremely important to know the first day on which a nonresident alien will be treated as a resident alien.

In general, an individual whose day count exceeds that required under the substantial presence test begins U.S. tax residency on the first day of the year on which that individual is physically present in the United States. But the law allows the first 10 days to be excluded in determining the residency start date, as long as the individual had a tax home in a foreign country and still maintained a closer connection to that country. Those excluded days are still counted when calculating the substantial presence weighted average.

This test can be critically important, not in determining whether someone is a resident under the substantial presence test, but in determining whether a particular item of non-U.S. source income was earned while a resident or a nonresident.

For example, suppose a musician enters the United States on January 1 of a year that will turn out to be the individual's first year of residence under the substantial presence test. She spends a week skiing in Aspen. On January 8, the musician flies to Monte Carlo, where she gives a concert and is paid $1 million. That fee is not U.S. source income, so it is taxed in the United States only if the musician is a resident on that January 8. If her residency start date is January 1, as it would be in most cases in which the individual is physically present in the United States on January 1, that $1 million will be taxable to her in the United States. But if she can take advantage of the test above to ignore the first week of the year in determining her residency start date, she will be able to exclude the $1 million from U.S. income.

Being aware of and understanding this rule can save clients a fortune in the right circumstances.

Bob Jason is a Principal with Nigro Karlin Segal Feldstein & Bolno LLC. *This piece is intended as a broad introduction to key fundamental income tax issues presented when a foreign entertainer or athlete comes to the United States, rather than as a comprehensive analysis.*

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Part Two of a Two-Part Article

By **Robert M. Jason**

This article is Part Two of a two-part article. Part One appeared in the June 2016 issue of Entertainment Law & Finance.

Even if a foreign athlete or entertainer has spent "too many" days in the United States and satisfies the "substantial presence test" (*i.e.*, the individual's weighted sum of days over a three-year period is at least 183 days), there are two important ways in which the individual might nevertheless be treated as a nonresident, rather than a resident, alien.

The 'Closer Connection' Exception

The first of these two exceptions is the "closer connection" test and is available to individuals who have a closer connection to a foreign country in which the alien's tax home is located. To qualify for this exception and thus not be treated as a resident alien, the individual must be present in the United States on fewer than 183 days during the current year. *See*, I.R.C. §7701(b)(3)(B). This is another example of how important it is to accurately count days in the United States, not just mechanically but taking into account the web of exceptions. The closer connection exception is extremely useful for aliens who spend a substantial amount of time in the United States each year, enough to trigger the substantial presence test, but not more than 182 days in the year in question.

To analyze whether an individual has a closer connection to a country other than the United States requires going through the same kind of exercise that one generally goes through in other kinds of residency determinations, *i.e.*, looking at the individual's connections to either, both, or neither country. Pertinent factors, and there are many, include the location of the individual's home(s), where the kids go to school, the location of prized and other personal possessions, the location of gyms, churches, doctors, etc. Residency determinations can require digging deeply into the client's personal life.

Treaty Tiebreak Exception

The second exception is the treaty tiebreak exception. Even if an individual would otherwise be treated as a resident under the substantial presence test, he or she will be treated as a nonresident alien if a tax treaty says the individual is a nonresident alien or, more precisely, if he or she is treated as a resident of our treaty partner under the treaty.

Here's a good way to think about this.

Occasionally two different countries will each claim an individual as their resident. There is no international law that prevents this. It frequently arises when a national of one country spends lots of time in another, whether for work, pleasure or as a result of actual immigration. Tax treaties, which are essentially contracts between countries, generally have provisions that are triggered when both countries treat a person as a resident. These provisions permit only one of the countries to treat the individual as a resident, notwithstanding internal laws that conclude otherwise. They are colloquially referred to as "tiebreak" provisions, or "treaty tiebreakers."

(Note that the same issue can arise within the United States when two different states each claim the same person as a resident. This can happen when the laws of two states, such as California and New York, apply different tests to determine whether an individual is a resident. Unfortunately, there are no treaties between the states that provide tiebreakers, and the law of the land is that it is not unconstitutional for an individual to be tax resident in two different states.)

The United States has tax treaties with numerous trading partners, and the bulk of them follow the same methodology for determining which country gets to treat the individual as a resident, thus breaking the tie.

The first test usually asks whether the individual has a permanent home available to him or her in one, both, or neither of the countries. If the individual has such a home in one but not the other, that country wins and the inquiry ends. If instead the individual has a permanent home available in both countries or in neither, the test is inconclusive and we move to the second test.

The second test usually asks where the individual's "center of vital interests" is located, *i.e.* , the country with which his personal and economic relations are closer. This requires a general inquiry and comparison of connections to the two countries, analogous to the "closer connection" test described above. It may be very difficult to determine whether an individual's center of vital interests is in one country or another. For example, an individual who is single with no children may lack the natural location anchors that families with children have (such as, for example, schools).

The vast majority of cases seem to be resolved by the permanent home or the center of vital interests tests. But if those tests are inconclusive, treaties typically next look at whether the individual has a habitual abode in one country but not the other; if this doesn't resolve the issue, then an individual is a resident in the country in which he or she is a national. If the individual is a national of neither or both, then the countries have to try to come to an agreement under a so-called competent authority procedure.

There are many issues that arise in applying the treaty tiebreaker provisions, but a discussion of any more will pull us too far astray from our main focus.

U.S. Source Income

If a foreign individual is not treated as a U.S. resident for tax purposes, she will nevertheless be taxed in the United States on her U.S. source income. This is a particularly important consideration for foreign entertainers and athletes, some of whom remain clear tax residents of their home countries while earning income from U.S. sources.

There are numerous items that can constitute U.S. source income. The most common include compensation for services rendered in the United States: income from the rental or sale of U.S. real estate; dividends from U.S. corporations; income from membership or partnership interests in limited liability companies or partnerships that are themselves doing business in the United States; and certain royalties.

Source-of-income is an enormous topic, so this piece will discuss the two types that tend to be the most important for nonresident athletes and entertainers: compensation for services rendered in the United States, and royalties.

Compensation for Services Rendered in U.S.

Compensation for services rendered in the United States is sourced to the United States. This is another seemingly straightforward principle that has spawned much controversy and uncertainty.

In the clearest cases there is no uncertainty. A Czech tennis player who earns $1 million by winning the U.S. Open has U.S. source income and pays tax on it here. A Canadian singer who is paid $1 million for giving a concert in the United States has U.S. source income and pays tax on it here.

But suppose that a top French business consultant is engaged by a French company to advise it on commencing operations in the United States. The business consultant spends two weeks in a New York hotel doing her analysis, for which she is paid $1 million, and then returns to France.

Her $1 million fee is sourced to the United States because that's where the services are rendered. But because of a tax treaty, her fee is exempt from U.S. tax.

Article 14 of the tax treaty between the United States and France exempts from U.S. tax any compensation paid to a French resident for independent contractor services rendered in the United States unless she has a "fixed base regularly available" to her in the United States for the purpose of performing her activities. A hotel room available to her for two weeks would likely not be a "fixed base" under the treaty. Article 15 of the treaty provides for a similar, but not identical, exemption for employees.

So why is the consultant who works for two weeks in the United States exempt from U.S. tax, while the athlete or musician who works for a similarly-short period of time is not exempt? That is because the treaty between the United States and France contains a common article — in this case titled "Artistes and Sportsmen" (Article 17), but elsewhere titled "Artists and Athletes" or "Artists and Entertainers" (with or without an "e" plunked near the end of "Artists") — that provides for the taxation of entertainers, musicians and athletes providing services as such, notwithstanding Articles 14 and 15 (re: independent contractors and employees).

Except in very rare cases where a tax treaty with the United States is so old that it predates the onset of Artists and Athletes clauses (such as the treaty with Hungary), athletes, entertainers and musicians are rarely eligible for an exemption. Providing services through a foreign loan-out corporation does not circumvent the problem, as was shown in the *in terrorem* lend-a-star rulings of 1974 (See Rev. Rul. 74-330 and Rev. Rul. 74-331).

Compensation for Services Partly Within and Partly Without the U.S.

In many situations, services are rendered both inside and outside the United States. Determining how much compensation is attributable to services rendered inside the United States is extremely important in determining overall tax liability, particularly for entertainers, musicians and athletes who, because of treaty overrides, are unlikely to enjoy an exemption. This can be a challenging exercise with significant financial consequences.

In some cases it may be straightforward. A foreign backup musician who is paid a flat $10,000 per concert, eight of which are performed in the United States, will have $80,000 of income.

But some cases are more complicated. Suppose, for example, a Canadian nonresident alien hockey player plays for the New York Rangers. Regular season games and playoff games are played both in the United States and in Canada. Training camp is in Canada, and he spends the off-season in Canada staying in shape for the season.

What days are counted in determining the hockey player's U.S. source income? Just the actual games? Training camp? The off-season?

This fact situation was addressed in *Stemkowski v. Commissioner*, 690 F.2d 40 (2nd Cir. 1982). The Second Circuit concluded that to determine how much compensation was allocable to the United States, training camp and regular season and playoff games counted, but offseason days did not count.

The contract required Stemkowski to show up for games and training camp, but it had no requirements for the offseason. Stemkowski argued that offseason days should be covered because his contract required that he show up in shape for the start of training camp. However, the appeals court concluded that this was merely a condition of employment.

Compensation for Services, Or Payment for Something Else?

Proper characterization of income can have material bottom-line economic consequences. In particular, whether a payment is compensation for services or is instead a royalty for the use of property can mean the difference between paying tax in the United States or not, although this is not always the case.

We already know from the discussion above that compensation received by foreign athletes from competing in the United States is generally subject to U.S. tax. This concept has an important corollary: payments to athletes for other types of services rendered in the United States (for example, shooting a commercial) should not automatically be taxed here. Instead, they should be analyzed under the treaty rules applicable to service providers generally, which usually exempt compensation unless, broadly speaking, that compensation is paid from a U.S. permanent establishment or a fixed base.

Royalties paid to nonresidents are frequently exempt from tax in the United States (*see* , for example, Article 12 of the treaty between the United States and the United Kingdom). But labels can be misleading. The term "royalties" is used in entertainment and sports in a much broader context than it is used in the tax world. Just because a payment is labeled a royalty does not mean that it will be taxed (or exempted from tax) as a royalty.

For example, consider the case of the famous composer and conductor Pierre Boulez. Boulez, who was a nonresident alien and was under contract with CBS Records. Under the contract, Boulez would make recordings that would be owned by CBS Records — what we recognize as a work for hire. The contract provided that he would receive royalties based on a percentage of the receipts from sales of the records.

Seizing on the fact that the contract described his remuneration as "royalties," Boulez argued that the payments were exempt from U.S. tax under the treaty with Germany, his home country, which exempted royalties from U.S. tax.

But even though the contract called his remuneration "royalties," Boulez did not own any property that was being licensed. The property was owned by CBS Records. The Tax Court concluded that the contract was for personal services and the exemption did not apply. *Boulez v. Commissioner*, 83 T.C. 584 (1984). CBS's ownership of the underlying rights was a key determinative factor. (Note: Under U.S. copyright law, post-1977 recordings aren't listed as a work-for-hire category.)

Application of the principles in *Boulez* has come to the fore in complicated fashion in a couple of relatively recent, but unrelated, cases involving the world-famous golfers Retief Goosen and Sergio Garcia. They illustrate the difficulties in determining what is compensation for services and what is not.

The broad ideas in the two cases are the same. A company that makes golf equipment and clothing pays a nonresident alien golfer substantial sums of money to allow the company to use the golfer's name and likeness in its marketing campaigns. In return, the golfer is required to wear and use the company's products and to perform some incidental services. The golfer plays tournaments around the world, including some in the United States. How should the golfer's income from the endorsement contract be classified? Is the income royalties, compensation for services, or both?

The more recent case involved Sergio Garcia. *See*, *Garcia v. Commissioner*, 140 T.C. 141 (2013). While one might expect that by now everyone would have a good idea how these endorsement deals should be structured and analyzed, this case highlights the fact that there are still many issues that have become needlessly confused.

Sergio Garcia entered into a contract with TaylorMade to be the brand's "Global Icon." TaylorMade had endorsement deals with many golfers, but Garcia was its only "Global Icon," and thus was the centerpiece of TaylorMade's worldwide branding efforts.

Garcia was a top golfer at the time, but he was not the best. He made his deal with TaylorMade in 2002, the year after he finished at #6 in the world. At the end of 2002, he finished at #4. He was neither Michael Jordan nor Roger Federer. But his personality and image apparently more than compensated for the fact that he was not #1, which explains why his endorsement income was disproportionate to his on-course achievements. Think Anna Kournikova.

In his deal with TaylorMade, Garcia was required to use TaylorMade golf products (clubs, balls, gloves, etc.) and wear its golf clothes. He was also obligated to make some personal appearances.

This endorsement deal was all about Garcia's name and image. The core of the marketing plan was for the world to see, on TV, in print and otherwise, the TaylorMade brand on the body of Sergio Garcia. The personal services were merely incidental to the branding.

Which is why it is mind-boggling that the IRS argued, in its original notice of deficiency, that 100% of the payments made by TaylorMade were compensation for Garcia's personal services. *100%* . The IRS at trial took a baby step back from this position to argue instead that the "vast majority" of the payments were compensation for services.

As absurd as the IRS's litigating position was in this case, it shouldn't hurt a golfer who is a resident of a country with which we have a double tax treaty, as was the case with Garcia. He was originally from Spain, but at all times in question was a resident of Switzerland, with whom we have a tax treaty. The treaty with Switzerland contains fairly typical clauses, including Artistes and Sportsmen (Article 17) and Independent Personal Services (Article 14).

Endorsement services should not be subject to the Artistes and Sportsmen clause, and instead should be exempt from U.S. tax (unless there is a fixed base or a permanent establishment, which there rarely is for endorsers). Article 17 allows for the United States to tax income derived by a nonresident alien athlete "from his personal activities as such" exercised in the United States. Endorsing is not golfing, so any income allocated to personal endorsement services should be tax-free under the treaty. The IRS doesn't see it this way, though.

This all should have been good news for Garcia, but inexplicably his counsel conceded on more than one occasion that all of his income from services rendered in the United States was taxable in the United States. By the time the Garcia camp realized the error and claimed the treaty exemption for the first time in their post-trial opening brief, it was too late, according to the Tax Court, because the IRS had not been given the opportunity to address the issue at trial.

Garcia and the IRS fought over how much was properly allocated to services vs. royalties. The details are not pertinent to this discussion, except for some observations they generate.

First, the original endorsement contract did not attempt to allocate payments between services and royalties. This was certainly not helpful to Garcia's cause. A later amendment did have an allocation, but neither the IRS nor the Tax Court was persuaded because a TaylorMade executive testified that the company was indifferent as to the allocation.

Second, as the Tax Court concluded, under the treaty with Switzerland the royalties were exempt from U.S. tax. The IRS wrongly argued that the royalties were: 1) compensation for personal services; and 2) covered by the Artistes and Sportsmen provision of the treaty. Both arguments are ridiculous and the Tax Court reached the right conclusion.

But look at what this all means. Sergio Garcia's royalties were determined to be exempt from U.S. tax. And his personal service endorsement income might have been exempt from U.S. tax had his counsel not conceded the issue. So Garcia should have paid no U.S. tax on his endorsement earnings.

More broadly, isn't this really entirely about royalties and not at all about personal services? TaylorMade doesn't care about the services. It only cares about the value of the brand. The services are relevant only to the extent that they increase that value. In other words, the better argument seems to be that no allocation should be made to services. And for Garcia, because he resided in a treaty country, the royalties would not have been subject to U.S. tax.

This argument would not be welcomed by Retief Goosen. A foreign golfer with generally a better ranking than Sergio Garcia, Goosen was another TaylorMade endorser who faced tax issues similar to Garcia. *See*, *Goosen v. Commissioner*, 136 T.C. 547 (2011). In that case, Goosen lost on the royalties issue because the right to receive his royalties was held by a Lichtenstein entity. The United States does not have a tax treaty with Lichtenstein. Thus, U.S. royalties paid to a Lichtenstein entity are subject to 30% withholding. Had the royalties been paid to Goosen directly, they likely would have been exempt from U.S. tax because Goosen was a resident of the United Kingdom, with which the United States has a favorable income tax treaty. It thus seems that with some advance thought and planning Goosen could have fared much better.

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