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The Taxation of Royalty Payments to International Athletes

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In most athlete endorsement arrangements, an athlete will license to the endorsing company the rights to make use of the athlete's name, image, voice, or likeness in various marketing materials, and the athlete will also promise to perform certain services to promote the endorsing brand, such as wearing the products of the endorser and making personal appearances at the endorser's events or other industry-related events. When entering into these agreements, most athletes will receive either a lump-sum payment or be paid on an installment payment plan. The athlete may also receive bonus consideration for higher rankings or success at major events. Non-U.S. athletes (for U.S. federal income tax purposes, as defined below) face a larger-than-necessary U.S. tax bill if these payments are not properly allocated between the "services" component of the agreement and the "royalties" component of the agreement.

In this article we discuss two critical tax issues that should be considered by a non-U.S. athlete before entering into an endorsement agreement. Some of the information discussed may also be relevant to a U.S. athlete who is considering giving up citizenship and relocating to a country outside the United States. First, we discuss the potential tax benefits that could apply to a non-U.S. athlete who is a resident[1] in a country that has an income tax treaty with the United States. This can result in the United States reducing or eliminating the imposition of tax on royalties. Second, we discuss the significance of properly allocating the endorsement payment to services and royalties. Finally, in the last part of our discussion, we provide a case study involving a hypothetical boxer and analyze these rules and the potential for U.S. tax planning.

Illustration: Anthony Nuccio

Summary of U.S. and International Tax Rules

Taxation of U.S. Persons vs. Non-U.S. Persons

For U.S. federal income tax purposes, the distinction between an individual's status as a U.S. person versus a non-U.S. person is critical. A U.S. person is an individual who is either a U.S. citizen (born or naturalized), a U.S. green card holder, or considered to be substantially present in the United States.[2] All other individuals are not considered U.S. persons.[3] U.S. persons are subject to U.S. federal income taxation on their entire worldwide income, regardless of the source of the income. For athletes, this generally includes salaries, endorsement income, royalties, bonuses, dividends from U.S. and foreign companies, prize money, capital gains, and other forms of income. These types of income can be subject to U.S. federal income tax at rates up to 43.4%, which includes the net investment income tax. For example, a soccer player who is a U.S. person would be subject to U.S. federal taxation on income earned from playing soccer games in the United States and from playing soccer games outside the United States.

In contrast, non-U.S. persons are subject to U.S. federal income tax on only certain types of "U.S. source" income. For these purposes, U.S. source income generally includes (1) income effectively connected to a U.S. trade or business (ECI),[4] and (2) certain types of passive income from U.S. sources that are not derived from a U.S. trade or business, such as dividends, rents, and interest (FDAP income).[5] Most relevant to non-U.S. athletes is ECI, which could include U.S. source service income and prize money. Non-U.S. persons generally are not subject to U.S. tax on foreign earned prize money and non-U.S. source endorsement income. ECI is taxed at graduated rates (currently a top marginal rate of 39.6%) for U.S. persons, and allowable deductions may be taken against such income. On the other hand, FDAP income is generally taxed at a flat rate of 30% (or a lower rate where the terms of a U.S. income tax treaty apply) and no deductions are allowed.[6] Finally, if a non-U.S. person sells certain personal property, even if the property is located in the United States, capital gains from the sale may be considered "foreign source" income and not subject to U.S. federal income tax.[7] This may be relevant where a non-U.S. athlete sells his or her image rights.

Taxation of Royalty Income

One of the most common types of income professional athletes earn is annual income from endorsement contracts. These endorsement contracts come in two principal forms, some requiring the athlete to wear the sponsor's apparel and use its products during performance (an "on-court" or "on-course" contract) and others simply requiring the athlete to endorse a brand or product by allowing the sponsor to use the athlete's name, image, fame, or likeness in its advertising (an "off-court" or "off-course" contract).

Most on-court endorsement contracts, either explicitly or implicitly, contain both a services component and a royalty component. For the services component, the athlete is compensated for performing "service days" that might include testing new products or entertaining corporate executives. The royalty component consists of compensation for the sponsor's right to use the athlete's intellectual property, including his or her name, fame, image, and likeness in the sponsor's advertising. The U.S. federal income tax of these two components can vary, in some cases drastically, depending on whether the taxpayer qualifies for the benefits of a U.S. income tax treaty.[8]

For instance, the United States generally taxes non-U.S. persons on their services income to the extent such services are performed in the United States. In contrast, if a U.S. income tax treaty applies, depending on the exact type of services performed, the taxpayer may not be subject to U.S. income tax notwithstanding the fact such services are performed in the United States. For example, if a professional golfer earns fees for entertaining corporate executives of the sponsor on his or her own account in the United States, such payments may not be subject to tax in the United States provided the golfer does not have a fixed base, such as an office, in the United States. Similarly, non-U.S. persons generally are taxable on their U.S. source royalty income and, assuming such royalty income is not ECI, it is subject to withholding tax at a 30% rate. On the other hand, if a U.S. income tax treaty applies, such withholding tax may be reduced, or in some cases fully eliminated. The *Goosen v. Commissioner*[9] and *Garcia v. Commissioner*[10] cases discussed below illustrate that fleshing out the components of an endorsement contract for U.S. federal tax purposes is an extremely important exercise during the endorsement contract negotiation.

Income Tax Treaty Benefits

For purposes of this article, we will refer to the U.S.-Netherlands Income Tax Treaty[11] to provide a general overview of the treaty articles, which are common in most U.S. income tax treaties.[12] Article 13 (royalties) of the U.S.-Netherlands Income Tax Treaty

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provides that royalties derived and beneficially owned by a resident of a foreign treaty country shall be taxable only in that treaty country unless attributable to a permanent establishment. Therefore, if the taxpayer is a resident of the Netherlands and qualifies for the benefits of the U.S.-Netherlands Income Tax Treaty, the royalties may only be taxable in the Netherlands, absent the individual having a permanent establishment or fixed base in the United States. Article 15 (independent personal services) provides that income derived by a resident of a treaty country in respect of the performance of "personal services in an independent capacity" shall be taxable only in the country of residence unless the individual has a fixed base regularly available to him or her in the source country for the purpose of performing his or her activities. If the individual has such a fixed base, including an office, then the portion of income attributable to that fixed base can be taxed in the country where the services were performed. To illustrate, if a Dutch resident tennis player qualifies for the benefits of the U.S.-Netherlands Treaty and has no fixed base in the United States, money earned from signing autographs on his own account would likely not be taxable to him in the United States under article 15. Article 18 (artistes and athletes), however, which is specifically applicable to athletes, may also apply to income derived by the athlete that relates to his or her personal activities as an athlete.[13] If article 18 applies, the income in question will be subject to tax in the source jurisdiction to the extent derived from the athlete's personal activities as an athlete in that country.

In determining whether the income is subject to article 18 or another article, such as article 13, the controlling factor generally is whether the income in question is predominantly attributable to the performance of itself or other activities or property rights. For example, income from awards or prize money from playing tennis would typically be covered by article 18. In contrast, income that is not earned from playing tennis or not predominantly attributable to playing tennis generally should not be covered by article 18.[14]

Any given endorsement contract may generate more than one category of income for treaty purposes. In allocating income from a single endorsement contract among the various categories of treaty income, the parties to the endorsement contract may consider comparable third-party contracts or other relevant valuation evidence to determine the appropriate value to assign to a particular component. Each provision of the endorsement agreement should be analyzed to determine whether it calls for the provision of a personal service or license of an intangible. Further, the amount of control the sponsor has over the athlete's activities may be relevant in determining the apportionment of services compared to royalties.[15] Determining which income tax treaty article the income falls under is significant as it can affect whether the non-U.S. athlete is taxable in the United States on such income and whether the sponsor is required to withhold on payments.

Goosen and *Garcia* Cases

Goosen[16] and *Garcia*[17] involved disputes between professional golfers Retief Goosen and Sergio Garcia, respectively, and the Internal Revenue Service (IRS) on the characterization and apportionment of endorsement income between royalty and personal services income, among other things. In *Garcia*, the IRS further contended that the royalty income component was subject to the artistes and sportsmen article rather than the royalties article of the U.S.-Switzerland Income Tax Treaty. Unlike in *Garcia*, the Tax Court determined that a U.S. income tax treaty was not applicable in *Goosen*. In both cases, the IRS asserted that the income received from worldwide endorsement agreements should be characterized solely or predominantly as personal services income. In both cases, the taxpayers argued that the income received was primarily for the right to use their name and likeness. In *Goosen*, the Tax Court held, based on the record before it, that Goosen's compensation for on-course endorsement contracts was 50% personal services income and 50% royalty income. Further, the Tax Court held that royalty income received from the on-course endorsement contracts was 50% U.S. source income effectively connected with a U.S. trade or business and that he was not insulated from this result by the U.S.-U.K. Income Tax Treaty, which the court noted was inapplicable. Thus, the U.S. source portion of Goosen's endorsement income was subject to U.S. federal tax. This was a largely unfavorable tax result for Goosen.

In *Garcia*, TaylorMade Golf Co. held the right to use Sergio Garcia's name, image, and voice in its advertising and marketing campaigns worldwide. Among other things, Garcia's contracts with TaylorMade required Garcia to use the company's products in his professional golf play, make personal appearances, and pose for TaylorMade. The parties to the endorsement agreed to allocate 85% of compensation from the endorsement agreement to royalties and 15% to personal services. Rejecting the IRS's contention that all of the TaylorMade endorsement income should be treated as service income, the Tax Court ruled that the endorsement income was allocable 65% to royalties and 35% to personal services. In reaching its decision, the Tax Court compared Goosen to Garcia, as golfers, and noted that Garcia was TaylorMade's only "global icon" during the years at issue, the centerpiece of TaylorMade's marketing efforts, and the golfer whom TaylorMade used to build its brand. The Tax Court reasoned that Garcia's status as a TaylorMade global icon, particularly to the extent TaylorMade used his image rights to sell its products, was strong evidence that his TaylorMade endorsement agreement was more heavily weighted toward image rights than Goosen's. Further, because Garcia had a "head to toe" deal and was not required to complete additional service and personal appearance days,[18] it appeared that Goosen was required to provide more personal services than Garcia. As such, the Tax Court ruled that Garcia's endorsement agreement was more proportionally weighted to royalties than personal services.

After determining that 65% of the payment was attributable to royalties, the Tax Court analyzed whether the royalty income was subject to the royalties article or the artistes and sportsmen article of the U.S.-Swiss Income Tax Treaty. The Tax Court focused its determination on whether the income was predominantly attributable to Garcia's performances or other activities or property rights. Disagreeing with the IRS's view that the artistes and sportsmen article applied to the income, the Tax Court ruled that although Garcia's golf play and personal services performed in the United States had some connection to his U.S. image rights, the income from the use of such rights was not predominantly attributable to his performance as a golfer in the United States. Instead, the image rights were a separate intangible that generated royalties described in the royalties article of the U.S.-Swiss Income Tax Treaty. Therefore, the U.S.-Swiss Income Tax Treaty fully eliminated the withholding tax that otherwise would have applied to the U.S. source royalty component of the payment and, under the royalties article, such royalties were taxable only in Switzerland. Unlike Goosen, because Garcia qualified for the benefits of a U.S. income tax treaty, the royalty component of his endorsement income from TaylorMade was fully exempt from U.S. federal income tax.

Planning Examples

For purposes of illustrating planning ideas based on the foregoing discussion, we will utilize the following factual pattern.

Igor Petrov is an up and coming professional boxer. He has been boxing for three years and has a record of 21–0, with 16 knockouts. Last year, Igor was in the running for *Ring* magazine's Fighter of the Year award. As a result, he has attracted the attention of numerous boxing brands. One such brand, Boxer Strength, a U.S. company regarded as one of the most reputable brands in boxing, has expressed interest in signing Igor to use a number of its boxing products, such as gloves, jump ropes, and trunks, during practice and boxing matches. Boxer Strength would like Igor to be the face on all of its company products, and would like to use his image to market products in magazines, billboards, and commercials. Boxer Strength also wants Igor to make appearances at company events and charitable functions. In addition to Boxer Strength, Igor was contacted by Pump Up, a U.K. company,[19] about making a "how to" video filmed in the United States on methods of becoming a better fighter in the ring. Pump Up would distribute the video internationally through online downloads.

Outside the ring, Igor is married and has two young children. Although Igor was born in Russia, he spent much of his childhood in Italy and Switzerland. Igor has properties all over the world, including the United States, England, Switzerland, and Russia. On an annual basis, Igor has about six to eight matches, with most of the matches taking place in North America, Europe, and Asia. He spends an average of three weeks training for each match. Igor has a lot of flexibility on where he decides to train before a fight. As long as the athletic facility has adequate equipment and space, Igor is indifferent to where he trains. Igor currently lives with his family in Russia, but they are considering moving to a country that is either in a more central location or where Igor frequently competes. Alternatively, after enduring many cold winters in Russia, Igor is also not opposed to moving to a tropical climate. In light of these aspirations, Igor is particularly interested in the United States, or, alternatively, Switzerland or Barbados, countries with which the United States has entered into double tax treaties.

Igor Petrov Moves to the United States

If Igor decides to permanently relocate to the United States and become a U.S. tax resident, he will be considered a U.S. person. As such, all of his future income, regardless of the source (domestic or foreign) and characterization (royalty income or service income) will be subject to U.S. federal tax at a maximum rate of 39.6%. Depending on the state and city where Igor relocates, he may also be subject to state and local taxes (ranging anywhere from a total of 0% to 13.3%) on all or some of his income. Ultimately, Igor could be subject to an effective tax rate of up to approximately 50% on all of his worldwide income.

Igor Petrov Moves to a Treaty Country

If Igor moves to a treaty country, such as Switzerland or Barbados, his U.S. federal income tax exposures will vary depending on whether the income in question is considered U.S. or foreign source, and further, whether it is attributable to intangible rights or personal services. We analyze the potential tax implications of the various types of income below.

Boxer Strength Agreement

At the time of entering into the Boxer Strength agreement, careful attention should first be given to each of the activities

to determine whether it results in income for the performance of services or income for the use of Igor's name, fame, or likeness. Igor's income from using Boxer Strength's boxing products during matches and practice will likely be considered, at least in part, income for the performance of personal services, while the remainder (e.g., merchandising and marketing income) will be considered royalty income. The income attributable to appearances at company events and charitable functions should be considered income for the performance of personal services. For purposes of this discussion, assume that this personal services income is governed by the artistes and athletes treaty article.[20] On the other hand, Boxer Strength's use of Igor's image to market products in magazines, billboards, and commercials should result in royalty income.

Igor's team, comprised of his tax counsel and economists, should negotiate with Boxer Strength to determine the appropriate apportionment that should be given to the services component and royalty component of the agreement. One of Boxer Strength's primary reasons for negotiating the apportionment is the extent of its U.S. withholding tax obligations, which can vary significantly in complexity depending on the character and source of the income. In the negotiation process, the facts and circumstances of each activity must be carefully analyzed and addressed in the agreement. Many questions must be answered, such as how much income does Boxer Strength expect to generate from the distribution of Igor's image in promotional materials, or how popular of a boxer is Igor compared to other boxers in the industry? Does Igor's fame transcend boxing (e.g., celebrity status)? How many appearances will Igor be required to make at company or charitable events, what is the nature of these appearances, and who will be attending these events? What are the allocation percentages in other third-party comparable endorsement contracts?

Assume that Igor's team and Boxer Strength's representatives find that the royalty component of the agreement should be 60% and the personal services component of the agreement should be 40%, and that this represents an economically defensible allocation of the respective values of what Igor is providing. Therefore, if Boxer Strength agrees to pay Igor $10 million as compensation for entering into the endorsement agreement, $6 million will be royalty income and $4 million will be personal services income. This income must be further apportioned to the extent it is considered U.S. source and non-U.S. source income. This is also relevant to Boxer Strength, because Boxer Strength may have U.S. withholding tax obligations with respect to the U.S. source income.

The personal services income will be taxable in the United States[21] to the extent Igor appears at company and charitable events in the United States, and has boxing matches in the United States wearing Boxer Strength's products.[22] This income will be considered U.S. source personal services income. The personal services income attributable to appearances and boxing events outside the United States should be considered non-U.S. source income and not subject to U.S. tax.

The $6 million of royalty income earned from the use of Igor's intellectual property in the United States should be considered U.S. source income, because the U.S. sourcing rules for royalty income are based on where the intellectual property is used. For purposes of this discussion, assume that this income is not subject to the artistes and athletes treaty article, but rather is governed by the royalties article.[23] In contrast, the income earned from the use of Igor's intellectual property outside the United States should be considered non-U.S. source income and not subject to U.S. federal tax. However, provided the requirements of the U.S. income tax treaty are met (depending on whether he chooses Switzerland or Barbados), the U.S. source royalty income may be subject to U.S. tax of 0% or 5%, under the U.S.-Swiss Income Tax Treaty and the U.S.-Barbados Income Tax Treaty, respectively, and instead would be taxed in Switzerland or Barbados depending on which country he is considered a resident of for treaty purposes.

Pump Up Agreement

Under the Pump Up agreement, Igor will be using his skill and fame to demonstrate to third-party users how to become a better boxer. If Igor owns the intellectual property rights to the video, then the compensation that is paid to Igor may be considered royalty income.[24] On the other hand, if Igor does not own the intellectual property rights to the video, then then the compensation that is paid to Igor will likely be categorized as personal services income.[25] The distinction is important because withholding tax on royalties may be reduced to 0% or 5% tax, while services would likely be subject to U.S. federal tax at rates up to 39.6%, plus applicable state and local taxes.

Assuming Igor owns the intellectual property rights and the income is royalty income, the income should be sourced according to where the video is ultimately used.[26] This should be true even though the video is filmed in the United States. Because this video will be circulated all throughout the world via online download, special rules, which are outside the scope of this article, should apply in determining how the income should be allocated for U.S. federal tax purposes. However, even if a portion of the payment under the Pump Up agreement is considered U.S. source royalty income, such income may be excludable or largely excludable (5% under Barbados)[27] from U.S. tax under the U.S. income tax treaty.

Result

Therefore, in contrast to Igor becoming a permanent resident of the United States and being subject to U.S. tax on all of his future worldwide income, Igor may be taxable in the United States only on his U.S. source personal services income.

Conclusion

A non-U.S. professional athlete should consider U.S. federal income tax as early in the individual's career as possible, as the stakes are high and performance and endorsement income can span 10 to 20 or more years. Regardless of whether the athlete or entertainer intends to remain a nonresident indefinitely or is considering becoming a U.S. income tax resident, discussing the issues raised in this article with qualified counsel is incredibly important. With proper planning, most non-U.S. athletes can avoid unnecessarily large U.S. tax bills on endorsement income. Finally, for those athletes considering becoming U.S. income tax residents, it is equally important to understand fully and appreciate the gravity of the U.S. federal tax consequences applicable to such change in residency status, even if only for a single year. ■

Endnotes

1. The United States has income tax treaties with many foreign countries around the world that strive to prevent the double taxation of income. For a foreign individual to qualify for the benefits of a U.S. income tax treaty, the individual must be considered a tax resident of the foreign country treaty partner. This determination can often be complex. While this article addresses various benefits that are available to an eligible treaty resident, it does not discuss the criteria necessary to establish residency.

2. I.R.C. § 7701(a)(30), (b)(1)(A).

3. *Id.* § 7701(a)(5), (b)(1)(B).

4. *Id.* § 871(b).

5. This includes interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income. *See id.* § 871(a)(1)(A).

6. *Id.* §§ 871(a), 1441.

7. *Id.* § 865(a)(2).

8. To be entitled to the benefits of a U.S. income tax treaty, a taxpayer generally must meet a residency test, and if applicable, a limitation on benefits test (to the extent such treaty includes one). Assuming the taxpayer qualifies for benefits of the U.S. income tax treaty, U.S. source endorsement income earned by the non-U.S. athlete that is not attributable to a U.S. fixed base or permanent establishment is generally classified as royalties (usually article 12), independent personal services income (usually article 14), dependent personal services income (usually article 15), artistes and sportsmen income (usually article 17), or other income (usually article 21).

9. 136 T.C. 547 (2011).

10. 140 T.C. 141 (2013).

11. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, U.S.-Neth., Dec. 18, 1992, 32 I.L.M. 457 (entered into force Dec. 31, 1993) [hereinafter U.S.-Netherlands Income Tax Treaty].

12. The article numbering used in the U.S.-Netherlands Income Tax Treaty is somewhat unique to most U.S. income tax treaties. Generally, royalties are governed by article 12 (as opposed to article 13), independent personal services income is governed by article 14 (as opposed to article 15), dependent personal services income is governed by article 15 (as opposed to article 16), artistes and sportsmen income is governed by article 17 (as opposed to article 18), and other income is governed by article 21 (as opposed to article 23).

13. The Organisation for Economic Co-operation and Development (OECD) generally views on-court endorsement income and certain off-court endorsement income to be subject to and governed by article 17. *See* OECD, Model Tax Convention on Income and on Capital art. 17 cmt., ¶ 9 (2014) ("Royalties for intellectual property rights will normally be covered by Article 12 [royalties] rather than Article 17 [artistes and sportsmen] . . . but in general advertising and sponsorship fees will fall outside the scope of Article 12. Article 17 will apply to advertising or sponsorship income, etc. which has a close connection with a performance in a given State (e.g., payments made to a tennis player for wearing a sponsor's logo, trade mark or trade name on his tennis shirt during a match).").

14. *See* Garcia v. Comm'r, 140 T.C. 141 (2013).

15. Rev. Rul. 84-78, 1984-1 C.B. 173 (focusing on the degree of control a foreign broadcaster had over when or where a prize boxing fight took place under a contract with a U.S. licensor and whether the U.S. licensor exclusively performed for the benefit of the broadcaster in determining whether a payment should be treated as personal services income or royalty income).

16. 136 T.C. 547 (2011).

17. 140 T.C. 141 (2013).

18. Garcia was required to complete a total of 12 service and personal appearance days each year for TaylorMade, while Goosen was required to complete only eight. However, the Tax Court recognized that Goosen's TaylorMade agreement was not a "head to toe" deal, and he was required to complete six additional service and personal appearance days for two other companies, Acushnet and Izod. As such, the Tax Court noted it appeared that Goosen was required to perform more service and personal appearance days per endorsed product than Garcia.

19. The domicile of a payer is particularly relevant where a U.S. income tax treaty contains a "royalties source clause." Some royalties source clauses can fully exempt royalties paid by a foreign payer to a foreign person from U.S. withholding tax, even if the royalties are viewed as being "U.S. source" for U.S. federal tax purposes. This is particularly relevant where the income tax treaty provides a minimum rate greater than 0% on royalties.

20. The determination of whether the personal services income falls under article 14 or article 17 will typically depend on how closely connected the activity is to a performance in the host state as an athlete. *See* OECD, *supra* note 13, at art. 17 cmt., ¶ 9.

21. As discussed above, for purposes of this article, we have assumed that this personal services income is governed by the artistes and athletes treaty article. The U.S. tax result could be different if the income is governed by a different treaty article (e.g., independent personal services or business profits).

22. As discussed above, a portion of the income paid to Igor for his use of Boxer Strength's boxing products during matches and practice will likely be considered royalty income.

23. Due care should be taken to determine whether a close connection exists between the income and the performance of the activities. If a close connection exists, the income may be governed by article 18 (artistes and sportsmen) as opposed to another treaty article (e.g., independent personal services). *See* OECD, *supra* note 13, at art. 17 cmt., ¶ 9 ("Such a close connection will generally be found to exist where it cannot reasonably be considered that the income would have been derived in the absence of the performance of these activities.").

24. Boulez v. Comm'r, 83 T.C. 584 (1984) (holding that certain payments to a world-renowned orchestra conductor to make recordings of orchestral works for CBS were not royalty payments, but rather personal services payments, because the conductor did not have an ownership interest in the recordings).

25. If Igor can prove that this income is not subject to the artistes and athletes treaty article and is eligible for the benefits of another treaty article, then this income may be excludable from U.S. tax.

26. Estate of Marton v. Comm'r, 47 B.T.A. 184 (1942).

27. The sourcing of royalty income becomes particularly important when an applicable income tax treaty provides a minimum rate greater than 0%.