The eSports Explosion

INSIDE:
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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. (foreign) athletes (for U.S. federal income tax purposes, as defined below) face a higher-than-usual federal 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 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.

Summary of U.S. and International Tax Rules

TAXATION OF U.S. PERSONS VERSUS 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. All other individuals are considered non-U.S. persons. U.S. persons are subject to U.S. federal income taxation on their entire worldwide income, regardless of the source of the income. Non-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 33.4%, 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), 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). 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 passive income and ECI, the income is generally 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. 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. This may be relevant where a non-U.S. athlete sells his or her image rights.

Taxation of Royalties

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: (1) “on-course” or royalty contracts and (2) off-course contracts. An “on-course” contract is a contract between the athlete and the sponsor (or a “professional athlete” contract) for use of the athlete’s name, image, fame, or likeness in advertising (an “off-course” or “off-course” contract). As an example of an on-course contract, a professional golfer may enter into a contract with a golf equipment company whereby the athlete agrees to wear the sponsor’s equipment during the event. As an example of an off-course contract, an athlete may enter into a contract with a sponsor whereby the athlete agrees to endorse a product or allow the sponsor to use the athlete’s name, image, fame, or likeness in its advertising (an “off-course” or “off-course” contract).
provides that royalties derived and beneficially owned by a resi-
dent of a foreign treaty country shall be taxable only in that treaty
country; the income tax treaty is considered permanent establish-
ment. 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 in-
dependent personal services. Article 15 (independent personal services)
provides the performance of "personal services in an independent capa-
"present" to be taxable only in the country of residence unless the
United States. Article 15 (independent personal services) provides
the performance of "personal services in an independent capa-
"source country for the purpose of performing his or her activities.
If the individual has such a fixed base, including an office, 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 (artists 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. 12
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 per-
sonal 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 is predominantly attributable to the performance (self) 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 play-
ing tennis or not predominantly attributable to playing tennis generally should not be covered by article 18. 13
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 vari-
cous categories of treaty income, the parties to the endorsement
contract may consider comparable third-party contracts or
other relevant valuation evidence to determine the appropri-
ate value to assign to a particular component. Each provision
of the endorsement agreement should be analyzed to deter-
mine whether it calls for the provision of a personal service or
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
pre-empted only taxable 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 Tay-
lorMade 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 maga-
zine's Fighter of the Year award. As a result, he has attracted
the attention of numerous boxing brands. One such brand, Boo-
ker 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.
Boozer Strength would like Igor to be the face on all of its com-
pany products, and would like to use his image to market products
in magazines, billboards, and commercials. Boozer Strength also wants Igor to make appearances at company
events and charitable functions. In addition to Boozer Strength,
Igor was contacted by Pump Up, a U.S. company, about
movies. Pump Up would distribute the video internationally.

Igor also not opposed to moving to a tropical climate. In light of these
inspirations, Igor is particularly interested in the United States on meth-
ods of becoming a better fighter in the ring. Pump Up would distribute the video internation-
ally through online downloads. 14

The outside ring, Igor is married and
has two young children. Although Igor was born
in Russia, he spent much of his childhood in Italy and
International. Igor is known
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 flexi-
ble areas, and he is a star in boxing.

Igor Petrov Moves to a Treaty Country
If Igor moves to a treaty country, such as Switzerland or Barba-
dos, his U.S. federal income tax exposures will vary depending
on whether his income in question is considered U.S. or for-

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likeness. Igor's income from using Boxer Strength's boxing products during matches and practice are considered personal services income. For purposes of this discussion, assume that Igor is not subject to the artistes and athletes treaty article. 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 tax agreements 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 promotions? 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?

Assuming Igor owns the intellectual property rights and the royalty income is the royalty income, the income should be sourced according to where the video is ultimately used. The source of the income, which will be true even though the video is if it is filmed in the United States. Because this video will be circulated all throughout the world via online downloads, 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, the income may be excluded or largely excluded (5% under Barbados) from U.S. tax under the U.S.- income treaty. As personal services income or royalty income).

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