

To Tax or Not To Tax: Is a Non-Resident Tennis Player's Endorsement Income Subject to Taxation in the United States?

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INTRODUCTION

In a Tax Court petition filed July 21, 1997, Stefan Edberg ("Edberg"), the Swedish tennis star, contested the Internal Revenue Service's ("IRS") determination of both the amount and character of the United States-source endorsement income ("U.S.-source income") he earned during taxable years 1989, 1990, and 1991.¹ During the years in issue, Edberg was one of the best tennis players in the world, evidenced by his holding the number one ranking in 1990.² He won the U.S. Open singles title in 1991 and 1992 and won or was finalist in several other Grand Slam tournaments.³ When he retired from singles competition in 1996, he was one of the leading money winners of all time.⁴ In addition, he was con-

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1. See Tax Court Petition Docket No. 15576-97, *abstract available in* [Dockets, Petitions, Index – Digest] Tax Court Reporter (CCH) 9584 (July 21, 1997)

2. See Jayne Custred, *1990: Triumph and Turmoil*, HOUSTON CHRON., Dec. thirty, 1990, § 2, at 15; *Edberg Wins ATP Event, Clinches No. 1*, ATLANTA JOURN. & CONST., Nov. 17, 1990, at D3.

3. See Thomas Bond, *Down Early, Edberg is Up to No. 1 Again*, L.A. TIMES, Sept. 14, 1992, at C1; Doug Smith, *Edberg Lands on His Feet at U.S. Open*, USA TODAY, Sept. 14, 1992, at C1.

4. Edberg amassed \$20,414,213 in official prize money during his tennis career. See VIP-LOUNGE: Track Your Star (visited June 16, 1999) <<http://www.atptour.com/viplounge>>. Only Pete Sampras and Boris Becker have higher career earnings.

sidered handsome and had a reputation for integrity and a likable public personality.⁵ Players with such star quality command huge fees to endorse tennis clothing, shoes, and racquets, and such items as soft drinks, fitness equipment, sports clothes, photographic film, and personal care items such as cologne and perfume.⁶ They also appear in television and print ads for such as cars and cereals.⁷ In rare cases, such as the “Kramer” tennis racquet and the “Lacoste” and “Fred Perry” clothing lines, licensed products continue to thrive long after the licensor’s playing days are over.

Edberg (1) determined his U.S.-source income by allocating his worldwide endorsement income on the basis of days in the United States to total days and (2) allocated U.S.-source income equally between taxable personal service income and royalty income.⁸ The eleven endorsement contracts were with both United States and non-United States companies, including Adidas, Volvo, Wilson, and Fuji. The royalties and endorsement fees were for the use of his name and services in both the United States and elsewhere. Apparently, the eleven endorsement contracts had varying royalty and personal services characteristics. The arrangement with Adidas apparently included a line of clothing. The IRS alleged that (1) U.S.-source income was materially understated and (2) 100 percent of the U.S.-source income was personal service income subject to

5. See Julie Cart, *Edberg to Retire with Style and in Style*, L.A. TIMES, Dec. 24, 1995, at C8 (stating that Edberg “has always been a voice of reason and dignity”); George Vescey, *A Warning to Tennis Champs – No Whining Allowed*, PHOENIX GAZETTE, Sept. 9, 1991, at C2 (stating that Edberg was a “handsome blond athlete”).

6. See Harry Berkowitz, *Next Generation of Celebs at the Net*, NEWSDAY, June 28, 1993, at 31. The article detailed some of the top tennis players’ endorsement contracts in 1993. At that time, Andre Agassi and Monica Seles led all active players with about \$7 million per year. Agassi had contracts with Nike, Canon cameras, Ebel Watches, a toy company, a video company, Nescafe in England, and an energy drink in Italy. Seles was associated with Canon cameras, Perrier, Fila Sportswear, Sony overseas, and had done an ad for No Excuse jeans.

7. See *id.* (stating that Pete Sampras endorsed Mitsubishi cars).

8. During the years at issue, Edberg was tax resident of the United Kingdom. Royalty income is not subject to United States tax under the United States-United Kingdom income tax treaty. See Convention between the Government of the United States of America and the Government of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and Capital Gains, Dec. 31, 1975, art. 12, ¶ 1, 31 U.S.T. 5668, 5681 [hereinafter U.K. treaty].

United States tax. Edberg's litigating position was that all of his U.S.-source income was tax free under the U.K. treaty, either as personal service income or royalty income, rather than taxable under the Artistes and Athletes article.

The case has been settled on a no-change basis.⁹ Had the case proceeded to a decision, it would have been the leading authority on sourcing and characterizing — as either royalty, personal service, or artiste and athlete income — the endorsement income of international sports celebrities. Although the U.K. treaty applied, the royalty, independent personal services, and artistes and athletes articles of the Organization for Economic Cooperation and Development (“OECD”) countries are very similar, the case would have been important whenever a treaty based on the *OECD Model Tax Convention On Income and On Capital*¹⁰ (“*OECD Model Treaty*”) was involved.

This Essay discusses the law that would have applied to both Edberg's *tax return position* — that half of his licensing and endorsement fees were tax free under the Royalty article — and *his litigating position* — that they were entirely tax free. Part I presents background material on the significance of whether endorsement income qualifies as royalty income rather than independent personal services income or artistes and athletes income. Part II examines different situations to determine what the proper characterization should be under both the United States Model Income Tax Convention (“1996 United States Model Treaty”) and treaties that are similar. Part III examines whether, in non-treaty situations, the income would be treated as income not effectively connected with a United States trade or business (i.e., as royalty income subject to thirty percent withholding) rather than as income effectively connected with a United States trade or business (e.g., a

9. Interview with John P. Napoli, Pryor, Cashman, Sherman & Flynn, New York, N.Y., Counsel for the Petitioner, Stefan Edberg.

10. The OECD Committee on Fiscal Affairs drafted a model tax treaty that serves as the basis for many international agreements involving taxes on income and capital. See 1 COMMITTEE ON FISCAL AFFAIRS, ORGANIZATION FOR ECON. COOPERATION & DEV., MODEL TAX CONVENTION ON INCOME AND ON CAPITAL (Rev. Nov. 1997) [hereinafter *OECD MODEL TREATY*]. The OECD has created extensive commentary to explain the *OECD Model Treaty*. For purposes of this Essay, the commentary will be referred to in the text as “OECD Commentary.”

player's tournament winnings). This Essay concludes that tax treatment will depend on whether there is a treaty and the nature and characteristics of the endorsement and licensing income.

I. BACKGROUND

Although it may have had little impact on the *Edberg* litigation whether the income was royalty or independent personal service (endorsement) income — because the rate was zero in either case under the U.K. treaty — often it will make a difference, in both treaty and non-treaty situations.

An athlete's endorsement income under the OECD and United States model treaties (and most United States treaties) generally is not taxed by the source country if the Independent Personal Services article rather than the Artistes and Athletes article applies. Likewise, royalty income is tax free in the source country under both model treaties, but many United States treaties provide for royalty withholding as high as fifteen percent. Moreover, endorsement income of athletes is taxable by the source country under the Artistes and Athletes article of the United States-Mexico treaty;¹¹ and, where there is no treaty, royalty income and endorsement income may be taxed differently.¹² Therefore, the dis-

11. Article 18 of the United States-Mexico tax treaty provides that: Remuneration derived by an entertainer or athlete who is a resident of a Contracting State shall include remuneration for any personal activities performed in the other Contracting State relating to that individual's reputation as an entertainer or athlete. The provisions of this Article shall not apply to auxiliary or supporting personnel, such as technicians, or to managers or coaches, who shall remain subject to the provisions of Articles 14 and 15.

Protocol, Convention between the Government of the United States of America and the Government of the United Mexican States for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income, Sept. 18, 1992, ¶ 16 (modifying Article 18 (Artistes and Athletes)), T.I.A.S. No. _____, available in 28 WALTER H. DIAMOND & DOROTHY B. DIAMOND, INTERNATIONAL TAX TREATIES OF ALL NATIONS 179, 243 (Series B 1994) [hereinafter Mexico Treaty].

12. The matters that the Competent Authorities can resolve include "the nature of particular items of income." U.K. Treaty, *supra* note 8, art. 25, ¶ 3(c), 31 U.S.T. at 5688. The United States Competent Authority is the Secretary of the Treasury or his delegate. See Mexico Treaty, *supra* note 11, art. 3, ¶ 1(e)(i), at 183. Currently, the delegate is the Assistant Commissioner (International) of the IRS, who, on interpretive issues, acts with the concurrence of the Associate Chief Counsel (International) of the IRS. See Treasury Department Technical Explanation, Convention and Protocol between the Government of

inction between royalty income and endorsement income is important.

The leading case to date on royalties versus personal services income, *Kramer v. Commissioner*,¹³ held that seventy percent of the fees paid to the famous tennis player were royalties for the use of his name and likeness, and only thirty percent were for personal services.¹⁴ The facts in *Kramer* are more royalty-supportive than those contemporary sports celebrities are likely to generate. Although the law is not well developed, much the same standard probably applies in non-treaty situations to differentiate personal service (“effectively connected”) income from income not effectively connected with a United States trade or business (“fixed and determinable income”).¹⁵

Absent a treaty, whether personal service treatment (graduated rates) or royalty treatment (thirty percent withholding) is better depends on (1) the taxpayer’s tax bracket and (2) the amount of deductions attributable to the royalty income (expenses attributable to royalties are not deductible). Personal service income is subject to thirty percent withholding, although lower withholding can be arranged where it is shown that it will cover the tax liability.¹⁶

the United States of America and the Government of the United Mexican States for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income, signed at Washington on September 18, 1992, art. 3, available in 28 WALTER H. DIAMOND & DOROTHY B. DIAMOND, INTERNATIONAL TAX TREATIES OF ALL NATIONS 250, 254 (Series B 1994).

13. 80 T.C. 768 (1983)

14. See *id.* at 782.

15. See *supra* Part III.

16. See 26 U.S.C.A. § 871(a)(1)(A) (West 1988 & Supp. 1999). Entertainers and athletes can request a Central Withholding Agreement to qualify for reduced withholding. See IRS Pub. 515, Withholding of Tax on Nonresident Aliens and Foreign Corporations, at 17 (Rev. Nov. 1998). If the income is exempt under either a statute or a tax treaty, withholding agents need not withhold tax if they have received proper documentation from the recipient of the payments. See *id.* at 5.

II. THE DETERMINATION OF THE TYPE OF INCOME DEPENDS ON THE SITUATION

A. *All or Nothing? – Depends on How You Define “Predominant”*

A threshold question is whether fees from an endorsement contract should be: (1) treated entirely as either (a) fees for personal services or (b) royalties for the use of a capital asset, or (2) allocated partly to one and partly to the other.

The OECD Commentary on the *OECD Model Treaty* states that there should be an allocation between the two unless one is clearly subordinate to the other.¹⁷ The IRS adopts by reference the view of the OECD Commentary, but there are indications that the enforcement policy is that payments should be entirely one or the other, depending on which characteristic is predominant. Both the OECD and IRS literature use the word “predominant,” but the OECD defines it as the opposite of “negligible,”¹⁸ while the IRS apparently would like to define it as “more than half.”¹⁹ The IRS claims to have settled many licensing/endorsement cases on the basis that 100 percent of the fees are for personal services.²⁰

In addressing the allocation between royalties and independent services, the OECD Commentary on Article 12 (Royalties) states:

In business practice, contracts are encountered which cover both know-how and the provision of technical assistance. One example, amongst others, of contracts of this kind is that of franchising, where the franchisor imparts his knowledge and experience to the franchisee and, in addition, provides him with varied technical assistance, which, in certain cases, is backed up with financial assistance and the supply of goods. The appropriate course to take with a mixed con-

17. See OECD MODEL TREATY, *supra* note 10, art. 17 commentary at ¶ 4.

18. See *id.*

19. See *infra* note 23 and accompanying text.

20. See Audit Technique Guide for Foreign Athletes & Entertainers, [Audit Binder] Market Segment Specialization Program (CCH) ¶ 204,601, at 22, 968 (Oct. 1994) [hereinafter Market Segment Study]; see also *infra* note 63 and accompanying text.

tract is, in principle, to break down, on the basis of the *information contained in the contract or by means of a reasonable apportionment*, the whole amount of the stipulated consideration according to the various parts of what is being provided under the contract, and then to apply to each part of it so determined the taxation treatment proper thereto. If, however, one part of what is being provided constitutes *by far the principal purpose* of the contract and the other parts stipulated therein are *only of an ancillary and largely unimportant character*, then it seems possible to apply to the whole amount of the consideration the treatment applicable to the principal part.²¹

That commentary supports the situation in which a franchiser like McDonald's splits the fee it receives from a franchisee between a license for the use of its name and a fee for technical assistance. There is no fundamental reason why it does not support Stefan Edberg making a similar allocation if the facts warrant.

The IRS acknowledges the seventy-thirty percent royalty-personal service split of *Kramer*, and the Technical Explanation to the United States Model Income Tax Convention notes with approval, as follows, the OECD Commentary quoted above:

The term "industrial, commercial, or scientific experience" (sometimes referred to as "know-how") has the meaning ascribed to it in paragraph 11 of the Commentary to Article 12 of the OECD Model Convention. Consistent with that meaning, the term may include information that is ancillary to a right otherwise giving rise to royalties, such as a patent or secret process.²²

21. OECD MODEL TREATY, *supra* note 10, art. 12 commentary at ¶ 11 (emphasis added). It is interesting to note that the OECD Commentary on Article 12, in discussing separating the royalty and personal service elements of a musical performance, states that it makes no difference whether the amounts attributable to each element are stated in one contract or in separate contracts. *See id.* at commentary ¶ 18.

22. Technical Explanation, United States Model Income Tax Convention art. 12, ¶ 2, available in RICHARD L. DOERNBERG & KEES VAN RAAD, THE 1996 UNITED STATES MODEL INCOME TAX CONVENTION, annex B, ¶ 181, at 313 (1997) [hereinafter 1996 Technical Explanation].

There is considerable evidence, however, that the IRS resists splitting fees between royalties and personal services. First, nowhere in the Treasury literature is there mention of apportioning fees in that way. And, as discussed *infra*, the IRS's Market Segment Study takes the position that fees should be characterized as entirely one or the other depending on the terms of the contract.²³ Also significant is the IRS's original position in *Edberg* — that no portion of the endorsement fees on any of the eleven contracts was a royalty.

Most endorsement income is predominantly personal service income because of the personal services that the contract usually requires. Pure “royalty” income is generated only when payments are solely for a license to use the celebrity's name and picture — no services, such as endorsements, wearing or using products, wearing patches, or making personal appearances, are required.²⁴

B. *The Kramer Case*

Jack Kramer was the best tennis player in the world from 1946 to 1953. When he turned professional in 1947, he contracted with the Wilson Sporting Goods Co. (“Wilson”) to give it “exclusive world rights and license to manufacture and/or advertise, sell and distribute tennis frames, tennis balls, and other tennis equipment identified by [his] name, facsimile signature, initials and/or portrait”²⁵ The contract also provided that he would use Wilson equipment exclusively and that he would “use his best efforts to promote and further the sale of such products.”²⁶ The contract did not require Kramer to play tournament tennis, but gave Wilson the right to cancel the contract if he died or became “incapacitated.”²⁷ The parties “understood and agreed that Kramer [would] make appearances, including appearances at Wilson's dealers' stores, and [would] conduct clinics and exhibitions at the request of Wilson

23. See *infra* Part II.D.

24. See Rev. Rul. 81-178, 1984-2 C.B. 135, 136.

25. See *Kramer v. Commissioner*, 80 T.C. 768, 770 (1983).

26. See *id.*

27. See *id.* at 771. Interestingly, the term “incapacitated” was not defined in the contract.

whenever it [was] consistent with the interests of both parties.”²⁸

The original contract was for seven years and was regularly extended through the years in issue — 1975 and 1976.²⁹ The most successful product, whose royalties were the subject of the Tax Court litigation, was the “Jack Kramer Autograph” tennis racquet (the “Kramer” racquet”), which under the terms of his agreement, Kramer helped develop, test, and promote.³⁰ The wooden “Kramer” racquet was Wilson’s best-selling racquet ever and the best-selling tennis racquet in the world for many years,³¹ until it was rendered obsolete by racquets made of graphite and other non-wood materials in the 1980s.

In 1975 and 1976, Jack Kramer devoted considerable time to working with Wilson marketing the “Kramer” racquet.³² The racquet was originally made for Wilson by Spaulding, which sold a substantially identical racquet called the “Pancho Gonzales Autograph” racquet.³³ Pancho Gonzales succeeded Jack Kramer as the best tennis player in the world.³⁴ Gonzales had a reputation as a player equal to Kramer’s and was likewise both colorful and popular.³⁵ The “Kramer” racquet outsold the “Pancho Gonzales” racquet eight to one, which the Court attributed to marketing.³⁶ In 1975 and 1976, Kramer was involved full-time in tennis and, based on his itinerary for those years, he probably spent ten to fifteen percent of his time promoting Wilson products.³⁷ His other activities included personal appearances for several tournaments, his job as executive director of the Professional Tennis Players’ Association, and promotion of the Davis Cup.³⁸ For all of his personal ap-

28. *See id.*

29. *See id.* at 770.

30. *See id.*

31. *See id.* at 776.

32. *See id.* at 776.

33. *See id.*

34. *See* John Devaney, *Where Are They Today: Pancho Gonzales*, CHICAGO SUN-TIMES, July 5, 1985, at 73 (detailing the life and career of Gonzales and drawing comparisons between Kramer and Gonzales).

35. *See id.*

36. *See Kramer*, 80 T.C. at 776-77. The Court acknowledged that the record contained little about Wilson’s contribution to the marketing effort. *See id.* at 780.

37. *See id.* at 772-75.

38. *See id.*

pearances he was paid ““very, very handsomely.””³⁹ Essentially, Kramer worked full-time at making money through tennis and at keeping and enhancing his reputation.⁴⁰

Jack Kramer received a royalty of 2.5 percent of net sales in the United States and Canada,⁴¹ which generated royalties of \$117,256.58 in 1975 and \$159,648.12 in 1976.⁴² In 1975 and 1976, the top tax rate on “earned income” was fifty percent,⁴³ and the top rate on all other ordinary income was seventy-seven percent.⁴⁴ Kramer reported his payments from Wilson as “earned income.”⁴⁵ The IRS contended that the payments were royalties for the use of a capital asset — his name and reputation — and therefore, no portion of the payments was “earned income.”

The tax court noted that, although Wilson approved of Kramer’s other tennis-related activities and that they no doubt helped sell “Kramer” racquets, the activities were not personal services performed for Wilson because they were not required by the Wilson contract.⁴⁶ Rather, they enhanced the value of Kramer’s name and reputation — his goodwill — which is a capital asset.⁴⁷ Payments from Wilson attributable to that capital asset were royalties.⁴⁸ Based upon its analysis, the court determined that seventy percent of the payments in 1975 and 1976 were royalties and the remaining thirty percent were for personal services.⁴⁹

39. *Id.* at 775.

40. *See id.* at 776.

41. *See id.* at 770.

42. *See id.* at 777. A crucial difference between *Kramer* and *Edberg* (and most other “royalty versus personal service” controversies involving athletes) is that by 1975 Kramer was in his mid 50s and had not played competitively for 20 years.

43. *See id.* at 777-78 & n.3.

44. *See* IRC § 1(h) (1976) (on file with the *Fordham Intellectual Property, Media & Entertainment Law Journal*).

45. *See Kramer*, 80 T.C. at 769.

46. *See id.* at 780-81. As will be discussed *infra* at Part II.E., actions by the licensor that benefit both the licensor and licensee are not personal services in characterizing license fees if they are not required by the contract.

47. *See id.*

48. *See id.* at 781-82.

49. *See id.* at 782.

C. Revenue Ruling 81-178

In Revenue Ruling 81-178, the IRS differentiates personal service income from royalty income for the purposes of section 512(b)(2) of the Internal Revenue Code because certain exempt organizations are taxed on personal service income but not on royalty income.⁵⁰ The IRS's Market Segment Survey states that Revenue Ruling 81-178 applies to characterizations involving endorsement fees of foreign tennis players.⁵¹ Edberg's Tax Court petition states that the ruling applies only to characterize the income of exempt organizations. The Ruling, in fact, has been cited only in cases where the issue was whether fees paid to exempt organizations for use of their mailing lists were royalties.⁵² The Ruling describes two situations.⁵³ The first produces royalty income; the

50. See Rev. Rul. 81-178, 1981-2 C.B. 135.

51. See Market Segment Survey, *supra* note 20, at 22,968-69.

52. See *Sierra Club, Inc. v. Commissioner*, 86 F.3d 1526 (9th Cir. 1996); *Disabled American Veterans v. Commissioner*, 942 F.2d 309 (9th Cir. 1991), *rev'g*, 94 T.C. 60 (1990).

53. The Ruling presents two factual situations:

Situation 1: The organization is exempt from federal income tax under section 501(c)(5) of the Code. Its purposes are to improve the economic and working conditions of its members, who are professional athletes. It engages primarily in activities in furtherance of these purposes.

The organization solicits and negotiates licensing agreements with various businesses. The licensing agreements authorize the businesses to use the organization's trademarks, trade names, service marks, copyrights, and members' names, photographs, likenesses, and facsimile signatures in connection with the distribution, sale, advertising, and promotion of merchandise or services offered by such businesses. Before entering into a licensing agreement permitting a business to use its members' names, photographs, likenesses, and facsimile signatures, the organization obtains a written authorization and assignment for such use from its members.

Under the terms of the agreements, the organization has the right to approve the quality or style of the licensed products and services. The agreements also require the businesses to refrain from engaging in any activity that would adversely affect the reputation of the organization or its members, or the value of the licensed products or services.

The income received by the organization from the agreements is based in some instances on a percentage of the gross sales of the licensed products or services, while in other cases the organization receives a flat sum each year. The organization uses this income to help defray operating expenses.

Situation 2: The facts are the same as in Situation 1 except that the agreements

second produces personal services income. The Ruling would be more useful if it also dealt with situations that combine personal service and royalty characteristics. However, it is helpful to know that the IRS believes that royalty treatment is not tainted by (1) the licensor retaining the right to approve the quality and style of the licensed product or (2) that payments are not based on sales. It also takes a hard line on “endorsements.”⁵⁴ Endorsements are not among the activities listed in Situation 1; they are listed in Situation 2.⁵⁵ The line between a tennis star letting Wilson put his name on a racquet and endorsing the racquet is a fine one indeed, particularly if the player retains the right to approve the quality and style of the racquet, which Revenue Ruling 81-178 permits. However, it is a line that the IRS has drawn, and it seems that their position — that an endorsement is not a capital asset — is sound.

D. IRS Study on Foreign Athletes and Entertainers

In October 1994, the IRS released its Market Segment Study on Foreign Athletes and Entertainers.⁵⁶ The Study instructs agents on how to prepare for audits, what they should look for, the IRS positions on various points, and the law as modified by court decisions.⁵⁷ Various categories of entertainers and athletes are discussed, including tennis players. In addressing tennis players, the Study states that the three recurrent audit issues of non-resident alien tennis players are: (1) the character of endorsement income (e.g., is it personal service or royalty income), (2) how much income is U.S.-source, and (3) what expenses can be deducted against U.S.-source income.⁵⁸

The Study states that the endorsement contracts of tennis players typically have three elements: (1) a flat retainer (a guaranteed

with the businesses are concerned *solely* with *endorsing* the products and services offered by such enterprises. *The agreements require personal appearances by and interviews with members* of the organization in connection with the endorsed products and services.

Rev. Rul. 81-178, 1981-2 C.B. 135, 136 (emphasis added).

54. *See id.* at 136-37.

55. *See id.*

56. *See* Market Segment Survey, *supra* note 20, at 22,901.

57. *See generally id.*

58. *See id.* at 22,967.

amount), (2) tournament bonuses (e.g., \$10,000 for winning the French Open), and (3) a ranking bonus based on the player's year-end standing in a specified computerized system (e.g., the Women's Tennis Association's ranking system).⁵⁹ The Study further states that endorsement contracts with sporting goods companies generally require the athlete to use or wear the manufactured item in competition, whereas non-sports companies require the player to wear a logo patch on his or her shirt.⁶⁰ Often, contracts also require players to make personal appearances and participate in interviews as directed by the sponsor.⁶¹

The Study goes on to state, "[u]nfortunately, the characterization of endorsement income is not clear cut. The facts and circumstances of each situation will have to be evaluated to make a determination."⁶² The Study then discusses Revenue Ruling 81-178 and the fact patterns that produce royalty income and personal service income. The Study states:

The argument has been successfully made at the examination level that all endorsement income is personal service income since the tennis player is required by the endorsement contract to play tournament tennis to receive the income. Various factors need to be considered to characterize the income:

1. How is the amount of compensation determined? Is it based on a percentage of the sales of the product? (Royalties are usually based on sales.)
2. Is the tennis player required to render any services to earn the income? The more services required the more likely the income is personal service income.
3. How much control is exerted by the sponsor over the individual's activities? The greater the extent of control the more likely the income is personal service income.

59. *See id.* at 22,967-22,968.

60. *See id.* at 22,968.

61. *See id.*

62. *Id.*

4. Is the contract payment dependent on performing in a certain number of events? Is the payment reduced if the athlete fails to perform in a certain number of events?

5. Does the taxpayer receive bonus amounts for superior play in certain tournaments (tournament bonuses) or for achieving a higher ranking over a certain period of time (ranking bonuses)? Is the tennis player's retainer reduced if his or her ranking falls under a certain level?

6. Is the endorsed product sold in the contract territory?⁶³

The Study then briefly discusses *Kramer*, noting the seventy-three percent allocation between royalty income and personal service income.⁶⁴

The six factors listed above have personal service overtones and would tilt a combined license/personal service contract toward personal service, but it should not negate the licensing element if (1) it is separately contracted for or (2) the financial arrangements are separately stated. The caveat on separate treatment is that, even if separately stated, the "royalty" element should be merged into the personal service element or vice versa if, in the words of the OECD Commentary, it is "only of an ancillary and largely unimportant character."⁶⁵ A reasonable standard for separate treatment is whether or not the player's name, likeness, and signature, standing alone, have significant value. In the United States, a tennis player ranked 150 in the world typically could not meet this standard, whereas the same player might be a national hero in his or her home country, and easily pass the test there.

E. *No Contractual Requirement to Use Product*

Kramer holds that acts of the licensor that help both the licensor and the licensee, and no doubt increase the licensor's royalties by increasing racquet sales, do not count as personal services in de-

63. See *id.* at 22,968-22,969.

64. See *id.* at 22,968.

65. See OECD MODEL TREATY, *supra* note 10, art. 12 commentary at ¶ 11.

termining the character of the royalties unless the contract requires the licensor to perform them.⁶⁶ Does this make 100 percent of the payments in the following scenario “royalties”?

Jimmie Star played with the Brand X “Slugger” tennis racquet for years because he liked it. He received no money from Brand X for doing so. Brand X and Jimmie contract that (1) the name of the “Slugger” will be changed to the “Jimmie Star Autograph” and (2) Jimmie will be paid two percent of the racquet’s net sales. Jimmie does not “endorse” the racquet and is not required to use it, but continues to do so.

On these facts, the arrangement passes the credibility “smell” test because there is plenty of evidence that Jimmie would have continued to use the racquet absent an arrangement with Brand X. If this can be sustained, arguably, goodwill is the predominant thing that Jimmie is being paid for. If separate treatment is desired, there should be separate contracts or the consideration for each element should be separately stated.

In *Edberg*, the endorsement contracts were *not* split, but 50-50 splits were made on the tax returns. That is a weaker approach because the contract is the basic document and the allocation is made unilaterally by the licensor.

A third approach to allocating endorsement income is to report the entire fee as a royalty. There are penalties for not disclosing tax return positions that are not supported by “substantial authority.”⁶⁷ Thus, the third approach would entail risk unless there is solid evidence that “royalty” is the predominant characteristic.

66. See *Kramer v. Commissioner*, 80 T.C. 768, 780-81 (1983).

67. See 26 U.S.C.A. § 6662(d) (West 1988 & Supp. 1999). Both United States and non-United States licensees/endorsees are required to withhold on payments of U.S.-source income to a non-resident alien licensor/endorser. See Treas. Reg. § 1441(a) (West 1988 & Supp. 1999). If there is not appropriate withholding, and the licensor/endorser ultimately pays the tax, the licensee/endorsee is not liable for the withholding amount, but may still be liable for interest and penalties. Thus, the licensee/endorsee should take care to see that withholding satisfies the “substantial authority” standard. Withholding of thirty percent on personal service income is required, unless the IRS has issued a certificate authorizing a lower rate, regardless of whether the payments are earned as an employee, an independent contractor, or an artiste/sportsman.

F. *Artistes and Athletes Article*

The purpose of the Artistes and Athletes article, called the Artistes and Sportsmen article in some treaties, is to tax highly-paid entertainers and athletes whose income would escape tax under the Independent Personal Services article because the services were not connected to a “fixed base.”⁶⁸

The essence of Article 17 is that a non-resident athlete is taxed on income from athletic activities in the United States as he would under Article 14 if he had a “fixed base” available to him in the United States.⁶⁹ The term “as such” as used in the 1996 United States Model Treaty means that only income derived from activities as an athlete are covered. The Treasury Explanation is specific that product endorsements are not within the scope of the article:

As explained in paragraph 9 of the OECD Commentaries to Article 17, Article 17 applies to all income connected with a performance by the entertainer, such as appearance fees, award or prize money, and a share of the gate receipts. *Income derived from a Contracting State by a performer who is a resident of the other Contracting State from other than actual performance, such as royalties from record sales and payments for product endorsements, is not covered by this Article, but by other articles of the Convention, such as Article 12 (Royalties) or Article 14 (Independent Personal*

68. See 1996 Technical Explanation, *supra* note 22, annex B, ¶ 227, at 322.

69. See United States Model Income Tax Convention art. 17, ¶ 1, available in RICHARD L. DOERNBERG & KEES VAN RAAD, THE 1996 UNITED STATES MODEL INCOME TAX CONVENTION, annex A, at 264-65 (1997) (emphasis added) [hereinafter 1996 United States Model Treaty]. The pertinent part of Article 17 of the 1996 United States Model Treaty states:

Income derived by a resident of a Contracting State as an entertainer, such as a theater, motion picture, radio, or television artiste, or a musician, or as a sportsman, from his personal activities *as such* exercised in the other Contracting State, which income would be exempt from tax in that other Contracting State under the provisions of Articles 14 (Independent Personal Services) and 15 (Dependent Personal Services) may be taxed in that other State, except where the amount of the gross receipts derived by such entertainer or sportsman, including expenses reimbursed to him or borne on his behalf, from such activities does not exceed twenty thousand United States dollars (\$20,000) or its equivalent in . . . for the taxable year concerned.

Id.

Services). For example, if an entertainer receives royalty income from the sale of live recordings, the royalty income would be exempt from source country tax under Article 12, even if the performance was conducted in the source country, although he could be taxed in the source country with respect to income from the performance itself under this Article if the dollar threshold is exceeded.

In determining whether income falls under Article 17 or another article, the controlling factor will be whether the income in question is predominantly attributable to the performance itself or other activities or property rights. For instance, a fee paid to a performer for endorsement of a performance in which the performer will participate would be considered to be so closely associated with the performance itself that it normally would fall within Article 17. Similarly, a sponsorship fee paid by a business in return for the right to attach its name to the performance would be so closely associated with the performance that it would fall under Article 17 as well. As indicated in paragraph 9 of the Commentaries to Article 17 of the OECD Model, a cancellation fee would not be considered to fall within Article 17 but would be dealt with under Article 7, 14 or 15.⁷⁰

Thus, a tennis player's endorsement of a tournament the player is competing in would fall within Article 17. However, the player's endorsement of anything else, including tennis equipment, would not. The crucial question is whether this would be the case if the player were required to use the equipment in tournament play. The OECD Commentary on Article 17 states:

Besides fees for their actual appearances, artistes and sportsmen often receive income in the form of royalties or of sponsorship or advertising fees. In general, other Articles would apply whenever there was *no direct link* between the income and a public exhibition by the performer in the country concerned. . . . Article 17 will apply to ad-

70. See 1996 Technical Explanation, *supra* note 22, annex B, ¶¶ 229-thirty, at 322-23 (emphasis added).

vertising or sponsorship income, etc. which is *related directly or indirectly* to performances or appearances in a given State.⁷¹

In context, the Commentary refers to money received for advertising the event itself. But it tends to support the position that money a player receives for endorsements that require him to use or wear the endorsed product or to wear the company's patch while he plays should be taxed under Article 17. Another probable Article 17 inclusion is a bonus based on tournament performance – for example, \$10,000 from a licensee for getting to the quarterfinals of the U.S. Open. Less directly tied to tournament *participation* would seem to be personal appearances at tournament functions – for example, working the crowd at a licensee's hospitality tent, which he could do whether or not he was playing in the tournament.

The standard to exclude endorsement income from Article 17 is far different and far more liberal than to qualify it as a royalty. For example, under the facts in *Kramer*, if Kramer was a non-resident, none of his income from Wilson would have been taxable under Article 17 because none of it was for his services as a player.

G. “Fixed Base” of a Tennis Player?

In a treaty situation, the U.S.-source income of a non-resident tennis player that escapes Article 17 is taxable only if it comes within the net of Article 14, unless it is treated as a royalty. Article 14, entitled “Independent Personal Services,” of the 1996 United States Model Treaty, states:

1. Income derived by an individual who is a resident of a Contracting State in respect of the performance of personal services of an independent character shall be taxable only in that State, *unless the individual has a fixed base regularly available to him* in the other Contracting State for the purpose of performing his activities. If he has such a fixed base, the income attributable to the fixed base that is de-

71. See OECD MODEL TREATY, *supra* note 10, art. 17 at commentary ¶ 9 (emphasis added).

rived in respect of services performed in that other State also may be taxed by that other State.

2. For purposes of paragraph 1, the income that is taxable in the other Contracting State shall be determined under the principles of paragraph 3 of Article 7 [the Business Profits article].⁷²

“Fixed base” is not defined, but the Treasury Explanation states that it is much the same as a permanent establishment.⁷³ A non-resident tennis player probably would not have an “office,” as the term is generally used, in the United States (even if a home were maintained). A resident agent, however, who has and could regularly make binding deals for the player, would meet the definition of a “permanent establishment” and presumably that of a “fixed base.”⁷⁴ Perhaps Edberg’s original *tax return position* — that half of his U.S.-source income was royalty income and half taxable personal service income — was based on the belief that he had (or might have) a “fixed base” in the United States. If a player has a “fixed base,” royalties will be taxed under the royalties article unless “the royalties are attributable to such . . . fixed base.”⁷⁵ Even if licensing arrangements are contracted by the player’s United

72. See 1996 United States Model Treaty, *supra* note 69, art. 14, ¶¶ 1-2, annex A, at 263 (emphasis added).

73. See 1996 Technical Explanation, *supra* note 22, annex B, ¶ 201, at 317. The Explanation states:

The term “fixed base” is not defined in the Convention, but its meaning is understood to be similar, but not identical, to that of the term “permanent establishment,” as defined in Article 5 (Permanent Establishment). The term “regularly available” also is not defined in the Convention. Whether a fixed base is regularly available to a person will be determined based on all the facts and circumstances. In general, the term encompasses situations where a fixed base is at the disposal of the individual whenever he performs services in that State. It is not necessary that the individual regularly use the fixed base, only that the fixed base be regularly available to him. . . . On the other hand, an individual who had no office in the other State and occasionally rented a hotel room to serve as a temporary office would not be considered to have a fixed base regularly available to him.

Id.

74. See 1996 United States Model Treaty, *supra* note 69, art. 5, ¶¶ 5-6, annex A, at 257.

75. See 1996 United States Model Treaty, *supra* note 69, art. 12, ¶ 3, annex A, at 262.

United States agent, royalties that merely entitle the licensee to exploit the player's goodwill would not be attributable to the player's fixed base.⁷⁶ As discussed *supra*, for active players, this generally will require separately stated royalty and personal service contracts.

III. TAX TREATMENT IN NON-TREATY SITUATIONS

Many of the best tennis players in the world are tax residents of jurisdictions, such as Monaco and Bermuda, that do not have tax treaties with the United States. A crucial factor in how these players are taxed on their U.S.-source licensing royalties and endorsement fees is whether, at any time during the year, they were engaged in a trade or business in the United States.⁷⁷ "Engaging in a trade or business" includes any business activity in the United States that involves one's own physical presence⁷⁸ or a deemed presence through a dependent agent.⁷⁹ For agents, the standard is similar to that to create a permanent establishment in a treaty situation.⁸⁰ Thus "engaging in business" includes playing in tennis tournaments and making personal appearances in the United States, and any other service as an employee or independent contractor, whether or not the activity is connected with tennis.⁸¹

If a player who is not resident in a treaty country engages in a

76. In an analogous situation, the Treasury Explanation of Article 12, Paragraph 2 of the 1996 United States Model Treaty states:

If an artist who is resident in one Contracting State records a performance in the other Contracting State, retains a copyrighted interest in a recording, and receives payments for the right to use the recording based on the sale or public playing of the recording, then the right of such other Contracting State to tax those payments is governed by Article 12.

1996 Technical Explanation, *supra* note 22, annex B, ¶ 178, at 312 (citing *Boulez v. Commissioner*, 83 T.C. 584 (1984), *aff'd*, 810 F.2d 209 (D.C. Cir. 1986)).

77. See Treas. Reg. § 1.864-2(a) (1996).

78. See *id.*

79. See Rev. Rul. 70-424, 1970-2 C.B. 150 (holding that a principal-agent relationship exists when a foreign corporation arranges with a domestic corporation for exclusive sales of its products within the United States; therefore, the foreign corporation is engaged in a trade or business within the United States).

80. See Treas. Reg. § 1.864-7(d)(1) (1996).

81. See 26 U.S.C.A. § 864(b)(1) (West 1988 & Supp. 1999); Treas. Reg. Sec. § 1.864-2(a) (1996).

trade or business in the United States at any time during the taxable year, he is taxable on *all* U.S.-source income received during that year, as follows:

1. At regular graduated rates (on a United States income tax return) on “taxable income which is effectively connected with the conduct of a trade or business within the United States.”⁸² This includes all tournament and personal service income, and any other U.S.-source income that does not qualify as “fixed or determinable.”⁸³ Endorsement income would fall within this net and, as will be discussed, some royalties may, too. “Effectively connected” income is subject to thirty percent withholding, but lower rates can be arranged if it is shown that they will satisfy the anticipated tax liability.⁸⁴ The “force of attraction” approach of Section 864(c)(3) treats as “effectively connected” income that otherwise would be tax free – for example, mail order sales from outside the United States.⁸⁵

2. At thirty percent via withholding on “interest (other than original issue discount as defined in section 1273), dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical [referred to as “fixed or determinable” and “FDAP”] gains, profits, and income [including royalties], . . . but only to the extent the amount so received is not effectively connected with the conduct of a trade or business within the United States.”⁸⁶

A player’s dividends and interest from United States portfolio investments would be FDAP. The critical question is whether income classified as “royalties” for tax treaty purposes would be classified as FDAP in non-treaty situations. As in treaty situations, it will depend on the facts whether royalty treatment results in higher or lower tax. The principal variables are (1) the player’s

82. 26 U.S.C.A. § 871(b)(1) (West 1988 & Supp. 1999).

83. “Fixed and determinable” is discussed in paragraph 2 below.

84. See *supra* note 16 and accompanying text.

85. See Treas. Reg. § 1.864-4(b), Example (3).

86. 26 U.S.C.A. § 871(a)(1)(A) (West 1988 & Supp. 1999).

marginal tax rate on effectively connected income (less or more than thirty percent) and (2) expenses that could be taken against the income if it were deemed to be effectively connected.

A player who is not engaged in a United States trade or business at any time during the taxable year is taxable only on his U.S.-source FDAP – via thirty percent withholding. Thus, royalty income would be taxed at thirty percent, while endorsement income would be tax free as personal services performed outside the United States. For example, a tennis player who is a resident of Monaco would not be taxed on fees received to endorse a product in the United States via print and television ads if presence in the United States was not involved and he was not otherwise engaged in a United States trade or business during the year.⁸⁷

Royalties that pass muster under Revenue Ruling 81-178 and would be treated as royalties for tax treaty purposes will not necessarily qualify as FDAP (rather than as effectively connected income). Section 864(c)(2) provides in part as follows:

PERIODICAL, ETC., INCOME FROM SOURCES WITHIN UNITED STATES—FACTORS.—In determining whether income from sources within the United States of the types described in section 871(a)(1) . . . or whether gain or loss from sources within the United States from the sale or exchange of capital assets, is effectively connected with the conduct of a trade or business within the United States, the factors taken into account shall include whether—

- (A) the income, gain, or loss is derived from assets used in or held for use in the conduct of such trade or business, or
- (B) the activities of such trade or business were a material

87. An analogous result in a non-treaty situation was reached in *Karrer v. United States*, 152 F. Supp. 66 (Ct. Cl. 1957). In that case, a Swiss scientist contracted with a Swiss employer to provide basic research in return for a portion of the patent royalties generated from the research. The patents were owned by the employer. The U.S. licensee paid the scientist his share of the royalties directly and characterized them as “royalties.” The Court held that the payments were compensation for personal service rendered to the employer rather than royalties, and thus were nontaxable as compensation for services provided outside the United States.

factor in the realization of the income, gain, or loss.⁸⁸

The Treasury Explanation of Article 7, Paragraph 2 of the 1996 United States Model Treaty, in discussing whether income is attributable to a permanent establishment, states:

The “attributable to” concept of paragraph 2 is analogous but not entirely equivalent to the “effectively connected” concept in Code section 864(c). The profits attributable to a permanent establishment may be from sources within or without a Contracting State.”

Paragraph 2 also provides that the business profits attributed to a permanent establishment include only those derived from that permanent establishment’s assets or activities. This rule is consistent with the “asset-use” and “business activities” test of Code section 864(c)(2). The OECD Model does not expressly provide such a limitation, although it generally is understood to be implicit in paragraph 1 of Article 7 of the OECD Model. This provision was included in the United States Model to make it clear that the limited force of attraction rule of Code section 864(c)(3) is not incorporated into paragraph 2.⁸⁹

Treasury Regulation section 861-4(c)(3)(i) provides that certain business activities will cause passive income to be treated as “effectively connected.” The Regulation states that “[t]he business activities test is of primary importance, for example, where . . . royalties are derived in the active conduct of a trade or business consisting of the licensing of patents or similar intangible property”⁹⁰ That section, coupled with the following example, suggests that royalties from licensing arranged by the player himself, or by a dependent agent who also handles endorsements and personal appearances, would be effectively connected income. Example 2 in Treasury Regulation section 864-4(c)(3)(ii), indicates that, while the active business must not be involved in negotiating

88. 26 U.S.C.A. § 864(c)(2) (West 1988 & Supp. 1999)

89. See 1996 Technical Explanation, *supra* note 22, annex B, ¶¶ 92-93, at 296 (emphasis added).

90. Treas. Reg. § 861-4(c)(3)(i) (1996).

licenses, the licenses can relate to the same type endeavor as the active business:

N has a branch in the United States which acts as an importer and distributor of merchandise. . . . N also carries on a business in which it licenses patents to unrelated persons in the United States for use in the United States. The businesses of the licensees in which these patents are used have no direct relationship to the business carried in N's branch in the United States, although the merchandise marketed by the branch is similar in type to that manufactured under the patents. The negotiations and other activities leading up to the consummation of these licenses are conducted by employees of N who are not connected with the United States branch . . . , and the United States branch does not otherwise participate in arranging for the licenses. Royalties received by N during [the year] are not effectively connected for that year with the conduct of its trade or business in the United States because the activities of that business are not a material factor in the realization of such income.⁹¹

This provides a higher degree of separation than required to separate royalties from personal services in treaty situations. The Treasury Explanation permits royalty treatment in treaty situations where the artist is directly involved in creating the intangible that produces the income.

The IRS Market Segment Study provides several methods for allocating a portion of a non-resident alien's worldwide endorsement income to the United States. Those are:

1. The amounts negotiated for each territory. Since these amounts can easily be manipulated, they can be used only if they are supported by additional evidence.
2. Gross sales of the endorsed product in the United States to total sales.
3. United States advertising expense of the endorsed product to total advertising expense.

91. Treas. Reg. § 864-4(c)(3)(ii), Example 2 (1996).

4. Days played tennis in the United States to total days played tennis world-wide. This method is appropriate only if it is determined that the income is personal service income.

5. Bonus points earned in the United States to total bonus points earned. Bonus points are based on where players place in each tournament.

The Study permits the use of this method to allocate endorsement income of higher-ranked players. The Study further states that agents should use the method that best reflects the amount of income earned in the United States; that the method chosen sometimes will reflect the information available; and that sales figures should be gotten from the company, not the player's agent.

It is clear that after testing the results under the various allocation methods, taxpayers and the IRS will disagree on which method best reflects the income earned in the United States. An analysis by the Court in *Edberg* of a number of contracts would have supplied welcome guidance in this area.

CONCLUSION

In treaty situations, the endorsement (and licensing) income of non-resident tennis players will be:

1. Compensation for personal service and tax free in the United States unless the player has a "fixed base" available to him in the United States (unlikely, unless the player has a dependent agent or an office in the United States); or
2. Royalty income subject to withholding at treaty rates ranging from zero to fifteen percent on the portion of the payment that is for use of the player's name and reputation (likely to be a small portion for arrangements that include an active player's product endorsement that includes using the endorsed product or wearing a logo patch in tournament competition); or
3. Taxable as "Artistes and Athletes" income (at ordinary income rates) to the extent the endorsement is closely asso-

ciated with the player's actual competition (e.g., endorsing the tournament and possibly using the endorsed equipment or wearing logo patches in tournament play).

Whether or not royalty treatment is preferable depends on (1) the amount of expenses attributable to the royalties (expenses cannot be deducted against royalty income), (2) the player's marginal tax rate on ordinary income, and (3) the treaty rate on royalty income. Where the facts indicate that the arrangement is part personal services and part royalty, and royalty treatment is wanted for that portion, the arrangement should be reflected by separate contracts or separately stated financial arrangements.

In non-treaty situations, endorsement income will be tax-free personal service income if at no time during the taxable year the player is engaged in a trade or business in the United States (playing in a tournament or making a personal appearance would be deemed to be so engaged). Otherwise such income will be taxed at ordinary rates and subject to thirty percent withholding (lower withholding can be arranged if it is shown that it will cover the expected tax liability). Royalty income is subject to thirty percent withholding (if the player is engaged in a United States trade or business during the year, royalties closely associated with the trade or business may be taxed at ordinary rates rather than thirty percent).