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U.S. Royalties vs. Services Income for Non-U.S. Citizens: A Hole-in-One or a Bogey?

Legal Alert
July 19, 2011

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Garvey Schubert Barer Legal Update, July 2011.

Introduction

Suppose Ford Motor Company contracted with famous *Harry Potter* author J.K. Rowling to use her likeness in its U.S. ad campaigns or if Nike contracted with golf star Rory McIlroy to promote its golf products in the U.S. Even though both Ms. Rowling and Mr. McIlroy are not residents of the U.S., the issue arises whether the income they receive from these endorsements by U.S. companies is subject to our tax system.

Artists, entertainers and athletes ("celebrities") often enter into agreements to authorize a company (a sponsor) to use the celebrity's name, face, image or likeness to promote the sponsor's brand and products. Often, the celebrity is simply paid a set fee in exchange for the sponsor's right to associate with his or her likeness. Other times, however, the celebrity is required to perform some services (e.g., make personal appearances, wear the company's clothing or use the company's products).

The U.S. tax consequences to nonresident alien celebrities, arising from receipt of fees paid pursuant to an endorsement or similar agreement vary depending on how the payment is classified. The question driving the U.S. tax treatment is whether the payment from the sponsor is treated as royalty income, or as payment for services.

Retief Goosen v. Internal Revenue Service

This question was recently addressed by the United States Tax Court in *Retief Goosen v. Internal Revenue Service*, 136 T.C. No. 21 (2011). The fees discussed in the *Goosen* case arose from six endorsement contracts entered into or on behalf of Retief

Goosen, a well known professional golfer who is a nonresident of the United States. Goosen's contracts with TaylorMade, Izod and Acushnet (the "On-course Contracts") required Goosen to engage in certain activities, in addition to allowing the sponsors to use Goosen's image and likeness to promote their products. Specifically, the On-course Contracts conditioned payment of his fee on the number of golf tournaments Goosen played and required that Goosen wear the company's products during golf tournaments and public appearances. The three other contracts, Electronic Arts, Upper Deck and Rolex (the "Off-course Contracts"), allowed those sponsors to use Goosen's name and likeness to promote their products, but they did not require Goosen to actually play golf, (*i.e.* Goosen would have been paid the fee even if he had never touched another golf club).

U.S. Tax Treatment: Personal Services Income or Royalties

Non-resident aliens are generally subject to U.S. income tax only if they have income effectively connected with a U.S. trade or business or receive U.S.-source fixed or determinable annual or periodic ("FDAP") income. Pursuant to Section 864 of the Internal Revenue Code ("IRC" or "Code"), performing personal services in the U.S. constitutes being engaged in a trade or business in the U.S. Accordingly, the IRS and Goosen agreed Goosen's golfing in the U.S. did amount to engaging in a U.S. trade or business. Also, it is well settled for U.S. tax purposes that payments for the right to use a person's name or likeness are treated as royalties (*i.e.* FDAP income). See *Cepeda v. Swift & Co.,* 415 F.2d 1205 (8th Cir. 1969). Consequently, the IRS and Goosen agreed the endorsement fees from the Off-course Contracts constituted royalty income to Goosen.

The ultimate question in the *Goosen* case related to the character of the income paid to Goosen pursuant to the On-course Contracts - - contracts that allowed the sponsors to use Goosen's name and likeness, but also required Goosen to play golf and wear or use the sponsors' products in tournaments and other public appearances.

According to the Tax Court, the characterization of Goosen's On-course Contract endorsement fees and bonuses depended on whether the sponsors primarily paid for Goosen's services (the IRS' argument) or primarily for Goosen's name and likeness (Goosen's argument), or both. In characterizing the On-course endorsement fees and bonuses the Tax Court found, the intent of the sponsors and Goosen, based on a review of the facts and circumstances, including the terms of the On-course Contracts, is the determining factor for establishing the character of the payments.

As the On-course Contracts did not specifically allocate amounts to be paid for the sponsors' use of Goosen's image and likeness versus amounts to be paid for Goosen's services, the Tax Court reviewed the entire record and found the sponsors paid for both the right to use Goosen's name and likeness and for his services. According to the court, the sponsors' "valued [Goosen's] image, and they paid substantial money for the right to use his name and likeness."

The record also showed, however, the sponsors valued Goosen's play at tournaments, requiring him to wear their respective products and only paying him if he played golf. Thus, the performance of services was not de minimis or ancillary to the use of his name and likeness. Instead, the Tax Court found the right to use the name and likeness and the performance of services were equally important. It concluded the endorsement fee represented 50 percent royalty income and 50 percent services income.

Source of Income

Once the Tax Court allocated the endorsement fee between services income and royalty income, it then reviewed the source of the fee to determine how much of the fee would be subject to U.S. tax, as Goosen would only be subject to U.S. tax on his U.S. source royalties and U.S. source service income.

The source of royalty income is determined based on the place of use of the intangible property. Goosen and each sponsor, as the contracting parties, are required to make an appropriate sourcing allocation if the royalty income relates to the right to use the property both within and without the United States. If the parties to the contract fail to make a reasonable allocation of royalty income, U.S. courts will generally allocate all of the royalty income to the United States. However, in the *Goosen* decision, the taxpayer did establish to the satisfaction of the Tax Court that he owned the rights in his name and likeness outside of the United States and that those rights had value. As a result, the Tax Court determined the source of the royalty income by examining where the sponsors actually used Goosen's name and likeness.

Effectively Connected v. FDAP Income

Once the Tax Court determined that Goosen did receive U.S. source royalty income, it examined whether such royalty income was effectively connected with the conduct of a United States trade or business and therefore subject to tax at the graduated rates of Section 1 of the Code rather than royalty payments constituting FDAP income subject to a 30 percent tax on the gross amount of the royalties.

As stated above, Goosen and the IRS agreed Goosen engaged in the United States trade or business of playing golf. Pursuant to Treas. Reg. Section 1.864-4(c)(3)(i), Goosen's U.S. royalty income is treated as effectively connected to his U.S. trade or business if the activities of the trade or business are a material factor in the realizing of the royalty income. Considering the On-course Contracts first, the Tax Court concluded Goosen's participation in the golf tournaments was material to receiving the income for the use of his name and likeness and as such the royalty income arising from the On-course Contracts was deemed to be effectively connected with Goosen's U.S. trade or business. The U.S. source royalty income received from the Off-course Contracts, however, did not depend on whether Goosen played in any golf

tournaments and the Tax Court determined that the Off-course Contract royalty income was FDAP, subject to a flat 30 percent tax.

Conclusion

The Tax Court's conclusion that the intent of the parties is determinative of the treatment of endorsement fees is important for many reasons.

For foreign celebrities who might benefit from a reduced U.S. tax rate on U.S. source royalty payments pursuant to an income tax treaty, the contract should clearly specify what portion of the endorsement fees are payments for the sponsor's right to use the celebrity's name and likeness.

If services are required to be performed, the contract should clearly address whether the services are of primary or ancillary importance to the use of the celebrity's name and likeness or specifically allocate a set sum for the services performed.

If the sponsor and the celebrity agree the payments for the use of the celebrity's name and likeness are for the right to use that property both inside and outside of the United States, the contract should expressly allocate payments among the United States rights and the foreign rights to avoid a potential argument from the IRS that all royalty payments should be treated as U.S. source income.

The *Goosen* case illustrates some interesting planning opportunities for non-resident celebrities when they enter into marketing or sponsorship agreements with U.S. companies. For more information on the topic, please contact any of the members of the GSB Tax & Benefits Group.

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