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MEMORANDUM FOR CHIEF, EXAMINATION GROUP 1110

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SUBJECT: The Classification of Endorsement Income Under U.S. Income Tax Treaties

This Technical Assistance responds to your request for advice concerning the classification of endorsement income under U.S. income tax treaties. Technical Assistance does not relate to a specific case and is not binding on Examination or Appeals. This document is not to be used or cited as precedent.

Issue

Whether U.S. source endorsement income earned by a nonresident alien artiste or sportsman, that is not attributable to a U.S. fixed base or permanent establishment, should be classified under U.S. income tax treaties as Royalties (Article 12)[1], Independent or Dependent Personal Services income (Article 14 or Article 15), Artistes and Sportsmen income (Article 17) or Other Income (Article 21).

Conclusion

If an item of endorsement income is closely and proximately related to a performance by an artiste or athlete in the United States, then it should be taxed by the United States as Artistes and Sportsmen income. If the income does not have that type of proximate relationship with a performance in the United States, then it generally should be classified under another treaty article, such as Independent or

[1]Unless otherwise specified, Article references are to the United States Model Income Tax Convention of September 20, 1996, Tax Treaties (CCH), vol. 1, ¶ 214.

Dependent Personal Services or Royalties, as appropriate.[2] For example, if the income is not proximately related, and is generated by the use of a type of intellectual property covered by Article 12 (Royalties), then the income may be considered royalty income.

Any given endorsement contract may generate more than one type of income for treaty purposes (e.g., Royalties and Artistes and Sportsmen income). In allocating income from a single endorsement contract among the various categories of treaty income, an examiner may consider comparable third party contracts or other relevant valuation evidence to place a value on each endorsement activity.

Discussion

1. Introduction

Under U.S. income tax treaties, many types of U.S. source income earned by nonresident aliens are exempt from U.S. taxation, unless the income is attributable to a fixed base or permanent establishment of the alien in the United States.[3] Under our newer income tax treaties, however, Article 17 allows the United States to tax U.S. source income earned by nonresident alien artistes and sportsmen for their performances in the United States, if that income exceeds a specified monetary threshold.[4]

While identifying income paid for an artiste's or athlete's performance in the United States is usually fairly simple, a more complex issue is how to classify income from endorsement contracts for treaty purposes. Typical endorsement contract activities include wearing or using a sponsor's product, making commercials, giving a sponsor the right to use one's name, photograph and signature, and appearing at charitable or promotional events organized by the sponsor. This spectrum of income-generating activities poses classification issues for artistes, sportsmen and examiners who are asked to determine the treaty

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[2]The provisions of the relevant treaty must always be examined. See the discussion of the U.S.-Mexico treaty, below.

[3]Also, certain Dependent Personal Service income may be exempt where, inter alia, the recipient is present in the United States for 183 days or less. See United States Model Income Tax Convention of September 20, 1996, Art. 15(2), Tax Treaties (CCH), vol. 1, ¶ 214.

[4]This threshold is $20,000 in the 1996 U.S. Model Treaty. See United States Model Income Tax Convention of September 20, 1996, Art. 17(1), Tax Treaties (CCH), vol. 1, ¶ 214.

category under which such income should fall: Artistes and Sportsmen (Article 17), Royalties (Article 12), Independent Personal Services (Article 14), Dependent Personal Services (Article 15), or Other Income (Article 21).[5] The discussion below will examine the treaty provisions and treaty background materials relevant in making such a classification, and give examples of appropriate classifications.

2. Article 17 (Artistes and Sportsmen)

In 1992 and 1996, the OECD and the United States, respectively, issued new model income tax treaties. The text of Article 17(1) of both of these model treaties provides the identical rule that:

> 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 . . . may be taxed in that other State.[6]

This rule applies even though the income might otherwise be exempt from source-state taxation under another treaty article, such as Article 14 (Independent Personal Services) or Article 15 (Dependent Personal Services).

The theory behind this rule is that artistes and sportsmen are often paid very large sums of money for very short periods of activity and physical presence in a host country. While such income is normally taxable in the individual's country of residence, it may be difficult for the home country to find out about the activities and income of its residents while they are abroad. These practical difficulties may lead to a general tax climate wherein well-known taxpayers are perceived to be avoiding the payment of taxes. Therefore, it is appropriate for the host country,

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[5]This discussion will not consider whether income is attributable to a fixed base or permanent establishment in the United States. Such income may be taxed by the United States under applicable provisions of treaty articles. See the United States Model Income Tax Convention of September 20, 1996, Article 7(1), Article 12(3), Article 14(1), Article 15(2)(c), and Article 21(2), Tax Treaties (CCH), vol. 1, ¶ 214.

[6]Organization for Economic Co-Operation and Development Model Tax Convention on Income and Capital [1992], Art. 17(1), Tax Treaties (CCH), vol. 1, ¶ 191; United States Model Income Tax Convention of September 20, 1996, Art. 17(1), Tax Treaties (CCH), vol. 1, ¶ 214. Note that, indeed, these new models carried forward the same provision from earlier models dating back to 1977 and 1981, essentially without change (other than substituting the term "sportsman" for "athlete").

which presumably has greater access to the relevant information, to have primary jurisdiction to tax the income.[7]

Although the treaty language itself does not mention endorsement income, Article 17 is broadly stated and, therefore, encompasses endorsement income if that income is proximately related to an artiste's or sportsman's "personal activities as such." That is, if the endorsement income could not be earned unless there were a performance in the contracting state and if it is closely linked with that performance, then that income should be included under Article 17. For example, if a U.S. company offers to pay a foreign soccer player a defined amount of money for wearing that company's clothing during a soccer game in the United States, then that money should be included under Article 17 because the endorsement income could only have resulted from "his personal activities as such" exercised in the United States and because it is closely linked with those activities. Both the OECD and the United States have provided further guidance in this area in the form of commentaries on Article 17.[8]

Paragraph 9 of the OECD Commentary to Article 17(1) of its 1992 Model Treaty reads in relevant part as follows:

> 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. Royalties for intellectual property rights will normally be covered by Article 12 rather than Article 17 . . ., 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 is related directly or indirectly to performances or appearances in a given State. Similar income which

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[7]Organization for Economic Co-Operation and Development Model Tax Convention on Income and Capital [1992], Commentary on Article 17 Concerning the Taxation of Artistes and Sportsmen, OECD Committee on Fiscal Affairs, Paris; Treasury Department Technical Explanation of the United States Model Income Tax Convention (September 20, 1996), Article 17, Tax Treaties (CCH), vol. 1, ¶ 214A; Issues in International Taxation No. 2, Thin Capitalisation, Taxation of Entertainers, Artistes and Sportsmen, Organization for Economic Co-operation and Development, Paris, 1987, p. 39.

[8]See also Issues in International Taxation No. 2, Thin Capitalisation, Taxation of Entertainers, Artistes and Sportsmen, supra n. 7, pp. 54-55, ¶¶ 77-84.

> could not be attributed to such performances or appearances would fall under the standard rules of Article 14 or Article 15, as appropriate.

This language establishes a proximate relationship approach to the treatment of endorsement income. That is, if but for the performance, the endorsement income could not have been earned, and the endorsement income is closely related to a public exhibition, then it is taxable under Article 17. By contrast, income that is more distantly related to the actual performance might be treated as independent or dependent personal services income or as royalty income.

The following example illustrates this approach. Assume that a U.S. recording company agrees to pay a nonresident alien musician (1) a fee to present a concert in the United States, (2) a fee to show the company's logo on a large screen over the stage during the concert, and (3) a royalty on sales of recordings made of the concert. Under the approach taken by the OECD Commentary, the first fee would simply be Article 17 income for the performance. The second fee would be directly linked (i.e., proximately related) to the performance; but for the performance, the fee could not have been earned, and it is closely connected to the performance. The royalty, by contrast, would be associated not so much with the performance itself, and with the musician's physical presence in the United States, as with a separate intangible created from the performance. This intangible, the copyright owned by the musician, could be exploited beyond the time of the actual performance. Thus, the royalty would be classified as Article 12 income under a treaty.[9]

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[9]See Organization for Economic Co-Operation and Development Model Tax Convention on Income and Capital [1992], Commentary on Article 12 Concerning the Taxation of Artistes and Sportsmen, OECD Committee on Fiscal Affairs, Paris, paragraph 18:

> The fee for the musical performance, together with that paid for any simultaneous radio broadcasting thereof, seems to fall to be treated under Article 17. Where, whether under the same contract or under a separate one, the musical performance is recorded and the artist has stipulated that he be paid royalties on the sale or public playing of the records, then so much of the payment received by him as consists of such royalties falls to be treated under Article 12.

The Treasury Department's Technical Explanations to U.S. treaties also take this proximate relationship approach. The Technical Explanations of treaties signed between 1989 and 1996[10] basically contain the following language.

> 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 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.[11] (Emphasis added.)

As noted in the underlined sentence above, income from *other than actual performance* may be classified in various ways. However, income that is closely associated with a performance must be considered Article 17 income.

It may be argued, based on the language underlined above and the example given in the commentary, that endorsement income is not income from an "actual performance," and that, therefore, such income is always excluded from Article 17 under the 1989-1996 treaties.[12] This interpretation of the pre-1996 Technical Explanations is not correct. Nothing in the Article 17 Technical Explanations suggests that the United States intended to follow a policy different from the OECD

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[10] France, Germany, India, Luxembourg (proposed), The Netherlands, and Sweden.

[11] Treasury Department Technical Explanation of the United States Model Income Tax Convention (September 20, 1996), Article 17.

[12] The pertinent language to be construed is:

> Income . . . from other than actual performance, such as royalties from record sales and payments for product endorsements, is not covered by this Article . . ..

approach. To the contrary, the United States has consistently followed the OECD position on this issue and has considered endorsement income that is proximately related to a performance to be Article 17 income.

Furthermore, the examples in the Article 17 Technical Explanations simply illustrate the OECD Commentary principles. The direct link – or proximate relationship – approach to Article 17 in the OECD Commentary is reflected in the conclusion in the U.S. Technical Explanations that record sales royalties generally should be covered under Article 12 instead of Article 17 because the payment stream is associated not with the performer's actual physical presence in the source state for the performance but with a separate intangible generated from the performance that could be exploited over time. Similarly, payments for product endorsements in many instances would not be covered by Article 17 if they were not in connection with an "actual performance."

Accordingly, to suggest that product endorsement income is excluded from Article 17 in all cases would be to misinterpret the Technical Explanation phrase "from other than actual performance, such as royalties from record sales and payments for product endorsements." While this clause may superficially appear to exclude endorsement income from the scope of Article 17, the clause intends to *include* income derived in connection with a performance (such as certain types of endorsement income) as Article 17 income and *exclude* income which is not proximately derived from entertainment or sporting activities.

In 1996, when the Treasury Department issued its new model Technical Explanation, the treaty text of Article 17 itself remained unchanged from that in the 1989-96 treaties. The Treasury Department also incorporated the Article 17 Technical Explanation language that it had generally used in treaties between 1989-96, as quoted above, into its new 1996 model. But, most importantly, to remove any ambiguity regarding the proper scope of Article 17, the 1996 Technical Explanation added the following paragraph:

> 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.[13]

The Technical Explanations of treaties containing the 1996 U.S. Model Treaty's Article 17 have included the foregoing additional paragraph.[14]

This paragraph leaves no doubt that the U.S. approach to Article 17 is identical to the OECD approach, both in its Model Treaty and in the treaties which were signed between 1989-1996. This is underlined by the fact that the treaty language itself is completely the same in the pre-1996 treaties, in the 1996 U.S. Model, and in the OECD Model. The last sentence of the second paragraph quoted above is particularly instructive since it notes that a sponsorship fee that is closely associated with a performance may be considered Article 17 income – a result directly at odds with the putative interpretation of the Technical Explanations of the earlier treaties. Finally, if the United States had intended to depart from its own or the OECD approach to endorsement income, the Technical Explanation of the 1996 U.S. Model Treaty would have so stated.[15]

One treaty that is so far unique in its treatment of endorsement income is the U.S. treaty with Mexico.[16] A protocol to that treaty reads as follows:

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[13]Treasury Department Technical Explanation of the United States Model Income Tax Convention (September 20, 1996), Article 17.

[14]See the Technical Explanations of the U.S. treaties with Austria, Ireland, South Africa, Switzerland, and Thailand. The Technical Explanation of the U.S. treaty with Turkey is substantively the same, though slightly abbreviated. The U.S. treaty with Mexico, which is discussed in detail below, contains a different and more expansive definition of Article 17 income.

[15]"[T]he strong identity between the provisions of the OECD and U.S. Models reflects the fact that the United States drew heavily on the work of the OECD in the development of the U.S. Model. References are made in the Technical Explanation to the OECD commentaries, where appropriate, to note similarities and differences." Treasury Department Technical Explanation of the United States Model Income Tax Convention (September 20, 1996); Tax Treaties (CCH), vol. 1, ¶ 214A.

[16]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, signed September 18, 1992, Tax Treaties (CCH), vol. 3, ¶ 5903, as amended by Protocol signed September 18, 1992, Tax Treaties (CCH), vol. 3, ¶ 5904.

> 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."[17]

The Joint Committee Explanation of this provision notes that "[t]he proposed treaty, unlike the U.S. model, provides that the income of an entertainer or athlete that would be subject to this article of the treaty includes remuneration for any personal activities he or she performs in the other treaty country relating to that individual's reputation as an entertainer or athlete (e.g., remuneration derived from product endorsements)."[18]

Unlike the direct link, or proximate relationship, approach of the 1996 U.S. Model Treaty, the Mexican treaty allows *any* remuneration from product endorsements to be taxed at source. Thus, it is substantially broader than the "direct link" standard, and the Joint Committee felt obliged to explain the departure from the U.S. Model.

Thus, endorsement income that is proximately related to a performance by an artiste or sportsman will be considered Article 17 income. However, if the income is not proximately related to such a performance, the treaty classification of the income depends on other factors. If the income is not proximately related, and is generated by the use of a type of intellectual property covered by Article 12 (Royalties), then the income may be considered royalty income.

3. Article 12 (Royalties)

Article 12 provides that "[r]oyalties arising in a Contracting State and beneficially owned by a resident of the other Contracting State may be taxed only in that other State."[19]

Under both the U.S. and the OECD model treaties, the term "royalties" means any consideration for the use of, or the right to use, the following types of

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[17] Protocol, supra n. 16, paragraph 16.

[18] Joint Committee on Taxation, Explanation of Proposed Income Tax Treaty (and Proposed Protocol) Between the United States and Mexico (JCS-16-93), October 26, 1993, Tax Treaties (CCH), vol. 3, ¶ 5945, paragraph 31.

[19] United States Model Income Tax Convention of September 20, 1996, Article 12(1), Tax Treaties (CCH), vol. 1, ¶ 214. The OECD Model contains the same rule, phrased slightly differently.

intellectual property: a copyright of literary, artistic or scientific work (including cinematographic films, and, under the 1996 U.S. Model, computer software, audio or video tapes or disks, and other means of image or sound reproduction), a patent, a trademark, a design or model, a plan, a secret formula or process, and information concerning industrial, commercial or scientific experience. The 1996 U.S. Model's list also includes (after process), any "other like right or property." For example, an individual's "right of publicity" may be such a property right. That is, permitting another person to exploit one's own *persona*, in the form of one's name, likeness, etc., is a use of property that would generate Article 12 income.

Thus, if endorsement income is not proximately related to a performance, and if it is paid for the use of a type of property listed above, then it may be considered Royalties income. If it is proximately related to a performance, then, despite the fact that it may also be generated from the use of intellectual property, it should still be classified as Article 17 income. Suppose, for example, that a U.S. recording company agrees to pay a nonresident alien musician (1) a fee to present a concert in the United States, and (2) a "royalty" for a simultaneous live broadcast of that concert. The musician may have an intellectual property right in the broadcast. However, the "royalty" will still be considered Article 17 income: but for the performance, the income could not have been earned, and it was closely connected with the performance. By contrast, royalties generated from recordings made of the broadcast would be Article 12 income. While, but for the performance, such royalties could not have been earned, they would <u>not</u> be closely connected with the performance.[20]

Suppose, in addition to the contractual provisions above, that for an additional fee the recording company was given the right to use a picture of the musician, downloaded from the musician's website, in promoting record sales in shopping malls and other outlets. This fee would be considered a royalty for the use of an "other like right or property," and would be classified as Article 12 income.

<u>4. Articles 14 & 15 (Independent and Dependent Personal Services)</u>

Under Article 14 (Independent Personal Services), income "in respect of the performance of services of an independent character" is taxable only in the individual's country of residence, unless the individual has a fixed base in the source country for the purpose of performing his activities. Under Article 15 (Dependent Personal Services), remuneration derived from employment is taxable in the individual's place of residence, unless the employment is exercised in the other treaty country. If the employment is exercised in the other treaty country, and if a *de minimis* exception (less than 183 days, foreign employer, no permanent

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[20]See <u>supra</u>, n. 9.

establishment or fixed base) does not apply, then the source country may tax the income. However, when classifying endorsement income, the distinction between Article 14 income and Article 15 income is usually not as difficult to draw as the distinction between Article 17 income and *either* Article 14 or Article 15 income. The distinction, again, depends on whether the income is proximately related to a performance.

Suppose, for example, that a golfer is paid to endorse a certain type of car. The player is required to drive the car and to make live promotional appearances at car dealerships. These services would not be proximately related to a performance (i.e., playing in a golf event). Therefore, the income would not be Article 17 income, but would be either Article 14 or Article 15 income. On the other hand, if the golfer were paid to endorse equipment and clothing, which she was required to carry and wear onto the course, then the endorsement income would be Article 17 income.[21]

5. <u>Other Income (Article 21)</u>

Items of income that are not dealt with under specific treaty articles are treated as Article 21 "Other Income," and are typically taxed only in the place of residence of the beneficial owner. The Technical Explanation of the 1996 U.S. Model Treaty provides some examples of Article 21 income. Income generated by some endorsement activities could be considered Article 21 income.

6. <u>Allocating Income Among Treaty Articles</u>

Once the appropriate treaty income classification for each type of endorsement activity is determined, there remains the issue of determining how much income should be allocated to each classification. A single endorsement contract may involve a mixture of activities. The contract may include a breakdown with separate amounts specified for each activity, or the contract may simply enumerate the activities that must be performed for a stated overall lump sum. Furthermore, contracts are frequently structured with a certain amount of base pay, plus additional amounts for achieving a certain ranking, for participating in certain events (e.g., playoff matches), or for having sales of endorsed products exceed certain limits. Where either separately enumerated amounts are not arm's length, or where the contract provides a lump sum for a group of activities, the amount of income attributable to each treaty classification needs to be determined. In such cases, for purposes of allocating income from a single endorsement contract

[21] Of course, as noted above, the provisions of the relevant treaty must always be examined. Under the U.S.-Mexico treaty, all of the endorsement income would be treated as Artistes and Athletes income.

among the various categories of treaty income, it may be necessary to look at comparable third party contracts for each endorsement activity or other relevant valuation evidence and to assign monetary values, or at least relative monetary values, to each.

Suppose, for example, that a U.S. sporting goods company agrees to pay a nonresident alien tennis player to (1) wear the company's clothing and use the company's racquets in tournaments, and (2) license the use of his name, likeness and signature for in-store displays of the clothing and racquets. The tennis player is paid a lump sum of $100,000 per year under the contract, plus a bonus of $100,000 for retaining his No. 1 ranking. Activity (1) generates Artistes and Sportsmen income that is taxable in the United States, since it is proximately related to the sportsman's performance in the United States. Activity (2) generates Royalties income that is exempt from U.S. taxation. The sportsman allocates 50% of his income to each category. The Service agrees with the classification of the activities. However, the Service may consider comparable third party contracts or other relevant valuation evidence for each of the activities to determine whether the amount allocated to each was appropriate.

To give a second example, suppose that a U.S. recording company agrees to pay a nonresident alien musician (1) a fee to present a concert in the United States, and (2) a royalty on sales of the musician's recordings of prior concerts given outside the United States sold by the company at the U.S. concert venue. The fee is $100,000, and the royalty is 10% of sales. Activity (1) generates Article 17 income, and activity (2) generates Article 12 income. However, it is determined that an arm's length royalty for sales of the musician's recordings at a record store is 5%. The additional 5% royalty earned by the musician for sales at the concert venue is a premium attributable to his personal appearance in concert. Therefore, that additional income should be classified as Article 17 income.

In this regard, it is important to note that formulary approaches should not be used. One case in particular, J.A. Kramer v. Commissioner, 80 T.C. 768 (1983), has been said to have created a bright line test that endorsement income should be allocated 70% to royalty income and 30% to personal services income. As noted above, however, the allocation of income among treaty classifications depends on the mixture of activities performed and upon the percentage of the whole amount that would have been paid, at arm's length, for each of the activities. The percentage of income attributable to each activity will vary depending on the facts of the case. Therefore, no bright line tests should be applied.