

TAXING ENDORSEMENT AND OTHER INCOME OF FOREIGN ATHLETES IN THE UNITED STATES

January 30, 2008

The US Internal Revenue Service recently has begun an aggressive targeting of foreign athletes in an effort to collect US federal income taxes attributable to the athletes' endorsement and other income.¹ While US tax law always has provided for an apportionment of endorsement and other income to the United States based on where the athletes performed their services, the IRS has proposed a new regulation clarifying the standard for apportioning an athlete's worldwide income between the United States and foreign countries. This new proposed regulation will not affect athletes who are US citizens or residents, as they are taxed in the United States on their worldwide income.

Under the IRS's proposed regulation, apportionment of an athlete's worldwide income to the United States will be based on the nature or significance of the events that the athlete attended in the United States rather than the time actually spent in the United States. In many circumstances, this proposed regulation may have a substantial impact on the amount of such income that is subject to US taxation. Moreover, because the tax laws of many US states and local jurisdictions are based on the

¹ For a self-employed foreign athlete who is not entitled to exemption from US tax under a tax treaty, the athlete's gross receipts from services rendered in the United States are generally subject to withholding tax at a rate of 30 percent. I.R.C. § 1441. Special rules may apply that can reduce the withholding tax rate. See Treas. Reg. § 1.1441-4(b)(3) and (4).

federal tax laws, the proposed regulation could have state and local tax implications as well.²

Even though a foreign taxpayer may be subject to increased US federal, state and local tax as a result of this proposed regulation, generally a taxpayer may be able to offset such additional tax at least to some extent through a tax credit in the foreign taxpayer's resident country. However, the extent of any tax credit to offset additional tax would depend on whether the US tax rate is higher or lower than the resident country tax rate. Moreover, the application of US bilateral tax treaties with the foreign taxpayer's resident country would have to be considered.

Under US federal tax law generally, a foreign individual who performs labor or services outside of the United States is not subject to US taxation on income attributable to such services.³ However, to the extent that the individual performs services both inside and outside of the United States, an apportionment of the income attributable to

² In August 2007, legislation was introduced in the US House of Representatives (H.R. 3359, the "Mobile Workforce State Income Tax Fairness and Simplification Act of 2007") that would place a 60-day threshold for income taxation of nonresidents to create a uniform standard for nonresident income tax withholding. This legislation, if enacted, would exclude professional athletes from the 60-day threshold for US state income taxation, leaving open the possibility that states may withhold taxes on payments made to a foreign athlete for any services performed in the state.

³ I.R.C. §§ 872(a), 862(a)(3).

Americas

Europe

Russia/CIS

Asia Pacific

Africa

Middle East

www.dl.com

those services is required to determine the amount of income that is subject to US federal taxation.⁴ Although endorsement income may not be in and of itself attributable to an athlete's performance of services while in the United States, in practice, foreign athletes have generally treated a portion of that income as related to the athlete's participation in athletic events. Accordingly, to the extent such events occur in the United States, some portion of the endorsement income may be subject to US federal taxation.⁵

The relevant US tax regulation currently in effect provides that multi-source income is apportioned "on the basis that most correctly reflects the proper source of the income under the facts and circumstances of the particular case."⁶ The regulation specifically provides that "[i]n many cases, the facts and circumstances will be such that an apportionment on the time basis . . . will be acceptable."⁷ For example, the ratio of the number of days an individual works in the United States versus the number of days worked in a foreign country may be used to apportion income between US and foreign

sources for purposes of allocating a year-end bonus.⁸ Although the regulation reserved its establishment of specific rules for artists and athletes,⁹ the use of the time-based method for apportioning endorsement income may typically have been used in the past by athletes to apportion income from endorsement contracts.

The IRS's clarification of the existing regulation is set forth in a proposed regulation published in October 2007. As stated above, this new proposed regulation requires that the apportionment of income earned by artists and athletes generally will be based on the nature or significance of events that the artist or athlete attended in the United States.¹⁰ Although this regulation is effective only when it becomes final, the IRS asserts that the proposed regulation represents its interpretation of the "facts and circumstances" test under the existing regulation and thus the IRS will apply the events-based test retroactively to athletes for prior tax years.

Under the events-based test as set forth in the proposed regulation, if an athlete is compensated for attending a specific athletic event that occurs in the United States, the entire amount of such

⁴ Treas. Reg. § 1.861-4(b).

⁵ The actual tax treatment of income from endorsement contracts is complicated because endorsement income is not necessarily considered income from services, but may in some circumstances be treated as royalty income that is subject to different tax rules.

⁶ Treas. Reg. § 1.861-4(b)(1)(i).

⁷ *Id.*

⁸ Treas. Reg. § 1.861-4(b)(2)(ii)(E).

⁹ Treas. Reg. § 1.861-4(b)(2)(ii)(C)(3).

¹⁰ Prop. Treas. Reg. § 1.861-4(b)(2)(ii)(G), REG-114125-07, 72 Fed. Reg. 58787 (Oct. 17, 2007), 2007-46 I.R.B. 1012.

income is treated as US-source income that is subject to US taxation. To the extent that the athlete is compensated for attendance at multiple events, some of which occur inside and others outside the United States, the income for such attendance is subject to US taxation based on the nature or significance of the events attended by the athlete in the United States as compared to the events attended worldwide. The proposed regulation provides examples to illustrate how the IRS would apply the events-based test. In one such example, a musical group contracts to tour 15 cities, 10 of which are located in the United States. The IRS allocates 80 percent of the group's compensation for the tour to the United States because the 10 domestic cities generated 80 percent of the group's gross income, even though domestic venues only represented 67 percent of the total locations of the group's performances.¹¹

Based on this proposed regulation, the IRS is likely to continue to assert that

11. Prop. Treas. Reg. § 1.861-4(c), Ex. 8. Although the proposed regulation continues to permit consideration of alternative methods for apportioning income, the preamble to the proposed regulation states that the use of the time-based method for apportioning income in these circumstances generally would not be appropriate. REG-114125-07, 72 Fed. Reg. 58787, 58788 (Oct. 17, 2007.) Further, the regulation itself states that the location of any work preparing for an event is generally not taken into account. Prop. Treas. Reg. § 1.861-4(b)(2)(ii)(G).

endorsement or other income that is not specific to any event attended by the athlete is to be apportioned based on the nature or significance of the events attended in the United States as compared to the events attended worldwide. Whether this application of the proposed regulation, or the IRS's interpretation of the existing rules for prior periods, is appropriate may depend on the particular facts and circumstances of the event attended (such as gross revenues from the event or viewer ratings), the terms of the endorsement contract, the nature of the professional sport, and the athlete's contract and relationship with the team or league.

As noted above, this use of an events-based test to apportion income of foreign athletes is a significant departure from the prior time-based test previously used by many such athletes, and thus careful consideration must be given to the factors that may impact the US tax reporting of an athlete's multi-source income going forward.

If you have any questions regarding this client alert, please contact Jeffrey L. Kessler at +1 212 259 8050 or jkessler@dl.com, Mark D. Allison at +1 212 259 6866 or mallison@dl.com, or your Dewey & LeBoeuf relationship attorney.

This brochure is a publication of Dewey & LeBoeuf LLP and is not intended as legal advice regarding specific transactions or matters. For further information, please contact one of the attorneys listed below.

| | | | | |
|----------|--|------------------------------------|---------------------------------------|------------------------------------|
| New York | 1301 Avenue of the Americas New York, NY 10019-6092 Facsimile: +1 212 259 6333 | +1 212 259 8050 +1 212 259 6866 | Jeffrey L. Kessler Mark D. Allison | jkessler@dl.com mallison@dl.com |
| | 125 West 55th Street New York, NY 10019-5389 Facsimile: +1 212 424 8500 | | | |

This memorandum is intended only as a general discussion of these issues. It is not considered to be legal advice. We would be pleased to provide additional details or advice about specific situations. For additional information on this important topic, please feel free to call upon your Dewey & LeBoeuf relationship partner.

No part of this publication may be reproduced, in whole or in part, in any form, without our prior written consent.

© 2008 Dewey & LeBoeuf LLP
All rights reserved.

For further information on Dewey & LeBoeuf, please visit

www.dl.com

+1 888 532 6383

6252 REV2 01-29-2008