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Carole C. Berry, *Taxation of U.S. Athletes Playing in Foreign Countries*, 13 Marq. Sports L. Rev. 1 (2002)
Available at: <http://scholarship.law.marquette.edu/sportslaw/vol13/iss1/3>

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ARTICLES

TAXATION OF U.S. ATHLETES PLAYING IN FOREIGN COUNTRIES

CAROLE C. BERRY*

I. INTRODUCTION

The old cliché, “the world is getting smaller,” is exemplified in ways our grandparents and even our parents never dreamed possible. Ease of travel and relatively open borders have made international travel for work and pleasure commonplace. Taken together with advancing technologies, this ease of travel has fueled an exponential growth in various societies’ thirst for entertainment, happily provided by globe-trotting performers. Athletes are one type of performer who are among the chief beneficiaries of increased international opportunities. Concomitant with a higher demand for athletic services come greater sources of income. As a consequence, an ever-increasing set of issues has been created for both developed and developing countries. Chief among those issues for all countries is how to ensure that an athlete’s income, from whatever source, is accounted for and taxed. Of equal concern, however, is to ensure that the taxation of that income is fair.¹

One need only observe the wild celebration by the Chinese people at having landed the 2008 Olympic Games to know that athletics is BIG business. It is big business for the sportsmen, for their agents, for the products they advertise, and for the government coffers they help fill. All interests are not necessarily compatible, especially when there are two or more taxing authorities that want a “piece of the action.” Therein lies the dilemma – how to reconcile these competing interests. Nowhere is this more evident than in the situation involving a high profile athlete who, through necessity or choice, plays in a foreign country.²

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1. The word “fair” is a value-laden word, the meaning of which is illusive. Used in this context, “fair” is meant to mean that one is taxed like a similar person in a like situation. Whether the ultimate figure in dollars paid to the tax man is “fair” is always a question and one left for the jurists to determine.

2. The article will develop what it means to play in a “foreign” country for purposes of taxing income acquired from that activity.

This article is designed as a primer on the international taxation of athletes who are residents and/or citizens of the United States but who, for the most part, live and play out of the country.³ It will assume that all income earned is of foreign source to avoid issues of source allocation within and without the U.S.⁴ Further, it will discuss both residents and citizens of the U.S. but not non-resident aliens who play in the United States and abroad.⁵

The article is not meant to be the definitive authority on the intricacies of treaty provisions or, more particularly, the interaction between the Internal Revenue Code and treaties. While it is a starting point for tax issues, it is not meant to guide business decisions for individual players. It will deal primarily with income tax matters as they relate to the three basic sources of income that athletes traditionally earn. These sources are: (1) income for athletic services performed by the athlete; (2) income from signing and incentive bonuses; and (3) income from endorsement contracts.

There are, of course, a myriad of other sources of income that athletes may earn, including income from dividends, annuities, real estate investments, and other business ventures. General issues surrounding estate planning are important. Also, there are questions about filing, withholding, and reporting requirements that must be addressed. However, all of these matters are beyond the scope of this article. That which is discussed are the basic elements of income earned by athletes based on their athletic skills and celebrity status. In short, this primer is a starting point for people who seek initial direction through the maze of laws that cover these topics.

Section II deals with the basic principles of income taxed internationally as well as definitions which have an impact on tax consequences for U.S. citizen and/or resident players earning money overseas. Included in Section II is a short discussion on the definition of residency, the importance of United States sourcing rules, and the characterization of income issues as they relate to income earned.

Section III discusses how, by whom, and with what consequences that income is taxed. More particularly, the vexing issue of double taxation is addressed and includes a discussion of the foreign tax credit and its limitations, as well as the Internal Revenue Code section 911 exclusion with

3. The taxation of a foreign national with U.S. residency is much like that of a citizen, to-wit on worldwide income. Suffice it to say, most foreign nationals with high income prefer to avoid U.S. residency for tax purposes. This is not always the case, however, because there may be some tax advantages in the short term. A resident is taxed on net income at graduated rates while a non-resident alien often is taxed on gross income at a flat rate.

4. This topic is covered sporadically throughout the article, mostly in passing.

5. The taxation of non-resident aliens brings an entirely different perspective to the international taxation of athletes and is beyond the scope of this article.

all of its intricacies.

Section IV analyzes the effects of tax treaties. Tax treaties define many international business transactions as well as mitigate double taxation. Indeed, a treaty may be the definitive source of law in any given situation. Thus, the complexities and importance of treaties require a separate section.

II. INTERNATIONAL TAX CONCEPTS AND THE ATHLETE

To grasp the intricacies of how athletes are taxed, it is first necessary to understand the basic constructs of the United States international taxing system. The U.S. taxes its residents on their worldwide income and, unlike any other major jurisdiction, also extends worldwide taxation to its citizens.⁶ The taxing authority is based on personal status and is justified by the many benefits that residents and U.S. citizens possess. These benefits are sometimes characterized as a type of insurance policy. For example, U.S. nationals have the protection of the U.S. government wherever they travel, and they have the right to return to the United States whenever they choose. Worldwide income taxes help pay for this insurance “protection” and, as noted, have been held to be a lawful means of taxation.⁷

In addition to taxing on the basis of personal status, many nations tax income which arises in their jurisdiction under the so-called “source” taxation theory. The notion of territorial taxation is that taxpayers are expected to share in the cost of operating the government and its services in the territory in which they earned the income. Through these operations, the taxpayer is able to produce income, and taxation is limited to that income from sources within the boundaries of the country.

While the above is an extremely simplified version of the terribly complex systems of world economics and taxation, it sketches the two basic theories of taxation that prevail. It also indicates the problems that arise when U.S. resident and citizen athletes, who pay taxes on their worldwide income, play in a foreign country with a territorial scheme of taxation. That country taxes the athlete because the income is generated therein, and the United States taxes the athlete on the same income based on the notion of worldwide taxation. Therefore, unless these taxation schemes are harmonized, the athletes pay

6. Interestingly, the U.S. taxation of worldwide income arises from the lack of definitions within the United States Code rather than from a specific power. Section 1 of the Code imposes a tax on the taxable income of “every individual,” while section 61 declares that the income to be taxed is “from whatever source derived.” I.R.C. §§ 1, 61 (2002). Hence, the taxation of income from all sources equates to the taxation of all income worldwide, from wherever and whatever source. This concept was upheld in the case of *Cook v. Tait*, 265 U.S. 47, 54 (1924).

7. *Cook*, 265 U.S. at 56.

taxes twice on the same income.⁸

Double taxation is not in accord with sound international business principles. Taxation, theoretically, should neither encourage nor discourage economic activity. In the international context, countries usually strive for some type of tax neutrality. Quite clearly, double taxation of any transaction or enterprise is contrary to any form of tax neutrality. To alleviate this problem, countries usually allow either an exemption from taxation in the country in which the income and subsequent taxes are generated or a credit for taxes paid in the foreign country against taxes owed in the country of citizenship.⁹

However, before beginning a discussion of double taxation, it is first necessary to define what constitutes a citizen and resident for purposes of the U.S. tax code. Second, how income is characterized and thus sourced is also critical to how income is ultimately taxed.

A. *Citizenship and Residency*

At first blush, it might seem a primer on representing athletes who play overseas would only encompass U.S. citizens. In fact, several foreign nationals reside in this country and, on occasion, perform their sport outside of the United States.¹⁰ Therefore, the discussion must include not only U.S. citizens but also foreign nationals who may qualify for U.S. residency.

The question of whether a person is a citizen of the United States is rarely an issue, and tax disputes that center on citizenship are uncommon. Basically, Regulation Section 1.1(c) defines a citizen as “[e]very person born or naturalized in the United States and subject to its jurisdiction”¹¹ As a U.S. citizen, taxation is based on worldwide income.¹²

However, non-citizen residents of the United States are also taxed on worldwide income. Unlike citizenship, the issue of residency has proven, over the years, to be a sticky issue and, until 1984, was defined in a number of ways.¹³ In that year, section 7701(b) was enacted. It defined “resident alien”

8. The purpose of distinguishing between worldwide taxation and territorial taxation is to show the problems faced by U.S. citizen and resident athletes who earn foreign income. It is not suggested that the U.S. taxation scheme of worldwide income sweeps in all income from all people who happen to have some U.S. source income.

9. These issues are developed fully in Sections III and IV of this article.

10. For example, Greg Norman, an Australian citizen, resides in the U.S. and often plays golf outside of the country.

11. Treas. Reg. § 1.1-(c) (2002).

12. See *supra* note 6 for discussion.

13. The concept of residency was based on notions of domicile and residency drawn from the

primarily in terms of mathematical formulas based on time in the country as well as immigration status.¹⁴ While section 7701(b) did not provide a “bright line” test, the process of determining residency was greatly simplified.

Perhaps the most straightforward test for residency is based on the U.S. immigration laws. A lawful permanent resident is one who is entitled to remain permanently in the United States based on his or her immigration status.¹⁵ In other words, that person is a so-called “green card holder” and remains so unless or until that status is revoked or otherwise terminated. A green card holder is a tax resident regardless of the time spent in the United States.

Test number two for residency, which has nothing to do with immigration status, centers on physical presence in the United States. Simply put, a foreign national meets this test if the individual is present in this country for 183 days or more in the calendar year¹⁶ AND does not qualify as an “exempt” individual.¹⁷ A foreign national who meets this test is said to have a “substantial presence” in the United States.¹⁸ Residency time is calculated from the time the alien enters the United States and continues for the remainder of the calendar year.¹⁹ Residence ends when the alien departs the U.S., provided that person has a closer connection to a foreign country than to the U.S. and, more importantly, is not a resident at any time during the next calendar year.²⁰

The test thus far is fairly straight-forward and quite easily manipulated. A person could simply stay in this country for 182 days each year, never become a resident, and never be taxed on worldwide income.

To counter this potential problem, section 7701(b)(3)(A) was enacted. Under this section, even if aliens are not present in the U.S. for 183 days during the calendar year, they still may be considered residents based on their

common law and incorporated the indicia of intention. Intention in turn often depended on outward manifestations of facts. It was a complicated issue that generated multiple litigation. JOSEPH ISENBERGH, *INTERNATIONAL TAXATION* 18-19 (2000) [hereinafter “ISENBERGH I”].

14. I.R.C. § 7701(b) (2002).

15. 8 U.S.C. § 1101(a)(20) (2000).

16. I.R.C. § 7701(b)(3)(ii).

17. Exempt individuals include foreign government officials of diplomatic and consular status, teachers, students and trainees, and professional athletes competing in charity events. *Id.* § 7701(b)(5)(A). People who find themselves in the U.S. as transients between countries or because of a medical condition also do not amass days for purposes of becoming residents. *Id.* § 7701(b)(3)(D).

18. I.R.C. § 7701(b)(3).

19. *Id.*

20. *Id.* § 7701(b)(2)(B).

cumulative presence during the year in question and the previous two years.²¹ To determine cumulative presence, an alien must be present in the U.S. in the current year for at least thirty-one days.²² In addition, days present in the current year are added to one-third of the days present in the immediate preceding year and one-sixth of the days present in the second preceding year.²³ If the sum total equals or exceeds 183 days, the alien is considered a resident.²⁴ It works like this: Assume that, in the year 2001, the alien was present for 120 days and likewise was also present for 120 days in each of the previous two years, 2000 and 1999. That individual would not satisfy the substantial presence test and therefore would not be considered a resident for the year 2001 because the days calculated under the formula only equal 180 days.²⁵ The math indicates the following: $[(120 \times 1) + (120 \times 1/3) + (120 \times 1/6)] = 180$.²⁶ However, if the individual was present for even two more days per year, he or she would meet the 183 day requirement and would be considered a resident.²⁷ Basically, an individual can spend up to 121 days each year in the U.S. without triggering residency for tax purposes.

B. Source and Characterization

Income can take on many forms and, as indicated in the Introduction, this article will discuss the three main sources of income for U.S. citizen and resident athletes who play in a foreign country. They are personal services income, bonus income, and endorsement income. As one would expect, the taxation of each component is dependent on both foreign and U.S. domestic notions of international law.

Basic to our system of international taxation is the concept of source. The source of the income has been described as the “essential mortar – if not the keystone – in the U.S. system of international taxation.”²⁸ Sections 861-865

21. *Id.* § 7701(b)(3)(A)(ii).

22. *Id.* § 7701(b)(3)(A)(i).

23. *Id.* § 7701(b)(3)(A)(ii).

24. *Id.*

25. *Id.*

26. *Id.*

27. *Id.* The cumulative presence test is softened somewhat if (1) the alien can establish, under Internal Revenue Code (hereinafter “I.R.C.”) section 7701(b)(3)(B) that he or she was present in the United States on fewer than 183 days during the calendar year in question (but more than an average of 183 days when calculated with carry back days during the preceding two years), (2) the individual has a “tax home” in a foreign country, and (3) the individual has a “closer connection” to that foreign country than to the United States. Neither “tax home” nor “closer connection” is defined in section 7701 but rather in other sections of the Code. *Id.* § 7701(b)(3)(B)(ii).

28. ISENERGH I, *supra* note 13, at 27. However, that same author, in his international treatise,

and the attendant regulations specify the rules for determining the sources of income as they are presently configured.²⁹ More particularly, they establish whether income is derived from sources within the United States, known as U.S. source income, or from sources without the United States, known as foreign source income. It is safe to say that the United States holds to the principle, as many commercial and developed countries do, that source is tied to some economic activity connected to the country that is taxing the income.

Nevertheless, there is no handy list to which one can refer to determine the exact nature of a particular portion of income and how it will be taxed. It depends on how the income is characterized. For example, transfers of rights to intangible assets such as patents, copyrights, and the like often have elements of personal services, sales, and licenses. If the right transferred is characterized as a license, it could generate foreign source royalty income, which is taxed quite differently than if it is characterized as a sale of a product.³⁰

Fortunately, the Code, in sections 861 and 862, sets out many classes of income and assigns them a source. Unfortunately, the sections deal with single types of income, generated within or without the United States.³¹ An athlete's income often does not neatly fall within any of the assigned sources and arises from both within and without the U.S.³² For example, if a sportsman³³ is not affiliated with a team, such as a golfer, tennis player or the like, an agent may deal with income earned performing that sport as well as possible endorsement income. For a team sportsman, the agent must also consider the likely possibility that, in addition to the basic service portion of a contract and endorsement income, there may also be incentive and signing bonus issues. Each will be discussed.³⁴

also noted that “[i]t is fair to say, within fairly broad limits, that countries do not tax income because of its source, but assign a source to it because they have decided to tax it.” JOSEPH ISENERGH, *INTERNATIONAL TAXATION* ¶ 10.1 (3d ed. 2002) [hereinafter “ISENERGH II”].

29. ISENERGH I, *supra* note 13, at 28.

30. These issues come into play for an athlete in determining the nature of income primarily from endorsement income but also, to some extent, from how the signing bonuses are characterized.

31. I.R.C. §§ 861-62 (2002).

32. Section 863(b) deals with income “partly from within and partly from without the United States” but leaves the apportionment to be “prescribed by the Secretary.” I.R.C. § 863 (2002).

33. “Sportsman” is meant to include male and female athletes. While clearly not gender neutral, the alternative, “sportsman and sportswoman,” is cumbersome.

34. The discussion of characterization and sourcing is a bit like the chicken/egg dilemma. In order to understand how a U.S. resident or citizen is taxed via the foreign tax credit or through a bilateral treaty, it is necessary to understand how the income is characterized and thus sourced. But to discuss characterization and source without relating it to the utilization of the foreign tax credit or applicable treaty provisions is to discuss the notions in a vacuum.

1. Playing the Sport

Perhaps the easiest characterization, and thus source issue, centers on the actual performance of an athlete in his or her sport. Income for personal services is sourced at the place where the services are performed.³⁵ Thus, a U.S. citizen playing basketball in Italy is deemed to have "foreign source" income for purposes of U.S. taxation. The issue can become tricky when services are performed both within and without the U.S.³⁶ In that case, personal service income is allocated pursuant to where the money is earned and then taxed accordingly.

2. Bonus Income

For the most part, athletes are likely to have the potential to earn two kinds of bonus income based on what are called incentive and signing bonuses. Incentive bonuses are based on personal or team performance. Thus, taking a basketball player for example, a contract may be entered that specifies that bonus dollars will be earned if the athlete scores a pre-determined number of points during the course of the year, or plays a specified number of minutes, or appears in a championship game. These types of payments are characterized as income related to personal services and are sourced where the income is earned.

Signing bonuses, on the other hand, have presented some difficulties as they relate to source and characterization. As with most of these issues, how income is characterized and sourced is important in the application of treaty provisions to income and the determination of the foreign tax credit.

In some cases, signing bonuses are deemed to be payments to assure that the athlete will play for the particular club. The bonus is considered part of the overall compensation to be paid for services rendered. It is deemed to be ordinary income and treated as if it were for the personal services of the athlete.³⁷

However, Revenue Ruling 74-108 likens a "sign on fee" (*i.e.*, a signing bonus) to a covenant not to compete, entered into to induce the player to sign and become bound by the provisions of a separate contract with that particular

35. I.R.C. § 861(a)(3).

36. The issue of dual source occurs on a regular basis with hockey players in the National Hockey League because of games played in Canada and the U.S. During the 1970s, more than 200 cases were docketed in U.S. courts that dealt with the appropriate taxation of these athletes. Many are still winding their way through the courts some thirty years later and present an array of cases that exhibit what has been described as "a long and tortured safari through years of proceedings, determinations and delay." *Brown v. Comm'r*, 896 F.2d 10, 11 (1st Cir. 1990).

37. See *infra* note 39 for a discussion on signing bonuses.

club.³⁸ The ruling states that “[n]o part of the sign on fee is attributable to future services, but the team anticipates the agreement and fee will induce the player to sign and become bound by the uniform player contract if the club wishes to use his services”³⁹ Essentially, it is income derived from nonperformance. Further, the revenue ruling states that such compensation is taxable as ordinary income, and its source is the place where the promisor forfeited his right to act.⁴⁰ If that nonperformance is both within and without the United States, the fee is attributable to all locales and must be apportioned accordingly.⁴¹

3. Endorsement Income

As with bonuses, endorsement income must be characterized and sourced in order to calculate taxes owed by U.S. citizen and resident alien athletes. If the endorsement income is characterized as royalty income, many bilateral treaties restrict the taxing right to the state of residence. If not, and it is treated as personal services, it is sourced and taxed in the country in which the income is earned.⁴² However, the impact of treaties cannot be ignored, as discussed *infra*. The treatment of personal service income and royalty income as they relate to treaties is developed thoroughly in Section IV of this article.

The question to determine at the outset is whether income earned from endorsement contracts are fees for personal services or royalties generated by the use of a capital asset. In 1994, the IRS issued its Market Segment Study on Foreign Athletes and Entertainers.⁴³ While this document was designed to facilitate IRS audits during income examinations of non-resident aliens, it is useful to analyze how the Service views various sources of income. A large portion of the document is devoted to identifying and characterizing royalty income as opposed to personal service income.⁴⁴ It is instructive to note that

38. Rev. Rul. 74-108, 1974-1 C.B. 248.

39. *Id.* A signing bonus is almost always signed concurrently with the main contract. It potentially serves two purposes for the player: immediate cash flow and guaranteed income. For the club, a signing bonus helps assure the services of the athlete. *Id.*

40. *Id.* at 249.

41. This position was basically upheld in the case of *Linseman v. Comm'r*, 82 T.C. 514 (1984).

42. For persons representing non-resident alien athletes, this issue is critical, and much of the case law and literature deals with this class of athlete. However, the issue cannot be ignored because how this income is characterized and thus sourced can be critical to citizens and resident aliens living abroad insofar as the section 911 exclusion application is concerned. I.R.C. § 911 (2002).

43. MARKET SEGMENT SPECIALIZATION PROGRAM (CCH) (Internal Revenue Manual Audit Binder), AUDIT TECHNIQUE GUIDE FOR FOREIGN ATHLETES & ENTERTAINERS 22,901 (2002) [hereinafter “Market Segment Study”].

44. *Id.* at 22,968.

the Service admits that “[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.”⁴⁵

In that document, the Service discusses its Revenue Ruling 81-178.⁴⁶ The main subject of the ruling is whether payments made to an exempt labor organization from various business enterprises for the use of the organization’s trademark and similar properties are royalties within the meaning of section 512(b)(2) of the Code.⁴⁷ While defining the term “royalties” is not the primary goal of the ruling, nevertheless the discussion of the term is useful.⁴⁸ The Service says:

To be a royalty, a payment must relate to the use of a valuable right. Payments for the use of trademarks, trade names, service marks, or copyrights, whether or not payment is based on the use made of such property, are ordinarily classified as royalties for federal tax purposes. Similarly, payments *for the use of a professional athlete’s name, photograph, likeness, or facsimile signature are ordinarily characterized as royalties.*⁴⁹

Citing that ruling, the Market Segment Study discusses how their examiners should view endorsement income.⁵⁰ It says:

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 . . . 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

45. *Id.*

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

47. *Id.*

48. The question considered in this ruling is whether certain payments are considered royalty payments or compensation for personal services. If they are deemed to be royalty payments, they are not taken into account in determining unrelated taxable income. If, however, they are considered compensation for personal services, they must be taken into account in computing unrelated business taxable income. *Id.*

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

50. Market Segment Study, *supra*, note 43, at 22,968-69. Once again, a cautionary note is that this Market Segment Study was written for purposes of determining taxable income for non-resident aliens. Further, in this portion of the study, the Service was discussing tennis players in particular. Thus, one can question its applicability to athletes in other sports. *Id.*

income is personal service income.⁵¹

The study then discusses the *Kramer* case⁵² in which a tennis player (Jack Kramer) received income from the sale of tennis equipment bearing his name.⁵³ Under his contract with the equipment company, he was required to use the equipment in tennis matches and, in addition, was required to make personal appearances on the sponsor's behalf.⁵⁴ The court held that the income was for both the use of the athlete's name and for personal services.⁵⁵ Thus, it allocated the income as part royalty and part personal services.⁵⁶ This was consistent with a previously decided case in which a golfer's name was used on a golf ball, and the court deemed the income to be royalty income.⁵⁷

The matter remains unsettled. It appears that the closer the tie to a specific event, the more likely it will be that the income is for personal services. For example, if the athlete engages in advertisement for a particular tournament or event, the likelihood is that the income will be deemed personal services. If, on the other hand, the athlete is well-known and his likeness or name is recognizable and appears on merchandise, the income generated from the sale of the merchandise may well be deemed a royalty. In other words, the more passive the athlete's activity in connection with sporting events, the more likely the income is judged to be a royalty.⁵⁸

III. TAXATION OF U.S. CITIZENS AND RESIDENTS

It is axiomatic that economies of nations are enhanced by international trade and business relations involving entities and individuals. Both are motivated, to a large degree, by gain made in the form of profits. Ultimately, profits are determined by numerous business factors, not the least of which is the taxation of the activity or the enterprise. Chief among the concerns of overseas ventures is the issue of double taxation. Recall that U.S. citizens and residents are taxed on their worldwide income no matter where it is earned.

51. *Id.*

52. *Kramer v. Comm'r*, 80 T.C. 768 (1983).

53. *Id.* at 770.

54. *Id.* at 768-69.

55. *Id.* at 781.

56. *Id.* at 782.

57. *Armour v. Comm'r*, 22 T.C. 181 (1954).

58. The key to much of the controversy is solvable by a well-drafted contract. As noted in the Market Segment Study, "if the taxpayer has a contract . . . it is *imperative* that the contract be scrutinized." Market Segment Study, *supra* note 43, at 22,955. Therefore, the drafter of the contract is well advised to familiarize himself with all aspects of international taxation to maximize tax relief for the athlete.

That same income could be taxed by the countries where the income is earned on the theory that the money is generated within the boundaries of that country; hence, double taxation.⁵⁹

Clearly, if monies are taxed twice, any impetus to invest human or monetary resources outside one's country is seriously impaired. Thus, nations have set out to eliminate double taxation to encourage international trade and investments. How this is accomplished varies from nation to nation and presents a labyrinth of complicated national tax systems with international ramifications.⁶⁰

While the mechanisms are highly complicated, the theories upon which they are based are fairly simple. When two countries have an interest in the same income, the general approach is to eliminate double taxation through either an exemption or a tax credit. In other words, a country that uses an exemption scheme simply excludes income from its tax jurisdiction and allows the other taxing authority to tax the income. Or, in the case of a tax credit, a country grants a credit for taxes paid toward the taxes owed in the crediting country. Either design is a product of each country's national tax scheme and comports with that country's notion of fairness and tax governance.

A. The Foreign Tax Credit

One mechanism used by the United States to eliminate double taxation is the foreign tax credit. To that end, the Congress has enacted sections 901-908. These sections, with their attendant regulations, are the basis of the U.S. rules for the taxation of foreign income.⁶¹

1. The Election of the Credit

The foreign tax credit is elective in nature. Any eligible person can either elect to use the credit or deduct the foreign taxes pursuant to section 164(a)(3). The deduction is usually not as advantageous as the credit. The foreign tax credit results in a dollar for dollar reduction of U.S. income tax by the amount

59. *But see infra* Section IV.

60. For the most part, the elimination of double taxation takes the form of either excluding income from a country's tax jurisdiction or allowing some kind of a tax credit for monies paid to the other country's treasury. Both are products of a national tax scheme within individual countries. The term "international taxation" then is somewhat of a misnomer. Tax treaties entered into by two nations are actually about the only true international mechanism used to eliminate forms of double taxation. PAUL R. MCDANIEL & HUGH J. AULT, *INTRODUCTION TO UNITED STATES INTERNATIONAL TAXATION* 175-76 (Kluwer Law International 4th rev. ed. 1998).

61. The foreign tax credit must be considered together with any applicable treaty provisions before reaching any conclusions about the taxation of foreign income.

of the foreign income tax paid to the foreign government. The deduction results in “a reduction of taxable income by the amount of a given expense, and reduces tax at the marginal rate of taxation otherwise applicable to the amount deducted.”⁶² Simple math indicates that if the credit is available, it is almost invariably preferable to use the credit rather than take the deduction.

The threshold issue is whether the taxes are creditable as developed in sections *infra*. If they are not, those taxes deemed to be noncreditable may still be deducted. For example, taxes on sales as well as excise and property taxes may be deductible but are not creditable in most instances.

a. Foreign Tax Eligibility

Pursuant to section 901(b), U.S. citizens and alien residents are entitled to the foreign tax credit.⁶³ However, no credit is allowed for income taxes paid to a foreign government with which the United States has no diplomatic relations or has severed diplomatic relations, or countries that the Secretary of State has designated as providing support for acts of international terrorism.⁶⁴ Further, in the case of resident aliens, section 901(c)(2) authorizes the President to disallow the credit to those persons whose country does not allow U.S. citizens a similar credit for taxes paid to the United States or other countries.

b. Qualifying Taxes

The language of section 901(b)(1) may seem straightforward and uncomplicated. It is neither. The language reads, in essence, that creditable taxes are “any income . . . taxes paid . . . to any foreign country. . . .”⁶⁵ As noted by Professor Isenbergh in his treatise INTERNATIONAL TAXATION,⁶⁶ a credit will be given “for 1) a tax on 2) income 3) paid to 4) a foreign country.”⁶⁷ Each of the four criteria has generated litigation. The real questions then are (1) is it a tax?; and if so (2) was it paid?; (3) was it paid on income?; and (4) was it paid to a foreign country?

Some aspects of the requirements are simple enough when determining whether an athlete who plays abroad qualifies for the credit. This is true provided the athlete is earning money from only personal service income,

62. ISENBERGH I, *supra* note 13, at 124.

63. I.R.C. § 901(b)(1), (3) (2002).

64. *Id.* § 901(j).

65. *Id.* § 901(b)(1).

66. ISENBERGH II, *supra* note 28, ¶ 55.1.

67. *Id.*

bonus income, and endorsement income. However, issues may arise that relate to one or more of the four components of the credit. Therefore, all aspects are discussed to provide a general understanding of how the credit works. Attention focuses on potentially troublesome issues that may directly relate to the three sources of income mentioned above.

To be creditable, whatever was paid must be a tax.⁶⁸ As noted by the Regulations, “[a] foreign levy is a tax if it requires a compulsory payment pursuant to the authority of a foreign country to levy taxes. A penalty, fine, interest, or similar obligation is not a tax”⁶⁹ Likewise, the payment cannot be voluntary or a payment in return for some gain or economic benefit not made substantially available on essentially the same terms to all persons subject to the tax.⁷⁰ Whether the payment is compulsory is determined by principles of U.S. law and not by principles of the law of the foreign country.⁷¹

As previously indicated, in order to take the foreign tax credit, the payment made must be not only a tax, but also an income tax. However, the notion of what constitutes income tax varies from country to country and the Internal Revenue Code does not conclusively define the term for purposes of the foreign tax credit or, for that matter, for any other purpose. The regulations speak of the tax having “[t]he predominant character . . . of an income tax in the U.S. sense” and a tax that “is likely to reach net gain in the normal circumstance in which it applies.”⁷² Simply put, the notion of income is tied to the term’s meaning as defined in the U.S. legal literature.

Further, section 901(b) requires that the tax be paid to the foreign government in order to qualify for the tax credit. The only remarkable part of this section, as it relates to athletes, is to note that “paid” means “paid.”⁷³ The regulations deem that the “amount is not . . . paid . . . to the extent that it is reasonably certain that . . . [it] will be refunded, credited, rebated, abated, or forgiven.”⁷⁴

68. Treas. Reg. § 1.901-2(a)(1)(i) (2002).

69. *Id.* § 1.901-2(a)(2)(i).

70. *Id.* § 1.901-2(a)(2)(ii)(B).

71. *Id.* § 1.901-2(a)(2)(i).

72. *Id.* § 1.901-2(a)(3).

73. I.R.C. § 901(b).

74. Treas. Reg. § 1.901-2(e)(2). Example (2) states “A’s initial income tax liability under country X law is 100u (units of country X currency). However, under country X law, A’s initial income tax liability is reduced in order to compute its final tax liability by . . . a credit for charitable contributions [say 10u]” *Id.* § 1.901-2(e)(2)(ii). In that case, the amount of the contribution reduces the tax paid to a foreign country by 10u and thus reduces the foreign tax credit. The law must be carefully researched for athletes with investments in the foreign nations to ensure that the taxes are

However, the athlete does not have to personally pay the taxes to meet the “paid means paid” standard. Taxes are customarily withheld at the source of the income that ultimately reaches the athlete. The withholding agent then remits the amount of the taxes to the foreign government. The taxes are thus paid. Likewise, it is not uncommon for another person or entity to assume the taxes of the athlete.⁷⁵ In either case, when the taxes are remitted to the government of the foreign nation, they are deemed paid.

Of the four requirements to qualify for the tax credit, the least contentious issue is whether the taxes are paid to a foreign country. Clearly, if the athlete resides in, works in, and pays taxes to a country other than the United States, he or she has paid taxes to a foreign country.⁷⁶

This section on tax qualification is not complete, however, without reference to section 903 of the Code, which allows the foreign tax credit to be taken if taxes are paid “in lieu of” income taxes.⁷⁷ In other words, an “in lieu of” tax is a substitute for an income tax.⁷⁸

The regulations are the defining authority on what constitutes a tax “in lieu of” an income tax. In order to qualify for a tax “in lieu of” an income tax, the country imposing the tax must first have a general income tax that would apply but for the “in lieu of” tax.⁷⁹ Also, a creditable “in lieu of” tax cannot be imposed in addition to the general income tax and be creditable under the section 903 provisions.⁸⁰ It must be imposed by the foreign country *instead of* an income tax.⁸¹

actually paid and will not be refunded, abated, etc. *Id.*

75. The notion of tax assumption by a third party is an article unto itself. Tax arrangements of this sort usually are made between either the taxpayer and a business partner or entity, or by the government of the country in which the taxpayer is working. Treas. Reg. § 1.901-2(f)(2) speaks to the issue and states that the “[t]ax is considered paid by the taxpayer even if another party to a direct or indirect transaction with the taxpayer agrees, as a part of the transaction, to assume the taxpayer’s foreign . . . liability.” Treas. Reg. § 1.901-2(f)(2).

76. The Regulations speak to the issue in § 1.901-2(g)(2) wherein “[t]he term *foreign country* means any foreign state, any possession of the United States, and any political subdivision of any foreign state or of any possession of the United States.” Treas. Reg. § 1.901-2(g)(2) (emphasis in original).

77. I.R.C. § 903 (2002).

78. Excise taxes and value-added taxes that are paid in addition to an income tax thus are not creditable.

79. I.R.C. § 903.

80. *Id.* For example, athletes who pay value-added taxes as well as income taxes cannot credit the value-added taxes.

81. *Id.*

c. Limitations on the Foreign Tax Credit

As indicated in section 901, the foreign tax credit is subject to the limitations in section 904 of the Code.⁸² Bothered by the continuing drain on the U.S. Treasury, Congress has, from time to time, attempted to curb the extent to which individuals and corporations can offset high foreign taxes against U.S. source income. To that end, section 904(a) specifies that the total credit “shall not exceed the same proportion of the tax against which such credit is taken which the taxpayer’s taxable income from sources without the United States . . . bears to his entire taxable income for the same taxable year.”⁸³ Its purpose is to prevent foreign source taxes from offsetting taxes owed on monies sourced in the U.S. This makes sense from the perspective of sound U.S. fiscal policy, but Congress did not stop with just the basic section 904(a) provision. As developed below, what originated as a rather benign tax code section has grown into a monstrosity of monumental proportions. It is a morass, the likes of which this author and people with whom this author has spoken have never encountered.⁸⁴ What follows is an attempt to alert the athlete’s representative to the Code sections and their possible implications.

The current version of the foreign tax credit came after years of tinkering with section 904. Its present version was passed in 1986, along with other sweeping revisions to many Code sections. The 1986 Act retained the overall method of limiting the foreign tax credit,⁸⁵ but it is no longer determinative of the exact amount of the limitation. To make that calculation, section 904(d) must be consulted. That subsection identifies nine separate kinds of income and places them in “baskets.”⁸⁶ The credit limitation is then determined separately for foreign income taxes imposed on the income in each of those baskets.⁸⁷

Fortunately, most of the “baskets” are fairly esoteric in nature and do not come into play with the three types of income – service, bonus, and endorsement – that the typical athlete will earn during the course of a year.⁸⁸

82. I.R.C. § 901(a).¹

83. *Id.* § 904(a) (2002).

84. Section 904 has been described by various authors as mind boggling, incredibly complicated, and a virtual maze.

85. I.R.C. § 904(a).

86. *Id.* § 904(d).

87. As explained by Professor Isenbergh in his single volume treatise on INTERNATIONAL TAXATION, “the separate limitation for each basket in a taxable year is the same proportion of the total U.S. income tax (determined before the credit) as the amount of foreign source taxable income within the basket bears to the taxpayer’s total taxable income.” ISENBERGH I, *supra* note 13, at 147 n.5.

88. Market Segment Study, *supra* note 43, at 22,968. Athletes may well have other types of

Most, but not all, of these types of income fall within the general limitation "basket," which is a sort of catch-all for everything not enumerated in the others. Comparatively speaking, this "basket" is diverse and encompasses many kinds of income. It includes income from services and marketing, exactly the type of income typically earned by an athlete.

However, not all of the U.S. athlete's foreign income falls into the general limitation "basket." For example, passive income includes dividends, annuities, interest, certain rents and *royalties*, and net capital gains.⁸⁹ Royalties may be of particular concern. If so, the passive basket comes into play. It is necessary to determine, therefore, whether the income is a royalty.

In Section II.B.3 *supra*, royalty income, which is a derivative of endorsement income, was discussed and defined, albeit in a fairly general manner. For purposes of auditing a *foreign athlete's* business income, the Service, in its Market Segment Study, states that royalties are those items, the payments of which are for the use of a professional athlete's name, photograph, likeness, or facsimile signature.⁹⁰ However, as further noted in the Study, this definition is tempered by case law, which states that endorsement income can take on the characteristics of both royalty and service income, depending on the nature of the endorsement that produced the income.⁹¹

Taking the analysis one step further, if the Service uses the same definition for purposes of evaluating citizen and resident income and if that income is deemed to be royalties, the issue is how to treat the income for purposes of the foreign tax credit as offset against U.S. taxes generated by all foreign income. Examination of section 904 indicates that royalties are among several classes of income designated for special consideration in the calculation of the foreign tax credit. As previously mentioned, most of the athlete's salary and bonuses fall into section 904(d)(1)(I) or "income other than income described in any of the preceding subparagraphs."⁹² However, further examination of section 904(d)(2)(A) describes passive income as that

income such as dividends or capital gains, for example. Because of the nature of this article, these categories of income are beyond the scope of this discussion.

89. Passive income is defined in I.R.C. section 904(d)(2)(A)(i) by reference to I.R.C. section 954(c)(1) as explained *infra*.

90. This definition must be considered with caution because it is taken from the Market Segment Study, which discusses Rev. Rul. 81-178, the topic of which is not specifically royalty income. Market Segment Study, *supra* note 43, at 22,968.

91. *Id.* Recall that endorsement income directly connected to a particular event in which the athlete is participating is generally characterized as service income, whereas a golf ball that reproduces an athlete's signature and thus produces endorsement income is usually defined as a royalty.

92. I.R.C. § 904(d)(1)(I).

“of a kind which would be foreign personal holding company income (as defined in section 954(c)).”⁹³ An examination of section 954(c)(1)(A) indicates foreign personal holding company income means “the portion of the gross income which consists of . . . royalties”⁹⁴

To this point, it appears that royalties likely are considered passive income. However, as with many Code sections, the exceptions are numerous and ultimately exclude many royalty arrangements. Section 954(c)(3)(A)(ii) indicates that foreign personal holding company income does not include rents and royalties from certain related persons. Related persons are then defined by section 954(d)(3). Also, certain rents and royalties are excluded from the passive basket if they are derived in the active conduct of a trade or business and are received from a person other than a related person as defined by section 954(d)(3).⁹⁵

Under the regulations,⁹⁶ which are semi-instructive at best, it appears the exceptions to the passive rules are meant to opt out those entities that are specifically engaged in the business of dealing in royalty-producing products.⁹⁷ That would not be the case of athletes who, in playing their sport, incidentally produce endorsement income that is deemed to be partially or wholly royalty in character.

None of the exceptions appear to remove the athlete’s income from the passive basket. Therefore, the initial conclusion that royalty income is passive in nature is likely correct. Thus, when figuring the foreign tax credit, the income allocable to royalty status should be opted out of the general basket, placed in the passive basket, and calculated separately.

Separately calculating the tax owed on income in each basket prevents taxes on low-taxed passive income from being averaged with taxes on high-taxed service income.⁹⁸ Thus, foreign taxes paid on one category of income cannot be offset or cross-credited against U.S. taxes imposed on income arising in another category. Simply put, income in one basket can give rise only to credits within that particular basket.⁹⁹

The inquiry of section 904 application does not end, however, with the

93. *Id.* § 904(d)(2)(A).

94. *Id.* § 954(c)(1)(A).

95. Treas. Reg. § 1.904-4(b)(2)(i) (2002).

96. While some of the regulations are not current, those that apply to this particular problem appear to be up-to-date.

97. Treas. Reg. § 1.904-4(b)(2)(ii).

98. This assumes, of course, a country in which services are highly taxed and passive royalty income is taxed at a low rate.

99. For a mathematical example of how the baskets are calculated and why, see MCDANIEL & AULT, *supra* note 60, at 98-99.

decision of which basket to allocate the income. To complicate matters further, the issue of whether the athlete is playing in a country with a bilateral treaty with the United States¹⁰⁰ must be considered under the three following scenarios:

(1) There is no treaty between the United States and the foreign nation. In this case, it is likely the country of source will tax the income, and the U.S., through section 904, will credit the tax paid via the passive basket; or

(2) There is a treaty, and it provides that royalty income is taxed in the resident country. This is the standard language in the U.S. Model Treaty¹⁰¹ and the OECD Model Treaty.¹⁰² In this case, the income, if deemed to be royalty income, will be taxed in the country of residence and likely exempted from income in the source country. Therefore, the foreign tax credit will not be an issue; or

(3) There is a treaty, and it provides that royalty income is taxed by the source country, though at a reduced rate.¹⁰³ In this instance, the tax will likely be deemed passive income and will be figured into that basket for purposes of the tax credit.

Whatever the case, in the event the income is deemed passive in nature, the tax is figured on gross income minus allocable deductions.¹⁰⁴ These concepts are determined according to the U.S. Internal Revenue Code that is in effect at the time. In the event of excess foreign tax credits, section 904(c) allows a carryback of two years and a carryforward of five years, but only in "the basket from which [the credits] originated and then only to the extent there is 'excess' limitation in that basket in the year [in] which they are

100. Treaties are developed fully *infra* Section IV.

101. United States Model Income Tax Convention, Sept. 20, 1996, art. 12(1), available at <http://www.ustreas.gov/taxpolicy/library/model1996-pdf> (last visited Sept. 26, 2002) (hereinafter "U.S. Model Treaty").

102. OECD Model Tax Treaty, Apr. 29, 2000, art. 12(1), available at <http://www.intltaxlaw.com/TREATIES/OECD%20model.pdf> (last visited Sept. 26, 2002) (hereinafter "OECD Model Treaty").

103. For example, Canada and Japan reserve the right to tax at 10% while France taxes at 5%. Other countries simply reserve the right to tax royalties at the source. ISENBERGH II, *supra* note 28, ¶ 104.10.

104. Conspicuously missing from this discussion is the issue of the so-called high-tax kick-out provision. Basically, this provision kicks out of the passive basket any income that is passive in nature but taxed by the foreign country at a high rate (defined as a rate greater than the U.S. rate). If this provision comes into operation, income that would fall into the passive basket is kicked out into the general limitation basket. Because royalty income is taxed at a fairly low rate by the source country, usually 5% or 10%, if at all, this provision would not come into play. However, should a foreign country, pursuant to its own tax code or via treaty, decide to tax royalties at a high rate, or should the taxpayer have other than royalty income in the passive basket, the high-tax kick-out provision should be investigated.

carried.”¹⁰⁵

A discussion on the limitations of the foreign tax credit would not be complete without a discussion of the Alternative Minimum Tax (hereinafter “AMT”) as it relates to the credit.¹⁰⁶ The goal of the AMT is laudable, but its implementation is complex. Basically, the AMT is meant “to ensure that no taxpayer with substantial economic income [is able to] avoid significant tax liability by using exclusions, deductions, and credits.”¹⁰⁷ More specifically,

alternative income tax imposed by the Code [is meant] to ensure that taxpayers who enjoy tax preference income must pay at least a minimum amount of taxes The tax is imposed at a flat rate on the taxpayer’s alternative minimum taxable income that exceeds certain specified exemption amounts. If the taxpayer’s liability for the minimum tax exceeds his regular tax liability, the excess amount is payable in addition to the regular tax.¹⁰⁸

The foreign tax credit is singled out specifically for special consideration in section 59(a). However, before calculating the amount of the credit, it is necessary to navigate through sections 55-58 of the Code to determine what income may be taken against which credit. Section 55 outlines the tax, its rates, and the applicable exemptions. Section 55(b)(2) requires the calculation of the alternative minimum taxable income based on the so-called “regular taxable income,” taking into account the adjustments in sections 56 and 58. Once this figure has been attained, the tax preference items outlined in section 57 must be added back to the taxable income prior to applying section 59(a) to calculate the alternative minimum foreign tax credit.¹⁰⁹ It should be noted that, for AMT purposes, each basket of income must be separately computed.¹¹⁰ Thus, if the athlete has income that falls in both the general limitation income basket and the passive income basket, each basket must be

105. MCDANIEL & AULT, *supra* note 60, at 105.

106. The whole notion of the Alternative Minimum Tax remains controversial. A review of the Code indicates pages and pages of legislation that has repealed [§ 57(a)(3)], stricken [§ 57(a)(4)] and amended [§ 57(a)(7) - numerous times] the Alternative Minimum Tax. I.R.C. § 57. It is not a favorite with many contingencies of the general tax-paying population. Nevertheless, it remains viable and creates numerous complexities. The U.S. taxpayer earning income abroad is included.

107. S. REP. NO. 99-313, at 518 (1986) (relating to the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085).

108. Meenakshi Ambardar, Comment, *The Taxation of Deferred Compensation Under I.R.C. § 854(c)(6) and Income Tax Treaties: A Rose is Not Always A Rose*, 19 FORDHAM INT’L L.J. 736, 778 n.285 (1995) (quoting ROBERT SELLERS SMITH, WEST’S TAX LAW DICTIONARY 21 (1992)).

109. I.R.C. § 55(b)(2) (2002).

110. Therefore, the credit for each basket must be computed twice each year: The calculation must be done for regular tax purposes and for alternative minimum tax purposes.

calculated twice.

To complicate the issue further, the AMT foreign tax credit is subject to another important limitation. The credit may not offset more than 90% of the tentative minimum tax computed without regard to the foreign tax credit and the AMT net operating loss deduction.¹¹¹ This makes sense because it prevents a high-income taxpayer with large foreign tax credits to reduce tax liability to zero on any taxable income that would otherwise draw U.S. income tax.¹¹² However, on the other hand, the 90% limitation imposes a double taxation on some income at the rate of 2.6 - 2.8% even when the foreign taxes are enormously high.¹¹³

All in all, the important points to consider with the alternative minimum foreign tax credit are: (1) it exists; (2) it will have an impact on taxes whenever regular income tax is eliminated by the regular foreign tax credit; and (3) if there exists excess tax credits not used because of the AMT, these may be carried back two years or carried forward five years.

One further note: Treaties enacted to eliminate the double taxation of residents and citizens do not prevent section 59 from reducing the alternative minimum foreign tax credit. In *Pekar v. Commissioner*,¹¹⁴ the court held that the conflict between the treaty and the section 59 tax provision depended on which was enacted later in time.¹¹⁵ At issue were two U.S. treaties, one with Germany and the other with the United Kingdom.¹¹⁶ Both were approved by the Senate prior to the enactment of section 59.¹¹⁷ Both were deemed subject to the section 59 limitations.¹¹⁸

B. Foreign Income and Housing Cost Exclusion

Section 911 of the Tax Code offers a second alternative to avoid double taxation for U.S. citizens and residents living abroad. While the mathematical complexities and procedural intricacies propounded by this section are beyond the scope of this article, of importance to the practitioner is whether (1) the

111. I.R.C. § 59(a)(2)(A) (2002).

112. The issue was raised in *Keese v. Comm'r*, 70 T.C.M. (CCH) 537 (1995). The taxpayer argued that surely the Congress could not give a tax benefit on the one hand (the foreign tax credit), and take it away on the other (through the 90% limitation). The taxpayer lost.

113. The alternative minimum tax for individuals is 26% or 28% which is found in I.R.C. section 55(b)(1)(A)(i).

114. 113 T.C. 158 (1999).

115. *Id.* at 161.

116. *Id.*

117. *Id.* at 161-64.

118. *Id.* at 162-64.

client/athlete qualifies for the exclusion, and, if so, (2) the amounts that may be excluded. If the individual qualifies, instead of a credit for taxes paid to the foreign entity, under section 911 the athlete simply removes the income from tax consideration before determining the amount of taxes, if any, owed the U.S. government. In effect, it is as if the money was never earned.

1. Qualified Individual

A qualified individual is one whose tax home is in a foreign country and who is (1) "a citizen of the United States and establishes to the satisfaction of the Secretary that he has been a bona fide resident of a foreign country or countries for an uninterrupted period which includes an entire taxable year,"¹¹⁹ (known as the bona fide resident test)¹²⁰ or (2) "a citizen or resident of the United States and who, during any period of 12 consecutive months, is present in a foreign country or countries during at least 330 full days in such period"¹²¹ (known as the physical presence test). This period of stay may be waived by the Secretary if the individual can show that the time period would have been met but for some "adverse condition."¹²²

While "bona fide resident" is not defined in the tax code, case law has spoken to its requirements. In *Sochurek v. Commissioner*,¹²³ the court noted the indicia for residency and listed, though not exhaustively, considerations for determining if a person is, indeed, a resident.¹²⁴ They included, but surely are not limited to, the taxpayer's intentions, establishment of a home, participation in and assimilation into the community, nature and duration of employment, assumption of economic burdens, and payment of foreign taxes.¹²⁵

The physical presence test is more definitive in its application. As noted, it applies to both resident aliens and to citizens. Simply put, to qualify, an

119. I.R.C. § 911(d)(1)(A).

120. Note that under the wording of the statute, only U.S. citizens may qualify under the bona fide resident test. However, resident aliens of the U.S. who are citizens of other foreign countries have been known to qualify through the nondiscrimination clauses of bilateral treaties between the U.S. and a foreign nation.

121. I.R.C. § 911(d)(1)(B).

122. A career-ending back injury was claimed as an adverse condition in *Branch v. Comm'r*, 67 T.C.M. (CCH) 2822, 2825 (1994). Unfortunately, the case was decided on other grounds and leaves unanswered the question of whether injury can qualify as an adverse condition so as to waive the time requirements of I.R.C. section 911.

123. 300 F.2d 34 (7th Cir. 1962).

124. *Id.* at 38.

125. *Id.* There were other factors, but as previously noted the list is not exhaustive. Some factors weigh more heavily than others. The courts view all factors collectively when determining residency. Careful case analysis must be made on an individual basis. *Id.*

individual must be physically present in a foreign country or countries during at least 330 full days during any consecutive 12-month period.¹²⁶ The twelve-month period may begin and end any time upon the arrival and departure of the person.¹²⁷

The statute also specifies that, to qualify for the exclusion, individuals must establish that their “tax home” is in a foreign country or countries.¹²⁸ Section 911(d)(3) defines tax home as the individual’s home pursuant to section 162(a)(2) and its attendant regulations. While over the years this issue has been litigated on numerous occasions with somewhat variant definitions emerging, “tax home” is generally considered to be where the principal place of employment is located (taking into account the permanentness or indefiniteness of the employment).¹²⁹

If there is no principal place of business, but the individual maintains an “abode,” this is considered the “tax home.”¹³⁰ The issue of what is “an abode” is not clearly defined and has generated substantial litigation.¹³¹ What is clear is that an individual is not considered to have a “tax home” in a foreign country if that individual’s “abode” is in the United States.¹³² Therefore, the notion of what constitutes an “abode” for purposes of section 911 must be carefully examined to determine if the athlete meets the criteria of “tax home” within the meaning of this Code section.

2. Excludable Amounts – Foreign Earned Income

Beginning in the year 2002, \$80,000 of foreign-earned income may be

126. I.R.C. § 911(d)(1)(B).

127. *Id.* For example, if a party arrives in a foreign country on March 15 of year one and stays for twenty months, the twelve-month period can be figured any time during that twenty months—from April 2 of year one, for example, to April 1 of year two. Further, the days need not be consecutive and, as indicated in the statute, need not be in the same foreign country. Care should be taken in calculating the days present if the athlete is traveling in and out of the United States and between foreign countries.

128. I.R.C. § 911.

129. *Id.* § 162(a)(2).

130. *Id.*

131. In *Bujol v. Comm’r*, the court noted that “abode has been variously defined as one’s home, habitation, residence, domicile or place of dwelling.” 53 T.C.M. (CCH) 762, 763 (1987), *aff’d*, 842 F.2d 328 (5th Cir. 1988). More particularly, the court noted that the definition does not mean one’s principal place of business. *Id.* at 763. It “has a domestic rather than vocational meaning, and stands in contrast to ‘tax home’ as defined for purposes of section 162(a)(2).” *Id.* at 763-64.

132. Treas. Regs. § 1.911-2(b) (2002). As noted in MARTHA A. KLASING ET AL., U.S. INCOME TAXATION OF CITIZENS AND RESIDENTS ABROAD 918 (1999), “[i]f an individual’s abode is located in the United States, a determination of that individual’s tax home within the meaning of § 162(a)(2) is immaterial for purposes of § 911.”

excluded.¹³³ Foreign-earned income is generously defined and includes income from services and royalties. Vacation and sick pay¹³⁴ are also defined as foreign-earned income. However, only income earned from a foreign source is excludable. If the compensation is mixed, earned both inside and outside the United States, only those amounts earned outside may be excluded.

Payments received in years subsequent to the year in which the services are performed are not excludable. This provision may come into play as it relates to bonus income. If the bonus is attributable to a previous tax year, the income is excludable in that year only and up to the amount that could have been excluded had it been taken in that year.¹³⁵ However, bonuses (and property) may be attributable to more than one year,¹³⁶ and foreign earned income received in the year in which it is earned must be applied to that year's exclusion before taking any income from prior or subsequent years.

3. Excludable Amounts—Foreign Housing

A separate allowance for housing expenses may be excluded by qualified individuals. The idea of this exclusion recognizes the potentially high cost of obtaining housing – American style – overseas. To accommodate this expense, section 911(c) allows a deduction for expenses that include rent paid by the employee, or it operates to exclude the fair market value of housing provided free to the employee.¹³⁷ The regulations specify additional amounts that may be excluded, such as utilities, insurance, furniture rental, repairs, leasing fees, and parking.¹³⁸ Items that are not excludable are likewise detailed in the regulations.¹³⁹ Care should be taken in the determination of excludable items because if the individual's housing costs are not attributable

133. The exclusion is computed on a daily basis calculated on the number of days that fall within the athlete's qualifying period during the taxable year. The qualifying days relate to days within which the individual meets the tax home requirement and either the bona fide residence test or the physical presence test.

134. Presumably payments made to an injured player are also deemed to fall within excludable items in section 911.

135. For example, if a qualified individual received a performance bonus in 1999 of \$10,000 and in the year 2000 earned and excluded \$70,000 (with a maximum of \$76,000 allowable for the tax year 2000) he or she may exclude \$6,000 of the \$10,000 carried over for the year 2000 (this assumes no housing cost exclusion).

136. To determine the amount eligible, see Treas. Reg. §§ 1.911-3.

137. I.R.C. § 911(c). The "housing cost amount" is the excess of the individual's "housing expenses" less a "base housing amount." The latter is a figure which is the product of a base equal to 16% of the salary of a grade GS14 (step 1) U.S. government employee and the number of days the individual qualifies under the bona fide resident test or the physical presence test.

138. Treas. Reg. § 1.911-4(b)(1).

139. *Id.* § 1.911-4(b)(2).

to employer-provided amounts or are over and above those provided, they likely are deductible in computing adjusted gross income.¹⁴⁰ There are, of course, limitations on the housing cost deduction, which are directly tied to the foreign earned income and the annual exclusion under section 911.¹⁴¹ The housing cost amount does not include expenses to accommodate a lavish or extravagant "life-style."¹⁴²

4. Excludable Income and the Foreign Tax Credit

The rule is quite simple. The foreign tax credit may not be taken on income that is excluded under section 911.¹⁴³ Likewise, deductions cannot be taken on that income. The problem arises when there is more foreign income than may be excluded under section 911. In that case, any remaining amount of foreign taxes paid, after an arduous calculation, may be claimed as credit pursuant to section 901 or a deduction under section 164. Further problems arise if there are both foreign earned income and some other form of income, such as that earned in the United States.¹⁴⁴

In the final analysis, special care must be taken to assure that the maximum tax benefit is afforded the athlete. It may turn out that deductions or credits may be more advantageous than the exclusions under section 911 of the Code. The calculations are complex and should be undertaken with great care.

IV. TREATIES

It is a discouraging thought, but brutally true. The foregoing analysis of the foreign tax credit, the alternative minimum tax, and the section 911 exclusions may be seriously influenced or changed completely by bilateral tax conventions¹⁴⁵ negotiated between nations. For that reason, the best approach is first to determine if there is a treaty between the host country and the U.S.

140. I.R.C. § 911(c)(3)(A).

141. *Id.* § 911(c)(3)(B).

142. *Id.* § 911(c)(2)(A).

143. *Id.* § 911(d)(6). Note also how the housing cost is treated under the regulation. Treas. Reg. § 1.911-6(c)(1).

144. There are a myriad of other potential complications for an athlete playing abroad. For example, other monies attributed to the athlete may come into play, such as contributions to a qualified plan, interest, and capital gains. Also, amounts not taxed by the U.S. but taxed by a foreign country or countries, unreimbursed employee business expenses, and other deductions, to name a few, must also be figured into the calculation.

145. Technically, tax treaties are known as "conventions." For purposes of this article, they will be referred to as "tax treaties."

and, if so, the provisions of that treaty. This section will outline some basic principles of tax treaties, as well as the provisions that most often affect an athlete playing abroad.

A. An Overview

Income tax treaties are the only “true” international element of the tax laws operating between nations affecting individuals and business enterprises. Through treaties, nations create a tax regime that may be substantially different from that of either country. Because the provisions of treaties may differ radically between countries, the outcome of a tax controversy between one country and the United States may be quite different from that of another country and the United States.¹⁴⁶ Simply put, because of lack of uniformity, there is no “common law” for predicting the outcome of many controversies involving treaty provisions. Each treaty must be scrutinized for its own possible uniqueness.

The main concern of tax treaties is the avoidance of double taxation that can result when two countries assert jurisdiction over the same person or business transaction. As noted by McDaniel and Ault, double taxation is “dealt with unilaterally by most countries . . . [and] treaties by and large operate to refine and adapt these methods for avoiding international double taxation to the specifics of the tax relationships between the two countries involved.”¹⁴⁷ The result is that a treaty apportions tax revenues between the treasuries of the two treaty countries via an agreed set of rules so as to avoid both powers asserting taxing authority. Both countries, in negotiating treaties, take into consideration the flow of capital and income between the two and provide accordingly to attempt to ensure the maximum protection of each of their treasuries. In the end, there are no two treaties exactly alike because each treaty takes into account the unique economic relationship between the individual countries.

B. Status of Treaties

The United States Constitution in Article VI, Section 2 provides that treaties and legislative enactments are of equal force. When a statute and a treaty provision conflict, clearly one must give way. The basic rule is that the later in time controls.¹⁴⁸ Thus, if a statute is enacted that overrides a treaty provision, technically the statutory provision prevails. The problem is that

146. Each treaty represents a separate and independent source of the law.

147. MCDANIEL & AULT, *supra* note 60, at 175-76.

148. *Whitney v. Robertson*, 124 U.S. 190, 194 (1888).

legislation of this nature, in effect, breaches treaty obligations made to treaty partners and thus violates international law.

This issue and others have been addressed by statute and case law over the years. More particularly, in 1988, section 7852(d) was amended to read: "For purposes of determining the relationship between a provision of a treaty and any law of the United States affecting revenue, neither the treaty nor the law shall have preferential status by reason of its being a treaty or law."¹⁴⁹ However, in the same Act, provision was made to indicate that some treaty obligations were to be overridden by certain provisions of the 1986 Act.¹⁵⁰ Even so, the axiom that the last in time prevails is still the norm.

The fact remains that the fallout of abrogating treaty obligations through inconsistent subsequent legislation may have serious international consequences. As a result, Congress has, by and large, acted prudently in shaping statutory provisions that effectively override treaty provisions with U.S. economic partners.

C. Model Treaties

Over the years, the United States has followed a number of model income tax treaties. The goal has been "to harmonize its domestic tax rules with the rules of other states and at the same time to preserve domestic tax jurisdiction over citizens and residents."¹⁵¹ The latest refinement and starting point for U.S. negotiators is the 1996 U.S. Model Treaty. Similarly, many European and other trading partners start with the OECD Model developed by the Organization for Economic Cooperation and Development.¹⁵² While the two are similar in many respects, there are differences that reflect unique concerns of the individual countries.¹⁵³ The models represent the starting point for negotiation between economic "contracting states."¹⁵⁴

149. I.R.C. § 7852(d).

150. For example, the alternative minimum foreign tax credit allowing only 90% of the U.S. taxpayer's liability prevailed over treaty obligations granting full relief from double tax. *Lindsey v. Comm'r*, 98 T.C. 672 (1992), *aff'd*, 15 F.3d 1160 (D.C. Cir. 1994).

151. RICHARD L. DOERNBERG, INTERNATIONAL TAXATION 107 (West Group 4th ed. 1999).

152. *Id.*

153. For example, the U.S. preserves the right to tax its citizens even if they reside in the foreign country; the U.S. uses a crediting mechanism while the OECD countries often use an exemption model; interest income is treated differently; the residency of corporations is defined differently, etc. *Id.* at 108.

154. Countries are referred to as "contracting states" in the model treaties. *Id.*

D. Some Basic Concepts in Treaties

1. Notion of Residency

"Income tax treaties involve the taxation of persons who are normally subject to the taxing power of one or both of the treaty countries."¹⁵⁵ With this basic construct in mind, the underlying precept of all treaties, using either the U.S. model or the OECD model, is the status of residency. For the most part, treaty benefits and detriments are predicated on a person's residence. Residence, however, is not necessarily defined by just the domestic laws of the treaty countries. Rather, a "resident," for purposes of an income tax treaty, is one who can invoke the benefits of the treaty. While this seems rather circular in nature, the U.S. Model Treaty defines resident to mean "any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, citizenship, place of management, place of incorporation, or any other criterion of a similar nature."¹⁵⁶

The inclusiveness of the model definition immediately raises the potential for people to be "residents" of both treaty countries. To alleviate the problem, the Model Treaty, article 4(2), provides for a "tie breaker" which establishes a single residence. This treaty article provides a series of tests, layered one on the other.¹⁵⁷ If the first one fails to determine residency, the next one is consulted, and this continues until resolution of residency is reached.¹⁵⁸

Therefore, in case of dual residency, the person is "deemed to be a resident of the State in which he has a permanent home available to him"¹⁵⁹ If there is a permanent home in both states, his residence is deemed to be the place where he has the closest personal and economic relations (this test is known as the center of vital interests).¹⁶⁰ If his interests are equally vital in both states, he is deemed a resident if he has an habitual abode.¹⁶¹ If he has an habitual abode in both states, he is deemed a resident of the country of his nationality.¹⁶² If all else fails and he is still deemed to be a dual resident, the matter is determined by the "competent authorities" of the

155. ISENBERGH II, *supra* note 28, ¶ 102.1.

156. U.S. Model Treaty, art. 4(1).

157. *Id.* art. 4(2).

158. *Id.*

159. *Id.* art. 4(2)(a).

160. *Id.*

161. *Id.* art. 4(2)(b).

162. *Id.* art. 4(2)(c).

treaty countries.¹⁶³

The issue of residency must be closely examined. A resident for treaty purposes does not necessarily mean that he or she is a resident for all other tax purposes. Thus, a person may not be a U.S. resident within an income tax treaty, but may nevertheless be a resident for other purposes.

2. The Saving Clause and Nondiscrimination

Common to most treaties negotiated between countries is a provision known as the "saving clause."¹⁶⁴ The saving clause allows a country to tax its citizens and residents as if there is no treaty at all.¹⁶⁵ Thus in U.S. treaties, even if a treaty article appears to provide exclusive taxing authority in the country of source, the saving clause could operate to deny benefits to citizens and residents of the United States. In other words, the U.S. (and most other countries) reserve in their treaties the right to tax their own citizens and residents who happen to live in another country.

This article appears to challenge, perhaps contradict, the essential purpose of international treaties. It is, however, subject to other articles. For example, most treaties contain mutual assurances that each treaty partner will not more heavily tax nationals and residents of the other contracting state than its own similarly situated nationals and residents.¹⁶⁶ This is known as the nondiscrimination article and provides that a citizen of one state who is a resident of the other will not be treated less favorably, tax-wise, than the former's own nationals and residents.¹⁶⁷ Interestingly, article 24 covers all taxes of every kind, including those imposed by state and local authorities.¹⁶⁸

E. Athletes and Their Income

The focus of this primer is to explore the taxation of the main types of

163. *Id.* art. 4(2)(d).

164. U.S. Model Treaty, art. 1(4). This clause provides: "Notwithstanding any provision of the Convention . . . a Contracting State may tax its residents . . . and by reason of citizenship may tax its citizens, as if the Convention had not come into effect." *Id.*

165. *Id.*

166. U.S. Model Treaty, art. 24. Article 24(1) states:

Nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith that is more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances, particularly with respect to taxation on worldwide income, are or may be subjected.

167. *Id.* Generally, the issue arising under this article is the meaning of "similarly situated."

168. In other words, a state or city is not allowed to discriminate against nonresidents so as to violate article 24(6). U.S. Model Treaty, art. 24(6).

income received by most athletes, to-wit income from (1) personal services, including direct compensation, (2) bonuses, and (3) endorsement contracts that may or may not be deemed royalties. To include the myriad of other income sources that an athlete might receive would unduly complicate this basic analysis. Should the athlete receive income of a different nature, the practitioner must examine the source of the income, characterize it, and deal with its taxation.¹⁶⁹

As developed above, the U.S. and most of its trading partners have treaties to deal with the finer points of double taxation. Indeed, recent treaties between the U.S. and foreign nations contain specific provisions that relate to the taxation of athletes' income. In both the U.S. and OECD Models, article 17, entitled *Artistes and Sportsmen*, covers the issue. There are four main requirements for article 17 to apply: (1) the individual is a sportsman; (2) the U.S. athlete is playing in a country that has a bilateral treaty with the U.S.; (3) the income falls within article 17; and (4) assuming there is a bilateral treaty, it contains an article 17 that covers the income in question.

The first requirement for treaty application is that the individual qualify as a "sportsman."¹⁷⁰ A sportsman is generally considered to be an individual who engages in some physical or mental activity, the exercise of which is deemed to be an end in itself. "No particular degree of [expertise or] professionalism is required."¹⁷¹ Traditionally, not only athletes such as baseball, hockey players, and the like come under article 17, but also other participants in sport-like activities such as horseback riders, golfers, and boxers. Likewise, participants in less common activities, such as players of billiards, chess, and bridge fall within article 17.¹⁷² In addition, the article is meant to apply to sportsmen who have some specific training and only to those who "perform in public – directly or via the media."¹⁷³

The second proposition is fairly straightforward. If there is no treaty, double taxation must be ameliorated by other methods. For example, if income is earned by a U.S. citizen or resident in a country with no treaty and tax is paid on that income to the other country, the foreign tax credit will likely apply to credit taxes paid by the athlete to the foreign taxing authority, thus

169. This might include dividends, annuities, interest, and investments from real estate ventures, to name but a few.

170. KLAUS VOGEL, KLAUS VOGEL ON DOUBLE TAXATION CONVENTIONS 976 (Kluwer Law International 3d ed. 1997).

171. *Id.*

172. *Id.*

173. *Id.* at 977.

reducing the U.S. tax obligations.¹⁷⁴

The third and fourth propositions force an examination and analysis of treaty provisions. Potentially, athletes who play a sport and are thus engaged in personal services may be subject to one of several provisions contained in most treaties. The income derived may be defined as compensation for independent personal services, compensation for dependent personal services or taxed within the "Artistes and Sportsmen" clause of article 17. In addition, endorsement income deemed to be royalties does not come under article 17 but is covered elsewhere in most treaties.

Because article 17 is present in so many recent treaties, and because it takes precedence over the other provisions, it will be discussed first. However, at the outset, one must determine whether the operative treaty contains an article 17 clause. If it does not, the inquiry is which of the other treaty provisions prevail.

1. Article 17—Artistes and Sportsmen

Article 17 is an outgrowth of large revenue losses by host countries involving performers and athletes who enter a host country, stay for a short period of time, make enormous amounts of money, and pay no taxes.¹⁷⁵ One authority summarized the problem: "If they [the performers] are (or make themselves) residents of a country connected to others through a useful network of treaties, and not itself given to fierce taxation, performers and athletes could enjoy virtual exemption from taxation under standard treaty provisions governing the performance of services."¹⁷⁶

To prevent the escape of taxation by high earning performers and athletes, both the U.S. Model Treaty and the OECD Model Treaty contain an article that deals specifically with that contingency. The U.S. 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 and 15] may be taxed in that other State, except where the amount of the gross receipts derived by such entertainer or

174. This is extremely simplified because of the multiple complications involving the credit. Recall the issues: (1) what is an income tax?; (2) was it paid?; and (3) to whom? Likewise, an alien athlete playing in the U.S. must rely on either a home country exemption or credit.

175. While the performances may be deemed personal services, articles 14 or 15 do not apply as noted *infra* Section IV.E.2.

176. ISENBERGH II, *supra* note 28, ¶ 104.8.

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 . . . for the taxable year concerned.¹⁷⁷

Simply put, if a non-resident entertainer or athlete makes more than \$20,000 in any given year, the country of source may tax the income even when it normally would not be able to do so.

This article applies only with respect to the income of the performers and not others involved in the performance or athletic event. Therefore, producers, directors, technicians, managers, coaches, and the like are subject to the provisions of articles 7, 14, or 15, not article 17. Also, unless covered by the second part of article 17, discussed *infra*, legal personnel are not subject to article 17 provisions.

If the performer exceeds the \$20,000 threshold, which includes "expenses reimbursed to the [individual] or borne on his behalf," *all* amounts may be taxed in the State of performance.¹⁷⁸ This means that if the gross receipts exceed \$20,000 (or its equivalent in the currency of the other contracting state), the full amount of the monies received may be taxed—not just the excess over \$20,000.

The OECD Model provides for taxation by the country of performance but begins negotiations with no dollar or time threshold.¹⁷⁹ As a result, many treaties negotiated between the U.S. and its treaty partners have significantly different provisions. Many specify dollar amounts and time present in the country. For example, the French treaty provides for a \$10,000 limit on monies earned but no time-in-country limit. On the other hand, the Japanese treaty with the U.S. provides that compensation of entertainers and athletes are taxed in the country of source, unless the dollar amount is less than \$3,000 and the performer is present in the country for ninety days or less.¹⁸⁰

The threshold question of whether the income falls within article 17 relates to the very nature of the income. If the income is predominantly

177. U.S. Model Treaty, art. 17(1).

178. *Id.*

179. OECD Model Treaty, art. 17.

180. A perusal of treaties between the U.S. and many treaty partners indicates that the \$20,000 figure contained in the Model U.S. Treaty is high. See New Zealand (\$10,000), Canada (\$15,000 with special provision for professional hockey and baseball players, together with special provisions for signing bonuses), Netherlands (\$10,000), United Kingdom (\$15,000), China (No limit—all source income taxed with minor exception), Norway (\$10,000 with a 90-day or less stay), Belgium (\$3,000 with a 90-day or less stay), Italy (\$12,000 with a 90-day or less stay). ISENBERGH II, *supra* note 28, ¶ 104.10. On the other hand, see the Switzerland treaty with no special rules for entertainers and athletes. *Id.*

attributable to the performance or athletic event, article 17 will usually prevail, and the source state will tax the income. If the activity is attributable to other endeavors, different provisions will apply. For example, if a fee is paid to the entertainer or athlete to promote a specific performance in which the individual is involved, his or her participation will be considered to be closely associated with the performance itself and will fall within the purview of article 17.¹⁸¹ However, if the income is earned by the endorsement of a product used in the event or general promotion of events of the nature in which the entertainer or athlete performs, the income will probably fall outside article 17. Interestingly, a cancellation fee for a performance or event does not fall within article 17, but rather is considered either article 7, 14 or 15 income.¹⁸²

Paragraph 2 of both the OECD Model and the U.S. Model is aimed at the abusive “loan-out” companies that were developed to by-pass source country taxation.¹⁸³ Both provide that income received from professional activities of the entertainer or sportsman, which accrue to another person, may be taxed to that person, notwithstanding the provisions of articles 7 (Business Profits) and 14. (Independent Personal Services), in the contracting state in which the activities are performed.

In one notable case, in an effort to qualify for favorable tax treatment, the boxer Ingemar Johansson, who was a citizen of Sweden, established “residence” in Switzerland and created a Swiss corporation.¹⁸⁴ The corporation “employed” him to fight in a championship bout against Floyd Patterson.¹⁸⁵ After the fight, the Swiss corporation (Johansson was its only client) paid him its entire receipts that resulted from the boxing match.¹⁸⁶ Claiming treaty benefits between the U.S. and Switzerland,¹⁸⁷ Johansson paid no tax to either country.¹⁸⁸ The U.S. took umbrage with the arrangement, sued Johansson, and ultimately prevailed in court.¹⁸⁹ The Fifth Circuit found that

181. The further removed from the event, the more likely the income is deemed to fall within one of the other provisions of most treaties.

182. “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.” U.S. Model Income Tax Convention, Technical Explanation, 1996, art. 17, ¶ 1, <http://www.ustreas.gov/taxpolicy/library/techxpln.pdf>.

183. U.S. Model Treaty, art. 17, ¶ 2; OECD Model Treaty, art. 17, ¶ 2.

184. *Johansson v. United States*, 336 F.2d 809, 812-13 (5th Cir. 1964).

185. *Id.* at 811.

186. *Id.* at 813.

187. See the discussion *infra* Section IV.E.2.b.

188. *Johansson*, 336 F.2d at 813-14.

189. *Id.*

the Swiss company had no independent identity except to provide Mr. Johansson with employment.¹⁹⁰ Nevertheless, language in the opinion set the stage for others to establish “loan-out” companies literally to avoid all worldwide taxation. Properly structured, the loan-out company accomplished this feat, at least for a time. However, at present, the second paragraph of both the U.S. Model Treaty and the OECD Model Treaty attempts to eliminate these types of arrangements.

2. Articles 14 and 15

As previously noted, if a treaty has a specific article addressed to entertainers and athletes,¹⁹¹ that article applies to both dependent and independent artistic and sporting activities. Thus, it supersedes the relevant provisions in articles 14 and 15 and is *lex specialis* in relation to them. However, also noted is that some treaties do not contain a special article addressing the taxation of income of entertainers and athletes. In addition, some income simply does not fall within article 17 coverage. Thus, articles 14 or 15 may apply.

Articles 14 and 15 define the status of the personal services delivered and, depending on the circumstances, establish the rules for how the individual activities are taxed. Article 14, Independent Services, deals generally with those services performed by an independent contractor or one not working for an enterprise or an individual.¹⁹² Article 15, dependent services, defines those services performed by an employee at the direction of an employer.¹⁹³

a. Article 14 - Independent Services

The model treaty basically provides that a resident of one country who performs in an “independent capacity” is taxed in the country of residence unless that individual has a fixed base¹⁹⁴ available to him in the source country for purposes of performing his activities.¹⁹⁵ This article is meant to accommodate the independent personal services of, for example, lawyers, doctors, and consultants who are in a foreign country for relatively short periods of time and who perform services on an *ad hoc* basis.

190. *Id.* at 813.

191. U.S. Model Treaty, art. 17; OECD Model Treaty, art. 17.

192. U.S. Model Treaty, art. 14.

193. *Id.* art. 15.

194. See discussion *infra* this Section and Section IV.E.3.

195. *Id.* The OECD Model Treaty deleted article 14 and now deals with employment in article 15 in a section entitled Income From Employment.

The notion of fixed base, while undefined in treaties, means something akin to a permanent establishment.¹⁹⁶ Also undefined in the U.S. Model Treaty is the term “personal services of an independent character,” though the words appear to encompass individuals who perform for his or her own account and accept both gain and loss through his or her endeavors.¹⁹⁷ Thus, a U.S. athlete, such as a golfer, who plays in a foreign country with a treaty *sans* article 17, likely would fall within article 14.

b. Article 15 - Dependent Personal Services

Articles 15 of the U.S. Model and the OECD Model are essentially the same.¹⁹⁸ Both provide that an employee, who draws a salary, wages or other remuneration, is taxed in the state in which the services are performed.¹⁹⁹ However, the services are *not* taxed in the country of performance (source) if (1) the employee is present there for 183 days or less during the taxable year, (2) “the remuneration is paid by an employer . . . who is not a resident” of the country where the services are performed, and (3) “the remuneration is not borne by a permanent establishment” or a fixed base which the employer has in that country.²⁰⁰

This provision allows a person to draw wages from a non-resident employer and play his or her sport for up to 183 days in each treaty country without paying taxes in that country. Of course, the wages of the athlete are still taxed in the resident country.

Most athletes who play team sports employed by U.S. owners will fall under this provision.²⁰¹ This makes sense. Otherwise, players on an American team who play abroad in several countries would have to file returns and pay taxes at each stop.

3. Article 12—Royalty Income

Royalty income is treated with other passive types of income in article

196. In some treaties, the fixed base concept is combined with a time-in-country notion. Thus, for example, the U.S.-United Kingdom treaty provides that a resident performing independent services in the other country may be taxed in the source or host country if that person either has a fixed base or spends more than 183 days in that country within a taxable year.

197. U.S. Model Treaty, art. 14(1).

198. *Id.* art. 15; OECD Model Treaty, art. 15. The U.S. Model is entitled Dependent Personal Services and the OECD Model is entitled Income from Employment.

199. *Id.*

200. U.S. Model Treaty, art. 15(2); OECD Model Treaty, art. 15(2).

201. This assumes it is not trumped by article 17 or that there is no article 17 between the countries in question.

12.²⁰² When royalty income is received by a resident of one treaty country, the country of residence taxes the income.²⁰³ Consequently, a U.S. resident who receives royalty income will generally be exempt from tax in the source country. In essence, the country of source cedes taxing authority to the country of residence. Most treaties contain this provision, but the provision is usually not all-encompassing in that many countries reserve the right to tax at a reduced rate.²⁰⁴

Article 12(2) of the U.S. Model Treaty defines royalties as:

any consideration for the use of, or the right to use, any copyright of literary, artistic, scientific or other work (including computer software, cinematographic films, audio or video tapes or disks, and other means of image or sound reproduction), any patent, trademark, design or model, plan, secret formula or process, or other like right or property, or for information concerning industrial, commercial, or scientific experience; and

(b) [gain from alienation of the above].²⁰⁵

From reading the above, it becomes clear that the characterization of royalties raises the same kinds of issues in treaty and non-treaty situations. Therefore, whether an item of income is a royalty requires a re-examination and analysis of the nature of the income.²⁰⁶ The practitioner must keep in mind that the income may be classified under article 17 and article 12. If deemed to be both article 17 and article 12 income, it must be divided, attributed, and taxed accordingly.

Treaties present a particularly complicated set of rules and add to the already complex general principles that relate to foreign income. To decipher the general principles, one must scrutinize the treaty in force between the U.S. and the country in which the athlete is playing.

V. CONCLUSION

The article began with the cliché, “the world is getting smaller.” It ends with another cliché, “this is but the tip of the iceberg.” Both are particularly appropriate to the complex issues surrounding athletes who are U.S. residents

202. U.S. Model Treaty, art. 12. If the income is deemed to flow from an active business enterprise and is attributable to business conducted in the treaty country through a permanent establishment, it will be subject to the business profits article of the treaty. *Id.* art. 12(3).

203. U.S. Model Treaty, art. 12(1).

204. For example, France taxes at 5% and Canada and Japan tax at 10%. *See supra* note 103.

205. U.S. Model Treaty, art. 12(2).

206. *See* Section II.B.3.

and citizens and who play outside the United States.

To summarize, the practitioner must first ascertain if there is a treaty between the host country and the U.S. If there is no treaty, or if the treaty provisions do not apply, the process by which a country eliminates double taxation must be ascertained. Most countries use either a crediting device or a type of income exemption. Keep in mind, the income tax codes of the host country and the U.S. work in concert with each country's scheme to eliminate double taxation. To that end, careful consideration must be given to the characterization and source of income. Finally, and admittedly, the article raises more questions than it answers. It introduces concepts and, hopefully, pinpoints the questions to ask and the places to go to obtain the answers.

In a primer, that is the best one can achieve.

