



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Elizabeth U. Karzon
Branch Chief, CC:INTL:BR1

SUBJECT:

This Field Service Advice responds to your memorandum requesting guidance regarding the character and source of income received by the above referenced taxpayer. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

LEGEND:

Taxpayer A	=
Corp B	=
Corp X	=
Corp Y	=
Contract Territory	=
Country A	=
Country B	=
Date A	=
Date B	=
Endorsement Contract	=
First Contract Year	=
X Dollars	=
Y Years	=
Z	=

ISSUE:

What is the character and source of the Lump Sum Payment from Corp X paid to Corp B pursuant to the Endorsement Contract.

CONCLUSION:

The character and source of the Lump Sum Payment from Corp X to Corp B should be determined based on the character and source of the annual base remuneration for the First Contract Year.

FACTS:

For the years in issue, Taxpayer A is a nonresident alien professional athlete who is a resident and citizen of Country A. Corp X is a domestic corporation producing athletic products. As discussed below, Corp X entered into an Endorsement Contract on Date A for Taxpayer A's services and endorsement of Corp X's products. However, because Taxpayer A had by contract transferred Taxpayer A's rights to provide endorsement and services exclusively to Corp B, a Country B corporation wholly owned by Taxpayer A, the Endorsement Contract at issue is between Corp B and Corp X. Taxpayer A, however, reports all the income received from Corp X directly on Taxpayer A's income tax return.

The Endorsement Contract provides that Corp X desired to acquire, on an exclusive basis, the right to use the name, image, endorsement and athletic renown of Taxpayer A in connection with the advertisement, promotion and sale of Corp X's products and to obtain certain services of Taxpayer A. The Endorsement Contract gave Corp X the right to use Taxpayer A's name, nickname, initials, autograph, voice, video or film portrayals, facsimile signature, photograph, likeness and image or facsimile image, and any other means of endorsement by Taxpayer A, in connection with the development, manufacture, promotion and sale of Corp X's products. Because Taxpayer A had contracted away these rights to Corp B, along with the right to sublicense such rights to third parties, the Endorsement Contract further provides that Corp B agrees to grant such rights to Corp X.

The Endorsement Contract also provides that, throughout the term of the contract, Corp B agrees to cause Taxpayer A to wear and use exclusively Corp X's products while participating in athletic and sports related activities in public. The Endorsement Contract also provides that Corp B agrees to provide Taxpayer A's services, upon Corp X's request, for up to Z appearances each contract year in connection with the promotion, advertisement and sale of Corp X's products. The Endorsement Contract is for a period of Y Years.

The Endorsement Contract provides for a fixed annual base remuneration, for the rights and services provided for under the contract, for each year during the Y Year contract period. In addition to annual base remuneration, the Endorsement Contract provides that Corp X shall make a one-time non-refundable payment (“Lump Sum Payment”) to Corporation B in the amount of X Dollars, within thirty (30) days following full execution of the Endorsement Contract. Such payment was made on Date B in accordance with the terms of the Endorsement Contract. The Endorsement Contract also provides that Corp B represents that neither Corp B nor Taxpayer A is a party to any agreement that would prevent or hinder performance of the obligations provided for in the Endorsement Contract.

Taxpayer A asserts that the Lump Sum Payment was an inducement to leave Corp Y, a competitor corporation to Corp X, and sign the Endorsement Contract with Corp X. Accordingly, Taxpayer A asserts that the Lump Sum Payment was not predicated on any prior, current or future services to Corp X, nor did it relate to the grant of rights provided to Corp X in the Endorsement Contract. Taxpayer A, therefore, argues that the Lump Sum Payment would be of a type of income that would fall within the “Other Income” articles of the OECD and U.S. Model Tax Treaties, and, thus, should only be taxable by the Taxpayer’s country of residence. Taxpayer A’s contract with Corp Y expired on Date A, the same day as he entered into the Endorsement Contract with Corp X.

There is no income tax treaty between the United States and either Country A or Country B.

LAW AND ANALYSIS

Taxpayer A asserts that the Lump Sum Payment is not subject to U.S. taxation because it is of a type of income that would fall within the “Other Income” articles of the OECD and U.S. Model Treaties, which generally assign taxing jurisdiction over income not dealt with in other articles to a taxpayer’s country of residence. There is, however, no income tax treaty between the United States and Taxpayer A’s country of residence. Therefore, Taxpayer A’s tax liability is determined under U.S. domestic law concepts. The issue, therefore, is the character and source of the Lump Sum Payment received by Taxpayer A as a part of the Endorsement Contract, under U.S. domestic law.

Although there are no cases or public guidance relating to sign on bonuses paid under endorsement contracts, there is some legal authority relating to the character of sign on bonuses paid to an athlete by a professional team. One such case is, Allen v. Commissioner, 50 T.C. 466 (1968), which involved a \$70,000 sign on bonus paid by a baseball team to a baseball player as a part of a contract wherein the player agreed to provide services as a baseball player. The \$70,000

sign on bonus in Allen was paid over a five year period beginning on the date the contract was signed. The player in Allen argued that the sign on bonus was not compensation “in respect of services” within the meaning of IRC section 73 because it was non-refundable, even if the player played no games for the team, and was in addition to stated compensation provided in the contract for the player’s services as a baseball player.

For the tax year in issue, the player in Allen was considered a “child” for purposes of section 73. Section 73 provides:

Amounts received in respect of the services of a child shall be included in his gross income and not in the gross income of the parent, even though such amounts are not received by the child. I.R.C. §73.

The Allen court found that:

[T]he bonus payments were paid by the Phillies as an inducement to obtain his services as a professional baseball player and to preclude him from rendering those services to other professional baseball teams; they thus certainly constituted amounts received ‘in respect of’ his services.

Accordingly, the Allen court found that, while the \$70,000 bonus was “an indirect rather than a direct payment for services,” it was compensation “in respect of” the player’s services and was, therefore, includible in the player’s income under section 73. The Allen decision therefore supports the general position that a sign on bonus paid after a contract has been entered into should be treated as paid in respect of that which the contract requires (i.e., in Allen, services as a baseball player).

In the instant case, Taxpayer A received the Lump Sum Payment for signing the Endorsement Contract with Corp X, an athletic wear company. The amount was nonrefundable and in addition to stated compensation. The Lump Sum Payment was consideration for having entered into the Endorsement Contract, pursuant to which Corp X was granted various rights and services, including the grant of rights to use both Taxpayer A’s endorsement and services in promoting Corp X’s products. Taxpayer A was entitled to the Lump Sum Payment only after Taxpayer A signed the Endorsement Contract. In view of Allen, the character of the Lump Sum Payment received by Taxpayer A should be based on the different rights and services provided for by the Endorsement Contract because the Lump Sum Payment was paid by Corp X in order to obtain those various rights and services. Therefore, because the Endorsement Contract encompassed both future endorsement rights and future services, the Lump Sum Payment should be characterized partly as payment in respect of endorsement rights and partly as compensation in respect of personal services.

This case is distinguishable from Revenue Ruling 74-108, 1974-1 C.B. 248, which held that a lump sum amount bonus paid, prior to any employment contract, by a domestic soccer team to a nonresident alien player was, in its entirety, paid in consideration of a covenant not to compete. In Rev. Rul. 74-108, the agreement was not an actual contract for the player's services, but merely prohibited the player from negotiating a player contract with any other team. In the instant case the Lump Sum Payment was paid pursuant to the contract actually granting Corp X the rights to Taxpayer A's endorsement and services.

In Ken Linseman v. Commissioner, 82 T.C. 514, 522 (1984), the Tax Court held that the most reasonable method of sourcing a sign on bonus paid by a domestic hockey team to a nonresident alien hockey player as an inducement to enter into a 6-year employment contract between U.S. and foreign sources was based on the number of games the team contemplated playing within and without the United States during the first year of the contract. Although the instant case is factually distinguishable from Linseman because the sign on bonus in Linseman was paid before the actual employment contract was entered into, it is our view that the same rationale used by the Tax Court in Linseman to allocate the source of a sign on bonus paid as an inducement to enter into a multiple-year contract should be used to allocate the Lump Sum Payment in this case, which was also paid pursuant to a multiple-year contract. Accordingly, we believe it is appropriate to allocate the source and character of the Lump Sum Payment paid during the first year of the contract based on the rights exercised and services performed during the first contract year.

Based on the foregoing, the allocation of the Lump Sum Payment to each component of the contract should be in the same proportion as the allocation of the First Contract Year's annual base remuneration to each component, based on the different rights exercised and services performed pursuant to the terms of the Endorsement Contract during the First Contract Year. The source of the Lump Sum Payment should also be in proportion to the allocation of the First Contract Year's annual base remuneration to U.S. versus foreign sourced income. Linseman, 82 T.C. 514. Each component of the annual base remuneration should be sourced using the appropriate sourcing rules, in view of the character allocated to that portion of the annual base remuneration. For example, any portion characterized as royalties should be sourced based on the place of use, while portions characterized as compensation for personal services should be sourced based on the place of performance of the services. I.R.C. §§ 861(a)(4), 861(a)(3)

If you have any further questions, please

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