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subject: U.S. Source Retainer Fees and Ranking and Placement Bonuses Derived by  
Professional Golf and Tennis Players from On-Court Endorsement Contracts

This general legal advice memorandum addresses the characterization of U.S. source retainer fees and ranking and placement bonuses paid pursuant to “on-court endorsement contracts” to non-resident alien (hereinafter “foreign”) professional golf and tennis players under the Internal Revenue Code (the “Code”) and the 2006 U.S. Model Income Tax Convention (the “2006 U.S. Model”).

Issues:

1. Retainer fees

- a. Whether retainer fees paid to foreign professional golf and tennis players pursuant to on-court endorsement contracts should be characterized as income from personal services, royalties, or both under the Code?
- b. Whether such retainer fees should be classified under the 2006 U.S. Model as business profits under Article 7, royalties under Article 12, or income derived by a sportsman under Article 16?

2. Ranking and placement bonuses

- a. Whether ranking and placement bonuses paid to foreign professional golf and tennis players pursuant to on-court endorsement contracts should be

characterized as income from personal services, royalties, or both under the Code?

- b. Whether such ranking and placement bonuses should be classified under the 2006 U.S. Model as business profits under Article 7, royalties under Article 12, or income derived by a sportsman under Article 16?

### Conclusions:

#### 1. Retainer fees

- a. The character of retainer fees will depend on whether a sponsor is retaining the golf or tennis player to perform personal services, to use his or her name and likeness rights independently of any meaningful performance of services, or to do both. Based on the terms of, and performance by the parties to, the typical on-court endorsement contract, the sponsor is retaining the player to perform personal services. The incremental value to the player, if any, for granting the sponsor the right to use his or her name and likeness rights on a stand-alone basis apart from those services is *de minimis*. Accordingly, retainer fees paid pursuant to these contracts should be characterized as income from personal services and, to the extent the fees relate to services performed in the United States, taxed on a net basis at graduated rates. In the atypical situation in which a player can establish that the sponsor retained the player to use his or her name and likeness rights on a stand-alone basis (for example, to market a signature line of equipment), a portion of the retainer fees may be characterized as royalties and, depending on the facts, may be effectively connected with the conduct of that player's U.S. trade or business.
- b. Based on the terms of, and performance under, a typical on-court endorsement contract, all or substantially all of the retainer fees derived by golf and tennis players are from their personal activities as such, and thus are classified as income derived by a sportsman under Article 16 (Entertainers and Sportsmen) of the 2006 U.S. Model. Article 16 governs the taxation of retainer fees derived from any use of the player's name or image that is directly or indirectly related to his or her personal activities as an athlete. Retainer fees derived from the use of a player's name or image that is not so related, as may be the case under certain "off-court endorsement contracts," would generally be classified as business profits under Article 7 (Business Profits).

#### 2. Ranking and placement bonuses

- a. Ranking and placement bonuses paid to golf and tennis players pursuant to on-court endorsement contracts are characterized as income from personal services under the Code.
- b. Ranking and placement bonuses paid to players pursuant to on-court endorsement contracts are classified as income derived by a sportsman under Article 16 of the 2006 U.S. Model. These bonuses are paid to golf and tennis players for their personal activities as such.

Facts:

On- and off-court or -course (collectively, “on-court” and “off-court”) endorsement contracts are an industry-wide practice in golf and tennis. Endorsement contracts that require an athlete to display, wear, or use equipment, clothing, footwear, and other items, such as a patch with the sponsor’s logo, during sports-related activity are categorized as on-court. Endorsement contracts for all other products are categorized as off-court.<sup>1</sup> The majority of ranked golf and tennis players have on-court endorsement contracts. Conversely, very few of them have off-court endorsement contracts.

*1. Elements of on-court endorsement contracts*

On-court endorsement contracts vary little, without regard to which player is giving the endorsement or which product is being endorsed. The period of the contract can be anywhere from one to five years for a major equipment or clothing manufacturer, generally with options to extend. Sleeve patches may be negotiated for a single important match, major tournament, or a prolonged period of time. The territorial scope of the contract varies, often according to underlying employment restrictions.

Under an on-court endorsement contract, the golf or tennis player generally receives a retainer fee for—

1. wearing or using the sponsor's product;
2. making promotional appearances;
3. participating in photo and filming days; and
4. permitting the sponsor to use his or her name, nickname, initials, autograph, voice, video or film portrayals, facsimile signature, likeness, image, representations, or combinations thereof, in connection with the advertisement, promotion, and sale of products (collectively, “name and likeness rights”).

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<sup>1</sup>Off-court endorsement contracts fall into two general categories: a contract for the endorsement of a product that is sold in the athlete’s home country or, where a player has world-wide recognition, a contract for the endorsement of a product that is globally marketed.

The player is generally required to exclusively use, wear, or display the product's logo during competition, practice, or any other sports-related activity. In addition, the player is obligated to use his or her best efforts to display the sponsor's products, even when attending photograph sessions for another sponsor's product.

Contract requirements relating to promotional appearances and photo and filming days generally have the same terms. The number of days or appearances that a player has to make is specified: typically one or two for photo and filming days, and between two and six for promotional appearances. The player's competition schedule must be accommodated when arranging promotional appearances, and photo and film days. Generally, days that the sponsor chooses not to use are not carried over from one contract year or term to the next. The retainer fee is not reduced for any unused days.

The sponsor has the right to promote its products by using the player's name and image in its advertising and promotional materials. Generally, the contract will state that the license to use the player's name and likeness is royalty-free, or that no additional compensation is paid for such rights. The player has the right to approve any advertising used by the sponsor, however, the contract will state that time is of the essence when reviewing advertising material connected to an important tournament at which the player wins or places. The sponsor may also contract for the use of a screen-grab (a frame from a live action reel) from an actual tournament in its worldwide advertising. In addition, some contracts will require the player to model for broadcast, internet, print, or display materials.

## *2. Compensation under on-court endorsement contracts*

The compensation package generally consists of a base in the form of a retainer fee plus bonuses. The contract will specify whether the retainer fee is paid quarterly, bi-annually, or on some other basis.<sup>2</sup> It will also state that the retainer fee is subject to minimum play and/or reduction clauses.<sup>3</sup> Under these clauses, if the player fails to play in a certain number of tournaments, takes a lengthy absence from playing, or falls out of the rankings, the retainer fee may be reduced or the contract may be terminated. Often, an endorsement contract will specify an amount or percentage by which an annual retainer fee will increase (or decrease) in the next contract term if the player attains (or fails to attain) a certain ranking.

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<sup>2</sup> On rare occasions, an endorsement contract, on- or off-court, will provide for an athlete's signature line of products in exchange for a percentage of net income from the sale of the products. Such agreements tend to be with athletes that are or were top players in their sport for a substantial period of time, making them recognizable and appealing to a wide age demographic; Arnold Palmer, for example, and his line of "Peerless" clubs.

<sup>3</sup> For example, a contract will typically state that a golfer must play a minimum of two complete rounds in a minimum of thirty tournaments during each contract year, including a minimum of twenty U.S. PGA Tour events and ten European Tour events. Only those events that count toward the official money list for each tour will satisfy the minimums. Major Championships are counted as two events. If, due to illness or injury, the golfer is unable to play in thirty tournaments, the annual base retainer will be decreased on a pro rata basis. Thus, if the golfer plays in four out of the thirty tournaments, the adjusted annual base retainer will be  $4/30$  x the annual base retainer for that year.

On-court endorsement contracts generally provide for placement and ranking bonuses in addition to the retainer fee. A player earns a placement bonus for a specific finish in a specific tournament.<sup>4</sup> Placement bonuses are higher for finishes at Grand Slam<sup>5</sup> tournaments or Major Championships<sup>6</sup> than for finishes at other tennis and golf tournaments. The contract will specify when a bonus payment will be made (for example, within 30 days of the win), and that no payment will be made unless at all times during the relevant tournament or event the athlete carried, wore, and/or played with all the endorsed products as required by the terms of the agreement.

A ranking bonus is paid if a player attains a certain rank on a specified system. The contract will provide how and/or when rank is calculated: at year end, as an average over a specific period of time, or in some other manner. Professional men's tennis players generally receive a ranking bonus based on ATP (Association of Tennis Professionals) Champions Race rank<sup>7</sup> at year end while professional women's tennis players receive bonuses based on WTA (Women's Tennis Association) rankings. In men's golf, bonuses are paid based on a position on the European Tour Official Money List,<sup>8</sup> U.S. PGA Tour Money List,<sup>9</sup> and/or Official World Golf Ranking. Bonuses may also be paid for the PGA and European Tour Player of the Year awards.

### *3. Other contract terms and conditions*

A sponsor may terminate an on-court endorsement if, during the contract period, the player retires from professional competition; tests positive for drugs; falls below a specified rank for a specified length of time; is inactive for a certain time period (for example, two consecutive months), for whatever reason; is banned from play by the governing body of the athlete's sport; or commits any act or becomes involved in any situation that brings the athlete into public disrepute, contempt, scandal or ridicule, offends public opinion or the sensibilities of any substantial class or group, materially reduces the value of the endorsement, or violates public morality or decency.

#### Law:

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<sup>4</sup> There are also a small number of endorsement contracts that provide for an athlete to play at a specific (and generally lesser-known) tournament for a fixed sum. Usually, the tournament is in the player's country of residence, or a country in which the athlete enjoys a high degree of fame and visibility.

<sup>5</sup> These include the U.S. Open, French Open, Australian Open, and Wimbledon.

<sup>6</sup> These include The Masters, U.S. Open, British Open, and PGA Championship.

<sup>7</sup> In men's tennis, events categories award winner's ranking points. For example, Grand Slam events award 1,000 winner ranking points. The ATP publishes weekly rankings, ATP entry rankings, 52-week rolling rankings, and ATP Champions Race. The Entry Ranking is the cumulative points earned in the past 52 weeks, except for the Tennis Masters Cup, the points of which are dropped following the last ATP event of the year. It is used to determine qualification for entry and seeding in all tournaments for both singles and doubles. The player with the most points by season's end is the top ranked player in the world.

<sup>8</sup> Also known as the Order of Merit, this is the total official money earned by a player on all European member tours.

<sup>9</sup> This is the total official money earned by a player on all U.S. PGA member tours.

### 1. *Taxation of services and royalty income derived by nonresident aliens*

Under the Code, income derived by foreign athletes is taxable in the same manner as income derived by other nonresident aliens: income that is effectively connected with the conduct of a trade or business within the United States is taxed at graduated rates on a net basis, and U.S. source income that is not effectively connected with a U.S. trade or business is subject to a 30% withholding tax. I.R.C. § 871(a), (b).

Under section 864(b), a “trade or business within the United States” includes the performance of personal services within the United States at any time within the taxable year.<sup>10</sup> Under sections 861(a)(3) and 862(a)(3), income from labor and personal services is sourced where the services are provided.<sup>11</sup> Consequently, income that a foreign athlete derives as salary, fees, wages, compensation, bonuses, and prize winnings for performances in the United States will be effectively connected U.S. source income, and taxed under section 871(b) at applicable graduated rates.<sup>12</sup> Deductions are allowed under section 873(a) to the extent they can be allocated or apportioned to effectively connected income.

Royalties derived from sources within the United States are generally subject to a 30% withholding tax on a gross basis unless the royalties are effectively connected with the conduct of a trade or business in the United States. Under section 864(c)(2), U.S. source royalty income may be effectively connected with the conduct of a U.S. trade or business if it is either derived from assets used in or held for use in the conduct of such trade or business, or the activities of such trade or business are a material factor in the realization of the royalty.<sup>13</sup> If an athlete derives royalty income that is effectively connected with the conduct of a trade or business in the United States, it will be taxable in the same manner as personal services income—at applicable graduated rates on a net basis. I.R.C. § 871(b).

Under section 861(a)(4), royalties from property located in the United States or from any interest in such property, including royalties for the use of, or for the privilege of using, in the United States “patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other like property,” are sourced within the United States.<sup>14</sup> The term “other like property” has not been defined by the Code or regulations.

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<sup>10</sup> But see section 864(b)(1) for a limited exception, generally not applicable in the case of a highly paid nonresident athlete.

<sup>11</sup> The Code provides a *de minimis* exception to the sourcing rule parallel to that in section 864(b)(1).

<sup>12</sup> When a foreign athlete receives income from events that are in the United States and in foreign countries, the income from services is allocated between U.S. and foreign sources, and only the former is taxable by the United States. See Treas. Reg. § 1.861-4(b)(2).

<sup>13</sup> Under section 864(c)(4)(B)(i), royalties from sources without the United States may be effectively connected with the conduct of a trade or business only if the royalties are 1) derived from the active conduct of a U.S. trade or business, and 2) attributable to an office in the United States.

<sup>14</sup> Determining whether a royalty is from U.S. or foreign sources is a difficult task. Courts have considered what constitutes a reasonable allocation method for sourcing lump sum royalty payments between U.S. and foreign sources in Misbourne Pictures Ltd. v. Johnson, 189 F.2d 774, 775 (2d Cir. 1951); Molnar v.

## 2. Name and likeness rights

Currently, twenty-eight states recognize the right of publicity by common law or statute. In some states, the scope of the right of publicity, which originally protected an individual's name and likeness, has been broadened to include nicknames, drawings, voices, and impersonators.<sup>15</sup> There is no federally protected right of publicity.

The right of publicity<sup>16</sup> has been defined as the right of an individual to control the commercial use of his identity.<sup>17</sup> The term was first used in Haelan Laboratories, Inc. v. Topps Chewing Gum, Inc., 202 F.2d 866 (2d Cir. 1953). In Haelan, a chewing-gum company entered into contracts with professional baseball players giving it the exclusive right to use each player's photograph in connection with the sale of its chewing gum. Id. at 867. The players also agreed not to grant any other gum manufacturer a similar right during the term of the contract. Id. Subsequently, some of the players contracted with Topps, a rival chewing-gum manufacturer, for the use of their photographs in connection with the sale of Topps' gum. Id.

The Court of Appeals for the Second Circuit held that a man has a right in the publicity value of his photograph, including the right to grant the exclusive privilege of publishing his picture. Id. The court stated:

This right might be called a 'right of publicity.' For it is common knowledge that many prominent persons (especially actors and ball-players), far from having their feelings bruised through public exposure of their likenesses, would feel sorely deprived if they no longer received money for authorizing advertisements, popularizing their countenances, displayed in newspapers, magazines, busses, trains and subways. This right of publicity would usually yield them no money unless it could be made the subject of an exclusive grant which barred any other advertiser from using their pictures.

Id. at 868. The court held further that the licensees and assignees of a right of publicity had a cause of action against infringing third parties. Id. at 869.<sup>18</sup>

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Commissioner, 156 F.2d 924 (2d Cir. 1946), aff'g 4 T.C.M. 951 (1945); Rohmer v. Commissioner, 153 F.2d 61, 65 (2d Cir. 1946), aff'g 5 T.C. 183 (1945); and Estate of Marton v. Commissioner, 47 B.T.A. 184 (1942). The courts have generally held that if taxpayers do not demonstrate a reasonable method for allocating royalties from property used within and without the United States, all of the royalties should be treated as from U.S. sources.

<sup>15</sup> Allen v. Nat'l Video, Inc., 610 F. Supp. 612, 624 (S.D.N.Y. 1985) (celebrity look-alike); Midler v. Ford Motor Co., 849 F.2d 460, 463 (9th Cir. 1988) (voice attributes); Motschenbacher v. R.J. Reynolds Tobacco Co., 498 F.2d 821, 827 (9th Cir. 1974) (racecar)

<sup>16</sup> The right of publicity, in turn, has evolved from an individual's right of privacy.

<sup>17</sup> See 1 J. THOMAS MCCARTHY, THE RIGHTS OF PUBLICITY AND PRIVACY § 1.3 (2d ed. 2003).

<sup>18</sup> The court observed that "[w]hether [the right of publicity] be labeled a 'property' right is immaterial; for here, as often elsewhere, the tag 'property' simply symbolizes the fact that courts enforce a claim which has pecuniary worth." Haelan, F.2d at 868. In a case decided after Haelan, the Tax Court seemingly concluded that the right of publicity was not property, holding that income from the sale of a right of

### 3. Treatment of name and likeness rights under the Code

The characterization of payments for the use of name and likeness rights arises in a number of contexts. There are two authorities to which taxpayers generally cite as support for their claim that the income they derive from on-court endorsement contracts should be characterized as a royalty.<sup>19</sup> The first is a line of unrelated business income tax (“UBIT”) decisions commonly referred to as the “affinity credit card cases.” The second is Kramer v. Commissioner, 80 T.C. 768 (1983), a non-UBIT decision.

In the affinity credit card cases, a financial institution would contract with a tax-exempt organization for the use of its name and logo on the financial institution’s credit cards, which it marketed to the tax-exempt organization’s members by using a mailing list that the tax-exempt organization provided. In return, the tax-exempt organization was paid a fee calculated as a percentage of the amount of the total purchases made with the credit cards. The issue before the courts was how to characterize the fees.

The courts held that affinity credit card agreements generally give rise to royalties because the agreements are primarily for the use of the tax-exempt organization’s name, and not any services the tax-exempt organization provides in connection with its mailing list. In so holding, the courts concluded that the services performed by the tax-exempt organization under the agreements are *de minimis*, and appropriate to protect the value of the intangible—the tax-exempt organization’s good name and reputation—that is being licensed.<sup>20</sup>

In Kramer, the issue was whether royalty income earned by Jack Kramer, a retired professional tennis player, qualified as earned income for purposes of the maximum tax on earned income and the computation of the maximum deductible contribution to a self-employment pension (Keogh) plan. Kramer, 80 T.C. at 769. Kramer’s income consisted of contractual payments from Wilson, a sporting goods company, for a

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publicity does not give rise to capital gain and is taxable as ordinary income. Miller v. Commissioner, 35 T.C. 631 (1961). In upholding the Tax Court’s decision, the Court of Appeals for the Second Circuit stated:

It is clear to this Court, at least, that many things can be bought and sold which are not ‘property’ in any sense of the word. One can sell his time and experience, for instance, or, if one is dishonest, one can sell his vote; but we would suppose that no one would seriously contend that the subject matter of such sales is ‘property’ as that word is ordinarily understood. Certainly no one would contend that such subject matter was inheritable. We conclude, therefore, that not everything people pay for is property.

Miller v. Commissioner, 299 F.2d 706 (2d Cir. 1962). More recently, however, courts have held that the right of publicity is descendible and subject to estate tax. Estate of Andrews v. United States, 850 F. Supp. 1279 (E.D. Va. 1994); Jim Henson Prods. v. John T. Brady & Assoc., 867 F. Supp. 175, 189-90 (S.D.N.Y. 1994); Price v. Hal Roach Studios, 400 F. Supp. 836 (S.D.N.Y. 1975).

<sup>19</sup> Taxpayers also refer to Chief Counsel Advice Memoranda (“CCA”) 199938031 (Sept. 24, 1999). See *infra* note 32.

<sup>20</sup> See Oregon State University Alumni Association v. Commissioner, T.C. Memo 1996-34 (1996), *aff’d*, 193 F.3d 1098 (9th Cir. 1998); Common Cause v. Commissioner, 112 T.C. 332 (1999), and its identical companion case, Planned Parenthood Federation of America, Inc. v. Commissioner, T.C. Memo 1999-206 (1999).

signature line of tennis racquets. *Id.* at 770. Kramer received 2.5% of the net income from the sale of all tennis racquet frames and other tennis equipment bearing his name in return for his best efforts to promote such products. *Id.*

Treas. Reg. § 1.401-10(c) defines earned income as the net earnings from self-employment to the extent such earnings constitute compensation for personal services actually rendered within the meaning of Code section 911(b). *Id.* at 779. Thus, the Tax Court had to determine whether Kramer's royalty income was for personal services such that it qualified as earned income. *Id.* The court concluded that the royalty income was primarily for the grant of the right to use Kramer's name, facsimile signature, and the like, and only secondarily for Kramer's personal services promoting his signature line of Wilson products. *Id.* at 781. The court held that, based on the limited evidence before it, 70% of the royalties Kramer received were compensation for the right to use his name, facsimile signature, and the like, and the remaining 30% of the royalties was compensation for personal services that qualified as earned income. *Id.* at 782.

#### 4. *Relevant treaty articles*

As a general rule, the country in which an item of income arises (the source state) will apply its internal law to determine the character of that income. This, in turn, will determine the treaty article that governs how that income is taxed. In some cases, however, the treaty will characterize income without regard to the source state's internal law. This occurs either because the treaty defines what is included (or not) in a category of income, or because the treaty requires a particular characterization under certain circumstances.

In the case of endorsement income earned by a foreign golf or tennis player, it is necessary to consider the scope of several different treaty articles:<sup>21</sup> Articles 16 (Entertainers and Sportsmen),<sup>22</sup> 12 (Royalties), or 7 (Business Profits).<sup>23</sup> Article 16(1) provides in relevant part:

Income derived by a resident of a Contracting State . . . 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

<sup>21</sup> Article 14 (Income From Employment) may also apply in the unusual situation in which the player is an employee of the sponsor.

<sup>22</sup> Article references are to the 2006 U.S. Model Convention (unless otherwise noted), which reflects the U.S. Department of the Treasury's current tax treaty policy.

<sup>23</sup> Article 7 includes income from the performance of independent personal services in its definition of business profits. Generally, in older treaties, Article 14 (Independent Personal Services) applies instead of Article 7 with the same tax consequences. Article 7 provides in relevant part:

The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as are attributable to that permanent establishment.

State under the provisions of Article 7 (Business Profits) and 14 (Income from Employment) may be taxed in that other State, except where the amount of the gross receipts derived by such . . . sportsman, including expenses reimbursed to him or borne on his behalf, from such activities does not exceed twenty thousand United States dollars (\$20,000) . . . for the taxable year of the payment.

The Treasury Department's Technical Explanation (TE)<sup>24</sup> to Article 16 observes that:

As explained in paragraph 9 of the Commentary to Article 17 of the OECD Model, Article 16 of the Convention applies to *all income connected with a performance* by the entertainer, such as appearance fees, award or prize money, and a share of the gate receipts. Income derived from a Contracting State by a performer who is a resident of the other Contracting State from other than actual performance, such as royalties from record sales and payments for product endorsements, is not covered by this Article, but by other articles of the Convention, such as Article 12 (Royalties) or Article 7 (Business Profits).

(Emphasis added.) Paragraph 9 of the Commentary to Article 17<sup>25</sup> of the OECD Model provides:

Besides fees for their actual appearances, artistes and sportsmen often receive income in the form of royalties or of sponsorship or advertising fees. In general, other Articles would apply whenever there was no direct link between the income and a public exhibition by the performer in the country concerned. Royalties for intellectual property rights will normally be covered by Article 12 rather than Article 17 . . . , *but in general advertising and sponsorship fees will fall outside the scope of Article 12. Article 17 will apply to advertising or sponsorship income, etc. which is related directly or indirectly to performances or appearances in a given State.* Similar income which could not be attributed to such performances or appearances would fall under the standard rules of Article 7 or Article 15, as appropriate. . . .

(Emphasis added.) Thus, fees paid for product endorsements come within the scope of Article 16 if the endorsements are related directly or indirectly to the performance itself. The TE to Article 16 states:

In determining whether income falls under Article 16 or another article, the controlling factor will be whether the income in question is predominantly attributable to the performance itself or to other activities or property

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<sup>24</sup> The Technical Explanation is an official guide to the Convention. It reflects the policies behind particular Convention provisions, as well as understandings reached with respect to the application and interpretation of the Convention.

<sup>25</sup> Article 17 is the OECD Model counterpart to Article 16 of the 2006 U.S. Model.

rights. For instance, a fee paid to a performer for endorsement of a performance in which the performer will participate would be considered to be so closely associated with the performance itself that it normally would fall within Article 16. Similarly, a sponsorship fee paid by a business in return for the right to attach its name to the performance would be so closely associated with the performance that it would fall under Article 16 as well.

Under Article 12(2) of the 2006 U.S. Model,<sup>26</sup> the term "royalties" means:

- a) payments of any kind received as a consideration for the use of, or right to use, any copyright of literary, artistic, scientific or other work (including cinematographic films), any patent, trademark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience; and
- b) gain derived from the alienation of any property described in subparagraph a), to the extent that such gain is contingent on the productivity, use, or disposition of the property.

Because the term royalties is defined by the Convention, as the TE to Article 12 observes, its meaning is independent of domestic law. Undefined terms that are included within the definition of royalties, however, take their meaning according to domestic law.<sup>27</sup> Thus, for example, domestic law would apply to determine the meaning of "copyright" and "trademark."

Payments that do not qualify as royalties under Article 12 are usually classified as business profits under Article 7, and therefore exempt from tax unless they are attributable to a permanent establishment or other fixed place of business in the United States. If such payments are derived by a sportsman in connection with a performance

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<sup>26</sup>Some U.S. tax treaties define "royalties" to include payments in consideration for the use of a right or property that is like one of those previously enumerated by the definition. For example, Article 12(2) of the 2002 U.S.-U.K. income tax treaty ("U.K. Treaty") provides:

The term "royalties" as used in this Article means:

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

(Emphasis added.) While the TE to the 1996 U.S. Model does not define the scope of "other like right or property," it does include an example in which income attributable to one of the rights described in Article 12 (specifically, endorsement income for the use of an artist's photograph to promote a film at a screening attended by the artist) is nevertheless governed by Article 16.

<sup>27</sup> Paragraph 2 of Article 3 (General Definitions) provides that terms not defined by treaty take their meaning from the law of the country to which the taxes applies.

in the United States, they will be governed by Article 16 and taxable, even if the payments would otherwise be exempt from tax under Article 7.

*The Taxation of Income Derived From Entertainment, Artistic and Sporting Activities*, an OECD pamphlet published in 1987 (the “OECD A&E report”), provides additional insight into the interrelationship between Articles 7, 12, and 16.<sup>28</sup> The report discusses the types of income subject to the provisions of Article 17 (Artistes and Sportsmen) and acknowledges “the difficulties inherent in taxing artistes and athletes, who receive a large variety of types of income from different sources.” It considers narrowly interpreting Article 17 such that—

only income deriving directly from an exhibition—normally in public or on television, in respect of live performance or of the first transmission of a recording—of the artistes’ or athletes’ talents would fall under Article 17, and all other types of income would be taxed in accordance with other relevant rules of the 1977 Model Convention.

It also considers whether broadly interpreting Article 17 is justified because—

the complexity of the contracts (often so-called package deals) governing the exercise of these activities, and the forms of payments received (frequently qualified as “royalties” for tax avoidance purposes) make it impossible for tax authorities to identify each of them separately, and since the payments are connected, they should all be brought within the scope of Article 17.

The report adopted neither extreme. A broad interpretation was disfavored on the theory that it would render meaningless many of the provisions—in particular Articles 12 and 14—dealing with indirect income habitually received by artistes and athletes over and above any direct remuneration, and because it would also be inappropriate to bring genuine royalties into the scope of Article 17. The report concluded:

[W]ith regard to the application of Article 17, account should be taken of the extent to which the income was connected with the actual activity of the artiste and athlete in the country concerned. *In general, Articles other than Article 17 would apply whenever there were no direct link between the income and a public exhibition by the performer in the country concerned. On the contrary, advertising or sponsorship income paid especially in connection with a performance (whether before or after the event) would fall under Article 17.*

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<sup>28</sup> The U.S. and OECD Model treaties have nearly identical Articles 7, 12, and 16 (17 in the OECD Model).

(Emphasis added). This report formed the basis for paragraph 9 of the Commentary to Article 17 of the OECD Model in 1992, referenced in the TE to Article 16 in the 2006 U.S. Model.

## Analysis

### 1. *Characterization of retainer fees under the Code*

The characterization of retainer fees derived by a nonresident golf or tennis player under an on-court endorsement contract depends on what the athlete is required to do to earn the fees: perform services, allow the sponsor to use a valuable intangible property right, or some combination of the two. To determine the expectation of the parties, the analysis centers on the contract language and the parties' performance in carrying out the contract.

The analysis begins with the terms of the contract. Boulez v. Commissioner, 83 T.C. 584, 585 (1984); Arkansas State Police Association, Inc. v. Commissioner, 282 F.2d 556, 560 (8th Cir. 2002). The terms of the contract are not determinative, however, of whether a payment is for services or royalties. Boulez v. Commissioner, 83 T.C. at 591.<sup>29</sup> The parties' performance under the contract is evidence of their expectations at the time the contract was formed. Kramer v. Commissioner, 80 T.C. 768 (1983). Finally, contractual payments that may be attributable to the performance of personal services and the use of a valuable intangible property right should be bifurcated between the two only where the amount in either category is not *de minimis*.<sup>30</sup>

With these case law principles in mind, the question presented is whether the sponsor is paying the retainer fee for the player's services, for the use of the player's name and likeness to promote its products, or for both. If the sponsor is paying the retainer fee for both, is the amount attributable to either category *de minimis* such that there is no need to allocate the retainer fee between the two?

Clearly, the terms of the contract require a player to perform services. Typically, the contract specifies the number of tournaments in which the golf or tennis player must compete, including U.S. PGA and European and Grand Slam events. If, for any reason,

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<sup>29</sup> In Boulez, Pierre Boulez, a well-known conductor, entered into a contract with CBS Records for the recording of a minimum of two LPs in the United States. Boulez, 83 T.C. 584, 586. Under the terms of the contract, Boulez agreed not to make similar recordings for others during the term of the contract and for a period of 5 years thereafter; his services were acknowledged to be unique and extraordinary; and his remuneration was conditioned on his performances, with the caveat that it would be suspended for nonperformance due to illness, injury, accident, or refusal to work. Id. at 592. Although the contract stated that Boulez was to be paid royalties, the court concluded that that the parties intended a contract for personal services, rather than one involving the sale or licensing of any property. Id. at 593.

<sup>30</sup> In Kramer, for example, the court held that 70% of the payments Kramer received represented royalties for the right to use his name, facsimile signature, and other like rights, and 30% represented royalties for promotional services. On the other hand, courts have not bifurcated a payment between income for personal services and a royalty payment when the income attributable to the personal services was a *de minimis* amount. See supra text accompanying note 20.

the player is unable to compete in the requisite number of tournaments, the retainer fee will generally be decreased on a pro rata basis. For example, if the player is required to compete in twenty tournaments for the year, and only competes in four, the adjusted retainer fee will be 4/20 of the total retainer fee possible for the contract term.

However, the terms of the contract also grant the sponsor the right to use the player's name and likeness in promoting its products. Although they do not specify the manner in which the player's name and likeness will be used, they generally state that the player is not agreeing to endorse a signature line of products. They also state that the license to use the player's name and likeness is royalty free, or that no additional compensation will be paid if the sponsor uses the player's name and likeness.

Taken as a whole, the terms of the typical on-court endorsement contract support the conclusion that it is a contract for services, and the amount of the retainer fee that the sponsor pays for the right to use the player's name and likeness is *de minimis*. The retainer fee is exclusively tied to the player's ability to compete in sporting activities. No portion of the retainer fee is allocated to promotional activities using the player's name and likeness. Thus, while such use is not precluded, it is not anticipated.

The performance of the parties supports this conclusion. The golf or tennis player under contract must compete to earn the retainer fee. Conversely, the retainer fee is not related to whether the sponsor uses the name and likeness of a player in connection with print or media advertising. The inference to be drawn from this is that the player's value to the sponsor is as a walking billboard, and that the sponsor relies on the broadcast of the live event in conjunction with the publicity the event generates (before, during, and after it takes place) to promote the sale of its products.<sup>31</sup>

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<sup>31</sup> Support for this argument may be found in the business and methodology of endorsement valuation. Sponsorship Research International ("SRI") analyzed the final round of The Masters, particularly the amount of exposure the Nike ball played by Tiger Woods received due to his chip-in on the 16th hole. According to SRI, the live camera shot of the Nike ball nearing the cup and sitting on the edge resulted in four seconds of "clear exposure" for Nike. There was another six seconds in a close-up shot before the ball was struck, and five replays of the chip-in. This resulted in \$233,333 worth of gross advertising value, based on the \$250,000 spot rate for the CBS broadcast. SRI estimated that five to seven times more value was achieved from subsequent replays of the chip-in on local news and highlight shows, as well as print and internet viewing of the shot. Thomas Bonk, *Chip for the Ages*, L.A. TIMES, Apr. 5, 2006, at D1.

In 2008, Nike again scored big at both Wimbledon and The Masters. At Wimbledon, Roger Federer and Rafael Nadal, the men's finalists, both wore Nike during the longest final in Wimbledon history. Federer wore seven gold swooshes (one on his shirt, one on his bandana, one on his wristband, and one on each of his socks and shoes) and Nadal wore eleven black swooshes (one on his shirt, one on his bandana, one on each of his wristbands, one on his shorts, one on each of his socks, and two on each of his shoes). Between the two players, Nike's logo was featured for 35 minutes and 23 seconds, equaling \$10,615,000 worth of equivalent advertising time, according to Eric Wright of sponsorship evaluation firm Joyce Julius & Associates. That does not include the exposure Nike received from replays on other networks and print coverage. Darren Rovell, *Nike Scores Big "Ad In" At Wimbledon*, CNBC, Jul. 8, 2008, <http://www.cnbc.com/id/25589218>.

At the 2008 Masters, the top three finishers—Stewart Clink, Tiger Woods, and Trevor Immelman—all wore Nike for a combined exposure of approximately one-fifth of the entire broadcast, the in-broadcast

Some player's have asserted that a significant portion, if not all, of the retainer fee they earn is a payment for the use of their name and likeness rights because the amount of the fee is based on the player's established celebrity status or "star quality." This argument is without merit. Although it is true that the retainer fee (and bonuses) paid to a very popular and successful player will exceed those paid to a lesser known player, this does not negate the fact that an on-court endorsement contract is fundamentally a contract for services. The amount of compensation that unrelated parties will pay for personal services takes into account the qualities of the individual providing the services, including that individual's reputation and name recognition. Accordingly, a retainer fee paid pursuant to the typical on-court endorsement contract should be treated solely as a payment for services. Celebrity or "star quality" does not form the basis for allocating the retainer fee between services and royalty income.

## *2. Treatment of retainer fees under treaties*

Assuming an on-court endorsement contract is treated as a contract for services, in the case of an athlete who is a resident of a country that has entered into an income tax treaty with the United States, it will be necessary to determine which treaty article governs the taxation of those services: Article 7 (Business Profits) or Article 16 (Entertainers and Sportsmen). While there have been a number of iterations of the standard for determining when endorsement income falls within Article 16, they are all relatively consistent with one another. The OECD A&E report considers endorsement income to fall within the scope of Article 17 if the income is "connected with the actual activity of the artiste and athlete in the country concerned. . . . [A]dvertising or sponsorship income paid especially in connection with a performance (whether before or after the event) would fall under Article 17." Paragraph 9 of the OECD Commentary to Article 17 observes that "[i]n general advertising and sponsorship fees will fall outside the scope of Article 12. Article 17 will apply to advertising or sponsorship income, etc. which is related directly or indirectly to performances or appearances in a given State." According to the TE to the 2006 U.S. Model, to determine whether income falls under Article 16 or another article, "the controlling factor will be whether the income in question is predominantly attributable to the performance itself or to other activities or property rights."

Given the nature of the services required of a golf or tennis player under a typical on-court endorsement contract in exchange for a retainer fee, the requisite connection or relationship generally always exists between retainer fees and the player's performance as such. Retainer fees are paid to players for wearing the sponsor's clothing and using the sponsor's equipment in a tournament, making promotional appearances on behalf of the sponsor immediately before or after the conclusion of a tournament, and participating in photo and filming days that coincide with the player's tournament schedule. Where an on-court endorsement contract requires a golf or tennis player to

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exposure value of which was nearly \$25 million, according to Joyce Julius & Associates. *Nike Earns \$14.7M Worth of Exposure From Masters Final Round*, STREET & SMITH'S SPORTS BUSINESS DAILY, Apr. 18, 2008, <http://www.sportsbusinessdaily.com/article/120149>.

visit the executive offices of the sponsor to address a shareholders meeting, or to participate in some other promotional activity not connected with an athletic event, the portion of the retainer fee that is allocable to such appearances could be covered by Article 7 of the 2006 U.S. Model. Often, however, under the typical on-court endorsement contract any amounts attributable to such services would be *de minimis*.

If a player establishes that he or she was paid more than a *de minimis* amount for the use of his or her name and likeness rights as part of a print or media advertising campaign that is not directly or indirectly related to a sports event, or for the use of his or her name on a line of clothing or equipment, that income would generally be business profits governed by Article 7 of the 2006 U.S. Model. Income covered by Article 7 is not taxed in the United States unless the golf or tennis player has a fixed place of business in the United States through which he or she carried on the business of generating endorsement income.

Notwithstanding the foregoing, some golf and tennis players claim that their retainer fees (or even the entire amount of compensation under their on-court endorsement contracts, including ranking and placement bonuses) should be characterized 50 percent as royalties and 50 percent as services, or even exclusively as royalties, on the theory that the services required of them are *de minimis* compared to the value of their name and likeness rights in promoting the sponsor's products. In support of a formulary split they rely, erroneously, on the Kramer case, which is factually distinguishable from the case presented under a typical on-court endorsement contract.<sup>32</sup> Kramer did not involve an income tax treaty or an on-court endorsement contract. Kramer did not compete during the years at issue in the case; he was retired. Finally, Kramer was paid

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<sup>32</sup> Players generally acknowledge that the 70%/30% split in the Kramer case is not appropriate if they are still actively participating in their sport, as opposed to having retired from play. Accordingly, many taxpayers erroneously refer to an example in CCA 199938031 to support a 50%/50% split. In the example, a tennis player allocates income from a hypothetical endorsement contract equally between royalties and income from the performance of services. The CCA states:

The Service agrees with the classification of the activities. However, the Service may consider comparable third party contracts or other relevant valuation evidence for each of the activities to determine whether the amount allocated to each was appropriate.

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*In this regard, it is important to note that a formulary approach should not be used. . . . [T]he allocation of income among treaty classifications depends on the mixture of activities performed and upon the percentage of the whole amount that would have been paid, at arm's length, for each of the activities. The percentage of the income attributable to each activity will vary depending on the facts of the case. Therefore, no bright line tests should be applied.*

(Emphasis added.) As is the case with Kramer, the example in the Chief Counsel Advice involves facts distinguishable from those addressed by this general legal advice memorandum. The CCA assumed that the sponsor did, in fact, exploit the tennis player's name and likeness rights for in-store displays of its clothing and racquets, separate and apart from the tennis player's performance on court. In addition, the analysis was based on the 1996 U.S. Model, which included the phrase "other like right or property" in its definition of the term "royalties." The advice nonetheless concluded that there would never be a "bright line test" for allocating income between services and royalties.

based on a percentage of the income from the sales of the products bearing his name and signature.<sup>33</sup>

There is no support for a formulaic split of retainer fees between services and royalties under the typical on-court endorsement contract. To the contrary, the evidence demands the conclusion that a typical on-court endorsement contract gives rise exclusively to services income; if a trivial amount of income were derived from a right enumerated under Article 12 in connection with a sporting event, it would also be governed by Article 16.

### *3. Ranking and placement bonuses under the Code*

Ranking and placement bonuses are payments for personal services under the Code. An athlete earns a placement bonus under an on-court endorsement contract by winning or placing at a specific event. An athlete earns a ranking bonus by performing at a certain level at multiple events over the course of a specified ranking period.

### *4. Characterization of ranking and placement bonuses under treaties*

Ranking and placement bonuses are governed by Article 16 because they are linked to an athlete's performance as such. Neither bonus may be earned unless the athlete actually competes.

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<sup>33</sup> Kramer provides an example of a situation where an athlete's image has been exploited by a sponsor in connection with the promotion of its product. It does not, however, involve an on-court endorsement contract. Kramer was not paid a retainer fee or placement and ranking bonuses. He had retired from tennis fifteen years prior to the years at issue. He granted Wilson the exclusive rights to manufacture and sell tennis frames and equipment under his name. In exchange, he earned royalties equal to 2.5% percent of net income from sales, which the court treated as a payment "for the use of a valuable intangible asset—namely, goodwill associated with his name." Although the contract required Kramer to use the sponsor's equipment, it was first negotiated in 1947, at the beginning of his professional tennis career, and extended with substantially identical terms after his retirement in 1960. The contract stated that it was "mutually understood" that Kramer would make personal appearances for Wilson "whenever it was consistent with the interest of both parties." The court found, based on an analysis of all his activities during the years at issue, that most of Kramer's activities were, in fact, undertaken on his own behalf and not for Wilson. Thus, while Kramer asserted that the contract gave rise exclusively to "earned income" for certain federal tax purposes, the court concluded that the "royalties" were paid primarily for the exclusive right to use Kramer's name on Wilson's equipment, and allowed Kramer to treat only 30% of the payments as "earned income" for the services he rendered to Wilson promoting his signature line of goods.