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Brief Outline of U.S. Tax Considerations Relevant to Artists, Entertainers and Athletes with a Particular Emphasis on Their Personal Appearance Income

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Executive Summary

Personal appearance activities give rise to income derived from the sale of tickets, from the sale of merchandise, from the sale of advertising, from the sale of tapes, films, and/or recordings of the live performances, as well as from live TV or cable simulcast broadcasts. It is possible, although unlikely, that the artist will be entitled to receive directly box office receipts from live performances. In the ordinary case, a promoter will undertake the responsibility of providing the concert hall arena. With that responsibility usually comes the legal entitlement to box office receipts, subject, of course, to an obligation to pay for the services of the artists who appear. The appearance fee will generally be considered compensation for the artist's services. The promoter may also pay separately for various aspects of the necessary production, staging, lighting, etc., or alternatively include in the appearance fee for the artist's services a sufficient amount so that the artist is able to provide such necessary ingredients. In the latter case, the production fee forms part of the gross revenue of the artist; in the former case, the production fee may not be so considered. Whether such fee is included in the artist's gross revenue will be relevant in jurisdictions which impose tax on gross revenue.

Since a non-U.S. artist's compensation income is taxed in the U.S. on a net basis (provided the artist files a tax return[1]) whether the amount attributable to production expenses is includible in the gross revenue of the artist and thereafter deducted in arriving at the net or

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[1] See IRC sections 874(a) and 882(c)(2). For a discussion of the filing requirement prerequisite to the obtaining of deductions, see Swallows Holding Ltd. v. Commissioner, 126 T.C. No. 6 (2006). (holding Treas. Reg. §1.882-4(a)(2) to be invalid).

taxable income subject to tax, or whether such amount is not included in the gross income of the artist, should not affect the artist's ultimate tax liability. However, the issue of whether such amounts are properly considered part of the artist's gross income could be relevant to the determination of such person's U.S. federal income tax liability if the artists or companies supplying the artist's services are not U.S. persons (for example where the required U.S. tax returns are not filed prior to a deficiency notice)[2]or in determining the amount which may be subject to U.S. federal income tax withholding. The issue could also be relevant in the case of artists performing in jurisdictions which impose tax on gross revenue. In such case, whether an amount is includible in gross income could affect the amount of the ultimate tax liability.

In the U.S., the possibility that withholding of tax could be imposed on payments to companies supplying the services of artists could, and until recently usually had been, avoided simply by having non-U.S. artists employed by U.S. companies. In such circumstances, as a general matter, local promoters in the U.S. need not be concerned with withholding, since withholding is generally not required on payments to U.S. corporations that provide an appropriate certification.. Of course, the U.S. corporation employing the artist would be required to deduct and withhold U.S. tax on the U.S. portion of any salary payments made to its nonresident alien employees. Significantly, however, depending on the circumstances, it may be that a significant portion of salary paid to the artist would properly be apportioned to non-U.S. preparatory activities with the result that the artist's tax (and the related withholding obligation) would be reduced.

While there have been no recent changes in U.S. tax law or regulations interpreting such law that would require withholding of U.S. tax on payments to U.S. corporations providing the services of nonresident alien artists they employ, as will be discussed later in this paper, the U.S. Internal Revenue Service (the "Service") has adopted an approach that, as a practical matter, effectively requires the nonresident artist and a company supplying such artist's services to enter into a written agreement in which such company and the artist's employed by the company to covenant, among other things, that there will be proper withholding of tax on payments of U.S. source compensation to the nonresident artists. This relatively new requirement of the Service

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[2] Swallows Holding Ltd., supra.

appears to go well beyond the limits of what the Service may require under existing law. Nor is it clear what the Service achieves by obtaining such an agreement. Because anyone operating in this area should be aware of these developments, this paper will discuss the development.

While a non-U.S. artist's U.S. source compensation income is generally subject to U.S. tax on a net basis, the U.S. tax generally is collected in the first instance by withholding at the source.[3] Any such withholding that is imposed on the artist is credited to the non-U.S. artist's tax liability. In the event the tax withholding which has so been credited exceeds the artist's U.S. tax liability, such excess may be claimed as a refund with the filing of the required income tax returns; by contrast, if the tax withholding is less than the tax liability, the deficiency is required to be paid with the filing of the required tax return (or in certain cases earlier with the filing of estimated tax returns).

The amount of U.S. tax required to be withheld depends on whether the compensation in question is treated as income from the performance of services in a capacity other than as an employee, in which case the required withholding is made at a 30% rate applied to the gross amount of U.S. source compensation pursuant to sections 1441 or 1442.[4] However, the Service is authorized to reduce the amount otherwise required to be withheld to an amount approximating the tax that would be due on net or taxable income pursuant to what has been referred to as a "central withholding agreement." If the compensation in question is treated as employment income, generally wage withholding under Section 3402[5] would apply rather than withholding pursuant to Chapter 3,[6] such withholding is generally imposed at graduated rates which do not exceed 35%. Where the services of the nonresident alien artists are furnished by a non-U.S. company, withholding under Chapter 3 would apply at a 30% rate (or such lower rate as may be agreed pursuant to Treas. Reg. section 1.1441-4(b)(3)) on the payment to the company but only if two conditions are met: (a) the artist whose services are being furnished owns more than 25% of the shares of the company, and (b) the recipient of the services is entitled to

[3] See IRC sections 1441, 3402.

[4] Sometimes referred to herein as Chapter 3 withholding.

[5] Unless otherwise indicated, all section references are to sections of the Internal Revenue Code of 1986, as amended.

[6] Treas. Reg. §1.1441-4(b)(1).

designate by name or description the person(s) required to perform the services.[7] Where these conditions are not met, payments which are beneficially received by a non-U.S. company furnishing the services of non-U.S. persons are not subject to withholding under Chapter 3. If the services of the nonresident artist are being furnished by a U.S. company, no withholding is required on the payment to that company for the services of the artist as Chapter 3 withholding is applicable only in connection with payments to non-U.S. persons. Of course, absent any tax treaty protection (with respect to which, see infra), the company employing the artist would be required to deduct and withhold U.S. tax on the U.S. portion of any salary payments made to its nonresident employees.

Since any person making a payment upon which withholding is required under Chapter 3, or under the employment provisions, becomes liable for the tax such person has failed to withhold[8], a person making a payment to or for the services of a nonresident artist must determine whether withholding is required on such payment and, if so, whether the applicable withholding comes under the Chapter 3 regime or the employment regime.

In general, a U.S. corporation is entitled to provide a Form W-9 claiming its status as a U.S. person not subject to withholding under Chapter 3. A foreign corporation with respect to which withholding is not required in the circumstances noted above is entitled to provide a Form W-8 ECI claiming its status as a person against whom withholding is not required.

In general, a withholding agent may rely on the information contained in a certificate such as a W-9 or W8-ECI unless it has actual knowledge or reason to know that such certificate is untrue.[9] Reason to know is defined as knowledge of relevant facts or other statements in the certificate such that a reasonably prudent person in the position of the withholding agent would question the claims made.[10] At least with respect to a claim of U.S. status or reduced rate, a notification by the Service that such claim of U.S. status (or reduced rate) is incorrect constitutes actual knowledge, but only beginning 30 days after the receipt of such notice.[11]

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[7] IRC sections 1441(c) and 543(a)(7), Treas. Reg. section 1.1441-4(a)(1). Cf. U.S.-Japan tax treaty, Article 16(2).

[8] IRC sections 1461 and 6672.

[9] Treas. Reg. §1.1441-1(e)(4)(viii).

[10] Treas. Reg. §1.1441-7(b)(2).

[11] Treas. Reg. §1.1441-7(b)(1).

Thus, in the case of Section 1441, a withholding agent that has received proper certification and who is not precluded from relying thereon (i.e., has no reason to know or actual knowledge that such certification is incorrect) is not liable under Section 1461 for a failure to withhold even if it turns out such certification was not correct and withholding was required. In essence, except where the withholding agent may not rely thereon, the withholding agent may use the receipt of an appropriate certificate as a defense to the imposition of Section 1461 liability. Significantly, however, Treas. Reg. § 1.1441-7(b) provides that notification by the Service that a claim of U.S. status (or reduced rate) is incorrect constitutes actual knowledge after 30 days that a claim of U.S. status (or reduced rate) is not to be relied upon.

Consider the case of a U.S. corporation which furnishes the services of its employees to a third party and is contractually entitled to receive from the third party U.S. source compensation for such services. Further assume that one or more of the employees whose services are being furnished is (or may be) a nonresident alien. If the U.S. corporation were an agent of the employee providing the services, rather than a principal in the transaction, and such employee were a nonresident alien, the payment to the U.S. corporation would constitute the gross income of the employee subject to tax under Section 871(b) and withholding under Section 1441.[12] By contrast, if the U.S. corporation were a principal in the transaction, income to which it is entitled under its agreement with such third party would not be subject to withholding under Chapter 3. Of course, the U.S. corporation would have to withhold U.S. federal income and employment taxes on the payment of wages to its employees. That withholding is imposed under provisions other than Section 1441.[13]

In a case where a nonresident alien performs services in the U.S. as an independent contractor, payments of compensation for such services would subject the nonresident alien to tax at the regular U.S. tax rates; and the payor would be required to deduct and withhold a tax of 30% of the gross amount under Chapter 3. Treas. Reg. § 1.1441-4(b)(3) allows for a reduction of the amount of tax which is required to be withheld under Chapter 3 in such circumstance to an amount more closely approximating the nonresident alien's tax liability provided an agreement

[12] See Treas. Reg. §1.1441-1(b)(2)(ii).

[13] See, e.g., Section 3402.

(the so-called "central withholding agreement") is entered into pursuant to that section.[14] Since the procedures for entering into central withholding agreements apply exclusively in the context of reducing or eliminating the withholding otherwise required by Chapter 3, these procedures could have no application to payments by third parties to a U.S. corporation providing services of its nonresident alien employees unless the U.S. corporation were an agent of such employees.[15] Nor, generally could Chapter 3 have any application to compensation paid to employees for services in the U.S.

Faced with the dilemma that Chapter 3 does not apply to payments to U.S. corporations that are not agents and that the procedures for entering into central withholding agreements would have no application to nonresidents whose services are being furnished by U.S. companies which employ them absent an agency relationship, the Service has appeared to adopt an informal "policy" at least with respect to foreign entertainers and athletes which can be described only thusly:

1. Unless a U.S. corporation employing a nonresident alien entertainer or athlete which may be in control of such corporation agrees to enter into an agreement with the Service regarding withholding in form and substance satisfactory to the Service and provide certain information regarding its projected receipts and expenditures, the Service will (threaten to) issue a notification ostensibly pursuant to Treas. Reg. § 1.1441-7(b) to the effect that the claim of U.S. status by such corporation is to be disregarded and that a payor of U.S. source compensation to such company must deduct and withhold a tax at a 30% rate thereon or face liability under Section 1461.

2. The alleged basis for the notification is that if the U.S. corporation is providing services of one or more nonresident alien individuals who are in a position to control the company, then without regard to any other facts (and without regard to the law[16]) such company will *ipso facto* be regarded as an agent of the nonresident alien individuals whose

[14] See Rev. Proc. 89-47, 1989-2 C.B. 598.

[15] Treas. Reg. §1.1441-1(b)(2)(ii).

[16] See Sargent v. Commissioner, 929 F.2d 1252 (8th Cir. 1991), and cases cited therein; Johnson v. Commissioner, 78 T.C. 882, 890 (1982), aff'd, 734 F.2d 20 (9th Cir.), cert. denied, 469 U.S. 857 (1984); Fogelsong v. Commissioner, 621 F.2d 865 (7th Cir. 1980); Pacella v. Commissioner, 78 T.C. 604 (1982).

services are being provided.

3. The Service will not entertain or, if entertained, will generally ignore any submissions provided for the purpose of establishing in a given case that the U.S. company is the employer, rather than the agent, of its nonresident alien employees. Moreover, this is true regardless of the record of past tax compliance.

4. Almost unbelievably, the Service will not also view such a U.S. company as an agent of its employees who may be U.S. citizens or who are considered U.S. residents under Section 7701(b).

5. The Service will, however, enter into an agreement, the details of which are a matter of some negotiation, pursuant to which they will agree not to provide such a notification and further to notify any third party that withholding under Chapter 3 is not required on payments to such company.[17] Such a "clear payment notice" in effect becomes the certification upon which the third party may rely, although it is unclear that any third party would be wise to forgo receiving a Form W-9 in addition (i.e., the form of certification specified in the regulations).

6. The Service will not point to a statutory or any other basis for entering into any such agreement. Nevertheless, the Service is willing to acknowledge in writing that they have such authority although it seems clear they do not. The Service acknowledges that they deem the agreement to be necessary regardless of whether jeopardy for payment of taxes exists. Indeed, the Service has informally acknowledged that they would be hard-pressed to rely on or obtain the relief they wish under the jeopardy or termination provisions of the Code, nor apparently do they wish to be restricted to the rights given taxpayers under those provisions. Rather, they wish to rely on the in terrorem effect of the threatened notification.

7. While as noted, certain of the terms (and indeed some terms of some significance) are a matter of negotiation, certain provisions are generally included.

(a) An independent U.S. person of substance, for example, an accounting firm, must accept the responsibility to withhold taxes on the payments the company makes to its nonresident alien employees. (If pressed, it will be acknowledged that those taxes

[17] As to why such notification may be necessary, see below.

will be withheld pursuant to the provisions of Section 3402, not Section 1441.)

(b) Projections of income must be provided as well as copies of relevant agreements.

(c) Copies of all payments of taxes withheld required under the agreement must be forwarded to the Service personnel administering the program.

(d) Regardless of the contractual arrangements, payments generally must be made before the end of the calendar year in which services are performed by the employees of the U.S. company at least to the extent the U.S. company has realized net income before deducting salary to its employees.

(e) An accounting of the company's income and expense must be provided before year end.

(f) The Service may review the figures provided, generally over some short period of time, and disallow certain expenses thought to be compensatory; if the parties disagree regarding such disallowance they may negotiate in good faith to resolve the differences but ultimately the Service can require "withholding" on what they believe the amount and source of the income of the nonresident alien employee to be. The Service will not enter into an agreement unless it contains a provision to the effect that the limited review referred to above does not constitute an audit for the purposes of the second audit proscription.

Not only has the Service "quietly" adopted the above policy, it is understood that certain large purchasers of services have been told by the Service on audit that withholding on payments to U.S. companies providing services of nonresident individuals was required even where they had previously received an appropriate Form W-9, had no proscribed knowledge or reason to know and had not received the notification referred to above. One obvious in terrorem effect of these audits was to ensure that the large purchasers of services would not enter into any agreement with service providers in the future without in effect requiring the U.S. company service provider to seek a clear payment notice pursuant to an agreement with the Service along the lines described above.

If, as has been suggested above, there is no basis for entering into such an agreement, why do so? Could the Service issue a notice to disregard a Form W-9 provided by a U.S. corporation where it has no basis for reasonably believing that the U.S. corporation is to be

regarded as an agent of its nonresident alien employees? Assume for the moment (only because it is true) that the only basis the Service is willing to put forth to support its agency theory is that all personal service companies owned or controlled by nonresident aliens are as a matter of law agents for such nonresident alien individuals. Under case law, there is no basis for such a legal conclusion. Could the Service then back-track from its broad legal posturing and state that in the particular case it does not have sufficient information to rule out an agency theory? While such an argument might have some merit if the Service were to require information and none was forthcoming, it is difficult to see how there can be any justification for refusing to look at any documents or information submitted which may be relevant. Moreover, it appears that if the most the Service can say is that they do not have sufficient information to rule out an agency, that should not be enough for them to issue a notice. At best as can be understood, the Service's view appears to be that unless an agreement along the lines described above is entered into, the Service has a reasonable justification for believing a U.S. company furnishing a Form W-9 is doing so in bad faith and is an agent, but if such agreement were entered into, there is no longer such justification. Thus, the only information that will convince the Service there is no reasonable justification for issuing the notice is an executed agreement for which there is no statutory or regulatory authority.

Effectively requiring such an agreement, where none is required under the applicable regulations, and using the absence of such agreement as the only justification for a notice appears to be a violation of the regulations which provide for a certification process. Certainly, it could not be, and to the Service's credit the Service has not been willing to admit (out loud), that the Service may issue such a notice when it has no reasonable basis therefor. Thus, it would appear that the issuance of a notice without a reasonable basis therefor would be a violation of the regulations which the Service is required to follow.

Not too long ago the Supreme Court[18] reminded the Tax Court that although it had some

[18] Ballard v. Commissioner, 544 U.S. __ (2005). While Ballard directly appears to go to the issue of whether a court may, or may not, deviate from its own rules, that the Court chose to support its holding by citing to two of its prior cases in which it held that an administrative agency must follow its published rules suggests there is a common set of policy regarding violations by a Court or an agency of its own rules, and thus the lessons of Ballard should apply to administrative agencies such as the Service. Cf. U.S. v. Caceres, 400 U.S. 741 (1979). But see Treas. Reg. section 1.1.861-4(b)(2)(C)(3) (marking a place for a reservation of the application of the general time basis allocation for artists and athletes, but neither promulgating any such special exception, nor indicating the basis, if

leeway in interpreting its own rules, it was required to follow its own rules and could not unreasonably interpret them to convey that which they were not meant to convey. If, as appears, the Service's new policy is to treat U.S. corporations providing the services of certain nonresident aliens (i.e., entertainers and athletes) differently from others where there is no distinction in the law or in the regulations which would allow the Service to do so, the policy appears suspect.[19] More recently, the Tax Court reminded the Service that it could not change a long-standing judicial interpretation of existing law by issuing a new interpretation of the very same statutory provision previously interpreted by the Courts.[20]

As a practical matter, nonresident artists planning a U.S. personal appearance tour should be resigned to the fact that they will incur a U.S. tax on any net profit derived therefrom. It would ordinarily be possible to structure the arrangements in such a way that any U.S. tax imposed would be imposed on the net income of the artist so that the artist may claim a credit therefor in his country of residence. It would also seem possible to structure the arrangements with a view to minimizing U.S. tax and withholding and its attendant cash drain. Additionally, depending on the facts, it may be possible to obtain favorable allocations of salary payments with the effect of reducing the artist's ultimate U.S. tax liability. Of course, ancillary income, such as merchandising and sponsorship, also needs to be carefully considered. In some cases, for non-U.S. tax reasons, it may be better to allow such income to be taxed in the same manner as performance income. U.S. resident artists should also be resigned to the fact that they will incur a U.S. tax on any net profit derived from their non-U.S. personal appearance activities. Since in many instances, non-U.S. jurisdictions also impose tax, the tax planning for U.S. resident artists generally focuses on limiting the foreign tax to the amount that could be absorbed as a credit against U.S. taxes and to obtaining a credit for non-U.S. taxes imposed. This latter point generally requires the use of entities which for U.S. purposes are considered tax transparencies.

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any, in the governing statutory provisions for any such distinction). Whether any such reservation would, if promulgated, withstand scrutiny is another matter under Kaiser, infra note 19 and Swallows Holding Ltd., supra, is open to question.

[19] See also U.S. v. Kaiser, 363 U.S. 294 (1960), concurring opinion of J. Frankfurter (the Service cannot tax one and not tax another without some rational basis for the difference).

[20] Swallows Holding Ltd., supra.

General U.S. Tax Rules Applicable to U.S. Persons

U.S. tax jurisdiction extends to the worldwide arising income of U.S. persons. A U.S. person includes U.S. citizens (regardless of their residence), U.S. corporations, U.S. resident trusts, and aliens (i.e., non-U.S. citizens) who are considered to be resident for U.S. federal income tax purposes as well as in certain cases certain former U.S. citizens and former "green card" holders. An alien may be considered to be resident for U.S. tax purposes in one tax year[21] but not in another.[22] An alien individual is considered to be a U.S. resident for U.S. federal income tax purposes if such alien is either (a) a lawful permanent resident of the U.S. (i.e., a green card holder), (b) present in the U.S. for a period or periods which in the aggregate equal or exceed 183 days during a calendar year, or (c) although not present in the U.S. for 183 days or more during a calendar year, is present for a sufficient period over a three year period to be considered U.S. resident,[23] absent a showing that such alien has a "tax home" in another country to which such alien is more closely connected. Under the above rules, and apart from tax treaty considerations discussed briefly below, an alien may be considered to be resident in the U.S. for a year even though such person does not maintain a home in the U.S. if such alien has the requisite U.S. presence or has a green card. Similarly, an alien may maintain his home in the U.S., even if such home were his principal home, without being considered to be resident in the U.S. for a year.[24]

If an alien is considered resident in the U.S. for a tax year, and is also considered to be resident of another country with which the U.S. has a modern double tax convention, i.e., one

[21] Most individuals are considered to have a calendar tax year for U.S. tax purposes even though e.g., an individual may have a different tax year for non-U.S. tax purposes. See IRC §7701(b)(9); however, although rare, it is possible that an alien may have a tax year ending on the last day of a month other than December.

[22] If an alien is considered to be resident in the U.S. for at least three consecutive years, and again is considered U.S. resident within three years of ceasing to be so considered, certain special rules apply. IRC §7701(b)(10). Additional special rules apply to so-called long-term legal residents of the U.S. who relinquish U.S. residence. These rules are beyond the scope of this paper.

[23] Under that test, an alien is considered to be a U.S. resident if the number of days of such alien's U.S. presence during the current calendar year, when added to one-third of the number of days such alien was present in the U.S. for the immediately preceding calendar year, and one-sixth of the number of days such alien was present in the U.S. in the second preceding year equals or exceeds 183 days.

[24] To be sure, whether an alien maintains a home in the U.S. could be relevant (a) for purposes of considering the tax-home closer connection exception to residence referred to above, or (b) for purposes of determining whether a dual-resident alien would be considered a resident of a treaty country for tax treaty purposes.

containing a fiscal domicile article such as Article 4 of the U.S.-U.K. treaty, for the same period, such alien would, for tax treaty purposes, either be considered to be resident in the U.S. or the tax treaty country depending on a number of ordering rules.[25]

A U.S. person is generally subject to U.S. federal income tax on his or its worldwide income. A U.S. person operating abroad, or deriving income from outside the U.S. may also be subject to tax in the country or countries in which such person is operating or from where such person's income is derived. In the absence of rules for the avoidance of double taxation, a U.S. person could theoretically be subject to two (or possibly more) taxes on the same income, i.e., the tax imposed by the foreign jurisdiction in which such U.S. person's income is derived (referred to as the source country), and in the U.S. (the country of tax residence). Under U.S. internal law, double taxation is sought to be avoided through a foreign tax credit mechanism. Simply put, in theory, non-U.S. taxes imposed on income considered to be derived from non-U.S. sources is generally available as a credit against U.S. taxes imposed on such income. Under this system, the U.S. cedes to the source country the primary right to tax such income, retaining only the residual right to tax such income to the extent the non-U.S. taxes imposed on such income is less than the effective U.S. tax rate. Thus, in theory, if the foreign tax credit mechanism works well, U.S. persons are subject to tax at the higher of the U.S. and foreign tax rates. Unfortunately, in practice, because of the highly complex nature of the rules, in a number of instances, a U.S. person will end up, in effect, paying or at least initially bearing more than one tax on the same income.

Since under the foreign tax credit rules, foreign taxes offset U.S. taxes, the conventional wisdom is that so long as the effective foreign tax rate is no greater than the effective U.S. tax rate applied to the same base of income, U.S. tax planning should be limited to insuring that the foreign taxes that are likely to be imposed will be imposed in a form which will be creditable against U.S. taxes. At the minimum, this requires that the U.S. taxpayer be considered the technical taxpayer with respect to the imposition of the foreign tax. Thus, if an entity is to be

[25] Under the rules, generally, an alien is considered resident in the country in which he has a permanent home; if he has a permanent home; if he has a permanent home in both countries or in neither country, he is considered resident in the place where his center of interest lies; if that place cannot be determined, the place of habitual abode governs residency. If the alien has an habitual abode in both countries or in neither country, the country of nationality controls the issue of residence; and if the alien is a national of neither country, the competent authorities are

used to conduct the non-U.S. activities, and if under foreign law, such entity will suffer a foreign tax, it is essential that for U.S. purposes such foreign tax be considered to be imposed on the individual. Ordinarily, this can be accomplished through the use of an entity which is considered to be a transparency for U.S. tax purposes. Under U.S. tax law, entities which are or may be considered transparent include partnerships, limited liability companies and so-called "S corporations." Although partnerships and limited liability companies accomplish the transparency objective for U.S. tax purposes, depending on the non-U.S. jurisdiction involved, it is possible either that such companies may not insulate the principals from liabilities, or that certain technical tax questions will be raised by their use.

S corporations are much less likely to raise these collateral issues. However, with certain very limited exceptions, only individuals who are U.S. persons may be shareholders of an S corporation. Thus, in certain circumstances, the requirements for meeting an S corporation may not be met. For example, if performances are to be undertaken by a group of entertainers, only certain of whom are U.S. persons, obtaining a foreign tax credit for the U.S. resident members of the group may require that the U.S. residents be employed by a separate S corporation. If nonresident aliens are also members of the group, it may be possible to achieve the overall objective by ensuring that they receive their tour entitlement by virtue of employment relationships with the S corporation owned by the U.S. resident performers. Other possibilities abound, including the use of joint ventures (treated as partnerships for U.S. tax purposes), the members of which include an S corporation owned by U.S. resident individual performers.

Certain non-U.S. tax jurisdictions impose a gross withholding tax on the performance income of nonresident entertainers. In a number of instances the tax so imposed, when applied to the gross performance revenue, would greatly exceed the U.S. tax that would be imposed on the net or taxable income derived from such performances. Tax treaties to which the U.S. is a party generally do not prevent the imposition of such taxes.[26] Moreover, since the foreign taxes so imposed will likely exceed the U.S. tax imposed on the same income, the U.S. foreign tax credit system will not prevent the overall tax rate from exceeding the effective U.S. tax rate. Consider,

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supposed to resolve the issue.

[26] See, e.g., Article 16, U.S.-U.K. treaty.

e.g., the case of a non-U.S. tax jurisdiction which imposes a gross withholding tax of 30%. Assume that gross performance revenue in such jurisdiction is $1,000, and that production, management and booking agency expenses amount to $500, leaving a net before tax profit of $500, upon which the U.S. tax will be approximately $175. It can readily be seen that a gross withholding tax of 30% applied to the $1,000 gross performance revenue, or $300, will exceed the U.S. tax. As a result, absent special planning, the effective overall tax rate becomes 60% (i.e., $300/$500), rather than say 35% (the U.S. tax rate). Planning in this situation should be geared to keeping the non-U.S. tax to $175, all of which theoretically would be absorbed by the U.S. foreign tax credit rules. In certain jurisdictions, this may be accomplished by insulating the artist or a company supplying the artist's services from the obligation to provide production expenses, management and/or booking services, so that the artist company (or the company supplying the artist's services) is entitled to gross revenue approximating net income. In our previous illustration, $500. Where this is successful, the foreign tax of $150 (30% x $500) usually can be absorbed by the U.S. foreign tax credit. The technique may also be profitable even in cases where the foreign withholding tax applied to gross revenue would produce a lower effective rate of tax than the U.S. tax. This is because such lower effective rate of tax may be averaged with higher effective rates of foreign tax under the overall limitation contained in the U.S. foreign tax credit rules.

Of course, insulating the artist from an obligation to provide production and management types of services may be easier said than accomplished, particularly where a portion of the production expenses (e.g., start-up expenses) are incurred outside the source jurisdiction. In certain instances, non-U.S. jurisdictions will permit artists or companies employing them to reduce the base upon which the withholding tax is imposed by proving expenses, albeit with some limits. The role of the tax planner is to acquaint himself with the applicable rules so that proper expense allocations may be made in order to take advantage of legally allowable deductions.

As noted above, the primary focus for the U.S. tax planner in connection with U.S. entertainers who perform abroad should be twofold: first, the planner should seek to obtain a credit for non-U.S. taxes likely to be imposed on the entertainer's income; and second, the planner should seek to reduce by all legal means possible the amount of the non-U.S. taxes

which may be imposed. Having the non-U.S. withholding tax, which might otherwise be imposed on gross performance income, be imposed on the net profit of the entertainer, generally affords the entertainer with a level of foreign tax which on average will not exceed the U.S. tax. Notwithstanding that this may accomplish the realistic objectives, U.S. tax planners are sometimes faced with some unrealistic wish lists. Among these, planners are often confronted with the desire for U.S. entertainers to avoid, or if that is not possible, defer the U.S. tax on non-U.S. income. Since U.S. persons are subject to tax on their worldwide income, avoidance of U.S. tax with respect to the non-U.S. income of a U.S. person is generally not feasible. While, in certain limited circumstances, it may be possible for a U.S. person to defer the current inclusion of non-U.S. income, this generally cannot be accomplished through the use of controlled foreign corporations.[27] Moreover, it is not always clear that deferral will produce a better overall tax result. For example, deferred income may be subject to a higher rate of tax upon receipt if U.S. tax rates increase. Furthermore, even if tax rates remain constant, a higher effective tax rate may obtain if by virtue of using a structure which achieves a deferral, the U.S. person loses the ability to obtain a foreign tax credit. While the latter point is generally not very significant with respect to non-U.S. income which is unlikely to suffer significant non-U.S. taxes (e.g., royalty income), the performance income of entertainers will generally be subject to a significant rate of source country tax or withholding. Of course, a suitably structured deferral will achieve very significant U.S. tax savings for the income recipient if the income deferred is considered to be from non-U.S. sources, and if the U.S. person will change his status to a non-U.S. person prior to receipt (actual or constructive) of the deferred income.[28]

General U.S. Tax Considerations Relevant to Non-U.S. Persons

Unlike the case of U.S. persons, non-U.S. persons (including aliens who are not considered to be U.S. resident, or nonresident aliens, and foreign corporations) are subject to only limited U.S. tax jurisdiction. A nonresident alien and a foreign corporation is, apart from tax treaty considerations, subject to U.S. federal income tax on income which is effectively

[27] I.R.C. §951 et seq.

[28] Cf. I.R.C. §§7701(b)(10); 877.

connected with the conduct of a U.S. trade or business at the regular rates applicable to U.S. persons, with such rates applied to a base computed after the deduction of allowable expenses.[29] Foreign corporations may also be subject to a branch profits tax at a 30% rate applied generally to the after-tax U.S. business income of the foreign corporation. In addition, a non-U.S. person is subject to U.S. federal income tax at a flat 30% rate (or lower rate applicable under a treaty) applied to the gross amount of U.S. source gross income of a fixed or determinable nature which is not effectively connected with the conduct of a U.S. trade or business.

Income of a non-U.S. person may be considered to be effectively connected with the conduct of a U.S. trade or business if the non-U.S. person is or was considered to be engaged in a U.S. trade or business (including, with one limited exception of little application, the performance of services in the U.S. at anytime during the year) for the year in which the income was earned. U.S. source compensation and U.S. source gain other than capital gain of a non-U.S. person is always considered to be effectively-connected income. By contrast, foreign source compensation of a non-U.S. person cannot be considered to be effectively connected. Moreover, since such income is not U.S. source income, a non-U.S. person is not subject to U.S. tax thereon. Other forms of income, for example, royalties, may or may not be considered to be effectively-connected income depending on a number of factors, including the source of such income, whether the taxpayer maintains an office in the U.S. and whether such income is derived from assets used in a U.S. trade or business.

Tax treaties to which the U.S. is a party modify some, but not all, of the above rules. For example, in general, the U.S. business income of a non-U.S. person entitled to the benefits of a treaty generally will not be subject to U.S. income tax unless the non-U.S. person has a permanent establishment in the U.S. to which such income is attributable. Royalties beneficially received by a resident of a treaty country will generally be subject to a reduced rate of or exemption from, tax. Finally, compensation received by a resident of a treaty country from the performance of services for or on behalf of a non-U.S. corporation will, subject to an important exception discussed below, be exempt from U.S. tax if the treaty resident has not been in the U.S. for a period or periods which aggregate to or equal or exceed 183 days.

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[29] However, for a non-U.S. person to obtain the benefit of otherwise allowable deductions, such person must file a tax return.

The latter exception, commonly referred to as commercial travelers exemption, does not, however, generally apply to the income of an entertainer or artist from his professional activities as such.[30] Income which does not accrue for the benefit of an entertainer may, nevertheless, be subject to tax. See U.S.-U.K. treaty, Article 16(2).

The latter provisions, referred to as the artist clause, appear in virtually all modern U.S. treaties. Given, however, that most modern treaties have a much more detailed limitation on benefits provision, it is unclear why the artist clause continues to be necessary. Nevertheless, all recent U.S. treaties contain such a clause.[31]

There are essentially two parts to the artist clause. The first deals with income of the artist from his personal activities as such. Thus, the clause has no application to so-called behind the scene participants, such as directors, producers, and cameramen. Less clear is whether the provision is intended to cover all income of an artist, or whether the provision is intended to apply only to personal appearance income. For example, the artist clause is not intended to cover royalties within its sweep.[32] Whether income generated by the activities of an artist is properly considered to give rise to royalties, service income or gain from the disposition of an asset, may not be entirely clear. In circumstances where an artist's recording income is considered to be personal service income, rather than royalties,[33] and such income is generated from U.S. recording services, an issue (not yet resolved) arises as to whether such income falls within the sweep of the artist clause. Nor is it clear whether the issue would be resolved differently in the case of income in respect of live recordings.

Whether income is properly characterized as a royalty or as compensation has ramifications beyond the treaty context. Indeed, different source rules obtain. Compensation is deemed to be sourced at the place where the activities were performed which gave rise to the payment of compensation. Where activities are performed both within and without the U.S., an allocation would be required to determine the amount of the compensation which is considered

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[30] Article 16(1), U.S.-U.K. treaty.

[31] For a more complete discussion of issues relevant to the artist clause, see Feingold, Article 17 – The Artiste Clause – Time for Reconsideration? (The Tax Club, January 20, 1999), appended hereto.

[32] OECD Commentary, Art. 17. ¶9.

[33] See Ingram vs. Bowers, 47 F.2d 925, 926 (S.D.N.Y. 1931), aff'd, 3 U.S.T.C. ¶915 (2nd Cir. 1932); Boulez vs. Commissioner, 83 T.C. 584, 590 (1984).

to be U.S. source income.[34] Ordinarily, such an allocation may be made on the basis of time. An individual may receive non-U.S. source compensation from a U.S. corporation, and U.S. source compensation from a non-U.S. corporation. Royalties are sourced at the place of exploitation regardless of the residence of the payer.[35]

To make matters somewhat more complicated, it is not always clear whether the person or entity purporting to contract for the services of an artist or for the rights in relation to an artist will be considered to be the beneficial owner of such services or rights. Indeed, the Service may take the position that the entity providing the services or the rights is not the true taxpayer.[36] While the courts generally have upheld taxpayers in cases where the form they use is consistent with the desired result, the U.S. Tax Court has indicated its reluctance to go too far in this direction.[37]

As noted previously, the U.S. federal income tax due from a non-U.S. person may, in certain circumstances, be collected by withholding at the source. Under the governing provisions, every person (whether U.S. or non-U.S.) that has the control, receipt or custody of U.S. source fixed or determinable income of a non-U.S. person (including U.S. source corporation) must deduct and withhold tax thereon at a 30% rate, or such lower rate as may be prescribed by an applicable treaty provision. Any tax which is deducted and withheld is credited toward the tax liability of the income recipient. If the income recipient's tax liability exceeds the tax withheld, the additional tax must be paid by the income recipient, together with the filing of appropriate tax returns. If the withheld tax exceeds the income recipient's tax liability, the excess withheld tax is refundable upon a timely claim being made therefor.

A person who is required to deduct and withhold a U.S. tax (referred to as a "withholding agent"), but fails to do so, becomes liable for the tax, and possibly penalties and interest. If, however, the person who receives the income upon which there should have been withholding ultimately pays the tax due, the withholding agent is relieved of his liability for the tax he has

[34] Treas. Reg. §1.861-4(b)(1).

[35] I.R.C. §861(a)(4); Cf. SDI Netherlands B.V. vs. CIR, 107 T.C. 161 (1996).

[36] See, e.g., Rev. Ruls. 74-330, 1974-2 C.B. 278, 74-331, 1974-2 C.B. 281. See also I.R.C. §7701(l) and Regulation §1.7701(l)-1.

[37] See Allen Leavell, 104 T.C. 140 (1995).

failed to withhold, but not for interest or penalties. Thus, a subsequent payment of the tax due by the income recipient will absolve the withholding agent from responsibility for the tax the withholding agent failed to withhold, the theory being that the U.S. does not wish to collect the tax twice. Thus, in situations where there has been a failure to withhold, a well-advised withholding agent may wish to take steps to insure that the income recipient pays the tax due.[38] It should be noted that withholding is not required with respect to income (other than personal service income)[39] that is effectively connected with the conduct of a U.S. trade or business. However, withholding is required with respect to the payment of compensation for services rendered; to the extent services are performed as an employee, wage withholding is generally required; to the extent the services are performed as an independent contractor, withholding is generally required at a 30% rate.

Subject to the provisos noted previously and the Service's recent approach in the area, although the withholding provisions are comparatively broad, withholding agents need not withhold a tax, or may withhold a tax at a reduced rate under an applicable tax treaty if they are provided with an appropriate ownership certificate, provided they have no reason to know that any statement contained in such ownership certificate is erroneous.

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[38] Although arguable (on the basis of unjust enrichment) that a withholding agent that is assessed a penalty equal to the tax for a failure to withhold, may have a claim for indemnity against the income recipient for the tax, it is by no means clear that a court in the U.S. would enforce such an implied claim. Nor is it entirely clear that a court in the U.S. would enforce an express indemnity undertaking.

[39] Including for this purpose, personal service contract income as defined in IRC §543(a)(7).