Sergio Garcia in Victory over the IRS

By Robert S. Fink and Wilda Lin

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The IRS has created an "Issue Management Team" within its International Individual Compliance Group (IIC). The purpose of this team is to scrutinize foreign athletes and entertainers to ensure that they have fully complied with their U.S. tax obligations.[1] Spanish golfer Sergio Garcia's star power and his millions of dollars of income made him a perfect target for the IIC. Mr. Garcia and the IRS recently faced off in the U.S. Tax Court. Mr. Garcia proved to have the better swing.

In 2002, Mr. Garcia entered into a seven-year sponsorship agreement with TaylorMade Golf Co. ("TaylorMade").[2] Eight years later, the IRS sent him a notice demanding an additional $1.7 million of taxes based on the income earned during the first two years of that agreement. Mr. Garcia refused to pay the $1.7 million. Instead, he challenged the IRS's determination in Tax Court. What followed was a trial that raised complex issues requiring the court to dissect the various assets embodied by the celebrity athlete, the ability of different countries to tax the income generated by those assets and the invocation of competing tax treaty provisions.

Background

Although born in Spain and a citizen of that country, Mr. Garcia was a resident of Switzerland. U.S. citizens and residents are generally subject to U.S. federal income tax on their worldwide income.[3] Non-U.S. citizens who are nonresidents are taxed only on the portion of their income comprising (1) certain U.S. source income, and (2) non-U.S. source income that is "effectively connected with the conduct of a U.S. trade or business."[4] The IRS agreed that Mr. Garcia was not a U.S. resident, and was therefore subject to U.S. tax on only a portion of his income. At issue was Mr. Garcia's U.S. source income, which could have been subject to tax by either the United States or his resident country, Switzerland.

Although two countries may have the requisite jurisdiction to tax a particular item of income, an existing tax treaty may prevent double taxation. The United States and Switzerland have such a treaty, and it played a pivotal role in this dispute.

As the Tax Court observed:

> [Mr. Garcia's] skill at golf and his dynamic character attributes have made him a fan favorite and a world-famous celebrity. Nicknamed "El Niño" in his early years as a professional, [Mr. Garcia] is notable for his charismatic and fiery personality which differentiates him from most others who play "the gentleman's game" for a living. [Mr. Garcia's] personality and his athletic image have helped to make him one of the most marketable golfers in the world, even more marketable than many of those golfers who rank ahead of him or who have won one of golf's four "Major" tournaments.[5]

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On the strength of that marketability, Mr. Garcia entered into a sponsorship agreement in 2002 with TaylorMade. The sponsorship agreement covered the seven years from 2003 through 2009. It gave TaylorMade the right to use Mr. Garcia's image, likeness, signature, voice and other features of his identity to promote its products. It also required Mr. Garcia to wear and to use golf products made exclusively by TaylorMade and its associated brands, such as Adidas and Maxfli, during professional events. Mr. Garcia had a number of other obligations under the agreement, including playing in at least 20 professional golf events each year, acting in a courteous and professional manner, completing at least 12 combined service and personal appearance days each year and using diligent efforts to be available for product testing.

TaylorMade spent several million dollars on a Maxfli advertising campaign featuring Mr. Garcia. However, by March 2003, Mr. Garcia had stopped using Maxfli golf balls and was using a competitor's golf balls in violation of his agreement with TaylorMade. To resolve that conflict, Mr. Garcia and TaylorMade amended their sponsorship agreement. The amendment reduced Mr. Garcia's base pay for 2003 from $7 million to $4 million. It similarly reduced his base pay for any later years during which Mr. Garcia used any golf balls other than Maxfli. The amendment also added a new provision dividing Mr. Garcia's pay: it stated that 85 percent of the payments represented compensation for the use of Mr. Garcia's image rights, and 15 percent was compensation for Mr. Garcia's personal services.

Several months after TaylorMade and Mr. Garcia amended their endorsement agreement, the golfer persisted in not using Maxfli golf balls. TaylorMade and Mr. Garcia then amended the sponsorship agreement again, further reducing Mr. Garcia's base pay.

Mr. Garcia had formed a Swiss entity called Long Drive Sàrl, LLC ("Long Drive") and a U.S. limited liability company called Even Par, LLC ("Even Par"). Mr. Garcia sold to Long Drive the image rights that had been licensed by TaylorMade for use in the United States in exchange for a seven-year promissory note from Long Drive to Mr. Garcia. Long Drive, in turn, assigned those image rights to Even Par in exchange for Even Par's agreement to turn over the payments from TaylorMade. As a result of this arrangement, TaylorMade issued payments under the endorsement agreement to Mr. Garcia's representative IMG, which took a portion of each payment as its own compensation. It then paid 85 percent of the remaining amount, which was earned on Mr. Garcia's U.S. image rights,[6] to Even Par. Even Par then paid that amount to Long Drive. Long Drive used those funds to pay down the promissory note to Mr. Garcia. IMG paid the 15 percent representing personal service income worldwide directly to Mr. Garcia.

Mr. Garcia filed U.S. income tax returns each year reflecting this arrangement and reported the TaylorMade payments that represented U.S. source personal service income. The IRS responded with a notice of deficiency on March 17, 2010, demanding an additional $1.7 million for the tax years 2003 and 2004. Mr. Garcia returned the favor by suing the IRS in the U.S. Tax Court. The case involved three issues: (1) the allocation of TaylorMade's payments between royalties and personal service income; (2) the role of Long Drive and which treaty provision should apply to the income it received; and (3) the portion of Mr. Garcia's U.S. source personal service income that was taxable in the United States.

Allocation of Income

The court first addressed the allocation of TaylorMade's payments between (1) royalties, *i.e.,* compensation for the use of Mr. Garcia's name and image, and (2) compensation for personal services. As described above, Mr. Garcia's royalty payments were made to Even Par, which in turn were paid to Long Drive. Long Drive qualified as a Swiss resident under the income tax treaty between the United States and Switzerland (the "U.S.-Swiss Tax Treaty"). Under that treaty, royalty income received by a Swiss resident is taxable only in Switzerland, unlike personal service income received by a Swiss resident, which depending on the facts, could be taxed in the United States. This distinction was important because the Swiss taxing authorities had agreed to tax Long Drive at a rate that was lower than the applicable one in the United States. Thus, payments characterized as royalty income would be subject to the lower Swiss tax rate, while personal service income would be subject to the higher U.S. tax rate.

The IRS argued that none of the income should be treated as royalties. In its view, all of the income was personal service income taxable in the United States. Mr. Garcia contended that the 85 percent royalties/15 percent personal service allocation set forth in the agreement should be respected; after all, that allocation represented an arm's-length negotiation between two unrelated parties with conflicting tax interests. He claimed that he had wanted more of the income to represent royalties, whereas TaylorMade wanted more of the income to represent personal service income. However, at trial, TaylorMade's CEO contradicted that claim by testifying that the allocation between royalties and personal service income was irrelevant to him. TaylorMade's outside counsel further contradicted that claim by testifying that Mr. Garcia's legal team had led the charge on the allocation, while TaylorMade had little input on the issue. Moreover, after reviewing the facts, the court concluded that the economic reality of the endorsement agreement did not support an 85 percent/15 percent split. Rejecting Mr. Garcia's argument that it should accept the allocation at face value, the court endeavored to determine what portion of the payments represented royalties and what portion represented personal service income.

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Untangling royalty income from personal service income is a thorny task. When Mr. Garcia swung a TaylorMade golf club, was he paid for actually swinging the club (personal service income) or for the image of him swinging the club (royalty income)? The Tax Court, in another case, had previously stated that:

> The characterization of … [a taxpayer's] endorsement fees and bonuses depends on whether the sponsors primarily paid for … [the taxpayer's] services, for the use of … [the taxpayer's] name and likeness, or both. We must divine the intent of the sponsors and of … [the taxpayer] from the entire record, including the terms of the specific endorsement agreement.[7]

Witnesses testified as to the importance of both Mr. Garcia's image rights and his personal services. TaylorMade's chief marketing director testified that Mr. Garcia "wears and plays our products, and then we tell the story about all the equipment he has in play. So if you pull one of those pieces out, like the house of cards kind of falls [*sic*]."[8] In order to tease apart the relative values of Mr. Garcia's actions and images, the court compared Mr. Garcia's TaylorMade arrangement with that of his fellow golfer Retief Goosen from South Africa. Only two years earlier, the Tax Court had decided in *Goosen*[9] that payments under Mr. Goosen's endorsement agreement with TaylorMade were appropriately split 50 percent/50 percent between royalties and personal service income. That allocation was based in part on a comparison of Mr. Goosen's contract to Mr. Garcia's, an approach that the court revisited in order to tackle the job at hand.

A comparison of the two contracts led the court to conclude that TaylorMade considered Mr. Garcia's image rights more valuable than Mr. Goosen's, despite Mr. Goosen's more successful golfing career. Mr. Goosen had a nonexclusive contract with TaylorMade that allowed him to enter into endorsements with other companies; he was merely one of many TaylorMade brand ambassadors. Mr. Garcia's contract, on the other hand, required him to don only TaylorMade and associated brand products from head to toe, and to play golf with only TaylorMade golf equipment. The importance of Mr. Garcia's use of TaylorMade products while playing was bolstered by witness testimony. Photos of Mr. Garcia using TaylorMade products in professional events appeared in ads, and Mr. Garcia's base pay was cut significantly when he refused to use TaylorMade's Maxfli golf balls. The court noted that:

> At the time the endorsement agreement was signed TaylorMade had endorsement and/or use agreements with nearly 200 professional golfers, but [Mr. Garcia] was the only one who held the Global Icon title …. As its only Global Icon, [Mr. Garcia] was the centerpiece of TaylorMade's marketing efforts; he featured prominently on TaylorMade's worldwide Web site, in TaylorMade's TV and print advertisements, point-of-sale materials (such as racks holding golf clubs and balls at sporting goods stores), and other forms of advertising.[10]

These factors led the court to reiterate its prior observation that "TaylorMade valued Mr. Garcia's flash, looks and maverick personality more than … [Mr. Goosen's] cool, 'Iceman' demeanor."[11]

The court also compared the personal service requirements under the two golfers' contracts. TaylorMade required Mr. Goosen to play in 31 professional golf events each year using endorsement products, compared to Mr. Garcia's requirement to play in only 20 such events. Mr. Goosen was required to perform eight service and personal appearance days each year for TaylorMade and six additional days for other brands, for a total of 14 days, whereas Mr. Garcia was required to perform 12 service and personal appearance days each year. However, Mr. Goosen's agreement covered fewer TaylorMade products than Mr. Garcia's, leading the court to conclude that Mr. Goosen was required to perform more personal service days per product than Mr. Garcia. Moreover, of Mr. Garcia's 12 required days, TaylorMade used no more than 10 during each of 2003 and 2004. These factors suggested that Mr. Garcia's personal services were of lesser importance than his image. TaylorMade's CEO emphasized this point by testifying that Mr. Garcia's personal appearances were "gravy."[12] The court dismissed as negligible the additional personal service terms that Mr. Garcia was required to perform such as "playing golf 'with style and charisma,' and representing TaylorMade's values even when … 'walking down the street.'"[13]

The court found the high value attributed to Mr. Garcia's use of TaylorMade products while playing, combined with the significantly fewer golf events required of him, to be strong evidence that his endorsement agreement was weighted more heavily toward image rights rather than personal services. It concluded that the payments to Mr. Garcia represented 65 percent royalty income that was taxable in Switzerland and 35 percent personal service income that was taxable in the United States. This holding fell short of Mr. Garcia's proposed 85 percent royalty/15 percent personal service income allocation, but was much more favorable than the IRS's proposed zero percent royalty/100 percent personal service income allocation. Victory: Sergio Garcia.

U.S.-Swiss Tax Treaty Provisions

Next, the IRS argued that the role of Long Drive should be ignored altogether and that Mr. Garcia should be taxed directly on its income under the U.S.-Swiss Tax Treaty provision titled "Artistes and Sportsmen." Taxation under this provision would mean that the income sent to Long Drive would be taxable in the United States at the higher rate. Mr. Garcia contended that the monies paid to Long Drive were royalty income taxable under the treaty provision titled "Royalties." Taxation under that provision would mean that the income would be taxable only in Switzerland at the lower rate.

To resolve this issue, the court sought clarification from the Department of Treasury's Technical Explanation of the U.S.-Swiss Tax Treaty. The Technical Explanation stated:

> In determining whether income falls under [Artistes and Sportsmen] or another article, the controlling factor will be whether the income in question is predominantly attributable to the performance itself or other activities or property rights.

By way of example, it stated that income from the sales of an entertainer's live recordings in his nonresident country would be exempt from taxation there under the Royalties provision, even though payment for the live performance itself could be taxable there under the Artistes and Sportsmen provision.

Based on the Technical Explanation's distinction between income from the sales of recordings and income from the actual performance that generated the recordings, the court held that Mr. Garcia's image rights constituted intangible property separate and apart from his golfing performance and other personal services and, therefore, that the income attributable to his image rights fell within the purview of the Royalties provision and was taxable only in Switzerland. Having reached this conclusion, the court held that it was irrelevant whether the payments were treated as made to Long Drive or directly to Mr. Garcia. Either way, it constituted royalty income of a Swiss resident and therefore not taxable in the United States. Victory: Sergio Garcia.

Personal Service Income

Finally, Mr. Garcia attempted to exclude part of his U.S. source personal service income from taxation in the United States. He argued that only the payments for wearing TaylorMade products while golfing in the United States should be taxable in the United States and that payments for other personal services should be taxable in Switzerland under the U.S.-Swiss Tax Treaty. However, Mr. Garcia's legal team had failed to raise this issue until the post-trial briefing. Moreover, on several occasions before and during the trial, Mr. Garcia's lawyers had conceded that all of his U.S. source personal service income was taxable in the United States. The court held that Mr. Garcia had raised the issue too late, and that all of his U.S. source personal service income was taxable in the United States, as originally reported on his tax returns. Victory: IRS.

Conclusion

While the Tax Court ruled against Sergio Garcia on some issues, Mr. Garcia was the tournament winner against the IRS. The IRS had sought to tax 100 percent of Mr. Garcia's TaylorMade endorsement income. The Tax Court, however, held that the IRS could only tax 35 percent of that income. Of that 35 percent, 15 percent had already been reported and taxed in the United States as personal service income, which left only 20 percent remaining. That 20 percent had already been reported and taxed in Switzerland, for which Mr. Garcia would receive a foreign tax credit against any U.S. taxes owed. Ultimately, Mr. Garcia owed only the difference between the U.S. tax rate and the Swiss tax rate on that remaining 20 percent of his income, with the addition of interest and penalties. While his tax liability has not been made public, it will be a very far cry from the IRS's demand of $1.7 million.

Endnotes

1 IRS Focus on Foreign Athletes and Entertainers, Aug. 3, 2012, available online at *www.irs.gov/Individuals/International-Taxpayers/IRS-Focus-on-Foreign-Athletes-and-Entertainers.*

2 *S. Garcia*, 140 TC No. 6, Dec. 59,484 (2013).

3 Reg. §§1.1-1(b), 1.1-1(a)(1), 1.871-1(a).

4 Reg. §1.871-1(a).

5 *Garcia*, *supra* note 2, 140 TC No. 6, at 4–5.

6 TaylorMade also paid Even Par for use of Mr. Garcia's image rights used outside the United States, which Even Par paid to a Netherlands company owned by Mr. Garcia. The IRS agreed that payments for Mr. Garcia's non-U.S. image rights were not taxable in the United States, and these payments were not further addressed by the court.

7 *Garcia*, *supra* note 2, 140 TC No. 6, at 20, citing *R. Goosen*, 136 TC 547, at 560, Dec. 58,655 (2011).

8 *Garcia*, *supra* note 2, 140 TC No. 6, at 21.

9 *Goosen, supra* note 7.

10 *Garcia*, *supra* note 2, 140 TC No. 6, at 6–8.

11 *Garcia*, *supra* note 2, 140 TC No. 6, at 24, citing *Goosen*, *supra* note 7, 136 TC 547, at 561–62.

12 *Garcia*, *supra* note 2, 140 TC No. 6, at 26.

13 *Garcia*, *supra* note 2, 140 TC No. 6, at 28.