What Non-U.S. Athletes, Entertainers, and Agents Need to Know About U.S. Taxes and How to Reduce Them

By Robert S. Fink and Wilda Lin

Introduction

Boxing fans who were looking forward to Manny Pacquaio's fifth fight against Juan Manuel Marquez did not see it live in Las Vegas. The reason? Taxes. The Filipino boxer-actor-singer-politician reportedly refused to submit to recent U.S. federal income tax increases, which would drain millions of dollars from his take-home pay.[1] He may have also been aware that foreign athletes and entertainers performing in the United States receive a great deal of attention from a most unwanted source: the Internal Revenue Service (IRS). Unfortunately for these individuals, the IRS has created an Issue Management Team that is "focused on improving U.S. income reporting and tax payment compliance by foreign athletes and entertainers who work in the United States."[2]

From tax enforcement perspective, having a foreign nationality and a career in sports and/or entertainment are a toxic combination. As an initial matter, foreigners of any profession often do not know what their tax obligations are or how to fulfill them. To make matters worse, athletes and artists frequently travel among various countries (i.e., tax jurisdictions) to participate in tours and competitions, thereby raising questions regarding residence for tax purposes. Some command very high salaries, royalties, or other payments while incurring significant business expenses; this financial situation may arouse suspicion of inappropriate deductions resulting in allegedly understated taxable income and lost tax revenue. Finally, celebrity athletes and entertainers of any nationality capture media attention, making them particularly attractive targets when the IRS decides to send the public a message of deterrence. Few have forgotten Wesley Snipes, who was in prison for failure to file tax returns until his release in April.[3] Brazilian race car driver Hélio Castroneves, along with his business manager and tax attorney, managed to avoid prison but endured a federal grand jury investigation, an indictment for tax evasion and conspiracy to defraud the government, and a lengthy trial before being acquitted by a jury.[4] Famed Mexican boxer Julio César Chavez, while not charged with any tax crime, reportedly underwent an IRS audit that resulted in a tax deficiency and tax lien of over $12 million.[5] More recently, in March 2013, the U.S. Tax Court found Spanish golfer Sergio "El Niño" Garcia liable for additional taxes on his royalty income for 2003 and 2004—although not the $1.7 million alleged by the IRS.[6]

U.S. tax laws are notoriously complex and riddled with traps for the unwary. The IRS's heightened scrutiny of foreign athletes and entertainers should propel these individuals to enlist a guide to navigate tax issues when contemplating any performance in, or transaction relating to, the United States. Skilled U.S. tax counsel can help foreign taxpayers not only stay out of trouble with the IRS but also save money by engaging in tax-efficient planning. The unhappy foreign taxpayer who forgoes proper tax planning only to receive a letter or visit from the IRS should immediately retain tax counsel—before any further communication with the IRS—to represent him or her in the course of any examination or other inquiry.

Tax Residence

Complying with the law first requires knowing which set of rules applies to the situation. For individuals, there are two basic tax[7] regimes: one for U.S. citizens and residents, and one for everyone else (known in tax parlance as nonresident aliens, or nonresidents). U.S. citizens and residents are generally subject to tax on their worldwide income.[8] Nonresidents, on the other hand, are subject to tax only on certain income from U.S. sources, as well as on income from non-U.S. sources that are "effectively connected with the conduct of a U.S. trade or business."[9] Thus, the first step in identifying anyone's tax obligations is to determine his or her tax residence.

Tax residence is a tricky business. The IRS may consider someone a resident of the United States for tax purposes regardless of where he or she calls home. To complicate matters further, U.S. residence as determined under tax law bears some relation to, but differs from, U.S. residence as determined under immigration law.

The Internal Revenue Code[10] and Treasury Regulations define a United States person for U.S. federal income tax purposes (a U.S. tax resident) as a citizen or resident of the United States.[11] U.S. citizens, therefore, are U.S. tax residents no matter where they live and without need for further inquiry. This leaves the murkier question of what constitutes a "resident of the United States." A non-U.S. citizen will be treated as a "resident of the United States"—and therefore a U.S. tax resident—if he or she satisfies any one of the following three tests:

1. He or she is a lawful permanent resident of the United States (i.e., holds a "green card") at any time during the calendar year.[12]
2. He or she is "substantially present" in the United States, meaning physical presence in the United States for at least 31 days during the current year and at least 183 days for the current and past two years combined, with each day of presence during the current year counting as one day, each day

of presence during the preceding year counting as 1/3 day, and each day of presence during the second preceding year counting as 1/6 day.[13]

3. He or she elects to be treated as a U.S. resident for the calendar year.[14]

A number of exceptions apply. For example, a green card holder would normally be treated as a U.S. tax resident. However, in some cases, an individual may be a "resident" of both the United States and his or her home country according to the internal tax laws of each country. In those instances, the tax treaty between the two countries (assuming one exists) provides a cascading set of tiebreaker rules to determine his or her residence for purposes of the treaty.[15] If the green card holder were determined to be a tax resident of his or her home country under the relevant treaty, that individual could avoid treatment as a U.S. tax resident by making an election and filing the relevant tax form and tax return each year.[16] Under another exception, an individual who is substantially present in the United States would normally be treated as a U.S. tax resident; however, he or she could avoid being so treated if he or she were present in the United States for no more than half of the current year and filed the proper form establishing a closer connection[17] to his or her home country.[18] Finally, some individuals, including certain teachers, students, and professional athletes who file the proper forms,[19] may exclude days that would otherwise count towards "substantial presence" in the United States.[20]

The case of the green card holder above illustrates how the existence of a tax treaty can affect one's tax residence. Tax treaty analysis is an important component of tax planning because treaties may provide relief where an individual would be taxed twice on the same income by both the United States and another country. Furthermore, some tax treaties provide that certain athletes and entertainers are exempt altogether from U.S. tax if their incomes from performing in the United States remain below a threshold amount.[21] In order to determine whether an individual may invoke treaty benefits, one must first determine the individual's country of residence as defined by the terms of the applicable treaty. Again, where an individual is a resident of two countries according to their internal tax laws, the relevant treaty's tiebreaker rules will determine his or her residence for purposes of that treaty.[22]

Source of Income and Expenses

As described above, U.S. tax residents are subject to tax on their worldwide income, while nonresidents are subject to tax only on U.S. source income and non-U.S. source income effectively connected with the conduct of a U.S. trade or business. Therefore, a foreign athlete or entertainer who is a nonresident must determine the sources of his or her income and expenses. The source of income depends on the type of income received. For example, compensation for personal services is sourced to where the services were performed;[23] if the services were performed in more than one country, the compensation is allocated to the countries on a time spent basis.[24] Royalties are sourced to where the property or right is used.[25] Interest income is sourced according to the residence of the payor;[26] similarly, dividends are sourced by the residence of the payor corporation.[27] Income from the sale of real property is based on where the property is located,[28] whereas income from the sale of personal property is generally based on the residence of the seller.[29]

Expenses are allocated to the appropriate class of income as described above. They are then apportioned between U.S. source and non-U.S. source based on any reasonable method, such as gross sales, gross income, or units sold.[30] These methods can produce vastly different tax results, and U.S. tax counsel should analyze a foreign taxpayer's specific situation to determine which would be most favorable.

Payment and Withholding

U.S. tax residents generally pay tax through a combination of withholding at the source and direct payment to the IRS. The ability to pay any additional tax due when filing tax returns reflects the assumption that U.S. tax residents who presumably live, work, and have family and friends in the United States are less likely to run afoul of their payment obligations than are nonresidents. The IRS loses much of its ability to enforce tax payment in the case of nonresidents who may have long left the U.S. by tax season. The United States has addressed this concern by passing collection responsibility onto the U.S. taxpayers who pay the nonresidents.

Payment of a nonresident's tax is generally achieved through withholding. In most cases, any U.S. taxpayer who pays U.S. source income to a nonresident must deduct and withhold 30% of such payment, and then turn over the withheld amount to the government.[31] The U.S. payor may forgo or reduce this withholding obligation if the nonresident payee is a resident of a country that has a tax treaty with the United States, the treaty provides for reduced withholding, and the payor receives certain forms from the nonresident payee entitling him or her to such reduced (or eliminated) withholding.[32]

"Central withholding agreements"[33] (CWAs) can make tax payment obligations of foreign athletes and entertainers more streamlined and efficient. This procedure creates a single withholding agent for multiple U.S. source payments, and allows for a reduced amount of withholding. As described earlier, nonresidents are subject to tax on U.S. source income, as well as non-U.S. source income that is effectively connected with the conduct of a U.S. trade or business, which may include the performance of personal services, within the United

States.[34] Generally, certain types of U.S. source income, such as interest, dividends, rents, salaries, wages, and compensation, are taxed at a flat 30% rate of gross income, unless reduced by an applicable tax treaty, with no deductions allowed.[35] In contrast, income that is effectively connected with the conduct of a trade or business in the United States is subject on a net basis[36] to the same graduated rates that are applicable to U.S. taxpayers.[37] This difference can significantly alter the amount of net income that a foreign athlete or entertainer receives upon payment.

In general, each payor of U.S. source income must withhold 30% of the gross payment to a nonresident for personal services, and the nonresident is subject to a flat 30% tax rate on gross income. Based on this rule, a foreign athlete receiving $1 million a year for the performance of services in the United States would have $300,000 of that amount withheld and paid over to the IRS by the withholding agent in satisfaction of the flat 30% tax rate, and would receive the remaining $700,000 from the various payors. He or she might have spent $500,000 on lodging, transportation, equipment, professional services, and other expenses. The 30% tax rate that was withheld on gross income, combined with the expenses, would leave the athlete with $200,000 ($1 million gross income – $300,000 withholding – $500,000 expenses = $200,000). However, if that athlete's services were deemed to be effectively connected with the conduct of a trade or business in the United States, that income would be subject to the top marginal rate of 39.6% on net income (i.e., deducting the $500,000 of expenses *before* applying the various marginal rates). His or her ultimate tax liability would be $161,700 thereby leaving the athlete with $339,300 rather than $200,000. In the latter instance, if there were withholding at 30% of gross income, the athlete has overpaid taxes. To recover the lost funds, he or she would need to file an IRS Form 1040NR in the following year to claim a refund of the difference.

Alternatively, the foreign athlete could arrange for a CWA before arrival in the United States. The CWA would allow the central withholding agent first to deduct estimated expenses, and then to withhold at the graduated withholding rates rather than at the 30% rate. This procedure allows the nonresident to reduce the amount of withholding on each payment so that it more closely matches his or her actual tax liability, rather than imposing the burdens of substantial over-withholding coupled with having to seek a refund in the following year.

Filing Obligations

U.S. tax residents with worldwide income[38] equal to or greater than the exemption amount must report that income on their annual tax returns.[39] Nonresidents must file tax returns if they are engaged in a trade or business within the United States at any time during the taxable year, or if they have any taxable income that was not fully satisfied through withholding.[40] As discussed previously, they also may choose to file tax returns, even if not required to do so, in order to claim refunds in the case of over-withholding. Similarly, nonresidents may voluntarily file tax returns to report tax payments in other countries, which could generate foreign tax credits and correspondingly reduce their U.S. tax liabilities.

In addition to tax returns, each "United States person" who—broadly speaking—owns or has certain types of control over bank, securities, or other financial accounts with an aggregate value of over $10,000 in one or more foreign countries, must report each foreign account each year on TD F 90-22.1, Report of Foreign Bank and Financial Accounts (the FBAR).[41] This little-known FBAR filing requirement has received significant attention in recent years, after the IRS summoned foreign banks demanding the identification of thousands of noncompliant U.S. account holders. U.S. tax residents are among those required to file FBARs.[42] Failure to do so can produce disastrous consequences, as described below.

Penalties

Improper reporting and filing can generate substantial civil and criminal penalties. Incorrect reporting of income can result in an accuracy-related civil penalty in the amount of 20% of any underpayment of tax.[43] Failure to pay U.S. federal income tax is punishable by a civil penalty of up to 25% of the tax owed.[44] Failure to file a federal income tax return is similarly punishable by a civil penalty of up to 25% of the tax owed.[45] If the failure to file an income tax return, filing a false tax return or failure to report or pay the tax due is a result of fraud (i.e., an intentional violation of a known legal duty), the penalty can rise to 75% of the tax owed.[46] Still more draconian is the civil penalty for failure to file an FBAR reporting a foreign bank account. This penalty can be as much as 50% annually of the value of the account as of June 30; in other words, a failure to file an FBAR for six years can generate a civil penalty equal to three times the value of the account.[47]

More threatening still are potential criminal penalties. For example, a willful failure to file a return or to pay the tax due is punishable by a fine of up to $100,000[48] and/or one year in prison.[49] A false or fraudulent statement made willfully on a tax return is punishable by a fine of up to $250,000 and/or three years in prison.[50] A willful failure to collect (i.e., withhold) or pay over taxes is punishable by a fine of up to $250,000 and/or five years in prison.[51] A willful attempt to evade tax is punishable by a fine of up to $250,000 and/or five years in prison.[52] Finally, willful failure to file an FBAR is punishable by a fine of up to $500,000 and/or 10 years in prison.[53]

Conclusion

It is vital for any foreign athlete or entertainer who works in or engages in any transaction relating to the United States to retain knowledgeable tax counsel. The IRS's stated focus on these individuals threatens to ensnare those attempting to navigate the intricacies of the U.S. tax laws without proper guidance. The overlap of foreign nationality, frequent travel, lucrative contracts, and fame heightens the risk of IRS inquiry. Tax-efficient planning will help foreign taxpayers steer clear of numerous pitfalls and save money that might otherwise be lost through tax overpayment, interest, and penalties. The goal is to allow the foreign athlete or entertainer, when coming to the United States, to avoid financial concerns so the individual can concentrate on his or her talent, training, and performance—the point of being here in the first place.

Endnotes

1. Martin Rogers and Kevin Iole, *Manny Pacquiao prefers to fight Juan Manuel Marquez in China because of high U.S. taxes*, Yahoo! Sports, Feb. 11, 2013 *at* http://sports.yahoo.com/news/boxing--pacquiao-prefers-to-fight-marquez-in-china-because-of-high-u-s--taxes-003802872.html; Ben Cohen, *Will Taxes Chase Pacquiao-Marquez V to Asia?*, Wall Street Journal, Jan. 18, 2013 *at* http://blogs.wsj.com/dailyfix/2013/01/18/manny-pacquiao-juan-manuel-marquez-v-will-taxes-chase-to-asia/.
2. IRS Focus on Foreign Athletes and Entertainers, Aug. 3, 2012, athttp://www.irs.gov/Individuals/International-Taxpayers/IRS-Focus-on-Foreign-Athletes-and-Entertainers.
3. United States v. Snipes, 611 F.3d 855 (11th Cir. 2010).
4. United States v. Castroneves, 08 20916 CR (S.D. Fla.) (DLG).
5. *See, e.g., Sports celebrities and their tax troubles*, AccountingWeb.com, Nov. 9, 2009, *at* http://www.accountingweb.com/topic/sports-celebrities-and-their-tax-troubles; Manny Davis, *Julio Cesar Chavez vs IRS: Chavez Owes $12.7M in Back Taxes*, BackTaxesHelp.com, Aug. 31, 2009, *at* http://www.backtaxeshelp.com/tax-blog/tax-news/julio-cesar-chavez-vs-irs-chavez-owes-12-7-million-in-back-taxes.html.
6. Garcia v. Commissioner, 140 T.C. No. 6 (2013).
7. Except where otherwise indicated, "tax" as used herein refers to U.S. federal income tax.
8. Treas. Reg. §§ 1.1-1(b), 1.1-1(a)(1); 1.871-1(a).
9. Treas. Reg. § 1.871-1(a).
10. Internal Revenue Code of 1986, as amended (the "Code").
11. Code §§ 7701(a)(30)(A), 7701(b)(1)(A).
12. Code §§ 7701(b)(1)(A)(i) and 7701(b)(6); Treas. Reg. § 301.7701(b)-1(b).
13. Code § 7701(b)(6).
14. Code §§ 7701(b)(1)(A) and7701(b)(1)(A)(iii).
15. *See, e.g.*, U.S. Model Tax Treaty Art. 4, Para. 3.
16. Code § 7701(b)(6); Treas. Reg. §§ 301.7701(b)-7(b), 301.7701(b)-7(c)(1)(i). Note that such a taxpayer may still be treated as a tax resident for purposes of the controlled foreign corporation rules and FBAR rules.
17. Treas. Reg. § 301.7701(b)-2(e).
18. Code § 7701(b)(3)(B); Treas. Reg. §§ 301.7701(b)-2(a), 301.7701(b)-8(a)(1), and 301-7701(b)-8.
19. Treas. Reg. § 301.7701(b)-3(a). Treas. Reg. §§ 301.7701(b)-8(a)(2) and 301.7701(b)-8(b)(2).
20. Code § 7701(b)(3)(D); Treas. Reg. §§ 301.7701(b)-3(a) and 301.7701(b)-3(b).
21. *See, e.g.*, U.S. Model Tax Treaty Art. 16, Para. 1.
22. *See, e.g.*, U.S. Model Tax Treaty Art. 4, Para. 3.
23. Code §§ 861(a)(3) and 862(a)(3).
24. Treas. Reg. § 1.861-4(b).
25. Code §§ 861(a)(4) and 862(a)(4).
26. Code §§ 861(a)(1) and 862(a)(1). Note that residence in the context of the sourcing rules does not have the same meaning as residence in the context of "Tax Residence." *See, e.g.*, Code § 865(g); Treas. Reg. §§ 1.861-2(a)(2) and 301.7701(b)-1(a).
27. Code §§ 861(a)(2) and 862(a)(2).
28. Code §§ 861(a)(5) and 862(a)(5).
29. Code § 865(a).
30. Code § 861(b) and 862(b).
31. Code § 1441 and 1442.
32. Treas. Reg. § 1.1441-1(b).
33. *See* http://www.irs.gov/Individuals/International-Taxpayers/Central-Withholding-Agreements and http://www.irs.gov/pub/irs-pdf/f13930.pdf for instructions on how to apply for a CWA. The application must be made at least 45 days before the nonresident alien's arrival in the United States.
34. Code § 864(b); Treas. Reg. § 1.871-1(a). Certain exceptions apply.
35. Code § 871(a)(1), Treas. Reg. § 1.871-7(b)(1). *See also* Code § 864(c)(2).
36. Code § 873.
37. Code § 871(b).
38. Treas. Reg. §§ 1.1-1(b), 1.1-1(a)(1); 1.871-1(a).
39. Code § 6012, Treas. Reg. § 1.6012-1(a)(1)(ii).
40. Treas. Reg. §§ 1.6012-1(b) and 1.6012-1(b)(2)(i).
41. 31 C.F.R. § 1010.350(a); 31 U.S.C. § 5314; 31 C.F.R. § 103.24(a); FBAR General Instructions, General Definitions, United States Person.
42. 31 C.F.R. § 1010.350(b)(2). The definition of "United States" is modified for such purposes but such modification is not relevant to the discussion set forth herein.
43. Code § 6662(a) and (b); Treas. Reg. §§ 1.6662-1, 1.6662-2(a), 1.6662-2(b).
44. Code § 6651(a)(2).
45. Code § 6651(a)(1). When the civil penalties for failure to file and failure to pay both apply, the failure to file penalty is reduced by the failure to pay penalty, resulting in a maximum combined penalty of 47.5%. Code § 6651(c)(1).
46. Code §§ 6651(f)(2), 6663(a).
47. 31 U.S.C. § 5321(a)(5)(C) and 5321(a)(5)(D).
48. The criminal fines set forth herein are those applicable to individuals only.
49. Code § 7203.
50. Code § 7206; 18 U.S.C. § 3571(b).
51. Code § 7202; 18 U.S.C. § 3571(b).
52. Code § 7201; 18 U.S.C. § 3571(b).
53. 31 U.S.C. § 5322(b).

Robert S. Fink is a Partner at Kostelanetz & Fink, LLP. He has favorably settled thousands of civil cases against government agencies, and has also convinced government agents and attorneys to civilly resolve cases that were originally thought to be criminal in nature. For more than 20 years, Mr. Fink has been an Adjunct Professor of Law at New York University Law School's Graduate Tax Program, teaching the course on Civil and Criminal Tax Penalties. In addition, Mr. Fink was a Visiting Professor of United States tax law at the University of Peking in Beijing, China, and is a nationwide lecturer via government television, teaching civil and criminal tax procedures to attorneys and agents of the Department of Justice and the Internal Revenue Service. Mr. Fink lectures frequently at tax and criminal symposia, and appears regularly as a commentator on radio, television, and in newspapers. Mr. Fink has served as Chairman of numerous committees of the American Bar Association, the NYSBA, and the New York County Lawyers' Association. Mr. Fink also has served on the Advisory Committee to the Tax Division of the United States Department of Justice and was the Co-Chairman of the IRS Northeast Regional Bar Liaison. He has testified as an expert witness on the Internal Revenue Service's investigative powers before subcommittees of both Houses of Congress and has testified before the New York State Assembly's Ways and Means Committee on tax legislation. For additional representative matters or to see a listing of Mr. Fink's published works, please visit: http://www.kflaw.com/sitecontent.cfm?pageid=9&itemid=11119.

Wilda Lin is an Associate at Kostelanetz & Fink, LLP. Her practice focuses on United States federal income tax issues. Prior to joining Kostelanetz & Fink, LLP, she was an associate at White & Case, LLP, and Stroock & Stroock & Lavan, LLP, where she developed a broad transactional tax practice that included structuring, launching, and reviewing private equity and hedge funds; negotiating credit facilities and leasing transactions; drafting documentation for debt and equity offerings; structuring mergers and acquisitions; and advising tax-exempt organizations. Her pro bono practice included obtaining tax-exempt status for nonprofit organizations and drafting VAWA petitions for immigrant victims of domestic violence. Ms. Lin received her B.A., cum laude, from Columbia University in 1999, her J.D. from Columbia Law School in 2003, and her LL.M. from New York University in 2008. She has working knowledge of both Spanish and Mandarin. For Ms. Lin's additional information, please visit: http://www.kflaw.com/sitecontent.cfm?pageid=9&itemid=11122.