Personal Service Versus Royalty Income for Athletes

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In the recent court case Sergio Garcia v. Commissioner[1], the Commissioner disputed the percentage allocation between personal service and royalty payments stated in Mr. Garcia's contract with TaylorMade. Sergio Garcia, a Swiss citizen, is a professional golfer. He had an endorsement agreement with TaylorMade, whereby he agreed to have TaylorMade use his image for advertising and marketing campaigns worldwide. He also agreed to perform personal services by playing professional golf tournaments and using TaylorMade's products. TaylorMade compensated Mr. Garcia by making payments to him with 85 percent treated as royalty payments and 15 percent to personal services as stated in their endorsement contract.

Switzerland has a tax treaty with the U.S., and in the Treaty the royalty income of Swiss residents like Mr. Garcia is not taxable in the U.S under Article 12 of the Treaty. However, in addition to disputing that the 85% and 15% allocation between royalty and personal income was unjustified, the Commissioner argued that the royalty income treatment under the U.S-Switzerland treaty was not governed under Article 12 of the Treaty. Because of the disagreement, the IRS issued a deficiency notice to Mr. Garcia for Federal income tax of $930,248 and $789,518 for tax year 2003 and 2004, respectively. To be relieved from the deficiency notice, Mr. Garcia had a burden of proof to determine that the Commissioner was incorrect in his assessment.

To determine the appropriate allocation between royalties and personal service for Mr. Garcia's endorsement compensation, the court examined the contract between Mr. Garcia and TaylorMade, testimonies from TaylorMade's CEO and other experts in the sports industry as well as considering other cases with similar fact patterns. The court also defined the royalty payments as the payment for the right to use Mr. Garcia's image, voice, and name in TaylorMade's advertising, whereas the personal service payments as the payment to Mr. Garcia for his performance for TaylorMade and using TaylorMade's products in the golf tournaments. While the court examined the facts and circumstances of Mr. Garcia's case, it focused on the real economic benefit of the TaylorMade's agreement with Mr. Garcia in regard to the 85% and 15% allocation between royalty and personal service payment.

1 Garcia v. Commissioner, 140 TC 6 (2013

The agreement between Mr. Garcia and Taylor Made was a "head to toe" deal, with Mr. Garcia serving as Taylor Made's Global Icon. His name, voice, signature, and image would globally be featured in Taylor Made's advertisements. The different allocations between the royalties and personal service payments were not important to TaylorMade per its CEO's testimony. In addition, many experts in the sport industry testified that Mr. Garcia's image rights and personal service were codependent and they were the most important aspects of Mr. Garcia's endorsement agreement. Although the court agreed with the expert's testimonies, the court was not convinced that the 50-50 allocation between the royalties and personal service would be suitable, just because they were simply important and relied on each other in the endorsement contract.

Furthermore, the court considered the case of *Goosen v. Commissioner*[2]. Retief Goosen is a professional golfer and was under contract with TaylorMade from 2002 to 2003. In his contract, Mr. Goosen allowed TaylorMade to use his image rights to advertise its products and was required to compete in the golf tournaments using TaylorMade's products. Under Mr. Goosen's agreement with TaylorMade, the court ruled that the 50-50 allocations between the royalties and personal service was appropriate. However, even though Mr. Goosen had a similar contract with Mr. Garcia, there were major distinctions between the two contracts.

These differences made the 50-50 split between royalty and personal service payments for Mr. Goosen's contract inappropriate for Mr. Garcia's contract. Mr. Goosen was not a Taylor Made Icon and did not have a "head to toe" contract with the company.

2 Goosen v. Commissioner, 136 TC 547, 599 (2011)

Mr. Goosen was granted the status of “brand ambassador”, unlike Mr. Garcia, who serves as the “Global Icon”. In addition, Mr. Goosen was required to play in less professional golf tournaments according to the Taylor Made contract, while Mr. Garcia was not. Mr. Goosen also had contract with Acushnent Co. to use its golf balls and golf gloves and Izod Club to wear certain Izod Club’s clothing line while playing golf. On the other hand, Mr. Garcia did not have contracts with other firms. TaylorMade’s marketing campaign significantly utilized Mr. Garcia’s image to establish its brands and sell its products. Evidently, TaylorMade heavily depended on Mr. Garcia’s image more, as compared with Mr. Goosen. Mr. Garcia took payment reduction when he decided not to use some of TaylorMade’s products and this caused his contact with TaylorMade to be revised many times.

The court had a very tough time determining the appropriate allocation of the royalty and personal service payments for Mr. Garcia in reference to Mr. Goosen’s contract with TaylorMade and other testimonies from many experts. However, the allocation needed to be made and the court ruled that the TaylorMade utilized and relied heavily on Mr. Garcia’s image right more than his personal service. Thus, the judge allocated 65% of the endorsement payments to royalty compensation and the remaining 35% to his personal service compensation.

The IRS believed Mr. Garcia’s royalty income was subjected to Article 17 of the Swiss Tax Treaty which states that “income derived by a resident of a Contacting State as an entertainer, such as a theatre, motion picture, radio, or television artiste, or a musician, or as a sportsman, from his personal activities as such exercised in the other Contracting State may be taxed in that other State.” However, Mr. Garcia argued that the royalty payments were governed under Article 12 which provided that royalty payments were for the use or right to use any image, work, trademark, design, or patent.

Article 17 of the Swiss Tax Treaty is for governing income generated by those in the entertainment industry. Additionally, the court felt Mr. Garcia has established his image, which was not solely attributed to his performance in U.S. as an intangible asset. Mr. Garcia has developed his image as his trademark from playing and winning professional golf tournaments in U.S. and Europe as well as his personality. The court believed that his royalty payments were for permitting TaylorMade to use his intangible asset. Thus, the court ruled that his income generated from TaylorMade using his image for marketing its products was royalty income governed under the Article 12 of Swiss Tax Treaty, and as such, Mr. Garcia was not subject to U.S. tax for his royalty income.

In this case, it is clear that the allocation stated in the contract between Mr. Garcia and TaylorMade did not have much weight under the applicable tax rules and the IRS could easily disregard what the contract said. The allocation may not be vital to TaylorMade but it has significant impact on Mr. Garcia’s tax liability in the U.S. The different allocations could mean different tax liabilities and there may be unfavorable adjustment to the endorser by the Commissioner. Furthermore, there is no safe harbor or guidance on such allocation. It depends on the economic aspect of the endorser’s image, performance, and contract term. Any allocation could be easily challenged by the IRS and the taxpayer must provide proof that the allocation is reflected the true economic benefit. It is very subjective and must be determined on a case-by-case basis. Also, as the differentiations of the allocation would only affect the endorser, it could be a significant element for the endorser to negotiate future contracts.

References : 1996 U.S.- Swiss Tax Convention http://www.irs.gov/pub/irs-trty/swiss.pdf