

By Barbara Rosenfeld

A Tax Anomaly That Penalizes Actors Working Abroad

Article 17 of the Model Tax Convention may result in double taxation

Income from services is generally taxable where they are rendered, including foreign countries. The rationale is that the compensation is drawn from the wealth of the host country, and, consequently, it is the appropriate tax locus. There are, however, a number of exceptions that are intended to encourage international commerce by focusing taxation on residence.¹

Article 15 of the Model Tax Convention of the Organization for Economic Co-Operation and Development (OECD), which is found in many treaties,² is one particular exception to the general rule of host country taxation. Transferring tax liability to the service provider's country of residence, Article 15 protects the directors, producers, and crew members who are working outside the United States from source country taxation whenever there is a limited physical connection³ in the foreign locale.⁴ In addition, Article 15 protects attorneys, accountants, and business managers who are working outside the

United States. The tests of physical connection to justify host country taxation are a "permanent establishment" or "fixed base," or a physical presence that continues for a period in excess of 183 days.⁵

Article 15, however, does not protect actors. They are subject to a provision common to most tax treaties, Article 17,⁶ which governs the tax treatment of "artistes and athletes." Article 17 shifts an actor's income tax liability from the United States to the host (or source) country, creating potentially significant tax and reporting obligations. This anomaly may create tax liabilities that tax attorneys can help their actor clients address.

The United States taxes the worldwide income of its citizens and residents⁷ and specifically requires that they report all income, wherever earned, on the U.S. income tax return.⁸ If income

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has already been taxed where it was earned, a credit can be claimed for the foreign taxes paid.⁹ While this foreign tax credit eliminates double taxation in theory, it does not necessarily eliminate double taxation in practice. The U.S. foreign tax credit may not fully offset the foreign taxes paid, and whether or not the credit eliminates double taxation, potentially complex reporting obligations remain for U.S. actors working outside the United States.¹⁰ An examination of this state of affairs

begins, however, with the treaties that make such a notable exception for actors and other performers.

Income tax treaties are bilateral agreements that create a set of adjustments and concessions between the tax laws of two countries. Each treaty is negotiated to avoid double taxation, which is generally accomplished by relieving taxpayers of liabilities they would otherwise have in the source country and enforcing them in the residence country. Model treaties serve as a starting point for each bilateral treaty negotiation, and the most commonly used of these is the Model Tax Convention of the OECD.¹¹ As noted by the Committee on Fiscal Affairs, the model was drafted to clarify, standardize, and confirm the fiscal situation of taxpayers engaged in cross-border transactions.¹² It is intended to provide a uniform basis for addressing, for the benefit of taxpayers and taxing authorities, common problems of international taxation.¹³

Model tax treaties traditionally address prevention of international double taxation, tax avoidance, and tax evasion. Additional objectives include 1) removal of the barriers to trade, capital flow, and commercial travel that result from the overlap of two countries' tax jurisdictions, and 2) reduction of the burdens of compliance upon taxpayers who have minimal contacts and earnings in a host country.¹⁴

Model treaties are ambulatory documents. The drafters update and revise them periodically to address experience; changes in economic, judicial,

legislative, and regulatory developments; new issues; and, changes in the nature or significance of transactions between the host country and foreign persons.¹⁵ Thus, it is possible that Article 17 of the OECD Model Convention could be narrowed or eliminated.

Arbitrary Distinctions

Commentary to Article 17 attempts, with limited success, to define who is subject to its exception. It includes a list of "artistes" but concedes that the term is not capable of a precise definition.¹⁶ While film actors are artistes, the commentary says that producers, directors, and camera operators, among others who are employed in the same production as film actors, are not.¹⁷ In 1987, the OECD Committee on Fiscal Affairs published a lengthy report analyzing the taxation of entertainers, artistes, and sportsmen.¹⁸ The report examines the definition of "artistes and athletes" and concludes that the words refer to any person engaged in "public entertainment."

It appears, however, that the definition of "public entertainment" includes a film actor but not a model, painter, or writer. While a fashion model is definitely performing in public, Article 17 has been found not to apply when the "primary purpose" of the activity was the promotion, sale, and marketing of products.¹⁹ On the other hand, while the film actor is merely providing services that will ultimately result in a product to be made available to the public for entertainment (in a theater or at

home), in the same way as a painter, recording artist,²⁰ or author, Article 17 applies to the income of the film actor alone.

As a result of the vagaries in the definition of “artiste” and “public entertainment,” the OECD’s main principles, “that the income from entertainment and sporting activities should be taxed in the same way as income from any other activities,” and that “artistes and athletes” are “fully liable to tax...in their country of residence and, ideally, should be taxed accordingly,” are defeated.²¹ Article 17 creates uncertainty, confusion, and inconsistent results rather than promoting the objective of having a uniform means for addressing common problems in international taxation.²² Understandably, U.S. actors may wonder how they came to be singled out by this article.

Ostensibly, the rationale for Article 17 is the ephemeral nature of public performance and the profit made from it. An excerpt from the OECD Fiscal Affairs Committee demonstrates inherent inconsistencies in the justification for the adverse treaty treatment given “artistes,” especially filmed entertainers. The committee observes, “[T]he problems of effectively taxing artistes and athletes are rooted in the diverse forms their activities take. Success can be sudden but ephemeral. Relatively unsophisticated people—in the business sense—can be precipitated into great riches.... Travel, entertainment and various forms of ostentation are inherent in the business and there is a tendency to be represented by adventurous but not very good accountants.”²³ Today, however, it is difficult to claim that these criticisms apply more to movie stars than they do to corporate executives. Moreover, the basis for the observations in the report was pop music concert tours, not filmed entertainment.²⁴

Excerpts from 1946 hearings before the Senate Foreign Relations Subcommittee on the 1945 treaty between the United States and the United Kingdom further reflect the absence of a factual basis to support the exclusion of film actors from the treaty protection afforded other professionals.²⁵ Although the exclusion was justified in view of the supposed high income of film actors, statistics of the time indicated that only 5 percent of the members of the Screen Actors Guild (SAG) earned more than \$15,000 annually, with less than 2 percent making \$50,000 a year or more. In 2002, SAG membership stood at 196,000, with less than 2 percent of its members earning \$100,000 or more per year.²⁶ There are professionals in other industries whose work takes them outside the United States who are at least as highly paid.

What emerges from review of the hearings is the level of advocacy that was required to

overcome antipathy toward film actors. John Dales Jr., executive secretary of SAG, asked, “[W]hat is there different about our profession that we alone should continue to carry the burden that our Government proposed to lift from the backs of everyone else—doctors, lawyers, salesmen, businessmen, government representatives, and all other professions, businesses, and activities?” Dales also argued: “[A]ctors as a class have proved their desire, worthiness, and ability to take their place in civic, community, and national affairs, and in fact in times of emergency or need are particularly called upon by their National Government...to give freely of their time and talents.”²⁷

In 1946, industry groups ultimately persuaded the Senate and the Treasury Department that it was wrong to discriminate against actors, but the United States began doing just that in the 1970s by including the “artistes and athletes” provision in its tax treaties.²⁸ This new U.S. treaty policy may have been the result of Ingemar Johansson’s efforts to bypass the effect of the “artistes and athletes” provision in the treaty between the United States and Sweden on his earnings from three heavyweight world championship boxing matches with Floyd Patterson in the early 1960s.²⁹

Johansson unsuccessfully attempted to utilize a Swiss loan-out corporation to invoke the treaty between the United States and Switzerland, which provided for taxation of an employee’s income in the country where a corporation’s “business seat” was located rather than where the services were rendered. The Fifth Circuit ruled in 1964 that the Swiss treaty protection was inapplicable and did not exempt Johansson from a U.S. tax liability of close to \$1 million.

Article 17 Continues

As recently as 1987, an OECD report justified the continuing existence of Article 17 by explaining that public performers are difficult to track, often visit on a short-term basis (e.g., for a single concert or performance), and reap large revenues from ticket sales at the gate.³⁰ While these reasons may justify applying Article 17 to public performers such as boxing champions, they clearly do not apply to film actors. Film actors are not difficult to track, and they are likely to shoot for many days or weeks in a given country, rather than appearing for a single event.

In addition, payroll records track the duration and location of their services. Film actors do not reap large revenues from ticket sales at the gate but rather are paid salaries in the same way as all the others who are involved in a production. These fundamental distinctions between film actors and public per-

formers should justify narrowing the scope of the “artistes and athletes” provision. Until this occurs, however, tax attorneys with clients who are affected by Article 17 will need to plan the steps that are necessary to minimize the article’s effects.

Dealing with Article 17

The anomaly of Article 17 creates complexity and potential additional tax costs for actors. Apart from the inconvenience of compliance with a foreign country’s tax and reporting obligations lies a more significant issue—whether the foreign tax credit eliminates double taxation. The answer, in many cases, is no.

While the foreign tax credit is designed to prevent the double taxation that would occur if the actor were to pay tax on income earned outside the United States, in the other country and in the United States, the credit is limited. The foreign tax credit³¹ is limited to the amount of federal taxes that would have been paid on the same income.³² Consequently, in some situations only part of the foreign taxes paid for the year can be taken as a credit on the taxpayer’s U.S. income tax return. The portion of the foreign tax that is paid and “creditable” that exceeds the amount of foreign tax credit that is “allowable” for the year effectively increases the actor’s tax cost.³³ The actor pays tax at a rate higher than the U.S. rate and must use the excess credit in another year.

An excess credit situation could arise by either of the following: 1) the allowance of a greater number of deductions in the United States than in the foreign jurisdiction, effectively reducing the amount of foreign source taxable income usable in the foreign tax credit limitation calculation, or 2) higher personal income tax rates in the foreign jurisdiction.

The most costly situation, however, is one in which an actor’s personal service (or loan-out) corporation contracts for the actor’s services outside the United States, and the foreign tax credit gets trapped in the corporation. Since the loan-out corporation paid the foreign tax, only the loan-out corporation can claim the credit. The actor, who may be the sole shareholder, will be taxable on his or her income but will not be able to claim the credit unless it flows through. Only use of a corporate structure that permits the foreign taxes paid to flow through³⁴ to the U.S. actor will eliminate or minimize the potential for double taxation.

To further complicate matters, Article 17 may not apply to all income that is payable to a film actor. Royalties and sponsorship or advertising fees, for example, may be governed by other articles of the treaty (e.g., Article 7, business profits; Article 12, royalties;

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or Article 15, employment income).³⁵ Treaties contain different rules for different types of income. The OECD model treaty eliminates source country taxation on business profits, royalties, and employment income, unless there is a sufficient physical connection to justify deviation from the residence rule. Issues such as these can complicate tax matters significantly.

Moreover, since personal service income is generally not subject to source country taxation under Articles 7 and 15, but is under Article 17, a clear apportionment is necessary when an actor performs in a dual capacity, such as acting and directing. The directing services are protected, while the acting services are not.³⁶ If the services to be provided do not fall clearly within one article or another, the "predominant purpose" and "proximate relationship" tests will likely be used.³⁷

Therefore, a clear allocation is important when an actor's activities generate multiple types of income. For instance, when contracting for use of "name and likeness" and acting services, the nature of each payment should be clarified in the contract. The former type of payment generates royalty income, which is generally protected from source country taxation³⁸—unlike the acting services, which are subject to source country taxation and (as a result) potentially to double taxation. In addition, many countries have special rules for the taxation of "artists and athletes," including special withholding mechanisms.

While model treaty review is an ongoing process, and existing treaties are renegotiated periodically, it is unlikely that Article 17 of the OECD model will soon be changed or eliminated. In the absence of change to the OECD model, there is little likelihood that a treaty partner will give up a current benefit without asking for something in return. Consequently, it is important for tax advisers to recognize the anomalous status of actors under tax treaties and to minimize the complexity and costs of compliance.³⁹ ■

¹ See *Johansson v. United States*, 336 F. 2d 809, 814 (5th Cir. 1964).

² 1 OECD COMM. ON FISCAL AFFAIRS, MODEL TAX CONVENTION ON INCOME AND ON CAPITAL M-1-60, summary of the convention (OECD, 2000) [hereinafter MODEL TAX CONVENTION].

³ *Id.* at M-34. Paragraph 2 creates an exception to the general rule if 1) the recipient is present in the other country for a period not exceeding 183 days in the aggregate in the relevant 12-month period, 2) the payments are made by or on behalf of an employer who is not resident in the other country, and 3) the payments are not borne by a permanent establishment that the employer has in the other country.

⁴ Article 7 protects the "business profits" of a company, and Article 15 protects an individual's "income from employment." MODEL TAX CONVENTION, *supra*

note 2, at M-18-19-34.

⁵ *Id.* See also *id.* at M-13-14.

⁶ The model treaty provision applies to actors working individually or through personal service corporations. The original Article 17 was titled "Artistes and Athletes," and renamed "Artistes and Sportsmen" by the OECD in 1992. The U.S. Treasury Model, in its 1996 version, conformed to the OECD's renaming. In the Treasury Model, treaty protection is lost only after a \$20,000 threshold is met. This is the most noteworthy difference between the U.S. and OECD model provisions. The threshold has not been increased since 1996.

⁷ See I.R.C. §§61, 7701(a) (30).

⁸ *Id.* See also I.R.C. §§894(a), 7852(d) (1) (establishing the relationship between internal tax law and the treaty).

⁹ I.R.C. §901.

¹⁰ The United States has signed tax treaties with 54 countries. More than two-thirds of those treaties contain a provision subjecting actors to source country taxation. See DANIEL SANDLER, *THE TAXATION OF INTERNATIONAL ENTERTAINERS AND ATHLETES* 287-299 (1995) [hereinafter SANDLER].

¹¹ The Organization for European Economic Cooperation (OEEC), the OECD's predecessor, established a Fiscal Committee in 1956 to submit a draft convention for the avoidance of double taxation. Four reports were prepared between 1958 and 1961 before the final report was submitted in 1963, titled "Draft Double Taxation Convention on Income Capital." MODEL TAX CONVENTION, *supra* note 2, at I-2. The OECD currently has 30 member countries.

¹² MODEL TAX CONVENTION, *supra* note 2, at I-1.

¹³ *Id.*

¹⁴ 1 JOINT COMMITTEE ON TAXATION, 107TH CONG., STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION, PURSUANT TO SECTION 8022(3) (B) OF THE INTERNAL REVENUE CODE OF 1986 97 (2001).

¹⁵ 2 *id.* 445-446.

¹⁶ MODEL TAX CONVENTION, *supra* note 2, at C(17)-1.

¹⁷ See *id.* See also Priv. Ltr. Rul. 8339012 (June 23, 1983) (holding that a U.K. director's U.S. income was protected under the U.S.-U.K. treaty, Article 14, independent personal services), and Priv. Ltr. Rul. 8614021 (July 29, 2003) (holding that Articles 7 (business profits), and 14 (independent personal services), exempted payments to a U.K. resident for development and directorial services rendered in the United States).

¹⁸ *The Taxation of Income Derived from Entertainment, Artistic and Sporting Activities*, in 2 OECD COMMITTEE ON FISCAL AFFAIRS, MODEL TAX CONVENTION ON INCOME AND ON CAPITAL R(7)-1-41 (2000) [hereinafter *Taxation of Entertainment*].

¹⁹ Field Service Advice 199947027 (Sept. 30, 1999) (describing a test to determine whether an actor/model's services fell within Article 17 and concluding that they did not, since the primary purpose was promotion, marketing, and sale, not entertainment). See also Tech. Adv. Mem. 199938031 (Sept. 24, 1999) (establishing the "proximate relationship" test for determining whether endorsement income will fall within Article 17).

²⁰ *Taxation of Entertainment*, *supra* note 18, at R(7)-5.

²¹ See *id.* at R(7)-6-7.

²² MODEL TAX CONVENTION, *supra* note 2, at I-1.

²³ *Taxation of Entertainment*, *supra* note 18, at R(7)-4.

²⁴ *Id.* at R(7)-5-9.

²⁵ *Conventions with Great Britain and Northern Ireland Respecting Income and Estate Taxes: Hearing Before a Subcommittee of the Committee on Foreign Relations United States Senate*, 79th Cong. (1946) [hereinafter *Conventions with Great Britain and Northern Ireland*]. See generally Joel Nitikman, *Article 17 of OECD Model Income Tax Treaty—An Anachronism?*, TAX NOTES INT'L, May 21, 2001, at 2637-45.

²⁶ Figures based on reports contributed by signatory

production companies to the Screen Actors Guild—Producers Pension and Health Plan, Feb. 22, 2003.

²⁷ *Conventions with Great Britain and Northern Ireland*, *supra* note 25, at 84-85.

²⁸ SANDLER, *supra* note 10. See also IRS, *Income Tax Treaties*, available at <http://www.irs.gov/businesses/corporations/article/0,,id=96739,00.html>.

²⁹ *Johansson v. United States*, 336 F. 2d 809 (5th Cir. 1964).

³⁰ *Taxation of Entertainment*, *supra* note 18, at R(7)-4.

³¹ I.R.C. §901.

³² I.R.C. §904(a).

³³ I.R.C. §904(c) provides a three-year carryback and five-year carryover for excess taxes paid, so the increased cost is the lost time-value of money until the credit can be used.

³⁴ I.R.C. §1366 provides a pass-through of tax credits for shareholders of S corporations.

³⁵ MODEL TAX CONVENTION, *supra* note 2, at C(17)-3.

³⁶ U.S. Treasury Department, *Article 17—Artistes and Sportsmen*, in TECHNICAL EXPLANATION OF THE UNITED STATES MODEL INCOME TAX CONVENTION ¶1 (Sept. 20, 1966). See also Priv. Ltr. Rul. 8339012 (June 23, 1983) and Priv. Ltr. Rul. 8614021 (July 29, 2003), *supra* text accompanying note 17.

³⁷ Field Service Advice 199947027 (Sept. 30, 1999); Tech. Adv. Mem. 199938031 (Sept. 24, 1999), *supra* text accompanying note 19.

³⁸ See MODEL TAX CONVENTION, *supra* note 2, at M-28.

³⁹ See generally Alan J. Epstein, *International Tax Planning for Entertainment Industry Talent*, in 1998 MEETING OF THE CALIFORNIA TAX BARS (1998); Paul A. Sczudlo, *U.S. Tax Planning for the Cross-Border Services of Entertainers, Athletes and Other Entertainment-Industry Service Providers*, in 2003 INSTITUTE ON ENTERTAINMENT LAW AND BUSINESS (2003).

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