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United States Tax Rules for Nonresident Authors, Artists, Musicians, and Other Creative Professionals

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United States Tax Rules for Nonresident Authors, Artists, Musicians, and Other Creative Professionals

ABSTRACT

Although the United States rules for taxation of non-resident creative professionals may seem straightforward, the Internal Revenue Code contains significant traps for the unwary nonresident. However, it also offers significant opportunities for nonresidents to protect themselves from United States taxation. Discovering these traps and loopholes requires close attention to the Code and to income tax treaties which further complicate the system. This Note examines the Code's rules on taxation of nonresidents and discusses the effect that tax treaties have on those rules. The Note, intended to be a practical guide for nonresident authors, artists, musicians, and other creative professionals, then offers suggestions to nonresident creative professionals for structuring their affairs to avoid United States taxation.

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I. INTRODUCTION

United States tax laws have serious consequences for unsuspecting foreign artists, musicians, authors, inventors, and other creative professionals who develop or market their works in the United States. For both financial and legal reasons, nonresidents must understand their United States tax obligations. In recent years, the United States Internal Revenue Service (IRS) has taken an increasingly aggressive role in collecting taxes from individuals, including nonresidents.[1] Moreover, the importance of tax compliance by nonresidents should continue to grow in the next several years because of the United States long term deficit problems and President Clinton's proposals both to modernize the IRS and to boost tax compliance in international transactions.[2]

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1. The IRS has grown increasingly more rigorous in enforcing the United States tax laws. Between 1981 and 1991, the number of tax penalties that the IRS collected on individual returns nearly doubled, rising from approximately $11 million to $20 million. Allen R. Myerson, *For Each Transgression the I.R.S. Has a Penalty*, N.Y. TIMES, Feb. 28, 1993, at F24. The IRS assesses penalties for activities such as fraud and failure to pay, and the total amount of penalties the IRS collected rose from approximately $1 billion in 1981 to over $3.5 billion in 1991. *Id.*

A major tool in IRS enforcement efforts is the return matching program. Edwin McDowell, *By Any Name, They Still Set Off Those Bells and Whistles*, N.Y. TIMES, Feb. 21, 1993, at F21. Under this program, the IRS receives over one billion information returns from employers, financial institutions, and other parties who make payments of compensation, royalties, capital gains, and other forms of income. *Id.* These documents account for 90% of all income that individuals report on their returns. *Id.* The IRS uses a computer program to match these reports with the income that individuals report on their tax returns. *Id.* In 1992, through this program, the IRS identified 4 million taxpayers who under-reported their income and 1.5 million individuals who failed to file a return and collected an additional $5.3 billion in taxes. The Code requires a broad category of payors to submit information returns. For an example of the reporting requirements, see I.R.C. § 6050N(a) (CCH 1993) ("Every person . . . who makes payments of royalties . . . aggregating $10 or more . . . shall make a return . . . setting forth the aggregate amount of such payments and the name and address of the person to whom paid.").

2. President Clinton has proposed spending $1.8 billion over the next four years to modernize the IRS tax system. This investment is intended to improve dramatically the ability of the IRS to administer tax laws and to combat tax evasion. For a discussion of the President's initiatives, see *A Vision of Change for America, the President's Economic Message to Congress* (Feb. 17, 1993), *reprinted in* 93 TAX NOTES TODAY 42-63 (Feb. 22, 1993).

President Clinton also has made several proposals to improve tax compliance in international transactions. The President's proposals include: (1) tightening the rules for valuing intangible assets, such as copyrights and patents, in arm's length transfers between related parties; (2) reducing the foreign tax credit benefits for foreign licensing of intangible assets; and (3) expanding the tax

The reach of the United States Internal Revenue Code (Code) for nonresidents extends to all income from a United States source[3] or connected with a United States trade or business.[4] In practice, however, the Code's rules are neither as simple nor as logical as they might first appear. For example, the Code applies different rules for determining the source for different types of income. In the case of compensation, the source is determined by where the individual performs the work.[5] For royalties, the source depends on the location of the property,[6] and for a sale of a copyright or patent, the tax treatment depends on the artist or inventor's residence, not the user's.[7] The Code also has special rules for determining whether an alien is a United States resident for United States tax purposes.[8] Moreover, some or all of these rules may not apply if the United States has negotiated an income tax treaty with the artist's state of residence.[9] These complexities and interactions make it essential that nonresident creative professionals carefully plan their transactions with United States parties with a close eye on United States tax laws.

The purpose of this Note is to guide foreign artists and other creative professionals through the traps and pitfalls posed by United States tax laws. First, this Note explains the rules for determining whether an alien is a United States resident for tax purposes. Part II also outlines the United States tax regime and the withholding system applicable to nonresident aliens. The

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reporting requirements for businesses that purchase services from individuals and businesses. For further explanation of the President's 1993 proposals, see *Summary of the Administration's Revenue Proposals, United States Department of the Treasury*, Feb. 25, 1993, *reprinted in* 93 TAX NOTES TODAY 46-14, Doc. 93-2657 (Feb. 26, 1993).

3. "[T]here is hereby imposed . . . a tax of 30 percent of the amount received from sources within the United States by a nonresident alien individual." I.R.C. § 871(a) (CCH 1994) (unless otherwise indicated, all citations in this note to I.R.C. are to the version published in CCH 1994).

4. "A nonresident alien individual . . . shall be taxable [at the regular graduated rates] on his taxable income which is effectively connected with the conduct of a trade or business within the United States." I.R.C. § 871(b)(1).

5. *See* I.R.C. §§ 861(a)(3), 862(a)(3) (source rules for compensation for labor or personal services).

6. *See* I.R.C. §§ 861(a)(4), 862(a)(4) (source rules for royalties).

7. *See* I.R.C. § 865 (source rules for personal property sales).

8. *See* I.R.C. § 7701(b) (defining test for resident and nonresident aliens).

9. For example, under the Income Tax Convention between Germany and the United States, royalties from patents, copyrights, or literary works are subject to tax only in the creator's home state. Convention for the Avoidance of Double Taxation, Aug. 29, 1989, U.S.-Germany, art. 14, Tax Treaties ¶ 3249 (CCH). *Contra* I.R.C. § 861(a)(4) (royalties for the use of property in the United States treated as United States source income).

Note then identifies in Parts III and IV the key factors under United States case and statutory law that determine the source and nature of income received by non-United States residents. It also discusses the special treatment that United States tax treaties provide for royalties and copyright and patent sales of nonresidents. Finally, in Part V, the Note instructs nonresident artists on how to draft their contracts and sell their interests to minimize exposure to United States taxes.

II. Overview of United States Taxation of Nonresidents

The scope and applicability of United States tax laws to a non-United States citizen depends on whether the alien is categorized as a resident or nonresident of the United States. The United States taxes United States citizens and resident aliens on their worldwide income.[10] The vast majority of other foreign states, by contrast, do not tax the foreign earnings of citizens residing or domiciled abroad.[11] In the case of nonresidents, the United States only taxes their income if it: (1) comes from a United States source;[12] or (2) is effectively connected with a United States business.[13]

A. *Test For United States Residency*

The Code treats a foreign citizen as a resident alien if he meets either of two objective tests. First, under the so-called green card test, the IRS treats an individual as a resident alien if he is a "lawful permanent resident of the United States at any time" during the year.[14] Thus, under this test a person's actual physical presence in the United States is irrelevant.[15] The Code also employs a substantial presence test to determine whether an alien is a resident of the United States for tax purposes. An individual meets the substantial presence test if he is present in the United States at least thirty-one days during the current year

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10. CHARLES H. GUSTAFSON & RICHARD CRAWFORD PUGH, TAXATION OF INTERNATIONAL TRANSACTIONS 1991-1993, ¶ 2037 (1991). The rule applies regardless of the source state from which the income was derived or paid. *Id.*

11. *Id.* ¶ 2049.

12. I.R.C. § 871(a)(1) (taxation of income of nonresidents from United States sources).

13. I.R.C. § 871(b) (taxation of income of nonresidents connected with a United States resident). *See* GUSTAFSON & PUGH, *supra* note 10, ¶ 2025.

14. I.R.C. § 7701(b)(A).

15. *See* GUSTAFSON & PUGH, *supra* note 10, ¶ 2067.

and has been present in the United States at least 183 days over the current and previous two years according to a weighted formula.[16] The individual, however, will not be treated as a nonresident alien if he is present in the United States for less than 183 days during the current year and has a tax home in a foreign state to which he has closer ties.[17]

The Code classifies an individual as a nonresident alien if he is not a United States citizen and does not meet either the green card or substantial presence test.[18] The Code, however, provides a modified test for United States residency for purposes of applying the source rules for personal property sales.[19] Additionally, different rules for determining a person's residence apply under United States tax treaties.[20]

B. *Imposition of United States Tax on Nonresidents*

The United States applies two different tax regimes to nonresidents. The tax liability's scope turns on whether the nonresident receives income connected with a United States business.

16. The Code formula tabulates all days an alien is present in the current year, one-third of the days present in the first previous year, and one-sixth of the days present in the second previous year. I.R.C. § 7701(b)(3)(A). To illustrate, if an alien is present in the United States 100 days in 1993, 150 days in 1992, and 198 days in 1991, he meets the substantial presence test because he is present 183 days from 1991 to 1993 under the weighted formula.

The Code does not count the following: (1) involuntary presence because of a medical condition (I.R.C. § 7701(b)(3)(D)(ii)); (2) regular commuting from Mexico or Canada (I.R.C. § 7701(b)(7)(B)); or (3) presence in the United States for less than 24 hours when in transit between two points outside the United States (I.R.C. § 7701(b)(7)(C)). For a discussion of the residence rules, see GUSTAFSON & PUGH, *supra* note 10, ¶ 2067.

17. I.R.C. § 7701(b)(3)(B). For a discussion of the rules on tax homes, see *infra* note 80.

18. I.R.C. § 7701(b)(1)(B).

19. For purposes of I.R.C. § 865, three classes of individuals are treated as United States residents: (1) United States citizens; (2) nonresident aliens who have a tax home in the United States; and (3) resident aliens who do not have a tax home in a foreign state. I.R.C. § 865(g)(1)(A). All other individuals are treated as nonresidents. I.R.C. § 865(g)(1)(B). *See infra* part III.D. (personal property sales).

20. Under the Treasury Department's Model Treaty, a person's residence is generally the state in which he is domiciled. For an explanation of the Model Treaty rules on domicile, see *infra* part V.C.1.

1. United States Trade or Business Income

If the nonresident's income is connected with a United States trade or business, the Code will tax the net income at the usual graduated rates applicable to United States residents,[21] which range from 15 to 39.6 percent.[22] The Code generally treats income from sales by creators of intellectual property as ordinary income,[23] to which these rates apply. The Code, however, provides preferential treatment for income from patents. If the transaction involves the sale or transfer of rights in a patent, the Code taxes the proceeds at preferential capital gains rates,[24] which are capped at twenty-eight percent.[25]

United States courts generally consider a nonresident to be engaged in a United States trade or business if he conducts regular and continuous business activities in the United States, either directly or through an agent or other representative.[26] The government imposes tax rates[27] on the nonresident's taxable

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21. A nonresident alien individual engaged in trade or business within the United States during the taxable year shall be taxable as provided in section 1 [graduated tax rate schedule for individuals] . . . on his taxable income which is effectively connected with the conduct of a trade or business within the United States.

I.R.C. § 871(b)(1). *See* GUSTAFSON & PUGH, *supra* note 10, ¶4001.

22. I.R.C. § 1 (tax rate schedules).

23. "[T]he term 'capital asset' . . . does not include . . . a copyright, a literary, musical, or artistic composition . . . or similar property . . . ." I.R.C. § 1221(3).

24. "A transfer . . . of all substantial rights to a patent . . . shall be considered the sale or exchange of a capital asset for more than 1 year, regardless of whether or not the payments . . . are . . . (1) payable periodically . . . or (2) contingent on the productivity, use, or disposition of the property transferred." I.R.C. § 1235(a).

25. I.R.C. § 1(h). In 1993, the United States increased the maximum tax rate on individuals from 31% to 39.6%. I.R.C. § 1. As a result, the capital gains differential for patents has become more valuable.

26. GUSTAFSON & PUGH, *supra* note 10, ¶ 4007. The Code does not define the term "trade or business within the United States." *Id.* Instead, the IRS applies a facts and circumstances test in each case. Reg. § 1.864-2(e). In European Naval Stores, S.A. v. Commissioner, the Tax Court explained that "'[c]arrying on business' does not mean the performance of a single disconnected business act. It means conducting, prosecuting, and continuing business by performing progressively all the acts normally incident thereto . . . of business being done . . . all the time." 11 T.C. 127, 133 (1948).

Under the Code, the performance of personal services in the United States generally constitutes a United States trade or business. I.R.C. § 864(b). The Code provides a de minimis exception if the individual is present in the United States no more than 90 days and is paid no more than $3,000. I.R.C. § 864(b)(1).

27. The tax rates range from 15% to 39.6%. I.R.C. § 1.

income.[28] In determining his tax liability, the nonresident may claim any appropriate tax deductions or credits connected with the United States trade or business.[29] In general, the United States does not subject nonresidents engaged in a United States trade or business to withholding on their United States source income.[30] The Code requires these nonresidents to file an annual nonresident tax return with the IRS that reports their effectively connected income and any resultant United States tax liability.[31]

The nonresident's business income must also be "effectively connected" with the activities of his United States business.[32] If the nonresident's income is from a United States source,[33] the Code generally treats the income as effectively connected income.[34] The Code may also treat foreign source income as effectively connected if the income is attributable to an office located in the United States and the income consists of rents or royalties.[35]

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28. I.R.C. § 871(b)(1).

29. "In the case of a nonresident alien individual, the deductions shall be allowed only for purposes of section 871(b) and . . . only if and to the extent that they are connected with income which is effectively connected with the conduct of a trade or business within the United States . . . ." I.R.C. § 873(a). The nonresident must file a tax return in the United States to receive the benefit of the tax deductions and credits. I.R.C. § 874(a).

30. "No deduction or withholding under subsection (a) shall be required in the case of any item of income (*other than compensation for personal services*) which is effectively connected with the conduct of a trade or business within the United States . . . ." I.R.C. § 1441(c)(1) (emphasis added). For a discussion of the withholding rules for compensation, see *infra* notes 46-49 and accompanying text.

31. GUSTAFSON & PUGH, *supra* note 10, ¶ 4223.

32. "A nonresident alien individual engaged in trade or business within the United States . . . shall be taxable . . . on his taxable income which is *effectively connected* with the conduct of a trade or business within the United States." I.R.C. § 871(b)(1) (emphasis added).

33. For an explanation of the rules for determining the income's source state, see *infra* part III.

34. "All income . . . from sources within the United States [other than investment income] shall be treated as effectively connected with the conduct of a trade or business within the United States." I.R.C. § 864(c)(3).

35. Income . . . from sources without the United States shall be treated as effectively connected with the conduct of a trade or business within the United States . . . if [the nonresident] has an office or other fixed place of business within the United States to which such income . . . is attributable and such income . . . consists of . . . royalties . . . derived in the active conduct of such trade or business.

I.R.C. § 864(c)(4)(B)(i). The Code attributes the income to the office if it plays a material role in the production of that income. I.R.C. § 864(c)(5)(B).

2. Income Not Connected with a United States Business

The Code applies a different taxation system to nonresidents whose United States source income is not effectively connected with the conduct of a United States business. The United States taxes these nonresidents on their gross income from United States sources at a flat rate of thirty percent.[36] The IRS assesses this tax obligation on nonresidents through a withholding system.[37] The Code's withholding requirement extends to most categories of United States source income of nonresidents, including compensation, royalties, and gains on the sale of personal property.[38] The party making the payment must collect the tax and remit it to the United States Treasury.[39] Because the withholding rate is thirty percent,[40] the same tax rate imposed

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> 36. [T]here is hereby imposed for each taxable year a tax of 30 percent of the amount received from sources within the United States by a nonresident alien individual as . . . compensations . . . gains from the sale or exchange of patents, copyrights, . . . trademarks . . . or of any interest in any such property, to the extent such gains are from payments which are contingent on the productivity, use, or disposition of the property . . . but only to the extent the amount so received is not effectively connected with the conduct of a trade or business within the United States.

I.R.C. § 871(a)(1).

37. The withholding mechanism serves several purposes. Most importantly, it overcomes the United States limited power to enforce its tax laws against nonresidents who have no seizable assets in the United States. Under long-standing international practice, the United States does not bring suit in other states to collect its taxes, nor do other states seek to enforce their tax laws in United States courts. *See* GUSTAFSON & PUGH, *supra* note 10, ¶¶ 2019, 5007; RESTATEMENT (THIRD) OF THE FOREIGN RELATIONS LAW OF THE UNITED STATES § 483 (1986).

38. The statute broadly defines income that is subject to withholding. "The items of income . . . are interest, . . . dividends, rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, . . . gains subject to tax under section 871(a)(1)(D) [sale of patents and copyrights] . . .." I.R.C. § 1441(b). The courts and the IRS have long interpreted this section to include royalties. *See* Commissioner v. Wodehouse, 337 U.S. 369, 382 (1949); Rev. Rul. 80-362, 1980-2 C.B. 208 (royalties from United States sources subject to withholding under § 1441).

> 39. [A]ll persons . . . having the control, receipt, custody, disposal, or payment of any of the items of income specified . . . to the extent that any of such items constitutes gross income from sources within the United States . . . of any nonresident alien individual . . . shall . . . deduct and withhold from such items a tax equal to 30 percent thereof. . ..

I.R.C. § 1441(a).

40. I.R.C. § 1441(a).

under section 871, it is not necessary for these nonresidents to file a United States tax return.[41]

Nonresidents whose income is not effectively connected with a United States business may pay a higher average tax on their income. First, Congress has not reduced the thirty percent withholding tax rate imposed on this class in tandem with the reduction in the top individual tax rate from 91 to 39.6 percent.[42] Thus, the relative tax burden on this class of nonresidents has risen compared to nonresidents who derive their income from a United States business.[43] Second, the tax base for this class of taxpayers is broader, because their tax is assessed on gross income, not net income.[44] Finally, the Code requires that one hundred percent of this class of nonresidents' tax obligations be withheld at the source.[45]

The Code subjects nonresidents who are self-employed and receive compensation income connected with a United States trade or business to both the tax withholding and return filing regimes. While the Code taxes the net compensation income of nonresidents at the lower graduated rates,[46] the Code still requires the payor to withhold taxes on the nonresident's gross compensation at a flat rate of thirty percent.[47] The nonresident therefore must file a tax return to pay any additional taxes due or to recover any excess taxes withheld.[48] The Treasury Department, however, has exercised its statutory authority to exempt pure employment relationships from withholding.[49]

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41. Nonresidents of treaty states would have to file a tax return in order to claim the treaty's lower tax rate and obtain a refund. I.R.C. § 874(a).

42. *See* GUSTAFSON & PUGH, *supra* note 10, ¶ 5007; I.R.C. § 1 (tax rate schedules).

43. *See* GUSTAFSON & PUGH, *supra* note 10, ¶ 5007.

44. *Id.*

45. *See* I.R.C. § 864(c)(40)(B)(i).

46. I.R.C. § 871(b)(1).

47. I.R.C. § 1441(c)(1) (compensation income connected with a United States trade or business not exempt from withholding).

48. *See* GUSTAFSON & PUGH, *supra* note 10, ¶ 5103.

49. *See* I.R.C. § 1441(c)(4) (granting regulatory authority to exempt compensation income of nonresidents from withholding); Treas. Reg. § 1.1441-4(b) (Feb. 2, 1990) (exempting employment relationships from withholding); Rev. Rul. 70-543, 1970-2 C.B. 173 (not exempting self-employed nonresidents from withholding under regulations).

III. United States Source of Income Rules

A. *General Rules*

The income's source initially determines whether the income of non-United States residents is subject to United States tax. If the income is from a United States source, as determined under the applicable tax rule, then the United States taxes the income.[50] On the other hand, if the nonresident receives income from a source outside of the United States, then the United States does not tax the income,[51] unless the foreign source income is attributed to a United States office of the nonresident.[52]

It is important to note that the Code applies different source rules for each type of income.[53] Accordingly, the starting point for determining whether the income is taxed is classifying the nature and the type of income received.[54] United States tax laws may treat nonresident authors or artists as receiving compensation for personal services, royalties from patents or copyrights, or proceeds from the sale of personal property, depending on the nature of the transaction.

B. *Compensation*

The first major category of income for nonresident authors or artists is compensation for personal services. The source rules for compensation focus on the state in which the individual performs the activity or service.[55] In general, wages for the performance of labor or personal services in the United States are

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50. I.R.C. § 871. See I.R.C. § 861 for the rules for determining whether income is from a United States source.

51. *See* I.R.C. § 862 (rules for determining whether income is from sources outside the United States).

52. If a nonresident alien individual is engaged in a trade or business in the United States and his foreign source income is attributable to a United States office of the nonresident, then the income will be taxed in the United States as effectively connected with the conduct of a United States business. I.R.C. § 861(c)(1), (c)(4)(B).

53. *Compare* I.R.C. § 861(a)(3) (personal services) *with* I.R.C. § 861(a)(4) (rentals and royalties).

54. *See generally* GUSTAFSON & PUGH, *supra* note 10, ¶ 3001 (Source Rules for Income and Deductions).

55. *See* Le Beau Tours v. United States, 547 F.2d 9 (2d Cir. 1976) (holding the place where compensable services are performed determines the source of income).

United States source income.[56] To illustrate, in *Boulez v. Commissioner*,[57] a United States company, CBS Records, hired world-renowned orchestra conductor Pierre Boulez, who resided in Germany. The CBS contract required Boulez to direct several orchestra recording sessions in the United States.[58] The Tax Court held that Boulez had performed personal services in the United States for compensation, and, therefore, the United States could tax his earnings.[59]

Likewise, if a nonresident performs services outside the United States, the United States will not tax his compensation.[60] For example, in *Cook v. United States*,[61] an Italian resident made bronze statues in his Italian studio pursuant to a contract with a United States corporation. Because the court held that Cook performed the personal services outside the United States, the United States could not tax his compensation.[62]

Although the Code generally taxes United States source income of non-resident aliens, it provides a de minimis exception for limited activities. If the nonresident is in the United States for no more than ninety days and is paid no more than three thousand dollars, the United States will not tax his income.[63] Also, the work must be performed under contract with a foreign business that is "not engaged in trade or business within the United States."[64]

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56. "The following . . . shall be treated as income from sources within the United States . . . Compensation for labor or personal services performed in the United States." I.R.C. § 861(a)(3).

57. 83 T.C. 584 (1984).

58. *Id.* at 585.

59. *Id.* at 584.

60. "The following . . . shall be treated as income from sources without the United States . . . compensation for labor or personal services performed without the United States." I.R.C. § 862(a)(3). *See* Cook v. United States, 599 F.2d 400, 404-05 (Ct. Cls. 1979) (sculptor creating abroad may treat earnings from his labor as from non-United States sources under I.R.C. § 862(a)(3)); *see also* Rev. Rul. 83-177, 1983-2 C.B. 112 (payments for services to be performed abroad are foreign source income).

61. 599 F.2d at 404-05 (Ct. Cl. 1979).

62. *Id.* at 400; *see also* British Timken Limited v. Commissioner, 12 T.C. 880 (1949) (commissions paid by a United States company to a foreign business for sales promotion work performed overseas is not United States source income); Rev. Rul. 60-55, 1960-1 C.B. 270 (commissions for promotion work overseas is sourced outside the United States).

63. I.R.C. § 861(a)(3).

64. I.R.C. § 861(a)(3)(C).

C. *Royalties*

A second major category of income that nonresident authors or artists receive is royalties. Under the Code, royalties include payments for the right to use a patent, copyright, or similar property.[65] The source rules for royalties are based on the location of the property which generates the income. If the individual derives royalties from property located or used in the United States, then generally the royalties are taxed in the United States.[66]

In *Sabatini v. Commissioner*,[67] a nonresident British author signed a contract granting a United States publisher the exclusive right to publish his book in the United States. The court held that Sabatini derived royalties from his United States publishing rights and that therefore the payments were United States source income.[68] For United States tax purposes, it did not matter that the author wrote the book in the United Kingdom.[69]

On the other hand, if a company pays royalties to a nonresident for the right to use his patent or copyright outside the United States, then the income is not taxed in the United

65. *See* I.R.C. §§ 861(a)(4), 862(a)(4).

66. "The following . . . shall be treated as income from sources within the United States . . . (4) . . . royalties from property located in the United States . . . including . . . royalties for the use of or for the privilege of using in the United States patents, copyrights, secret processes and formulas . . . and other like property." I.R.C. § 861(a)(4).

67. 98 F.2d 753 (2d Cir. 1938).

68. *Id.* Similarly, in Commissioner v. Wodehouse, the Supreme Court held that royalties paid to a nonresident for the use of his copyright in the United States are United States source income. 337 U.S. 369 (1949). *See* Rev. Rul. 80-362, 1980-2 C.B. 208 (nonresident's royalty income from licensing United States rights is taxed in the United States).

69. Under United States tax rules, an author in this situation is treated as being paid for the property right to publish his book in the United States, not for performing the labor of composing the book. Thus, it does not matter where the book is written. Because the location of the rights generating income is the United States, the royalties from those rights are taxed in the United States. *See* I.R.C. § 861(a)(4).

In contrast, in Revenue Ruling 74-555, 1974-2 C.B. 202, the IRS addressed a situation in which a nonresident alien author granted a United States corporation the right to publish all of his new books in the United States. According to the contract, the author was to write all of the books outside the United States. The IRS ruled, however, that the payments were not compensation for personal services performed outside the United States. *Id.* According to the Service's analysis, the author had not contracted to perform personal services because he had not committed to write anything. *Id.* at 203. Because the United States corporation had no control over the author's work product, the payments were royalties, rather than compensation. *Id.*

States.[70] Take the case of a French corporation that licensed to a United States corporation the rights to manufacture products with its trademark in every state except the United States in exchange for a percentage of the sales price of each product made by the United States corporation. Because the royalties emanated from non-United States trademark rights, the Code would treat the French corporation as receiving royalties from sources outside the United States.[71] Thus, as this example illustrates, the buyer's state of residence is not controlling; rather, the state having rights over the trademark or copyright is. As long as the contract at issue does not convey United States rights to the trademark or copyright, the income will not be taxed in the United States.[72]

D. *Personal Property Sales*

The third common type of income for nonresident authors and artists is gain from the sale of personal property. The determinative factor for identifying the source of income from the sale of personal property such as a copyright[73] is the residence of the artist or author. If the artist is a United States resident, the Code treats the sale proceeds as United States source income.[74] If the artist is a nonresident, on the other hand, the Code considers the income to be from a source outside the United States.[75] Thus, the residence of the buyer and the state in which the buyer will use the property are irrelevant.[76] A separate rule applies, however, in the case of sales through an office or other fixed place of business. For example, if a resident author or artist sells his copyright through an office outside the United States,

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70. "The following . . . shall be treated as income from sources without the United States . . . (4) . . . royalties from property located without the United States . . . including . . . royalties for the use of or for the privilege of using without the United States patents, copyrights, secret processes and formulas . . . and other like property." I.R.C. § 862(a)(4).

71. *See* Rev. Rul. 68-443, 1968-2 C.B. 304 (royalties paid for the use of a trademark outside the United States is income from sources outside the United States).

72. *Id.*

73. The Code applies different rules in the case of sales of inventory property (personal property held for sale to customers, like appliances), which are beyond the scope of this Note. *See* I.R.C. §§ 865(b), 861(a)(6).

74. "[I]ncome from the sale of personal property . . . by a United States resident shall be sourced in the United States." I.R.C. § 865(a)(1).

75. "[I]ncome from the sale of personal property . . . by a nonresident shall be sourced outside the United States." I.R.C. § 865(a)(2).

76. *See* I.R.C. § 865(a).

the income will be sourced outside the United States.[77] Similarly, if a nonresident sells a copyright through an office in the United States, the income will be United States source income.[78]

It is important to note that section 865 employs a special rule for determining a person's state of residence. If a resident alien, as defined under section 7701(b),[79] has his tax home in a foreign state[80] and does not have an abode in the United States,[81] he is not a United States resident for section 865 purposes.[82] Similarly, a nonresident, as defined under section 7701(b), is a United States resident under section 865 if he has a tax home in the United States.[83]

Consider, for example, the case of an author who is a citizen and resident of Germany and does not have a tax home in the United States. The German author sells all of his rights and interests in his manuscripts to a United States publisher. Because the author is a resident of Germany, the United States would not tax the proceeds from the sale of the copyright.[84] On the other hand, if the German citizen were a United States resident with his tax home in the United States and had sold his copyright to a German publisher, the income would be sourced in the United States.[85] This result will prevail regardless of the other characteristics of the transaction.[86]

The source rules for personal property sales may not apply to certain dispositions of intangible assets such as patents and

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77. I.R.C. § 865(e)(1).

78. I.R.C. § 865(e)(2). Sales through an independent agent in the United States or through a United States office that does not materially participate in the sale would not be attributed to a United States office. I.R.C. §§ 865(e)(3), 864(c)(5)(A)-(B).

79. Section 7701(b) provides the general definitions of resident and nonresident aliens. Section 865 adds requirements to these general rules. For a discussion of the general residency rules, see *supra* part II.A.

80. I.R.C. § 865(g)(1)(A). A person's tax home is his principal business headquarters or the place where most of his income is earned. *See* I.R.C. §§ 911(d)(3), 162(a)(2); Rev. Rul. 75-432, 1975-2 C.B. 60 (defining tax home for purposes of § 162(a)(2)).

81. I.R.C. § 911(d)(3). An abode is a residence that is readily available to the individual.

82. Nevertheless, if the nonresident did not pay a tax of at least 10% of the gain on the sale of the property to a foreign state, the gain will be treated as United States source income. I.R.C. § 865(g)(2).

83. I.R.C. § 865(g)(1)(A)(i)(II).

84. *See* I.R.C. § 865(a)(2).

85. *See* I.R.C. § 865(a)(1).

86. *See* GUSTAFSON & PUGH, *supra* note 10, ¶ 3133.

copyrights.[87] For example, if the payments due on the sale of a copyright are made contingent upon the "productivity, use, or disposition" of the copyright, the United States will tax the proceeds in the same manner as royalties.[88] Non-United States residents may thereby be exposed to United States tax because the source of the income for royalties is the state in which the acquirer will use the copyright.[89] In addition, the Code will impose a tax of thirty percent on the gain from the conditioned sale.[90] If the payments are not subject to this contingency, the general rule under section 865, which does not tax nonresidents, will continue to apply.[91]

IV. DETERMINING THE CHARACTER OF NONRESIDENT ALIEN INCOME

The applicable United States source of income rule depends on the character of the income the nonresident receives.[92] This determination, in turn, depends on the particular facts and circumstances of the author or artist's transaction. The actions of the Internal Revenue Service and the courts make it clear that how the parties label the income in a contract will not necessarily be conclusive.[93] Instead, the character of the income for United States tax purposes depends in large part on whether the author

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87. Under I.R.C. § 865(d)(2), intangible is defined as "any patent, copyright, secret process or formula, goodwill, trademark, trade brand, franchise, or other like property."

88. I.R.C. § 865(d)(1)(A)-(B).

89. In that situation, the source rules for royalty income under I.R.C. § 861(a)(4) and I.R.C. § 862(a)(4) would apply. *See supra* part III.C.

90. [T]here is hereby imposed . . . a tax of 30 percent of the amount received from sources within the United States by a nonresident alien individual as . . . gains from the sale or exchange . . . of patents, copyrights, . . . trademarks, . . . and other like property, or of any interest in such property, *to the extent such gains are from payments which are contingent on the productivity, use, or disposition* of the property or interest sold or exchanged. . . .

I.R.C. § 871(a)(1)(D) (emphasis added).

91. "[T]his section shall apply only to the extent the payments in consideration of such sale are not contingent on the productivity, use, or disposition of the intangible. . . ." I.R.C. § 865(d)(1)(A).

92. *See generally* GUSTAFSON & PUGH, *supra* note 10, ¶ 3001.

93. *See, e.g.*, Boulez v. Commissioner, 83 T.C. 584 (1984) (income taxed as compensation, even though the contract labeled the payments as royalties based on recording sales); Tobey v. Commissioner, 60 T.C. 227, 235 (1973) ("[T]he character of the income does not depend upon a mechanical reading of the terms of a contract or upon the existence or nonexistence of an end product. . . .").

or artist retains a property interest in his work under the agreement, and thus receives a royalty, or whether the payments in question are compensation for services rendered.[94]

A. *Identifying Compensation Income*

The key criterion in identifying compensation income for United States tax purposes is whether the payments to the nonresident author or artist are based on the performance of personal services.[95] In general, the income's character depends on the particular facts and circumstances of the transaction, including the language of the contract and the intention of the parties. However, the determinative question for the IRS is one of control. For example, if the artist or author performs the activities for the exclusive benefit of the payor and the payor has control over the activities performed, then the IRS more likely will treat the payments as compensation.[96] The IRS is less likely to characterize the payments as royalties because the artist has not retained any property rights for himself in his work product; instead, the individual derived the income from his labor.[97]

For example, in *Boulez v. Commissioner*,[98] the United States corporation paid the conductor a share of the receipts from the sales of the recordings.[99] The payment structure strongly suggested that the conductor received royalties because the

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94. The determination of the income's character is based on United States tax rules, not the contract or tax laws of the foreign state in which the agreement was made. *See* Misbourne Pictures Ltd. v. Johnson, 189 F.2d 774, 776 n.2 (2d Cir. 1951) (British contract law does not control regarding character of the income received).

95. "Compensation for labor or personal services performed in the United States . . . shall be treated as income from sources within the United States." I.R.C. § 861(a)(3).

96. In Revenue Ruling 84-78, 1984-1 C.B. 173, the IRS considered the tax treatment of payments for partial broadcasting rights to a live boxing match. A United States corporation paid the participants for the exclusive rights to broadcast the fight. Subsequently, a foreign corporation paid that United States corporation for the right to broadcast the fight in its state, but had no control over the prize fight or its contestants. In addition, the foreign corporation was not the owner of the United States corporation's labor, because its services were not performed for the exclusive benefit of the foreign corporation. Therefore, the Service concluded, the payments were not compensation for labor or personal services. *Id.* at 174; *see also* Rev. Rul. 74-555, 1974-2 C.B. 202 (payments to foreign author were not compensation because the United States corporation did not control what was to be written or when it was to be done).

97. *See* Boulez v. Commissioner, 83 T.C. 584 (1984).

98. *Id.*

99. *Id.* at 586-87.

payments were based on sales. The court, nevertheless, found that the conductor had retained no property rights to the recordings under the terms of the contract.[100] Instead, the court found that the contract more closely resembled an employment arrangement under which Boulez's services as a conductor and producer were retained by CBS Records.[101] Consequently, the court ruled that Boulez derived the payments from labor performed at the direction of, and for the benefit of, the United States corporation.[102] Therefore, the court held that Boulez received compensation income from a United States source.[103]

The same analysis regarding control over the performance of the creative professional's services applies if the nonresident works outside the United States. In *Karrer v. United States*,[104] a Swiss company contracted with a Swiss scientist to perform research in its Swiss facility. While working for the Swiss company, the scientist discovered a synthetic source for Vitamin E, and the company patented the scientist's invention in the United States.[105] The Swiss company directed and supervised the work of the inventor, which suggests an employment arrangement. Yet the company paid the inventor a percentage of the proceeds from all United States sales of synthetic vitamins made with his inventions, which suggests the payments were royalties. The court nevertheless held that the inventor derived his income from the performance of personal services outside the

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100. Boulez's mistake was that he had not expressly reserved any property rights in the recordings pursuant to the requirements under the Copyright Act. The Copyright Act was revised in 1971 to recognize a conductor's rights in a copyright. The Act, however, recognizes only expressly stated property interests. When Boulez revised his contracts in 1971 and 1974, he did not insert any explicit language regarding his property interest in the recordings; instead, the contracts were silent, as they had been prior to the time when a conductor's rights were recognized. This omission suggested to the court that the parties did not intend to convey any of the rights in the recordings to Boulez. *Id.* at 594-95.

101. *Id.* at 595.

102. *Id.*

103. Because Boulez produced and performed the recordings in the United States, the income was considered compensation from a United States source. *Id.*

In a similar case, Ingram v. Bowers, celebrated Italian tenor Enrico Caruso entered into a recording contract with a United States company. 57 F.2d 65 (2d Cir. 1932). In *Ingram*, the court held that Caruso's income was compensation for personal services because "he had no proprietary interest in the profits arising out of the records." *Id.* Even though the payments were labeled royalties, Caruso had not reserved any rights in the recordings under the contract. He had agreed only "to sing into the recording apparatus." *Id.* Therefore, the court held the payments could not "be looked at as emanating from property." *Id.*

104. 152 F.Supp. 66 (Ct. Cl. 1957).

105. *Id.* at 67-69.

United States, not from a property interest in the inventions.[106] The inventor therefore received foreign source compensation income, which is not taxed under the Code.[107]

B. *Distinguishing Royalty Income from Compensation Income*

Disbursements of royalties and compensation share two characteristics. First, under each arrangement, the author or artist generally receives a stream of periodic payments. Second, each payment is related to the author or artist's work product. The distinguishing feature of royalty income under United States tax laws is that the creator or inventor has retained a property interest in the creation or invention.[108] The courts will treat the payments as royalties if the creator has not transferred away his full "bundle of rights" in his work under the contract.[109] The notion is that the author or artist derived the payments from the use of his property, not from the performance of personal services.[110]

In *Misbourne Pictures Ltd. v. Johnson*,[111] a British film company, Misbourne Pictures, entered a contract with United States theater company Samuel Goldwyn. The contract granted the United States company exclusive rights to distribute the film

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106. *Id.* at 72.

107. The court held that the income was foreign source compensation, even though it resembled royalty payments. The determinative factor was that Karrer's right to the payments "derive[d] from his services to his employer and not from any rights in inventions owned by the employee." *Id.* Therefore, because Karrer made his inventions in Switzerland, he was treated as receiving compensation from a source outside the United States. *Id.* *Karrer*, however, is a difficult case to rely on for distinguishing between royalty and compensation income because of its particular facts. The taxpayers relied specifically on Swiss law regarding employer-employee relationships and expert testimony to advocate that the customary practice in Switzerland was for Swiss inventors to be paid compensation for services, not royalties. *Id.* at 71-72.

108. *See* Sabatini v. Commissioner, 98 F.2d 753, 755 (2d Cir. 1938) (noting that the rights to publish a manuscript in the United States are "an interest in property in the United States").

109. *See* Rohmer v. Commissioner, 153 F.2d 61, 63 (2d Cir. 1946). Rohmer transferred only the serial rights in his writings to a United States company, while reserving book, motion picture, and other significant rights. Therefore, the court held that the payments constituted royalties. *Id.* *Contra* General Aniline & Film Corp. v. Commissioner, 139 F.2d 759, 760-61 (2d Cir. 1944) (payments under contract granting entire right, title, and interest to the patents are not royalties subject to United States tax).

110. *See* Rev. Rul. 74-555, 1974-2 C.B. 202, 203 (payments for the right to publish a manuscript are royalties because the payor did not control the author's labor).

111. 189 F.2d 774 (2d Cir. 1951).

"Spitfire" in every state except the United Kingdom.[112] The British company reserved for itself the exclusive rights to distribute the film in the United Kingdom.[113] Because the foreign company retained significant ownership rights in the film, the court held that the payments were royalties.[114] The IRS would treat the income as compensation only if the United States company had controlled the production of the film and the film had been made exclusively for the United States company's benefit.[115]

The structure and timing of the payments under the contract do not always determine whether the IRS will characterize the payments as royalties. Typically, royalties are paid out over a number of years, as a series of payments coinciding with the exploitation of the property.[116] In some cases, however, the artist or author receives a single lump sum payment for the use of his copyright. In *Wodehouse v. Commissioner*,[117] a British author of children's books, Pelham Wodehouse, transferred the United States serial rights of his compositions to several United States publishers. Wodehouse evidently preferred to receive a single, albeit lower, payment at the time his works were published in the United States, rather than waiting to receive payments as the books were sold.[118] Wodehouse retained significant interests in his works, including the film rights.[119] Determining the nature of the payments to be royalties, the Supreme Court held that consolidating them into one payment did not change the character of the income.[120] Thus, the IRS may still treat income

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112. *Id.* at 775.

113. *Id.*

114. *Id.* at 776. Because Misbourne had not contracted away all of its property rights in the film, the proceeds were taxed as royalties. *Id.* For additional factual background to the case, see Misbourne Pictures Ltd. v. Johnson, 90 F. Supp. 978, 979 (S.D.N.Y. 1950). *See also* Rev. Rul. 80-362, 1980-2 C.B. 208 (nonresident alien who licenses United States patent rights to a non-United States company treated as receiving royalty income from a United States source).

115. *See* Rev. Rul. 84-78, 1984-1 C.B. 173 (distinguishing characteristics of compensation income).

116. *See, e.g.*, AMP, Inc. v. United States, 492 F.Supp. 27, 31 (M.D. Pa. 1979) (defining royalties generally as a series of payments that are contingent upon the use of the property).

117. 337 U.S. 369 (1949).

118. *Id.* at 372-73.

119. *Id.* at 399.

120. *Id.* at 393. The Court stretched its reasoning to reach this result. It presumed that the payments to Wodehouse were royalties without analyzing whether Wodehouse had transferred away all of his rights, which would have made the transaction a tax-free sale. *See id.* at 425 (Frankfurter, J., dissenting).

as royalty income, even if it is consolidated into one payment rather than paid out over a period of time.[121]

C. *Distinguishing Royalty Income from Sales of Personal Property*

Just as royalty and compensation income are similar in some respects, contracts for royalties and for personal property sales also have common attributes. Each contract conveys the right to use a copyright or patent to another party. The courts and the IRS distinguish between the two forms of income based on the degree and extent of the ownership rights that the author or artist conveys under the contract.[122]

In general, if the owner has relinquished all rights and interests in the copyright or patent under the contract, the courts and the IRS will treat the transaction as a sale for United States tax purposes.[123] In *Herwig v. United States*, a French author sold the motion picture rights for his book to a United States film company.[124] The United States company was granted exclusive rights to exploit the film rights throughout the life of the copyright.[125] The court treated this transaction as a sale for tax purposes.[126] When the contract is ambiguous as to ownership rights retained by the author or artist, courts look to the intent of the parties to determine if the transaction constituted a complete sale.[127]

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121. *Id.* at 371, 393.

For additional cases on this issue, see Sabatini v. Commissioner, 98 F.2d 753, 755 (2d Cir. 1938) (noting that a lump sum payment, instead of a series of payments, for the use of property doesn't alter the payment's character); Misbourne Pictures Ltd. v. Johnson, 189 F.2d 774, 776 (2d Cir. 1951) (treating up front payment for distribution rights as advance royalties).

122. *See* Rev. Rul. 84-78, 1984-1 C.B. 173, 174 (distinguishing royalty from sales income based on whether the rights transferred are exclusive and permanent in duration); Commissioner v. Wodehouse, 337 U.S. 369 (1949) (distinguishing royalty from sales income).

123. *See* Rev. Rul. 60-226, 1960-1 C.B. 26 (transfer of exclusive right to use patent or trademark treated as sale regardless of how payment received); Rev. Rul. 58-353, 1958-2 C.B. 408 (exclusive license treated as a sale); *see also* Myers v. Commissioner, 6 T.C. 258 (1946); Coplan v. Commissioner, 28 T.C. 1189, 1190 (1957) (exclusive transfer treated as a sale).

124. 105 F. Supp. 384 (Ct. Cl. 1952).

125. *Id.* at 385.

126. *Id.* *See* Rev. Rul. 54-409, 1954-2 C.B. 174 (grant of exclusive right throughout life of copyright is a sale). *But see* Rev. Rul. 84-78, 1984-1 C.B. 173 (transfer of broadcast rights not a sale because the right is not exclusive and its duration is less than remaining life of the copyright).

127. *See* Commissioner v. Celanese Corp., 140 F.2d 339, 341 (D.C. Cir. 1944) (payments not treated as royalties because the parties clearly intended to effect a sale).

Although the parties to a contract may intend to effectuate a sale, if the sale is not complete but contingent on some factor, the income may still be treated as royalties. For example, if the acquirer agrees to pay the author or artist only if he uses or exploits the copyright, then the Code will treat the income as royalties.[128] In *Bloch v. United States*, a German inventor sold all worldwide rights to manufacture and sell products made with his patent to a United States company.[129] Under the terms of the contract, the owner appeared to relinquish all interests in the patent. The court nevertheless held that the inventor received royalties from a United States source because the contract provided that the payments were contingent on the number of units that the company produced with Bloch's patent.[130]

V. UNITED STATES INCOME TAX TREATIES

A. *Reach of Tax Jurisdiction Under International Law*

Customary international law limits state power to tax.[131] Under international law, states have several jurisdictional bases on which they may exercise their taxing authority.[132] Thus, states most commonly assert tax jurisdiction based on nationality, residence, and territorial source of the income.[133] These bases enable states to extend their taxing authority beyond their own borders.[134] Because states can impose their tax regime extraterritorially, individuals who engage in international transactions may be taxed by more than one state for the same

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128. If the sale of an intangible asset, including copyrights and patents, is made contingent upon its "productivity, use, or disposition," the source of the payments will be determined "in the same manner as if such payments were royalties." I.R.C. § 865(d)(1)(B). *See* AMP, Inc. v. United States, 492 F.Supp. 27, 31-33 (M.D. Pa. 1979) (payments made under an exclusive licensing contract and totally dependent on the use of the patent are royalties).

129. 200 F.2d 63 (2d Cir. 1952), *cert. denied*, 345 U.S. 935 (1953).

130. Because Bloch retained "an interest in the profitable exploitation of the patented articles by receipt of a percentage of the sales price," the IRS treated the payments as royalties. *Id.* at 66. *Contra* General Aniline & Film Corp. v. Comm'r, 139 F.2d 759, 760 (2d Cir. 1944) (payments under contract granting all rights to the patent that are not contingent on future profits are not royalties).

131. *See* GUSTAFSON & PUGH, *supra* note 10, ¶ 2007.

132. *See* RESTATEMENT (THIRD) OF THE FOREIGN RELATIONS LAW OF THE UNITED STATES § 411 (1986).

133. *See* GUSTAFSON & PUGH, *supra* note 10, ¶ 2007.

134. *Id.*

item of income.[135] Thus, states have negotiated bilateral income tax treaties in part to provide a solution to the double taxation problem.[136]

B. *Overview of United States Income Tax Treaties*

The major function of tax treaties is to limit the authority of one state to tax domestic source income realized by another state's residents.[137] The objective is to protect individuals and businesses from being taxed twice on their earnings from international transactions.[138] Consequently, tax treaties may reduce or eliminate United States income tax liabilities for residents of treaty states.[139]

The United States currently has bilateral income tax agreements in effect with forty-one states,[140] and this number continues to grow. For example, the United States has signed bilateral income tax agreements that are awaiting ratification with nine states[141] and is in the process of negotiating income tax treaties with fourteen more states for the first time.[142] In addition to these growing treaty obligations, the United States is renegotiating twelve of its treaties currently in effect.[143]

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135. *Id.*

136. *Id.* ¶ 10,007.

137. *Id.*

138. *Id.*

139. *Id.* A treaty will never result in higher tax obligations for residents of treaty states. Bilateral income tax treaties may dictate different rules for the taxation of residents of the two treaty partners. *Id.*

140. Income tax treaties are currently in force between the United States and the following states: Australia, Austria, Barbados, Belgium, Canada, China, Cyprus, Denmark, Egypt, Finland, France, Germany, Greece, Hungary, Iceland, India, Indonesia, Ireland, Italy, Jamaica, Japan, Korea, Luxembourg, Malta, Morocco, the Netherlands, Netherlands Antilles (terminated in part), New Zealand, Norway, Pakistan, Philippines, Poland, Romania, Spain, Sweden, Switzerland, Trinidad & Tobago, Tunisia, USSR, the United Arab Republic, and the United Kingdom. 1 Tax Treaties (CCH) 23-24 (July 1992); 1 Tax Treaties (WGL) ¶ 1011.

141. The United States has signed income tax treaties with Argentina, Bangladesh, Brazil, British Virgin Islands, Israel, Mexico, Russia, Sri Lanka, and Thailand. 1 Tax Treaties (WGL) ¶ 1011; 1 Tax Treaties (CCH) 25 (Aug. 1993).

142. The 14 states negotiating their first income tax treaty with the United States are Algeria, Bulgaria, Czech Republic, Kazakhstan, Kuwait, Malaysia, Portugal, Singapore, Taiwan, Thailand, Turkey, Ukraine, Venezuela, and Zambia. 1 Tax Treaties (WGL) ¶ 1011.

143. The United States is negotiating new treaties with the Austria, Belgium, Canada, Denmark, France,, Ireland, Italy, the Netherlands, Pakistan, Sweden, Switzerland, and Trinidad & Tobago. 1 Tax Treaties (WGL) ¶ 1011.

The comprehensive income tax treaties that the United States has negotiated with other states provide special rules for all sources of income that individuals and businesses receive. These treaties address at least four major issues that affect nonresident alien artists, musicians and similar professionals: residence;[144] royalties;[145] sale of personal property;[146] and compensation.[147] Tax treaties may also include a special provision for artists and performers.[148] Although almost every treaty differs in significant respects from state to state,[149] the Treasury Department has developed a model income tax treaty[150] which serves as a guide to explain the myriad of tax issues facing nonresidents.

C. *United States Treasury Department Model Tax Treaty*

The Treasury Department's model income tax treaty (Model Treaty) establishes the United States current position with other states[151] by providing a draft set of tax rules for each type of income that non-United States residents may receive.[152] As a result, the Treasury model serves as a useful guide for residents of states currently negotiating or renegotiating a treaty with the United States.[153] The Model Treaty provides a good indication of the transactions likely to be affected and provides some basis on which nonresidents whose states are or will be negotiating tax treaties with the United States may plan future transactions. The Model Treaty is also useful for comparing and contrasting the provisions of actual tax treaties that the United States has negotiated.

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144. *See* Treasury Department's Model Income Tax Treaty of June 16, 1981, Tax Treaties (CCH) ¶ 211, art. 4 [hereinafter Model Treaty].

145. *Id.* art. 12.

146. *Id.* art. 13.

147. *Id.* arts. 14, 15, 17.

148. *Id.* art. 17 (higher earnings threshhold for artists and entertainers).

149. GUSTAFSON & PUGH, *supra* note 10, ¶ 10,007.

150. Model Treaty, *supra* note 144.

151. GUSTAFSON & PUGH, *supra* note 10, ¶ 10,013.

152. *Supra* notes 144-48 and accompanying text.

153. *See supra* notes 142-43 (listing pending treaties). The Model Treaty is also undergoing revisions. In 1992, the Treasury Department announced plans to review and revise the Model Treaty. Treasury requested comments on several topics, including the classification of different types of royalty income and personal services income. Treasury also announced its withdrawal of the 1981 Model Treaty because it was outdated. *See* Treasury News Release 92-6387 (July 17, 1992), *reprinted in* 92 Tax Notes International 31-29 (July 29, 1992) (Treasury Announces Review of Model Income Tax Treaty).

1. Residency Rules

The residents of treaty states benefit from the tax reductions and other helpful clarifications provided by tax treaties.[154] To protect against double taxation, the treaties give preference to the income tax of the taxpayer's state of residence.[155] The residence rules represent the switching station under tax treaties, determining which state's income tax rules will apply.

Under the Treasury Department's Model Treaty, the residence of the taxpayer generally is considered to be his domicile.[156] If the individual has a domicile in both states, his residence is the state in which he has a permanent home or which is the center of his personal and economic interests.[157] The treaty, however, does not provide relief to an individual who receives income from only one of the treaty states.[158]

2. Royalty Income

The tax treatment of royalty income also is based on the individual's residence. Article 12 of the Model Treaty provides that royalties may be taxed only by the state in which the individual resides[159] and broadly defines royalties to include payments for the use of any copyright, patent, or trademark.[160]

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154. *See* GUSTAFSON & PUGH, *supra* note 10, ¶ 10,103.
155. *Id.* ¶ 10,175.

> 156. For purposes of this Convention, the term 'resident of a Contracting State' means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, citizenship, place of management, place of incorporation, or any other criterion of a similar nature . . .

Model Treaty, *supra* note 144, art. 4.

> 157. Where . . . an individual is a resident of both Contracting States . . . he shall be deemed to be a resident of the State in which he has a permanent home available to him; if he has a permanent home available to him in both States, he shall be deemed to be a resident of the State with which his personal and economic relations are closer (center of vital interests).

Id.

158. "[T]he term 'resident of a Contracting State' . . . does not include any person who is liable to tax in that State in respect only of income from sources in that State . . . ." *Id.*

159. "Royalties derived and beneficially owned by a resident of a Contracting State shall be taxable only in that State." *Id.* art. 12.

160. "The term 'royalties' . . . means payments of any kind received . . . for the use of, or right to use, any copyright of literary, artistic, or scientific work (but

The Treaty treats the sale of a copyright or patent as generating royalty income if the payments are made contingent on its productivity, use, or disposition.[161]

Thus, the United States does not tax residents of treaty states on any income they generate from selling or licensing their copyrights or patents in the United States. This rule provides a major exception to the United States Tax Code, under which the United States taxes royalty income only if the copyright or patent is used in the United States[162] with the copyright owner's residence being irrelevant.[163] The Model Treaty also exempts residents of contracting states from the thirty percent excise tax imposed by section 865 on the sale of copyrights or patents.[164]

Article 12's benefits are not available to non-United States residents whose royalties are attributable to a permanent establishment or fixed base in the United States.[165] In a leading case, *Simenon v. Commissioner*,[166] a French author maintained a home in the United States. Simenon continually used his United States residence as an office[167] where he wrote and promoted his mystery novels and negotiated their translation and distribution with United States publishers.[168] Because the author's income from the books was derived from a fixed place of business in the United States, the Model Treaty did not shelter that income from United States tax.[169] In a situation such as Simenon's, the

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not including . . . films . . .), any patent, trademark, design or model, plan, secret formula or process, or other like right or property. . . ." *Id.*

161. "The term 'royalties' also includes gains derived from the alienation of any such right or property which are contingent on the productivity, use, or disposition thereof." *Id.*

162. I.R.C. § 861(a)(4); *see supra* part III.C.

163. *See* I.R.C. § 861(a)(4).

164. *See supra* part III.D.

165. [Article 12] shall not apply if the beneficial owner of the royalties, being a resident of a Contracting State, carries on business in the other Contracting State . . . through a permanent establishment . . . or performs in that other State independent personal services from a fixed base situated therein, and the royalties are attributable to such permanent establishment or fixed base.

Model Treaty, *supra* note 144, art. 12.

166. 44 T.C. 820 (1965).

167. The treaty lists an office as a fixed place of business. Model Treaty, *supra* note 144, art. 5.

168. *Simenon*, 44 T.C. at 827.

169. *Id.*

United States would either tax the income as business profits[170] or as income from personal services.[171]

Many existing treaties between the United States and its major trading partners follow the Model Treaty rules for royalties.[172] For example, the United States tax conventions with Germany[173] and the United Kingdom[174] provide the same tax relief as the Model Treaty. Alternatively, several treaties provide tax relief for royalties by capping the tax that the United States may impose on nonresidents. The convention with Japan, for example, limits the tax on royalties of nonresidents to ten percent.[175] In some cases, United States tax treaties provide tax relief only for certain categories of royalties. The United States convention with Canada, for instance, exempts only copyright royalties from double taxation.[176] It does not, however, relieve patent royalties from United States tax.[177] At the other extreme, the United States convention with the former Soviet Union provided no tax relief for royalty income.[178] A new tax convention with Russia has yet to be ratified,[179] leaving Russian citizens subject to United States tax on their royalty income.

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170. Model Treaty, *supra* note 144, arts. 7, 12.

171. *Id.* arts. 12, 14.

172. For simplicity, the comparisons will be limited to conventions with the United States major trading partners: Canada, France, Germany, Japan, and the United Kingdom.

173. Convention for the Avoidance of Double Taxation, Aug. 29, 1989, U.S.-Germany, art. 12, Tax Treaties ¶ 3249 (CCH).

174. Convention for the Avoidance of Double Taxation, Dec. 31, 1975, U.S.-U.K., art. 12, Tax Treaties ¶ 10,903 (CCH).

175. Convention for the Avoidance of Double Taxation, Mar. 8, 1971, U.S.-Japan, art. 14, Tax Treaties ¶ 5203 (CCH). *See also* Convention for the Avoidance of Double Taxation, Sept. 26, 1980, U.S.-Can., art. XII, Tax Treaties ¶ 1903 (CCH) (tax on royalties capped at 10%); Convention with Respect to Taxes on Income and Property, Jul. 28, 1967, U.S.-Fr., art. 11, Tax Treaties ¶ 3003 (CCH) (royalty tax capped at 5%).

176. Convention for the Avoidance of Double Taxation, Sept. 26, 1980, U.S.-Can., art. XII, Tax Treaties ¶ 1903 (CCH). The treaty defines copyright royalties as royalties from literary, dramatic, musical, and artistic works. *Id. See* Convention with Respect to Taxes on Income and Property, Jul. 28, 1967, U.S.-Fr., art. 11, Tax Treaties ¶ 3003 (CCH) (no tax on royalties from literary, artistic, or scientific works, unless interest is fully alienated).

177. Convention for the Avoidance of Double Taxation, Sept. 26, 1980, U.S.-Can., art. XII, Tax Treaties ¶ 1903 (CCH). The convention with Canada is in the process of being renegotiated. 1 Tax Treaties ¶ 1011 (WGL).

178. Convention for the Avoidance of Double Taxation, Jun. 20, 1973, U.S.-U.S.S.R., Tax Treaties ¶ 10,953 (CCH).

179. The convention between the United States and Russia was signed on June 17, 1992. 1 Tax Treaties ¶ 1011 (WGL) (listing treaty status).

3. Sales of Personal Property

The Model Treaty's rules on the tax treatment of personal property sales are based on the seller's residence. Article 13 provides that gains from the sale of personal property are generally taxable in the state of residence.[180] However, if the individual performs personal services at a fixed base[181] in another state, then the other state may tax any gains attributable to that activity.[182] This rule is generally consistent with the source rules under Code section 865 as amended in 1986.[183] The 1986 Act provided that the relief provisions of section 865 will prevail over existing treaty requirements.[184]

It is important to note, however, that the Model Treaty generally applies different rules to the sale of a copyright or patent. If the nonresident receives gains from the sale of copyright interests, article 13 generally does not apply,[185] but the rules under article 12 would prevail if the payments were made contingent on the productivity or use of the copyright.[186] Thus, the treaty grants these payments preferential treatment. Absent article 12, the United States would tax the proceeds from the sale of a copyright or patent in the United States by a nonresident at a thirty percent rate.[187]

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180. Model Treaty, *supra* note 144, art. 13.

181. For a discussion on determining a permanent establishment or fixed base, see *supra* notes 165-70 and accompanying text.

182. *Id.* For further discussion of the criteria for identifying a permanent establishment, see GUSTAFSON & PUGH, *supra* note 10, ¶ 10,031; Simenon v. Commissioner, 44 T.C. 820 (1965).

183. *See* I.R.C. § 865(a) (source of income from the sale of personal property based on residency); I.R.C. § 865(e) (sales from fixed place of business taxable where business is located).

184. I.R.C. § 7852(d)(1). For a discussion of the interaction of the 1986 Act and treaties, see *infra* part V.D.2. Existing treaty articles that provide less generous treatment than I.R.C. § 865 will no longer be relevant since the purpose of tax treaties is to provide relief from higher tax burdens that would otherwise prevail in the respective states without the treaties. *See* GUSTAFSON & PUGH, *supra* note 10, ¶¶ 10,007, 10,157.

185. "Gains described in Article 12 (Royalties) shall be taxable only in accordance with the provisions of Article 12." Model Treaty, *supra* note 144, at art. 13.

186. *Id.* arts. 12, 13. *See supra* part V.C.2.

187. The rules under I.R.C. § 865 do not apply to royalty payments made contingent on the productivity, use, or disposition of the copyright or patent. I.R.C. § 865(d)(1). *See supra* note 88 and accompanying text.

4. Compensation

The Model Treaty rules on compensation income focus on two factors: where the nonresident performs the work and whether he is working in an independent capacity. Thus, the Model Treaty grants limited tax relief for nonresidents with compensation income by providing that a nonresident who performs personal services in the United States will not be taxed in the United States if he meets certain conditions. First, if the nonresident is performing services under an employment arrangement with a nonresident employer, the United States will not tax his compensation if he spends no more than 183 days in the United States.[188] If the nonresident is working in an independent capacity in the United States, the United States will not tax his compensation income if the income is not attributable to a fixed base of operation in the United States.[189] The United States treaties with Canada and Germany follow the Model Treaty on this matter.[190] Several tax treaties, however, grant narrower exceptions for nonresidents performing independent services. For example, the treaty with Japan allows the United States to tax the compensation income of nonresidents who work independently if they are present in the United States for more than 183 days.[191]

In the case of artists and athletes, the Model Treaty stipulates different rules.[192] For example, if a nonresident entertainer or musician performs in the United States, the United States may tax his earnings[193] unless his receipts do not exceed

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188. Model Treaty, *supra* note 144, art. 15. Article 15 also requires that the nonresident employer not maintain a fixed base in the United States. *Id.*

189. *Id.* art. 14. The United States may tax the nonresident's compensation if a United States site is available to him regularly for the performance of his activities. *Id.*

190. Convention for the Avoidance of Double Taxation, Sept. 26, 1980, U.S.-Can., art. 14, Tax Treaties ¶ 1903 (CCH); Convention for the Avoidance of Double Taxation, Aug. 29, 1989, U.S.-Germany, art. 14, Tax Treaties ¶ 3249 (CCH).

191. Convention for the Avoidance of Double Taxation, Mar. 8, 1971, U.S.-Japan, art. 17, Tax Treaties ¶ 5203 (CCH). The treaties with the United Kingdom and France mandate the same limit. Convention for the Avoidance of Double Taxation, Dec. 31, 1975, U.S.-U.K., art. 14, Tax Treaties ¶ 10,903 (CCH); Convention for the Avoidance of Double Taxation, Jul. 28, 1967, U.S.-Fr., art. 14, Tax Treaties ¶ 3003 (CCH).

192. The treaty provision provides relief to musicians and to theater, motion picture, radio, and television entertainers. Model Treaty, *supra* note 144, art. 17.

193. "[I]ncome derived by a resident of a Contracting State as an entertainer, such as a theater, motion picture, radio, or television artist, or a musician . . . from his personal activities . . . in the other State, may be taxed in that other State . . . ." *Id.*

twenty thousand dollars.[194] Despite this twenty thousand dollar exception in the Model Treaty, the United States has negotiated lower earnings ceilings for artists and athletes with many states. For example, the treaty with France exempts only artists who earn no more than ten thousand dollars in the United States,[195] and the treaty with Japan grants an even narrower three thousand dollar exemption.[196]

In general, the Model Treaty provides more generous exceptions for nonresidents than does the Code. For example, section 861 of the Code taxes nonresidents on their compensation for services performed in the United States[197] and exempts nonresidents only if they are present in the United States for no more than ninety days per year and earn no more than three thousand dollars.[198]

5. Withholding Tax Relief

The Model Treaty is also more generous than the Code with respect to United States withholding tax because it suspends the withholding tax on royalties paid to nonresidents.[199] The Treaty also exempts certain compensation income of nonresidents from withholding.[200] Some treaties, including the treaty with Germany, however, do not relieve nonresidents from withholding tax.[201] Instead, the nonresidents must file for a refund if the item is exempt from United States tax.[202]

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194. *Id.*

195. Convention with Respect to Taxes on Income and Property, Jul. 28, 1967, U.S.-Fr., art. 16, Tax Treaties ¶ 3003 (CCH); *see also* Convention for the Avoidance of Double Taxation, Sept. 26, 1980, U.S.-Can., art. XVI, Tax Treaties ¶ 1903 (CCH) ($15,000 ceiling); Convention for the Avoidance of Double Taxation, Dec. 31, 1975, U.S.-U.K., art. 17, Tax Treaties ¶ 10,903 (CCH) ($15,000 ceiling).

196. Entertainers may be present no more than 90 days and may earn no more than $3,000 in the United States. Convention for the Avoidance of Double Taxation, Mar. 8, 1971, U.S.-Japan, art. 17, Tax Treaties ¶ 5203 (CCH).

197. I.R.C. § 861(a)(3).

198. *Id.*

199. Model Treaty, *supra* note 144, art. 12.

200. *Id.* arts. 14, 15. For a discussion of the tax withholding requirements, see *supra* part II.B.

201. Convention for the Avoidance of Double Taxation, Aug. 29, 1989, U.S.-Germany, art. 29, Tax Treaties ¶ 3249 (CCH) (withholding regime still applies).

202. *Id.*

D. *Coordination Between United States Tax Laws and Tax Treaties*

A basic tenet of United States jurisprudence is that when a treaty and statute conflict, the later in time prevails.[203] Historically, however, when the terms of a tax treaty and the United States Tax Code differed, the provisions of the treaty governed unless the Code provided otherwise. Prior to the Tax Reform Act of 1986, the Code deferred to treaty obligations. The Tax Reform Act codified the principle that the most recent iteration of the United States, whether treaty or statute, would prevail.[204]

1. Pre-1986 United States Tax Law

Prior to the Tax Reform Act of 1986, the Code generally provided that statutory changes would not disturb existing United States treaty obligations. The Code's former section 894 deferred to a treaty, stating that the individual would not be taxed if a treaty exempted the item of income.[205] Similarly, when Congress recodified the Tax Code in 1954, it decreed that existing treaty obligations would not be disturbed by the reconsolidation.[206]

In most instances, this issue does not arise because a tax statute makes clear that it is not intended to interfere with existing treaty obligations. On several occasions, however, the United States Congress has expressly overridden existing tax treaty obligations. Provisions of this sort are referred to as "treaty overrides," and United States courts will uphold these laws, even though the United States would then be in violation of a treaty and thereby international law.[207]

203. RESTATEMENT (THIRD) OF THE FOREIGN RELATIONS LAW OF THE UNITED STATES § 115 (1986).

204. *See infra* note 208 and accompanying text; *see also* GUSTAFSON & PUGH, *supra* note 10, ¶¶ 10,157, 10,163.

205. "Income of any kind, to the extent required by any treaty obligation of the United States, shall not be included in gross income and shall be exempt from taxation under this subtitle [Income Taxes]." I.R.C. § 894(a) (1982). For examples of the Internal Revenue Service's application of the old provision, see Rev. Rul. 84-152, 1984-2 C.B. 381 and Rev. Rul. 84-17, 1984-1 C.B. 308. For an example of the Tax Court's application of the old rule, see Aiken Industries, Inc. v. Commissioner, 56 T.C. 925 (1971). For additional background, see Cook v. United States, 288 U.S. 102 (1933) (treaties are superior to domestic tax laws).

206. "No provision of this title shall apply in any case where its application would be contrary to any treaty obligation of the United States in effect on the date of enactment of this title." I.R.C. § 7852(d) (1982) (amended in 1988).

207. *See* GUSTAFSON & PUGH, *supra* note 10, ¶¶ 10,157, 10,163.

2. Post-1986 United States Tax Law

When Congress enacted the 1986 Tax Reform Act, it adopted a different posture regarding treaty obligations. Congress expressly codified the judicial doctrine that the latest expression of the sovereign prevails,[208] and that position became the general rule under section 7852(d). Consequently, a tax treaty no longer provides the same degree of security against future United States tax law changes. First, all existing treaties are subject to override by future amendments to the Code.[209] Second, the law now requires taxpayers to disclose when they are relying on a conflicting treaty provision,[210] and individuals are subject to a fine of one thousand dollars for failure to comply with the reporting requirements.[211]

The 1986 Act expressly provides which provisions of the Act would defer to an existing treaty obligation.[212] For purposes of this Note, the most relevant section that Congress amended was section 865, regarding the sale of personal property. Pursuant to section 7852(d), section 865 prevails over the provisions of existing treaties.[213]

Despite congressional efforts to indicate when the Code defers to an existing treaty obligation, future problems could still arise because of the interaction between the 1986 Act and treaty obligations. If a future conflict is discovered between a pre-1986 Act treaty and the Code that the drafters of the 1986 Act did not address, the Code provides that the Code prevails.[214] The problem is that the 1986 Act recodified the entire Code, including many provisions in which Congress retained the old statutory language without change. The point of contention is whether

208. "For purposes of determining the relationship between a provision of a treaty and any law of the United States affecting revenue, neither the treaty nor the law shall have preferential status by reason if its being a treaty or law." I.R.C. § 7852(d)(1). Section 894 was amended to provide as follows: "The provisions of this title shall be applied to any taxpayer with due regard to any treaty obligation of the United States which applies to such taxpayer." I.R.C. § 894(a)(1). The "due regard" given to a treaty obligation is the principle that the latest expression prevails, as provided under I.R.C. § 7852(d). *See* I.R.C. § 894(a)(2). For a general interpretation of these sections, see GUSTAFSON & PUGH, *supra* note 10, ¶ 10,157.

209. Similarly, any new treaty article that conflicted with an existing Code provision would prevail over the Code.

210. I.R.C. § 6712(a).

211. I.R.C. § 6712(a).

212. H.R. CONF. REP. NO. 1104, 100th Cong., 2d Sess., pt. 2, at 11-12 (1988).

213. For a discussion of the rules under I.R.C. § 865, see *supra* part III.D.

214. I.R.C. § 7852(d).

Congress intended those recodifications to nullify thereby all treaty obligations in existence in 1986.[215]

3. Withholding Tax Relief

In general, the Code requires payors to withhold United States income taxes from payments made to nonresident aliens.[216] The Code, however, provides the Treasury Department with regulatory authority to exempt compensation income of nonresidents from withholding.[217] The Treasury has issued regulations exempting compensation paid to nonresidents if a United States tax treaty exempts that income from United States tax.[218] Under the regulations, the payor must file a statement with the IRS in order to receive this exemption.[219]

VI. STRATEGIES TO MINIMIZE UNITED STATES TAX EXPOSURE

Despite the United States aggressive tax stance on collecting taxes from nonresident authors, artists, and other creative professionals, United States tax rules provide significant planning opportunities for these individuals that help to minimize their tax exposure. The Code provides particular rules with which nonresidents must conform in order to reduce or eliminate their tax obligations to the United States government. Nonresidents must anticipate the tax consequences before engaging in business arrangements in the United States. The best opportunities for tax planning strategies are available for nonresidents who are citizens of a state that has negotiated a tax treaty with the United States .

A. *Nonresidents Without Tax Treaty Protection*

United States tax laws are much more likely to reach the income of nonresidents whose home states have not negotiated a tax treaty with the United States. These nonresidents face a greater risk of being taxed twice on their income. United States

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215. The 1986 Act did not include a savings clause similar to the provision in the 1954 recodification act that insulated existing treaty obligations. *See supra* note 206 and accompanying text; GUSTAFSON & PUGH, *supra* note 10, ¶ 10,163.

216. I.R.C. § 1441(a), (c)(1).

217. I.R.C. § 1441(c)(4).

218. Treas. Reg. § 1.1441-4(b) (Feb. 2, 1990).

219. Treas. Reg. §§ 1.1441-4(b)(2), 1.1461-2(c)(2)(ii) (Sept. 19, 1984).

tax laws, nonetheless, provide these nonresidents with several means to avoid United States income taxes in transactions with United States parties.

1. Compensation for Personal Services

Nonresidents need to plan in order to avoid receiving compensation income that the Code will source in the United States.[220] Nonresidents without treaty protection have two options available. First, assume that the nonresident is an author of children's books who lives and works in Germany. Before composing any books, the author should enter into a service contract with a United States publisher specifying how many children's books the author is to write and when the author is to finish them. In addition, the contract should stipulate that the author's specified books are for the exclusive use and benefit of the United States publisher. The contract should also establish that the author is deriving his income from his labor, not from any ownership interest in his books,[221] and, finally, the author must write the books in Germany.[222] If these conditions are met, the Code will treat the author's income as compensation from a source outside the United States, which is free from United States tax.[223]

The nonresident's second alternative is to act within the parameters of the de minimis exception for compensation.[224] For example, consider a nonresident musician with the French Symphony, which has booked several performances in the United States. The nonresident musician will not be taxed in the United States on his earnings if he meets the following requirements. First, he must not be on tour in the United States for more than ninety days during the year. Second, he must be paid no more than three thousand dollars for the United States engagements.

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220. In general, the Code taxes all income from United States sources. *See supra* part III.A.

221. The IRS will treat the income as compensation if the author performs for the exclusive benefit of, and under the direction of, the United States publisher. *See supra* part IV.A. (discussing identification of compensation income).

222. The Tax Code sources compensation income from the state in which the work is performed. *See supra* part III.B. (discussing source rules for compensation).

223. I.R.C. § 862(a)(3).

224. *See* I.R.C. § 861(a)(3); *see supra* part III.B (discussing de minimis exception).

Third, he must be working for a foreign business, in this case, the French Symphony.[225]

Another option may be available to nonresidents who are not protected by a tax treaty and who do not qualify for tax exempt compensation. For example, the United States imposes a lower tax on nonresident compensation income connected with a United States trade or business than on royalties.[226] Therefore, a nonresident may want to meet the criteria for conducting a business in the United States.[227] To illustrate, the Code would treat the French musician as conducting a United States business if he accepted a position with a United States orchestra. Thus, although the French musician would be taxed on compensation income sourced in the United States, this tax would be lower than that on royalties received from similar activity.

2. Sale and Licensing of Copyrights

Many authors and artists may not have the standing or reputation to negotiate a pre-composition compensation agreement with a United States company, which would avoid higher tax liability. They also may be unable to satisfy the de minimis compensation rule. To avoid paying United States taxes, these nonresidents should orchestrate a sale of their copyright interests, which the United States does not tax.[228]

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225. The Code also requires that the foreign business not be engaged in a United States trade or business. I.R.C. § 861(a)(3)(C)(i).

226. The United States taxes net compensation income connected with a United States business at graduated tax rates, from 15% to 39.6%. I.R.C. § 1. By contrast, the Code taxes gross royalties from a United States source at a flat 30%. I.R.C. § 871(a)(1) To illustrate, a nonresident who earned $10,300 in royalties not connected with a United States business would pay $3,090 in United States taxes, while a nonresident who received $10,300 in compensation connected with a United States business would pay no more than $1,200 in United States taxes. (A single nonresident is allowed a personal exemption amount, which was $2,300 in 1993; the Code would tax the remaining $8,000 at a rate of 15%. The tax would be even lower if the nonresident had any deductible expenses connected with the United States business.) For a discussion of calculating the taxes on nonresidents, see *supra* part II.B; GUSTAFSON & PUGH, *supra* note 10, ¶¶ 4175, 4205.

227. Conversely, if the nonresident clearly receives compensation income solely from sources outside the United States, he should avoid establishing any United States ties that would suggest engagement in a United States business. The Code considers a nonresident to be conducting a United States trade or business if he performs services in the United States for a United States business. I.R.C. § 864(b)(1); GUSTAFSON & PUGH, *supra* note 10, ¶ 4013; *see infra* part VI.A.3.

228. I.R.C. § 865(a); *see supra* part III.D. (discussing personal property sales).

To illustrate, the German author of children's books should take the following steps. First, he should write the books and copyright them, thereby establishing his ownership interests, and then sell all of his manuscript rights to a United States publisher. The contract must clearly establish that the author is conveying all of his property interests in the books,[229] and should not make the payments contingent on the United States publisher's use or exploitation of the manuscripts.[230] For additional security, the contract should provide that the author will receive a single, lump sum payment.[231] The United States publishing house presumably will not pay as much for a copyright interest if it is not allowed to condition its payment on the copyright's productivity. This option therefore will be viable for a nonresident only if the sales proceeds are greater than a comparable royalty payment after United States taxes.[232]

3. United States Trade or Business Income

Nonresidents who receive only foreign source income may still be exposed to United States taxes if they meet the criteria for engaging in a United States business. Significantly for authors and artists, the Code will reach foreign source royalty income of nonresidents who are engaged in a United States business.[233] A nonresident may be treated as engaged in a United States business if he performs personal services in the United States[234] or if he has an office or established place of business in the

229. *See supra* notes 122-27 and accompanying text.

230. The Code taxes contingent sales of copyrights as royalties. I.R.C. § 865(d)(1).

231. *See supra* note 116 and accompanying text. Finally, the author should not maintain a home in the United States, which could trigger United States tax. *See supra* note 83 and accompanying text. If the individual inadvertently becomes a United States resident by satisfying the substantial presence test, he can still insulate his proceeds from United States tax by selling the copyright through a foreign office. *See supra* note 77 and accompanying text.

232. To illustrate, assume that the publisher will pay the author $1,000 for the sale of his copyright. The United States would not tax this payment. The publisher will also pay the author royalties of $2,000 contingent on the success of book sales. The after-tax value of the royalty payment is $1,400 ($2,000 less the 30% tax under I.R.C. § 871 or $600). In this example, therefore, the author may prefer to receive royalties and retain future interests in his publication.

233. I.R.C. § 864(c)(4)(B)(i) (foreign source royalty income connected with a United States business).

234. I.R.C. § 864(b) (performance of personal services in the United States is a United States business).

United States from which he developed his copyrighted material.[235]

For example, if a nonresident author was hired by a United States publisher to write a series of Broadway musical reviews from its New York offices,[236] copyrighted the articles, and received royalty payments on the sale of the articles to newspapers and magazines around the world,[237] he may be subject to United States tax on his worldwide royalty income from the articles,[238] not just his royalties from United States sales. To avoid exposure to this expansive United States tax liability, the nonresident author should take steps to ensure that he does not evidence an office or fixed place of business in the United States. For example, he should travel to the United States only for purposes of attending the Broadway shows, request that the publisher not set aside office space for his use in New York, and write his reviews back in his home state. He should also make sure that his articles are marketed and sold on his behalf only by independent United States agents and publishers who also represent other writers.[239]

B. *Nonresidents Covered by Tax Treaties*

In contrast to nonresidents who are not protected by tax treaties, nonresidents whose home states have negotiated tax treaties with the United States have more significant opportunities to shelter their income from United States taxes. Because these nonresidents rely on a treaty, they must consider several factors. First, tax treaties vary from state to state, so the nonresident must review the particular provisions of his state's tax treaty. Second, the nonresident must make sure that both governments have put the treaty into effect because a treaty that has been signed but not ratified provides no tax relief to nonresidents.[240] Similarly, tax treaties are subject to

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235. I.R.C. § 864(c)(4)(B)(i) (royalties derived from active United States business).

236. This arrangement would meet the performance of personal services in the United States prong, establishing a United States business.

237. This arrangement satisfies the royalties attributable to a United States business prong since the royalties were derived from writing the articles in the United States.

238. The Code attributes the foreign source royalties to the United States business. I.R.C. § 864(c)(4)(B)(i).

239. The Code also attributes the office of an exclusive agent to the nonresident author. I.R.C. § 864(c)(5)(A).

240. For example, the United States tax treaty with Russia has been signed but has not been ratified. *See supra* note 179.

renegotiation and revision,[241] and the nonresident must check the treaty's status before proceeding under the assumption that the treaty is valid and applicable in the particular situations. Third, the United States Congress may override existing treaty obligations through subsequent statutory changes.[242] Nonresidents, therefore, must consider including contingency clauses in their contracts to insulate them from future tax law changes. Fourth, the nonresident must review the treaty's residency rules to determine whether the treaty's provisions apply.[243] Once the nonresident has completed these steps, he may proceed to consider possible tax reduction strategies.

1. Royalty Income

United States tax treaties almost uniformly provide significant tax relief to the royalty income of nonresidents.[244] Nonresidents generally will prefer to receive royalties from United States sources over other forms of income. Royalty income has three principal advantages for citizens of treaty states. First, the United States generally does not tax royalties that these nonresidents receive from United States sources.[245] Second, the author or artist retains significant ownership interests and control over his creative works.[246] Finally, the author or artist may have an easier time marketing his works and be able to receive a higher return because the treaty allows him to make his royalties contingent on the productivity or use of his copyright without being taxed in the United States.[247]

The nonresident must plan to avoid two traps in the Code for royalty income. First, he must avoid establishing, either directly or through an agent, a fixed base of operation in the United States, such as by working in an office or residence in the United States. Tax treaties generally provide no relief for nonresidents whose royalties are attributable to a fixed base or permanent establishment in the United States.[248] Second, United States tax treaties generally do not provide relief for royalties from films

241. For a list of treaties under negotiation or renegotiation, see *supra* notes 142 and 143.

242. *See supra* note 204 and accompanying text.

243. For a discussion of the residency rules, see *supra* part V.C.1.

244. *See supra* notes 172-77 and accompanying text.

245. *Id.*

246. By contrast, the Code relieves copyright income from tax only if the nonresident relinquishes all of his ownership interests. *See supra* part IV.C.

247. *See supra* notes 185-87 and accompanying text.

248. *See supra* notes 165-71 and accompanying text.

distributed to theaters or from films or tapes broadcast by television or radio stations.[249]

Nonresident artists from treaty states also have the option of engaging in tax-free sales of copyrights.[250] The Code exempts sales of copyrights and other intangible assets by nonresidents from United States tax. Congress provided that the provisions under section 865 would be available to all nonresidents, even if they were entitled to less generous treatment under a pre-existing tax treaty.[251]

2. Compensation for Personal Services

Most tax treaties grant nonresidents wide opportunities to earn compensation income in the United States free from United States tax. First, most tax treaties allow nonresidents to work for a longer period in the United States on behalf of a foreign employer without being taxed on their compensation.[252] Second, most treaties allow entertainers, like musicians and actors, to earn more compensation in the United States than other nonresidents before incurring United States taxes.[253] Because the earnings ceilings vary by treaty, it is critical for the musician or entertainer to be aware of these ceilings so that he stays within their boundaries.

VI. CONCLUSION

The United States aggressively asserts its tax jurisdiction over nonresidents who do business in the United States. At the same time, United States tax laws provide significant opportunities for nonresidents to receive income from United States sources without paying United States taxes. The most significant transaction that the Code exempts for all nonresidents is the sale of copyright interests to United States entities. United States tax treaties grant greater tax-free opportunities for residents of treaty states. Tax treaties provide significant tax relief to non-United States residents for their royalty and

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249. *See* Model Treaty, *supra* note 144, art. 12(2) (defining covered royalties).

250. The same benefits are available to residents of non-treaty states. *See supra* part IV.A.2.

251. *See supra* notes 212-13 and accompanying text.

252. For example, the Model Treaty allows nonresidents to work up to 183 days in the United States for a foreign employer. *See supra* notes 188-91 and accompanying text.

253. *See supra* notes 192-96 and accompanying text.

compensation income. But, in the process, both the Code and tax treaties create significant tax traps for unwary nonresidents. The Code and treaties may deny tax benefits if all of the specified criteria are not met.

Nonresidents have several reasons to be vigilant in researching United States tax laws. First, nonresidents who do not plan properly may be taxed twice on their United States earnings, by both the United States and their home states. The United States alone may capture up to thirty percent of nonresidents' gross United States earnings. Second, the IRS has become more vigilant in recent years in enforcing United States tax laws. As the breadth of tax withholding and tax reporting expands, the likelihood that nonresidents will be able to disregard their United States tax obligations without getting caught and then paying the consequences becomes more remote.[254] Finally, in light of the United States continuing deficit problems, it is not improbable that nonresidents could become an attractive target for additional tax revenues in the future. President Clinton has proposed several tax changes that target international businesses and transactions.[255] Also, it should be noted that, following the 1986 Tax Reform Act, existing tax treaties no longer provide absolute protection against future United States tax law changes. Thus, nonresidents may cope with many of these problems satisfactorily only if they investigate United States tax laws prior to entering transactions with United States parties or with a United States nexus.

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254. *See supra* note 1 and accompanying text.
255. *See supra* note 2.