Kramer v. Commissioner, 80 T. C. 768, 1983 U. S. Tax Ct. LEXIS 93, 80 T. C. No. 38, 221 U. S. P. Q. (BNA) 268 (1983)

Royalties paid primarily for the use of a celebrity's name and likeness are not earned income, but royalties paid for personal services required by the contract may qualify as earned income.

Summary

Jack Kramer, a former tennis champion, received royalties from Wilson Sporting Goods Co. for the use of his name on tennis equipment. The court had to determine whether these royalties constituted 'earned income' for tax purposes. The Tax Court held that 70% of the royalties were for the use of Kramer's name, which did not qualify as earned income, while 30% were for personal services, which did qualify. This ruling necessitated an allocation between earned and unearned income, affecting Kramer's eligibility for certain tax benefits.

Facts

Jack Kramer, a former amateur and professional tennis player, entered into a contract with Wilson Sporting Goods Co. in 1947, extended in 1959, which allowed Wilson to use his name, nickname, and likeness on their tennis equipment. In return, Kramer received royalties based on sales. The contract also required Kramer to exclusively use Wilson products, promote their sales, and make promotional appearances. During 1975 and 1976, Kramer's activities in the tennis world extended beyond those required by the Wilson contract, including running tournaments and maintaining his reputation. The royalties received from Wilson in those years totaled $117,256. 58 in 1975 and $159,648. 18 in 1976.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Kramer's federal income taxes for 1975 and 1976, asserting that the royalties did not qualify as earned income for purposes of the maximum tax on earned income and contributions to Kramer's Keogh pension plan. Kramer petitioned the U. S. Tax Court, which then ruled on the allocation of his royalties between earned and unearned income.

Issue(s)

1. Whether royalties received by Kramer from Wilson for the use of his name and likeness on tennis equipment constitute 'earned income' for purposes of the maximum tax on earned income under section 1348 and contributions to a Keogh plan under section 404.
2. Whether an allocation between earned and unearned income is required when royalties are paid for both the use of a celebrity's name and personal services.

Holding

1. No, because the royalties were primarily for the use of Kramer's name, which represents goodwill and is not earned income, but royalties paid for personal services required by the contract do qualify as earned income.
2. Yes, because the court determined that 70% of the royalties were for the use of Kramer's name and 30% for personal services, requiring an allocation to accurately reflect earned income.

Court's Reasoning

The court applied sections 401(c)(2)(C) and 911(b) of the Internal Revenue Code to define 'earned income. ' It determined that royalties for the use of Kramer's name were not earned income because they represented goodwill, which is explicitly excluded from the definition of earned income. However, the court recognized that Kramer did perform some personal services required by the contract, such as promotional appearances, which were compensable as earned income. The court made a 70/30 allocation based on the evidence, acknowledging that precision was unattainable but necessary. The decision was influenced by the contract's terms, which stated that royalties were compensation for both the use of Kramer's name and the services he performed. The court also considered other cases involving royalty allocations but found them not directly applicable. The court's decision was guided by the principle that income from personal services can be distinguished from income derived from the use of a valuable intangible asset like a celebrity's name.

Practical Implications

This decision clarifies that royalties paid primarily for the use of a celebrity's name do not qualify as earned income for tax purposes, but royalties for personal services required by the contract can be treated as earned income. This necessitates careful allocation between the two types of income, which can significantly impact the tax treatment of celebrities and athletes who receive such royalties. Legal practitioners must consider this ruling when advising clients on structuring endorsement deals and royalty agreements to optimize tax benefits. The decision also affects how similar cases should be analyzed, requiring a detailed examination of the contract terms and the nature of services performed. Subsequent cases have cited Kramer v. Commissioner when addressing the tax treatment of royalties, reinforcing the need for clear distinctions between income sources.

