Garcia v. Commissioner, 140 T. C. 6 (2013)

In Garcia v. Commissioner, the U. S. Tax Court ruled on the allocation of income from a professional golfer's endorsement deal, determining that 65% was royalty income exempt from U. S. taxation under the U. S. -Swiss Tax Treaty, while 35% was taxable personal service income. This decision underscores the complexities of classifying income under tax treaties and impacts how athletes structure endorsement deals.

Parties

Sergio Garcia, a professional golfer and resident of Switzerland, was the petitioner. The respondent was the Commissioner of Internal Revenue. Garcia was represented by Thomas V. Linguanti, Jenny A. Austin, Jason D. Dimopoulos, Robert F. Hudson, Jr. , and Robert H. Moore. The Commissioner was represented by W. Robert Abramitis, Tracey B Leibowitz, and Karen J. Lapekas.

Facts

Sergio Garcia, a professional golfer, entered into a seven-year endorsement agreement with TaylorMade Golf Co. (TaylorMade) starting January 1, 2003. Under this agreement, Garcia was designated as TaylorMade's "Global Icon" and was obligated to exclusively use and endorse TaylorMade products, while TaylorMade was granted the right to use Garcia's image, name, and likeness to promote its products. The agreement initially allocated 85% of Garcia's compensation to royalties for his image rights and 15% to personal services, including product endorsements and appearances. Garcia established Even Par, LLC (Even Par) in Delaware to receive royalty payments, which were then directed to Long Drive Sàrl, LLC (Long Drive) in Switzerland. The IRS contested this allocation, arguing for a higher percentage attributed to personal services and asserting that all payments should be taxable in the United States, challenging the validity of the U. S. -Swiss Tax Treaty's application.

Procedural History

The IRS issued a notice of deficiency to Garcia for the tax years 2003 and 2004, determining deficiencies of $930,248 and $789,518, respectively. Garcia timely filed a petition contesting these deficiencies. The case was heard in the U. S. Tax Court, where both parties presented their arguments and expert testimonies on the allocation between royalties and personal services. The court's task was to determine the correct allocation and the applicability of the U. S. -Swiss Tax Treaty to Garcia's income.

Issue(s)

Whether the payments made by TaylorMade to Garcia under the endorsement agreement should be allocated 85% to royalties and 15% to personal services, as initially agreed upon?

Whether the U. S. source royalty income is taxable to Garcia under the U. S. -Swiss Tax Treaty?

Whether Garcia's U. S. source personal service income is taxable in the United States under the U. S. -Swiss Tax Treaty?

Rule(s) of Law

The U. S. -Swiss Tax Treaty provides that royalties derived and beneficially owned by a resident of Switzerland shall be taxable only in Switzerland. The treaty defines royalties as payments for the use of any copyright of literary, artistic, or scientific work, or other like right or property. Article 17 of the treaty states that income derived by a resident of one contracting state as a sportsman from personal activities exercised in the other state may be taxed in that other state.

The court must determine the intent of the parties by examining the endorsement agreement and the economic reality of the payments, as established in Goosen v. Commissioner, 136 T. C. 547 (2011).

Holding

The court held that the payments made by TaylorMade to Garcia were to be allocated 65% to royalties and 35% to personal services. The court further held that any U. S. source royalty income received by Garcia was exempt from taxation in the United States under the U. S. -Swiss Tax Treaty. However, all U. S. source personal service income was taxable to Garcia in the United States.

Reasoning

The court's reasoning was based on a detailed analysis of the endorsement agreement and the economic substance of the payments. The court found that Garcia's status as TaylorMade's "Global Icon" and the extent to which TaylorMade used his image rights to sell products indicated a higher value attributed to royalties than to personal services. The court compared Garcia's situation to that of another golfer, Retief Goosen, in Goosen v. Commissioner, where a 50-50 split was deemed appropriate. However, Garcia's unique position and the terms of his endorsement agreement warranted a different allocation.

The court rejected the 85-15 allocation in the endorsement agreement, citing testimony that TaylorMade did not heavily negotiate the allocation and that it did not reflect economic reality. The court also considered expert testimonies but ultimately relied on its own analysis of the facts and circumstances.

Regarding the U. S. -Swiss Tax Treaty, the court applied Article 12, which exempts royalties from U. S. taxation, finding that the income from Garcia's image rights was not predominantly attributable to his performance in the United States but rather to the separate intangible rights. The court rejected the IRS's argument that the royalty income was taxable under Article 17, which deals with income from personal activities as a sportsman.

The court also addressed Garcia's attempt to argue that some of his U. S. source personal service income might not be taxable, but found that this issue was raised too late and was thus not considered.

Disposition

The court's decision was to allocate 65% of the payments to royalties and 35% to personal services, with the royalty income being exempt from U. S. taxation and all U. S. source personal service income being taxable in the United States. The decision was to be entered under Rule 155.

Significance/Impact

This case is significant for its analysis of the allocation of income between royalties and personal services under endorsement agreements and the application of tax treaties to such income. It provides guidance on how courts may view the economic substance of endorsement deals and the intent of the parties in structuring such agreements. The decision impacts how athletes and other endorsers structure their deals to optimize tax benefits under international tax treaties. It also underscores the importance of timely raising issues in tax litigation and the potential consequences of late arguments.

