CHAPTER 1

Introduction

Wesley and Willie

The IRS received more than 127 million individual tax returns for 1999.[1] That is a huge number. But it was at least one short.

Wesley Snipes didn't file a return for 1999. He didn't file returns for 2000 or 2001 either, or for 2002, 2003, or 2004, even though he earned more than $37 million during those years. Snipes' failure to file wasn't an accident or an oversight; for 1999, 2000, and 2001, it was "willful." What's more, at the times he should have been filing returns for 2000 and 2001 but wasn't, he did file amended returns for 1996 and 1997 demanding refunds of more than $11 million in taxes he claimed he had paid "in error" for those years.

Snipes is an award-winning actor and producer, known to countless fans for his portrayal of the vampire-superhero in the *Blade* movie trilogy. He attended college. But his training accomplishments were in martial arts, not tax. The reason he didn't file tax returns was that he was advised that he didn't have to. Snipes did *not* get this advice from his lawyers. It is a matter of public record that his "long-time tax attorneys" told him that he was "required to file tax returns,"

1. *SOI Tax Stats – Individual Statistical Tables by Size of Adjusted Gross Income*, Internal Revenue Serv., http://www.irs.gov/uac/SOI-Tax-Stats---Individual-Statistical-Tables-by-Size-of-Adjusted-Gross-Income (last updated Aug. 22, 2014).

and when he refused to do so, the law firm "terminated Snipes as a client."[2]

Snipes was advised that he didn't have to file returns by a fellow named Eddie Ray Kahn—a notorious "tax denier" who spent 1985 to 1987 in prison for violating federal tax laws.[3] It's a shame that Snipes didn't know about Kahn's background—or if Snipes knew about it, that he ignored it—because Snipes took Kahn's advice and was indicted and convicted for doing so. The consequence: Snipes spent three years in federal prison for willfully failing to file tax returns.[4] He was released to house arrest in April 2013[5] and was released completely that July[6]—shortly after singer Lauryn Hill began serving a three-month federal prison sentence because she failed to file tax returns for three years.[7]

Compare Snipes' imprisonment, and Lauryn Hill's, with the consequences of the well-publicized tax travails of singer-songwriter Willie Nelson. The legendary country music star filed tax returns every year, but from 1978 to 1982, his business manager reportedly failed to pay Nelson's taxes. What's more, Nelson invested in tax shelters whose supposed benefits were disallowed.[8] The consequence: the IRS assessed him $6.5 million in taxes, plus $10.2 million in interest and penalties. Nelson didn't then have $16.7 million in cash on hand to pay the assessment. So in 1990, the IRS seized and auctioned all of Nelson's assets. When that didn't fully discharge his tax debt, he recorded *The IRS Tapes: Who'll Buy My Memories*—an album that generated $3.6 million in royalties that also went to the IRS.[9] Nelson's

2. United States v. Snipes, 611 F.3d 855 (11th Cir. 2010), *cert. denied*, Snipes v. United States, 2011 U.S. LEXIS 4280 (2011).
3. *Eddie Ray Kahn*, Wikipedia, http://en.wikipedia.org/wiki/Eddie_Ray_Kahn (last updated Sept. 19, 2014).
4. United States v. Snipes, 751 F. Supp. 2d 1279 (M.D. Fla. 2010).
5. Ann Oldenburg, *Wesley Snipes Finishes Prison Time for Tax Evasion*, USA Today (Apr. 5, 2013, 7:57 AM), http://www.usatoday.com/story/life/people/2013/04/05/wesley-snipes-finishes-jail-time-for-tax-evasion/2057455/.
6. *Inmate Locator*, Fed. Bureau Prisons, http://www.bop.gov/inmateloc/ (click on "Find by Name"; enter "Wesley Trent Snipes" in appropriate boxes; click on "Search") (last visited Oct. 22, 2014).
7. Alan Duke, *The Tax Education of Lauryn Hill: Prison*, CNN (May 7, 2013, 5:07 PM), http://www.cnn.com/2013/05/06/showbiz/lauryn-hill-prison/index.html; *Inmate Locator*, *supra* note 6 ("Lauryn N Hill").
8. Cheryl McCall, *The Feds' Full Nelson*, Ent. Wkly., Nov. 30, 1990, http://www.ew.com/ew/article/0,,318718,00.html.
9. Linernotes, Who'll Buy My Memories? The IRS Tapes, http://www.linernotes.com/o/1/e724f6d3-2f58-3f94-b93f-0b856ed3bb3b (last visited Nov. 15, 2014);

tax debt was eventually discharged. Better still, Nelson was never indicted, let alone convicted or imprisoned.

So, the first lesson of this book is: entertainers, athletes, and artists *must* file tax returns, even if they don't have enough cash on hand to immediately pay the taxes they owe. Having assets seized by the IRS is terrible. Going to prison is far worse.

Tax Planning

Part of Willie Nelson's tax problems stemmed from tax planning that didn't work out for him, because the anticipated benefits of his tax shelter investments were disallowed. This doesn't mean, though, that tax planning is bad or useless. It simply means that Nelson's plan was too aggressive.

On the aggressiveness scale, tax planning ranges from the illegal, like not reporting gross income, in which case it's called tax *evasion*, to perfectly legal strategies, like carefully structuring and documenting transactions, in which case it's called tax *avoidance*. Tax avoidance is fine. As long ago as 1934, Judge Learned Hand observed:

> Anyone may arrange his affairs so that his taxes shall be as low as possible; he is not bound to choose that pattern which best pays the treasury. There is not even a patriotic duty to increase one's taxes. Over and over again the Courts have said that there is nothing sinister in so arranging affairs as to keep taxes as low as possible. Everyone does it, rich and poor alike, and all do right, for nobody owes any public duty to pay more than the law demands.[10]

This is still true today, eight decades later.

Most taxpayers want their taxes to be "as low as possible." But this book is not about *most* taxpayers. It's about entertainers, athletes, and artists, many of whom earn much more than they require for day-to-day comfortable living, but do require, for their success, the admiration of their fans and the respect of the press.

The point: Most of this book will look at tax law doctrines with an eye on what they mean for tax planning. But those who give tax

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Wikipedia, The IRS Tapes: Who'll Buy My Memories, http://en.wikipedia.org/wiki/The_IRS_Tapes: Who'll_Buy_My_Memories%3F (last visited Nov. 15, 2014).

10. Gregory v. Helvering, 69 F.2d 809, 810 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935).

advice to entertainers, athletes, and artists should not *assume* that their clients need or want the most aggressive tax plans allowed by law.

For example

- NBA players Andre Iguodala and Russell Westbrook were interviewed on a Fox Business television show in September 2010 about whether they favored extending the "Bush tax cuts" to *all* taxpayers—something President Obama had recently said he opposed. Iguodala and Westbrook both said they did *not* favor extending the cuts to all taxpayers. Rather, both of them agreed with the President that rates should go back up for those at the top of the income scale, even though it would mean that their own taxes would go to up too.[11]
- Author J.K. Rowling told *The Daily Show*'s Jon Stewart in October 2012 that she now pays "a lot of tax" in the United Kingdom, and the reason she "stays and pays" and has not moved to Monaco where taxes are lower is that she received "benefits" (what Americans call "welfare") before *Harry Potter* made her wealthy, and she was grateful for the help she received from her country.[12]
- Recording artist Bono and other members of his band U2 are Irish. They also are well known for advocating that Ireland and the European Union do more to help impoverished Africans. Music fans and reporters also know that after Ireland put a cap on what had been tax-free royalties, U2 moved its publishing company to Holland because Holland has a lower tax rate than Ireland. Bono and U2 have been widely and severely criticized for doing that, even though it was perfectly legal.[13]

11. *Andre Iguodala, Russell Westbrook Talk Taxes, Politics*, Fox Bus. (news broadcast Sept. 23, 2010), *available at* http://video.foxbusiness.com/v/4347317/andre-iguodala-russell-westbrook-talk-taxes-politics/.
12. *J.K. Rowling Extended Interview Pt. 1*, Daily Show, http://www.thedailyshow.com/watch/mon-october-15-2012/exclusive---j-k--rowling-extended-interview-pt--1 (last visited Oct. 22, 2014).
13. *See, e.g.*, Edward Collins, *U2 Tax Compliance: The View from Ireland*, Balt. Sun (July 15, 2011), http://articles.baltimoresun.com/2011-07-15/news/bs-ed-u2-tax-compliance-letter-20110713_1_low-corporate-tax-rate-ireland-u2; George Arbuthnott, *"Saint Bono" the Anti-poverty Campaigner Facing Huge Glastonbury Protest—for Avoiding Tax*, Daily Mail Online (June 5, 2011, 12:58 EST), http://www.dailymail.co.uk/news/article-1394422/Saint-Bono-facing-huge-Glastonbury-protest--avoiding-tax.html#ixzz2CQbfhYpz; Jim Carroll, *Taxing Questions for Bono and U2*, Irish Times (June 7, 2011, 2:06 PM), http://www.irishtimes.com/blogs/ontherecord/2011/06/07/taxing-questions-for-bono-and-u2/; Ronald Quinlan, *Bono and U2 Should "Pay Up" After*

You could say that these three examples are simply anecdotes, not evidence, and that would be an accurate observation. Entertainers, athletes, and artists have never been surveyed about their attitudes towards tax planning. But executives of 600 publicly traded corporations have, and this is what the authors of that survey found:

> The executives indicate that reputation is very important [to their companies], with 70% of firms rating it as "important" or "very important" in their decision to avoid a tax planning strategy, and 58% of firms rating the risk of adverse media attention as "important" or "very important."[14]

If executives of publicly traded corporations are concerned about the impact of aggressive tax planning on their companies' reputations, and if they are concerned about adverse media attention, it is reasonable to infer that entertainers, athletes, and artists may be, or should be, as well. This doesn't mean that tax planning should be shunned or that the tax chips should be allowed to fall wherever they might, without any thought at all. It simply means that before aggressive tax planning is done, entertainers, artists, and athletes should be asked if that's what they really want—especially because tax planning sometimes goes awry, as it did in cases involving director William Wyler and actress Marilyn Monroe.

Director William Wyler's Compensation for Ben Hur—Perpetually Deferred

In 1958, William Wyler entered into a written contract with MGM to direct the movie *Ben Hur*. The contract specified that MGM would pay Wyler $350,000 plus a "percentage compensation" equal to 3 percent of the film's gross receipts in excess of $20 million. The contract also provided that Wyler's "percentage compensation" would be paid "in annual installments not to exceed the sum of $50,000 in any one year . . . ." The $50,000-a-year cap was requested by Wyler's own

Tax Revenues Go Abroad, Says Protest Group, Independent (June 5, 2011), http://www.independent.ie/national-news/bono-and-u2-should-pay-up-after-tax-revenues-go-abroad-says-protest-group-2666765.html.

14. John R. Graham, Michelle Hanlon, Terry Shevlin & Nemit Shroff, *Incentives for Tax Planning and Avoidance: Evidence from the Field*, 89 Acct. Rev. 991 (2014), *available at* http://ssrn.com/abstract=2148407.

lawyer because, in 1958, the top marginal tax rate was 91 percent on taxable income over $400,000.[15]

Ben Hur was a huge success. By 1995, it had earned more than $131 million in gross receipts. This meant that Wyler's "percentage compensation" came to $3.3 million. MGM and its successor, Turner Broadcasting System, paid Wyler and his successor, Wyler Summit Partnership, annual $50,000 installments that totaled $1.8 million. So by 1995, Turner was holding $1.5 million in accrued but unpaid percentage compensation. At the time, U.S. Treasury Bonds were yielding 6.35 percent, which meant that the $1.5 million being held by Turner could earn $97,000 a year, without risk[16]—almost twice the amount the contract specified was the most that Turner was to pay Wyler each year. The consequence: at the rate of $50,000 a year, Wyler would never receive all of his percentage compensation.

Not surprisingly, in 1995, Wyler "waived" the $50,000-a-year cap. Also not surprisingly, Turner said the cap couldn't be waived. Wyler filed a lawsuit. It was dismissed, twice, in response to Turner's motions for summary judgment; and the dismissals were reversed, twice. The second time around, the legal issue concerned whether the cap was intended to benefit Wyler alone, in which case he could waive it, or whether it was intended to benefit MGM as well, in which case Wyler couldn't waive it. The court of appeals held that the facts on that issue were in dispute, so summary judgment should not have been granted.[17] Then the case disappeared from the advance sheets, so the outcome is not of public record.

It's likely the case was settled. Even if it was settled favorably to Wyler, doing so took years and substantial attorneys' fees—all because of an annual payment cap that was part of a plan to avoid (not evade) paying taxes at high rates.

Marilyn Monroe's Right of Publicity—Perpetually Lost

Marilyn Monroe died in 1962 in California, where she then had a home in Brentwood. At the same time, she also had an apartment and staff in New York. This meant that her "domicile" on the day of her death wasn't clear. It could have been either state. But California

15. *Marginal Tax Rates 1913–2003*, Pappas Group (Dec. 3, 2009), http://www.pappastax.com/marginal-tax-rates-1913-2003/.
16. Wyler Summit P'ship v. Turner Broad. Sys., Inc., 135 F.3d 658, 661 n.6 (9th Cir. 1998).
17. Wyler Summit P'ship v. Turner Broad. Sys., Inc., 235 F.3d 1184 (9th Cir. 2000).

imposed a tax on the estates of decedents who were domiciled in California. So Monroe's estate would have had to pay the California estate tax, if she were domiciled in California at her death, but not if New York were her domicile. Not surprisingly, her estate argued that Monroe was domiciled in New York when she died, not in California. The argument was factually detailed, persuasive, and successful, and her estate avoided paying the California tax.

At the time of her death, neither New York nor California protected the rights of publicity of those who had died. That's why establishing that Monroe was domiciled in New York seemed like the right thing to do. There were California taxes to be avoided, and nothing to be lost.

Flash forward several decades. By 2005, California had enacted a posthumous (and retroactive) right of publicity statute that protected the rights of the successors of those who were domiciled in California when they died. Also by 2005, a couple of companies (at least) were using Monroe's image and likeness for commercial purposes, without the consent of Monroe's successor or its exclusive licensee. Litigation ensued. New York did not have a posthumous publicity right when Monroe died, and still doesn't, so the first issue in the case was whether Monroe was domiciled in California at her death, in which case her successor and its licensee did own an enforceable right of publicity, or whether instead Monroe was domiciled in New York, in which case her successor and its licensee owned nothing.

A federal district court in Los Angeles ruled that Monroe's successor owned nothing, and that ruling was affirmed by the court of appeals, which said,

> We conclude that because Monroe's executors consistently represented . . . that she was domiciled in New York at her death to avoid payment of California estate taxes, . . . appellants [Monroe's successor and its licensee] are judicially estopped from asserting California's posthumous right of publicity.[18]

The court of appeals' decision doesn't indicate how much Monroe's estate would have paid in California estate taxes if she had been domiciled in California. But the opinion does reveal how much her successor stands to lose now, because her estate successfully asserted that she was domiciled in New York:

18. Milton H. Greene Archives, Inc. v. Marilyn Monroe LLC, 692 F.3d 983 (9th Cir. 2012).

> Monroe LLC [her successor] would reap tremendous financial benefits if it could lay claim to Monroe's right of publicity. *Forbes Magazine* identifies Monroe as the third highest money-maker in its annual ranking of "The Top-Earning Dead Celebrities," with an income of $27 million in 2011. Ownership of Monroe's right of publicity would allow Monroe LLC to control and profit from most, if not all, commercial exploitations of Monroe's name, likeness and persona. Monroe LLC would thus derive a substantial advantage—one which it contrived to create through the California legislature—were it not estopped from asserting its current position.[19]

The point: a tax strategy that was successful in 1962 led to a very expensive loss in 2012.

Tax Law's Complexity

All of tax law is terribly complex. (That's part of its charm, for those who like complicated puzzles.) Those segments of tax law that are most relevant to entertainers, athletes, and artists are at least as complicated as the rest, and maybe a bit more so, for a couple of reasons.

As you will see in the chapters that follow, the law makes tax-significant distinctions between people and things that really aren't very different from one another. The law distinguishes, for example, between

- entertainers, athletes, and artists, on the one hand, and people who earn their livings in more ordinary ways, on the other
- U.S. citizens and aliens
- resident aliens and nonresident aliens
- employees and independent contractors
- independent contractors who work as individuals and those who are partners
- personal service income and royalties
- U.S.-source income and foreign-source income
- U.S.-source income that is effectively connected with a U.S. trade or business and U.S.-source income that is not effectively connected with a U.S. trade or business

19. *Id.*

Layered on top of these (and other) exceedingly fine distinctions are provisions of the Internal Revenue Code and tax treaties that contain key terms that are confusingly similar to one another.

For example, the Internal Revenue Code sections that make up the Alternative Minimum Tax (which is very important to employees who have a lot of unreimbursed but deductible expenses, as many in the entertainment industry do) contain these terms:

- "alternative minimum taxable income," which is not the same thing as "taxable income"
- "exemption amount," which is not the same thing as "exemptions" or the "standard deduction"
- "taxable excess," which is not the same thing as "taxable income"
- "tentative minimum tax," which is not the same thing as the "alternative minimum tax"[20]

Likewise, the United States has entered into tax treaties with other countries that contain provisions that

- repeatedly refer to countries as the "Contracting State" and the "other Contracting State" when referring to income earned in one place by a resident of the other and
- use the phrases "dependent personal services" and "independent personal services" when referring to income earned by employees on the one hand and those who are self-employed on the other.[21]

The Internal Revenue Code and U.S. tax treaties are written in English. But reading them is a lot like reading a foreign language and translating on the fly.

This Book's Organization and Editing Style

This book is divided into two parts.

Part I deals with U.S. *domestic* taxation. It addresses the way in which the United States taxes income earned *in the United States*

20. See Chapter 5.
21. See Chapter 12.

by entertainers, athletes, and artists who are *U.S. citizens* and *resident aliens*.

Part II deals with *international* taxation. It addresses the way in which the United States taxes income earned in the United States by entertainers, athletes, and artists who are *nonresident aliens*; the way in which *other countries* tax income earned in *those countries* by entertainers, athletes, and artists who are *U.S. citizens* and *U.S.-resident aliens*; and the way in which the United States has provided some tax relief for those of its citizens and resident aliens who pay tax in other countries.

A point about style: This book is about the taxation of "entertainers, athletes, and artists," and in these introductory pages, I've already used that phrase almost a dozen times. If you didn't notice how often the phrase was repeated, or if you noticed but it didn't irritate you, good. When I wrote the first draft of the first few chapters of this book, I used the whole phrase over and over again, and it did irritate me. It gave the book an excessively precise "style"—similar to the Internal Revenue Code itself—and it made the book awkward, I thought. So I cut the phrase down to "artists and athletes," on the theory that singers are artists and so are actors and writers and all the rest. But it was still awkward. Finally, I settled on the single word "entertainers."

So, in this book, "entertainers" means entertainers *and* athletes *and* artists. If you are particularly interested in recording artists or actors, you'll be comfortable with this, I'm sure. If you are interested in athletes, especially Olympic athletes, you may not like calling them "entertainers," because they don't do what they do for the purpose of *entertaining* others (though if athletes get paid for what they do, they get paid because they do entertain people). If you are interested in artists—painters, sculptors, photographers, and the like—you, too, may think it's not right to call them "entertainers," and you'd be right. All I can say in response is that we're about to begin a several-hundred-page journey into tax law, and if I had stayed with "entertainers, athletes, and artists" for the rest of the book, you wouldn't have liked that either. So, feel free to do a mental search-and-replace whenever you get to the word "entertainer," and don't hold it against me that I have strived to make this book as easy to read as a book about tax can be.