DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF CHIEF COUNSEL

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MEMORANDUM FOR
ASSOCIATE AREA COUNSEL

FROM: W. Ed Williams

SUBJECT:

This responds to your memorandum requesting that we reconsider certain advice that we gave to the Revenue Service Representative in , on May 23, 1994.

LEGEND

Team A =
Team B =
League C =
Country D =
Country E =
Country F =

Issue

Whether signing bonuses paid by Team A to nonresident alien baseball players in League C are subject to withholding under I.R.C. section 1441?

Conclusion

No. Under section 872(a), a nonresident alien is subject to U.S. tax only on income that is derived from U.S. sources and not connected to a U.S. trade or business, and on income effectively connected with the conduct of a U.S. trade or business. Under section 862(a)(3), compensation for labor or personal services performed outside the United States is not sourced in the United States. If the nonresident alien baseball players did not perform services in the United States in the year in which they received the signing bonuses from Team A, it is our view that they are not subject to U.S. tax. However, if they performed services in the United States and also abroad in that year, the bonus must be allocated to sources both within and without the United States, as required by section 863(b).

Background

Major League Baseball ("MLB") consists of thirty teams, with two in Canada, and the remainder in the United States. MLB teams are affiliated with a number of minor league baseball teams. The minor league consists of the following competitive levels: Class AAA, AA, A, Short A, Rookie Advanced, and Rookie. Different leagues exist within each level. For instance, Class AAA consists of the International League, Pacific Coast League, and Mexican League.

Team A has entered into uniform player contracts with a number of individuals who are nonresident aliens. These players primarily reside in Country D. The only differences in the contracts signed by particular players is in the dollar amount of their salaries and signing bonuses.

Relevant provisions of the uniform contract state:

> VII. Payment
>
> > A. For the performance of all of the skilled services by Player and for Player's other promises herein contained, Club will pay Player at the monthly rate set out in Addendum C-1 . . . by this Minor League Uniform Contract . . . .
>
> * * *
>
> XV. Player's Representations
>
> > D. Player is not a party to, and will not enter into, any contract or any contractual obligation to render skilled services as a professional baseball player with any person or organization other than Club . . . .
>
> * * *
>
> XVII. Playing For Others
>
> > A. For the purposes of avoiding physical injuries, Player agrees that during the term of this Minor League Uniform Player Contract, Player will not play baseball other than for Club, without the written consent of the Club . . . .

Addendum B of each uniform contract outlines the bonus, if any, which Team A agrees to pay a player. The signing bonuses for each contract vary. Addendum B generally contains the following language:

> Player is to receive a signing bonus of $X,XXX to be paid upon approval of this contract by the Commissioner of Baseball.

Addendum C-1 of each uniform contract outlines the monthly salary that Team A will pay each player.

Initially, Team A assigned the nonresident alien players to Team B. Team B competes in the Rookie League, which is a part of the minor league system, and plays exclusively in Country D; it is not a franchise of Team A, and Team A does not have an ownership interest in Team B. Team A simply directs various players under contract to play in League C in an attempt to develop talent suitable for playing major league baseball in the United States.

The issue presented to you was whether Team A had an obligation to withhold tax from the signing bonuses that it paid to Team B's nonresident alien players. There is no withholding obligation if the bonuses are characterized as advance compensation. However, if the bonuses are characterized as compensation in exchange for covenants not to compete, Team A has a withholding obligation.

You have concluded that the bonuses paid by Team A should be treated as payments for covenants not to compete, stating:

> The uniform contract in this case provides that a player will not render professional baseball services to any other person or organization. The uniform contract does not indicate whether the bonuses were paid for a player's promise not to render services to any other team or whether the payments were some form of compensation. However, because the players received monthly salaries for their services and the bonuses were nonrefundable, we believe that the bonuses should be characterized as covenants not to compete, not compensation.

Your view is that "[t]o the extent the bonuses were paid for the player's promises not to compete in the United States, the signing bonuses are subject to withholding under I.R.C. § 1441." Recognizing that baseball is played in a number of countries other than the United States, you ask that we determine a method for allocating a bonus to U.S. and non-U.S. sources. The conclusion that the bonuses in question are paid for a covenant not to compete is contrary to the advice that we previously issued in a case with facts almost identical to this one. In that case, we concluded that a signing bonus that a player received after signing an employment contract is advance compensation for personal services.

You believe that our prior advice is incorrect because of its reliance on Beaver v. Commissioner, 55 T.C. 85 (1970), and Bouchard v. Commissioner, 13 T.C.M. 1223 (1954). In both of those cases, the court found that the funds received by the petitioners was advance compensation. In Beaver, the court's decision, in part, rested on the fact that the recipient of the advances had agreed to forgo future salary payments until the funds were repaid. Similarly, in Bouchard, the recipient had to repay the advances through future profits. You believe our reliance on Beaver and Bouchard is misplaced because in our advice issued in 1994, and in this case, the baseball players receive monthly salaries for their services, and are under no obligation to repay the bonuses.

Discussion

1. Revenue Ruling 74-108

Revenue Ruling 74-108, 1974-1 C.B. 248, considers the source of a sign-on bonus paid by a U.S. soccer team to a nonresident alien prior to the individual signing an employment contract. In the revenue ruling, a U.S. soccer club that played games both in the United States and abroad enters into an agreement with a nonresident alien. As described by the revenue ruling:

> [t]he agreement does not require the player actually to play for the club; *it is merely a preliminary agreement that is separate and distinct from a "uniform player" contract which binds a player to play soccer for a salary.* When a player enters into an agreement, the taxpayer places him on its reserve list thereby protecting such player from recruiting efforts of any other club and preventing him from negotiating to play or playing for any other professional soccer club. No part of the sign on fee is attributable to future services, but the team anticipates the agreement and fee will induce the player to sign and become bound by the uniform player contract if the club wishes to use his services *and a separate employment contract is negotiated for this purpose.* [Emphasis added.]

The revenue ruling concludes that a preliminary agreement that does not require a player to perform any services is a covenant not to compete, for which the sign-on bonus serves as consideration. Because the player promises not to compete inside and outside the United States, the revenue ruling concludes that the bonus must be apportioned to sources within and without the United States. According to the revenue ruling, this should be done in a way that is reasonable in light of all the facts and circumstances of the particular case, such as relative value of the player's services within and without the United States, or alternatively on the basis of the portion of the year during which soccer is played within and without the United States. The revenue ruling concludes by noting that if no reasonable basis for allocating a sign-on bonus is presented by the taxpayer, all the income should be sourced in the United States.

2. Linseman v. Commissioner

The Commissioner defended Rev. Rul. 74-108 in Linseman v. Commissioner, 82 T.C. 514 (1984). In Linseman, the taxpayer, a Canadian citizen and resident, received a $75,000 sign-on bonus from a U.S. hockey team as consideration for entering into the following agreement:

> WHEREAS, the club wishes to enter into a contractual relationship with Player in order to engage his services;

AND, WHEREAS, Player is a highly skilled athlete, and is currently under no contractual commitment to a professional hockey team and is therefore a free agent, and maintains his amateur status:

NOW, THEREFORE, THIS AGREEMENT WITNESSETH THAT:

1. Player will relinquish both his "free agent" and amateur status and enter into an agreement with Club.

2. As consideration for Player accomplishing the above, Club shall pay Player the sum of . . . ($65,000), to be paid on or before June 3, 1977.

An addendum to this agreement increased the sign-on bonus to $75,000. The bonus was nonrefundable, regardless of whether the player signed an employment contract. On the same day that the sign-on agreement was executed, the player signed a standard player's contract that obligated him to play for the team from the 1977-78 through the 1982-83 hockey seasons.

In Linseman, the IRS argued that there was no reasonable basis for allocating the sign-on bonus and, therefore, it should be sourced entirely in the United States. Alternatively, the IRS argued that the bonus should be allocated on the basis of the number of games that the team played within and outside the United States during the first year of Linseman's contract.

At the outset, the Tax Court stated that in order to make its decision, it would have to determine the "nature" of the sign-on bonus received by Linseman. The court stated:

> Resolution of this question involves an analysis of the nature of a sign-on bonus. If, as respondent suggests in Rev. Rul. 74-108, *supra*, and in the instant case, the sign-on bonus is essentially a payment for a covenant not to compete and its locus is where the taxpayer forfeits his right to act, the further question is posed as to where that forfeiture takes place. If the covenant not to compete is worldwide, it can be argued that, at least in theory, the taxpayer forfeits his right to act in any place where he might otherwise act. On a worldwide basis, that forfeiture would seem to occur wherever the activity (in this case hockey) is played or, indeed, might be played.

However, the Court did not accept the Commissioner's view that the sign-on bonus was paid for a covenant not to compete. In discussing Rev. Rul. 74-108, the Court observed that

> [i]f the covenant not to compete is worldwide, it can be argued that, at least in theory, the taxpayer forfeits his right to act in any place where he might otherwise act. On a worldwide basis, that forfeiture would seem to occur wherever the activity (in this case hockey) is played or, indeed, might be played. The required analysis thus becomes exceedingly complex. [Footnote and citations omitted.]

Instead, the court found that the "primary purpose" of the sign-on bonus was to induce the player to sign a contract to play, and thus to perform the affirmative act of playing. The court stated:

> The reality of this approach is clear in the instant case, where the sign-on agreement provided that petitioner "will * * * enter into an agreement with Club [Bulls]", and petitioner did in fact enter into such an agreement. *However, in pointing to this fact, we are not suggesting that we would necessarily reach a different conclusion had the sign-on agreement not contained the above language or been limited to a promise not to play hockey for anyone else. Whatever the specifics of the sign-on agreement, the fact remains that the underlying purpose of such an agreement is to induce the player to perform the affirmative act of playing.* [Emphasis added.]

The court then turned to the task of sourcing the income from the sign-on bonus. The court concluded that, based on the facts and circumstances, the sign-on bonus should be allocated based on the number of games that the Bulls contemplated playing within and without the United States in the 1977-78 season, which was the season in which Linseman received his bonus. The court noted that "[t]he fact that the sign-on bonus is not itself compensation for service does not preclude us from using the places where the contemplated services were to be performed as the basis for allocation."

3. Chief Counsel Advice # 0382-94

On May 23, 1994, our office issued advice based on facts that were almost identical to this case in response to a request from a Revenue Service Representative who wanted to know whether advice we had issued in 1992 was still our position. We confirmed that it was. However, we thought that the two cases were factually distinct. Accordingly, we issued additional advice in 1994.

Our 1992 advice concerned the proper tax treatment of a sign-on bonus paid by a U.S. hockey team to a citizen of Country E. The player had signed a contract in which he agreed to sign an employment contract with the hockey team. Upon signing the first agreement, the player received $50,000. Later that day, the player signed a one-year employment contract. The player and the team sourced the bonus 50-percent within the United States, and the team withheld 30-percent of this amount.

Exams took the position that Revenue Ruling 74-108 had been overruled by Linseman. We concluded that Exams should continue to follow Revenue Ruling 74-108. However, we noted that the revenue ruling and Linseman require income that can be attributed to U.S. and non-U.S. sources to be allocated on a reasonable basis, and both approve an allocation method that is based on the location of the games to be played by the team. Accordingly, we recommended that the IRS argue that the source of the sign-on bonus should be based on the location of the team's games.

4. Chief Counsel Advice #0382-94

The facts on which the 1994 CCA was requested are basically identical to those in this case. The taxpayer, a citizen and resident of Country F, was recruited by a U.S. professional baseball club. He signed a Minor League Uniform Player Contract, pursuant to which he agreed to play for a baseball club in League C. The terms of the contract in the 1992 Chief Counsel Advice are the same as those in the contract used by Team A.

The CCA discussed the factual distinctions between the bonuses paid in its case, and the bonuses paid in Linseman and Rev. Rul. 74-108. With respect to Linseman and Rev. Rul 74-108, the sign-on bonus was paid in connection with an agreement that *preceded* the particular player signing an employment contract. The CCA concluded that the bonuses in those cases were also inducements for the player to sign the employment contract. The CCA contrasted the bonuses paid in Linseman and Rev. Rul. 74-108 to the bonus in its case, which was paid only "upon approval" of the Uniform Player Contract. The CCA found that the sign-on bonus paid by the U.S. baseball club was not an inducement to sign an employment contract (as in Linseman), or for a covenant not to compete, as in Rev. Rul 74-108, because the taxpayer had a right to the bonus only after signing an employment contract stating that he would provide his services exclusively during the contract term.

Instead, the CCA treated the sign-on bonus as payment for future services and for the player's agreement to play for no other team during the term specified in the contract because it was paid only after the execution of the employment contract. In making this determination, the CCA relied on Beaver v. Commissioner, 55 T.C. 85 (1970), and Bouchard v. Commissioner, 13 T.C.M. 1223 (1954) for support. In both of those cases, the court found that funds received by the petitioners was advance compensation. In Beaver, the court's decision rested in part on the fact that the recipient of the advances had agreed to forgo future salary payments until the funds were repaid. Similarly, in Bouchard, the recipient had to repay the advances through future profits.

You believe our reliance on Beaver and Bouchard is misplaced because in our advice issued in 1994, and in this case, the baseball players receive monthly salaries for their services, and are under no obligation to repay the bonuses. However, you do not say why these facts should result in any change to the analysis in our CCA. There, we noted that:

> We think the bonus paid to . . . [the taxpayer] is properly characterized as advance compensation for the services he agreed to perform *even though he is under no apparent obligation to repay the bonus if he does not perform any services*. The situation here is similar to that in Bouchard v. Commissioner. In Bouchard, a manufacturing company, Juneau, advanced the taxpayer funds to cover his living expenses with the

understanding that the taxpayer would work on developing certain inventions. The advances would be recoverable by Juneau only if the taxpayer developed a marketable product.

Thus, we were aware of the differences between the facts in our case and those in Beaver and Bouchard, but still found the latter cases to be relevant, for the reasons detailed above.

Conclusion

We have reexamined the advice that we issued in 1994, and are of the view that it remains the position of this office. Because the sign-on bonuses were paid by Team A after the employment contracts were signed, they are distinguishable from the sign-on bonuses under consideration in Rev. Rul. 74-108 and Linseman. We have concluded that the bonuses are properly characterized as advance compensation for personal services.

Please contact if you have additional questions.

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