"STAR WARS" – HOW TO WIN THE TAX BATTLE WHEN YOUR TALENT CLIENTS WORK ABROAD

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The past two decades has witnessed the "globalization" of the entertainment industry. Foreign production of films is now a regular occurrence, as the studios and independent producers scour the globe for foreign tax subsidies, cheap financing and exotic or unusual locations.

The reasons for these developments are numerous. It is often cheaper to produce a film outside of the United States, due to cheaper labor and location costs and guild considerations and foreign currency exchange opportunities. This can often be done without creating the look of a "foreign" movie, as most "American" locations and sets can be found or recreated in the United Kingdom, Canada, New Zealand or Australia at substantial cost savings. In some situations a film must be produced in certain foreign countries and contain a minimum level of foreign "content" in order to satisfy the requirements of a Co-Production Treaty or other governmental subsidy, grant program or tax shelter. In addition, foreign distribution rights are now generally regarded to be worth more than domestic distribution rights, a trend which is likely to continue. The domestic theatrical exhibition business is relatively mature and highly competitive, whereas many foreign markets are in a significant expansion mode, being driven by a nearly insatiable hunger for Hollywood product and increased profitability from multiplex theaters, which are now starting to appear throughout the world. All of these factors have contributed to a huge increase in the number of movies (both studio and independent) being made outside the U.S., thereby potentially subjecting such talent to tax in numerous foreign jurisdictions with respect to the income earned from the film, as well as potentially other income.

The specific locations of foreign productions are determined by a myriad of factors, however one of the most important considerations is the extent of foreign film production incentives and subsidies. Countries jockey for the business of Hollywood through creative financial arrangements and incentives that are designed to lure in foreign production. Despite their efforts to build up an indigenous production industry, film commissioners are often frustrated to find out that production dollars are highly portable and that they will follow the next best deal. The case of the United Kingdom is a relevant example, as summarized by a recent article in The Wrap:

> *"It is a testament to how [London] is attracting filmmakers in droves because of lucrative tax incentives that make one of the most expensive cities in the world cheaper to*

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shoot films in than Los Angeles. More than 1,000 films have used the country's film tax credit in the five years since they were established, with the U.K. doling out an estimated £800 million (about $1.2 billion) in rebates. And the rise of London as a major destination for filmmakers has been unavoidable this summer. Nearly every studio has embraced the U.K., with Disney readying movies like the next "Star Wars" film and "Guardians of the Galaxy" for production there and Paramount premiering movies like "Star Trek Into Darkness" in Leicester Square. Universal, whose successful "Fast and Furious" franchise had filmed in Los Angeles, Japan and across South America, moved the newly released sixth installment to London. . . .

[The U.K.] rewards productions by refunding between 20 percent to 25 percent of the money spent in the U.K., depending on the size of a production's budget. The definition of what qualifies as a U.K. expense is also flexible -- if costumes or props are produced in Los Angeles but used for filming in London, for example, they are eligible for the refund.
.
The U.K. also reimburses studios a percentage of what they pay talent from a film's financial performance. So if an actor's deal awards him a certain percentage of box-office grosses -- millions on a big studio movie -- the U.K. reimburses a percentage of that money to the studio."[1]

This highly competitive marketplace for high-value film production dollars creates a very dynamic and constantly shifting playing field that requires the talent's tax advisors to stay on top of the latest developments across the globe, with the goal of minimizing their clients' worldwide tax liability resulting from offshore engagements.

This article summarizes the tax rules applicable to U.S. resident "talent" performing services outside the United States, with an overview of specific tax issues affecting individuals performing services in Canada, the United Kingdom and Australia. Please note that this article uses the term "talent" broadly, to cover actors and behind-the-camera talent such as directors, writers and producers. Some of the planning strategies and analysis discussed in this article may not apply to "below the line" personnel. In addition, this article focuses only on talent residing in the U.S. for income tax purposes who work outside of the U.S. Very different considerations apply to talent residing outside the U.S. who come here to work, none of which considerations will be addressed in this article. This article also does not address the tax consequences to talent providing endorsement services or granting the right to use name or likeness rights outside of the U.S., as different considerations apply in that context as well.

[1] "*Why Hollywood's Biggest Films Are Leaving L.A. for London*", The Wrap.com (June 5, 2013), at http://www.thewrap.com/movies/article/hollywood-tax-incentives-world-war-z-star-wars-fast-and-furious-95251

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I. INCOME TAX.

The primary consideration when tax planning for talent is to understand the extent to which the talent will receive a foreign tax credit in the U.S. against his or her U.S. federal income tax liability for the taxes paid to the foreign country. The first step in this process is to understand the talent's foreign tax exposure. In this regard, the following issues should be considered:

a. Seek Foreign Tax Advice.

It is advisable to hire a tax expert in the foreign country(ies) in which services are being rendered to opine on the local tax considerations. If this is not possible (e.g., not enough time, dollars too small, etc.), then the production company should be asked how it intends to structure the production, whether it intends to withhold foreign tax, and whether it has consulted with a foreign tax expert (if so, ask for copies of the foreign tax advisor's written analysis).

Reliance on the production company's advice alone can be dangerous. The production company (as is often the case with small independent producers) may not have done the proper foreign tax analysis, and the company's assurances that the entertainer has no foreign tax liability or compliance requirements should be greeted with some skepticism due to the obvious conflict of interest (for instance, if significant foreign tax problems exist, highlighting those problems may result in the talent asking for a tax indemnity). The production company will often state that it has no obligation to withhold foreign tax, based on the theory that it does not have a permanent establishment or fixed base in the country where services are being rendered. Indeed, most production companies set up offshore (sometimes tax haven) production companies to achieve this very result. The absence of withholding, however, does not mean that there may be no obligation for the talent to file foreign tax returns and pay foreign taxes, and you should check with a foreign tax advisor in each instance to make sure that you understand the talent's foreign tax payment and filing responsibilities.

b. Withholding Tax as Interim or Final Tax.

When analyzing foreign tax systems, it is important to understand whether any withholding taxes will be imposed, and if so, whether the withholding tax is an interim tax or a final tax liability. If the withholding tax is an interim tax, the talent is generally required to file a tax return in the foreign country, with the withholding tax being treated as a payment against the ultimate tax liability (e.g., Australia). In some countries the withholding tax is a final tax, meaning that no foreign tax return is required and no additional taxes are due (e.g., for actors only, Canada [23% tax], Italy [30% tax] and the U.K. [if an Advance Ruling is obtained])

c. Residency Considerations.

It is also necessary to make sure that the talent, by virtue of his or her presence in the foreign country, will not become a tax resident there. In some countries, if the talent spends more than 183 days in that country or buys a home or otherwise maintains a permanent establishment or

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fixed base there, etc., he or she may become a tax resident of the foreign country, and possibly become taxable in the foreign country on his or her worldwide income. In addition, in certain situations it is possible that the talent's other U.S. companies or projects having nothing to do with the foreign country, could be swept into the foreign tax net and have to pay tax there on income earned elsewhere. It is imperative to understand the talent's residency status prior to committing to work on a particular project.

Fortunately, in most cases the foreign country residency issue can be avoided if a modern tax treaty is in place with the U.S. and the applicable foreign country. If the talent is both a U.S. tax resident (because of U.S. citizenship, green card or substantial presence) and a tax resident of another country (by virtue of foreign citizenship, domicile, physical presence, etc.) in a given year (a "dual resident") with which the U.S. has a tax treaty, the tax treaty may have a "tie-breaker" residency provision, which attempts to resolve the dual residency in favor of the country with which the talent has the closest connections. In most cases, the talent will qualify as a U.S. tax resident under the dual resident provisions of the applicable tax treaty, which will result in the talent being treated as a nonresident of the foreign country in which he or she worked.

Consider, as an example, the "tie-breaker" clause of Article 3(3) of the U.S.-France Income Tax Treaty, which is set forth below:

> "An individual who is a resident in both Contracting States shall be deemed a resident of that Contracting State in which he maintains his permanent home. If he has a permanent home in both Contracting States or in neither of the Contracting States, he shall be deemed a resident of that Contracting State with which his personal and economic relations are closest (center of vital interests). If the Contracting State in which he has his center of vital interests cannot be determined, he shall be deemed a resident of the Contracting State in which he has an habitual abode. If he has an habitual abode in both Contracting States or in neither of the Contracting States, the competent authorities of the Contracting States shall settle the question by mutual agreement. For purposes of this Article, a permanent home is the place in which an individual dwells with his family. An individual who is deemed to be a resident of one Contracting State and not a resident of the other Contracting State by reason of the provisions of this paragraph shall be deemed a resident only of the former State for all purposes of this Convention (including Article 22)."

These criteria oblige every dual resident to draw a closer connection to, and be resident of one country, and a nonresident of the other, for Treaty purposes.

In some situations, the applicable tax treaty may override a determination of resident status under domestic law. For instance, the Protocol to the U.S.-Germany Treaty provides that a U.S. green card holder will be treated as a U.S. resident for treaty purposes only if he or she also has a "substantial presence, permanent home, or habitual abode in the United

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States". This provision is designed to prevent a German citizen from escaping German taxation by claiming U.S. residency solely by virtue of a green card.[2]

Turning now to the "tie-breaker" tests:

i. Permanent Home. The first factor gives preference to the country where the talent maintains a permanent home. If the talent maintains a permanent home in both countries, then this factor is inconclusive and preference is given to the country where the talent's center of vital interests lies.

A permanent home is any residence owned or possessed by the talent that is available continuously to him or her. Any form of home can be taken into account (e.g., house or apartment, owned or rented). To be "permanent", the home needs to be available for a non-temporary period. Availability, not use, is what matters.

ii. Center of Vital Interests. If the talent has a permanent home available in both countries, a typical "tie-breaker" clause (like Article 3(3) above) looks to where the talent's "center of vital interests" lies. The center of vital interests standard is a concept similar to that of domicile, and looks to the talent's personal and economic relations. Most talent clients who are dual residents qualify as U.S. residents under the permanent home or center of vital interests tests of the applicable tax treaty.

The center of vital interests is determined by objective criteria. The relevant personal relations include the place of family, social, cultural and religious interests. The relevant economic relations include the place of business, the place of employment, the place from which investments are administered and monitored and the situs of business and investment capital. Significantly, the number of days of physical presence in a given country does not appear to be directly relevant, although a continuous presence in one country will certainly shift some (if not all) of the personal and economic relations there. The circumstances must be examined as a whole, but it is nevertheless clear that considerations based on the personal acts of the individual must receive special attention. Thus, if a talent client who has a home in one Country sets up a second home in the other Treaty Country while retaining the first home, the fact that the talent retains the first home in the environment where the talent has always lived, where the talent has worked, and where the talent has his or her family and possessions can, together with the other elements, demonstrate that the talent's center of vital interests is in the first Country.

iii. Habitual Abode. If the talent's center of vital interests cannot be determined, a typical "tie-breaker" clause looks to where the talent has a "habitual abode." Generally speaking, the talent's place of habitual abode is where he or she spends the most time.

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[2] A similar provision is found in Article 4(2) of the Treaty between the U.S. and France.

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iv. Competent Authorities. If the talent has an habitual abode in both Treaty countries or in neither of them, the competent authorities of the Contracting States shall settle the question by mutual agreement. Competent authority procedures are quite complex and involve the two countries meeting to determine the tax residency of the talent (or any other matter for which the talent believes that he or she is being taxed by either country in a manner that is not in accordance with the terms of the tax treaty, such as transfer pricing methodologies or the attribution of profits to a permanent establishment).[3]

d. Impact of Tax Treaty.

The foreign tax consequences to talent working outside of the U.S. in a treaty country depend on a number of factors, such as whether the talent will be considered as an independent contractor or employee under foreign law, whether the talent utilizes a foreign or U.S. loanout corporation to furnish his or her services, and the length of the talent's stay in the foreign country.

One of the most important and relevant considerations is whether the U.S. has a bilateral income tax treaty in place with the foreign country in which production is occurring. As noted above, the U.S. has entered into tax treaties with all of its major trading partners, and most of the major countries in which films are distributed and produced. The tax treaties have a number of objectives, which include the avoidance of double taxation, the modification of tax withholding rates, the exemption of certain types of income and the resolution of situations of dual residence (the dual residency issue was discussed above). Several additional treaty provisions may be relevant to talent working in a foreign country with a tax treaty in place (a "treaty country"):

i. Dependent Personal Services. Employment income (as opposed to independent contractor income)[4] received by talent working in a treaty country directly as an individual is usually addressed in the Dependent Personal Services clause of the particular treaty. Under most modern treaties, the Dependent Personal Services clause will apply only to "behind-the-camera" entertainers, such as writers, producers, directors, etc. Talent working "in front-of-the camera", such as actors and actresses, concert touring artists, etc., are generally subject to a different set of rules under the Artists and Athletes clause, which will be discussed in more detail below.

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[3] See, Rev. Proc. 2002-52, 2002-31 IRB 242, for the IRS rules on competent authority procedures. Also see, e.g., IR 2000-79 (Nov. 13, 2000), for an Announcement of the New Administrative Agreements for Mutual Agreement Procedures between the US and the UK. Similar procedures have been developed with certain other Treaty partners.

[4] The criteria for determining whether the talent is an independent contractor or employee for foreign tax purposes will be based on the law of the applicable foreign country. In many countries, unlike the U.S., most talent (even actors) may be treated as independent contractors for tax purposes. This is in stark contrast to the position in the U.S., where the studios (prompted by possibly sanctions from the IRS and FTB) take a very narrow view of independent contractor status, with most individuals not working through loanout corporations being treated as employees.

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For purpose of illustration, the Dependent Personal Services clause contained in Article 14 of the U.S.-U.K. Treaty will be analyzed. Article 14 provides that, except with respect to artists and athletes who are covered by Article 16, the talent may be taxed in the U.K. on income received for employment services rendered there, unless all of three conditions are met:

(a) The talent is present in the U.K. for a period not exceeding in the aggregate 183 days in any consecutive 12-month period commencing or ending in the taxable year concerned;

(b) The remuneration is paid by, or on behalf of, an employer who is not a resident of the U.K.; and

(c) The remuneration is not borne as such by a permanent establishment or a fixed base that the employer has in the U.K.

ii. Independent Personal Services. Independent contractor income received by talent directly as an individual for work performed in a treaty country is generally governed by the Independent Personal Services clause of the particular tax treaty (if such a clause exists). Again, though, this generally applies only to behind-the-camera personnel, with performing artists being treated under the applicable artists and athletes clause.

For purpose of illustration, the Independent Personal Services clause of Article 14 of the U.S.-Australia Treaty will be analyzed. Article 14, which is quite typical, provides that independent contractor income received by talent from services rendered in Australia will be taxable there if either of the following two conditions are met:

(a) The talent is present in Australia for a period or periods aggregating more than 183 days in the taxable year; or

(b) The talent has a fixed base regularly available to him or her in Australia for the purpose of performing such activities, in which case so much of the income as is attributable to that fixed base may be taxed in Australia.

Significantly, the Independent Personal Services clause does not require that the remuneration be paid by an employer in Australia, with the only meaningful restriction being that the talent must be present there for less than 183 days and must not maintain a fixed base there (which is similar to a permanent establishment).

iii. Business Profits. Some modern tax treaties have deleted the Independent Personal Services clause and instead treat service businesses under the Business Profits clause. As an example, in 2001 the U.K. Tax Treaty was amended to follow this approach. The Business Profits clause generally provides that an enterprise shall be taxed in a foreign country only if it

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carries on business in the foreign country through a "permanent establishment" (a "PE"). If so, the foreign country may tax the business profits of the enterprise "attributable to" the PE.

(a) *Permanent Establishment.*

The Permanent Establishment clause defines a PE as a "fixed place of business", such as a place of management, branch office, factory or workshop. The clause lists examples of activity constituting (and not constituting) a PE. One such example is that "[a] building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months."

The Permanent Establishment clause also provides that the presence of an agent acting on behalf of the enterprise constitutes a PE if the agent habitually exercises authority in the foreign jurisdiction to conclude contracts on behalf of the enterprise. Talent is commonly an authorized agent of his or her loanout corporations and other companies (i.e., as a director and/or officer thereof). Therefore, it is important to remove the talent from any and all such positions prior to arriving in the foreign country. If such action is not taken, his or her presence in the foreign country could cause the companies to have a PE and be subject to foreign country tax on unrelated deals concluded while the talent is on location, even though the deals have nothing to do with the foreign country. In the U.K., it could also cause the loanout corporations to be considered UK-resident corporations taxed on their <u>worldwide</u> income, as discussed more fully below.[5]

(b) "Services" Permanent Establishment.

A few recent modern tax treaties have incorporated the concept of a "Services Permanent Establishment." If a Services PE is found to exist, the taxpayer will be taxed in the country where services are performed on the profits attributable to the Services PE. The Services PE rules are generally much more demanding than the general PE rules or the independent contractor rules, and can sweep many unsuspecting taxpayers into the foreign country's tax net.

The most relevant example for talent of a Services PE regime can be found in the U.S.-Canada Tax Treaty. In 2008, the Fifth Protocol to the Treaty added the concept of a Services PE in Article V(9), which provides that an "enterprise of a contracting state" that provides services in the other contracting state and does not otherwise have a permanent establishment in the other state will be deemed to have a permanent establishment in the other state if one of the following conditions is satisfied:

- the services are performed by an individual who is present in the other state for a period or periods of more than 183 days in any 12- month period and, during the period or periods in which the individual is present in the other state, 50% of the

[5] See, U.K. discussion in Section VII below.

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active gross business revenues of the enterprise consist of income derived from the services provided by the individual in the other state; or

- the services are provided for an aggregate of 183 days or more in any 12-month period and relate to the same or connected projects for customers who are resident in the other state or who maintain a permanent establishment in the other state.

The Services PE rule will have a huge impact on writers, producers and directors working in Canada who cross the 183-day threshold. The rules will not impact actors working in Canada, who are still eligible for the 23% flat tax. Behind-the-camera talent who are subject to this rule will be subject to Canadian tax rates in excess of the applicable U.S. tax rates, which will likely result in an excess foreign tax credit position. Certain planning opportunities are available that will be discussed below in more detail.

v. Artists and Athletes Clause. As noted above, income received by performing artists, such as actors, actresses, concert performers, etc., as well as athletes, is generally taxable in the country in which services are rendered. Some treaties contain de minimis exceptions (such as Article 16(1) of the U.S.-U.K. Treaty, which states that the Artists and Athletes clause does not apply if the performing artist receives less than $20,000 of gross income in the year concerned, which amount generally is inclusive of per diems, expense reimbursements and expenses paid directly on behalf of the artist).

Most treaties also contain an anti-loanout clause, which provides that performing artist income may be subject to the Artists and Athletes provisions even if the services are rendered through or on behalf of a loanout company or any other entity or person. A very limited exception to the anti-loanout rule may apply if it is established that neither the entertainer nor the athlete participate directly or indirectly in the profits of the loanout company or such other entity. To apply, this generally would require the entertainer to be paid a fixed fee for his or her services and to have the loanout company owned by third parties. Since entertainers rarely will want to forego the ability to participate in any profits from a particular project, this exception is not likely to be of much use.[6]

In some situations it is not clear whether or not the particular type of income would fall under the Artists and Athletes clause. Consider, for instance, the case of a fashion model (who may also be a performing artist) receiving income from a photo shoot.

vi. Royalty Income. The royalty provisions of most modern tax treaties generally provide that royalty income received from licensing film distribution rights, merchandising rights, rights to exploit name and likeness, etc., are subject to substantially reduced U.S. tax withholding rates. In many cases, the royalty withholding rate is reduced to zero (e.g., U.K., France, Germany, etc.).

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[6] See, e.g., Article 16(2) of the U.S.-U.K. Treaty.

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The preferable treatment of royalty income generally does not apply to a typical talent client providing services outside the U.S. Such an individual generally receives substantially all of his or her income from the rendition of personal services on a "work-for-hire" basis, and not the licensing of intellectual property.[7] The royalty provisions are generally relevant to an independent producer owning and licensing distribution rights, an actor granting name and likeness rights in connection with an endorsement deal, or a concert touring artist receiving merchandising or sponsorship income from licensing his or her name and likeness in connection with the promotion of the tour.[8]

II. OTHER FOREIGN TAXES -- VAT AND SOCIAL SECURITY TAXES.

All types of foreign taxes should be considered, not just income taxes. Of particular importance are value added taxes ("VAT") and social security taxes or similar charges.

a. VAT.

Most EC-member countries (and many other countries throughout the world) have a VAT system. In general, the VAT is a tax imposed on the producer, merchant, etc. based on the incremental value he or she adds to any particular product. The ultimate end user/consumer of the product pays the full VAT on the consumed product and cannot recoup the VAT cost. VAT is generally collected through a registration system.

Most countries exempt from VAT payments made to nonresident talent or their loanout companies. Nonetheless, when representing talent it is advisable to be cautious by having the talent contracts provide that any payments owing to the talent are "net of" or "exclusive of" any applicable VAT. Under the laws of some countries, contractual silence on this point may result in the talent being deemed to be responsible for the VAT, so it is important to make this an express contractual requirement. Note that this concern applies not just to service providers, but also to writers selling "spec" scripts.

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[7] It is acknowledged that the talent's back-end or contingent compensation is sometimes referred to as a "royalty" in the underlying agreements. Except in the rare case where the talent has an ownership interest in the underlying intellectual property being exploited (e.g., the record master), the royalty income is nothing more than deferred compensation for services rendered, and should be analyzed for tax purposes as such. See, e.g., Boulez v. Comm'r, 83 T.C. 584 (1984).

[8] In this regard, it is important to distinguish between payments for the license of name and likeness and payments for promotion and endorsement services. See, Kramer v. Comm'r, 80 T.C. 768 (1983) (held that Jack Kramer, the famous tennis player who received percentage royalties from the sale of tennis rackets bearing his name, was required to allocate 70% to name and likeness royalties, and 30% to promotion services); Rev. Rul. 81-178, 1981-2 C.B. 135 (held that payments to a professional athlete for the use of name, likeness, signature, etc. are ordinarily characterized as royalties).

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When representing the producer of a film, much more analysis is necessary. Local counsel should be engaged to advise on the VAT payment, refund and registration requirements.

b. Foreign Social Security Taxes.

Foreign social security taxes also should be considered. Many foreign countries impose social security charges substantially in excess of the U.S. payroll taxes. (Consider, for instance, the French rates of 38-42% for employer contributions, and 15-17% for employee contributions.)

Always check to see if there exists a Social Security Totalization Agreement between the U.S. and the foreign country in question. In order to claim benefits under a Totalization Agreement and to avoid foreign social security withholding, the U.S. entertainer is usually required to provide a certificate from the U.S. Social Security Administration confirming that he or she is subject to U.S. social security withholding and coverage.

Totalization Agreements are likely to be of much more benefit to a U.S. resident entertainer working abroad, than they are to a foreign entertainer working here. This is because the foreign jurisdiction may respect the U.S. loanout company furnishing the entertainer's services as a bona fide foreign employer, or alternatively the foreign jurisdiction may treat the entertainer as an independent contractor. Either of these characterizations generally results in the elimination of foreign social security charges under the Totalization Agreements. Many foreign countries require the U.S. entertainer to obtain a certificate of coverage from the U.S. Social Security Administration as a condition to avoid foreign social security taxes under a Totalization Agreement.[9]

III. FOREIGN TAX CREDIT PLANNING.

Once the foreign tax pattern is understood, the next task is to determine whether and to what extent the talent will be entitled to claim a foreign tax credit against his or her U.S. tax liability with respect to the amount of foreign taxes (if any) paid. If the talent is able to utilize fully and currently the foreign tax credits, then there may be no net increase in his or her worldwide tax liability, and thus reduce the need to do any complicated tax planning.

a. General Rules.

A complete discussion of the U.S. foreign tax credit rules is beyond the scope of this article. In general, a U.S. resident can claim a foreign tax credit for income taxes paid to foreign countries (except for certain countries described in Section 901(j)).[10] The taxpayer can also elect to deduct the foreign taxes instead of claiming a credit. For this purpose, social security taxes paid to

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[9] To obtain a Certificate of Coverage from the Social Security Administration, mail the application to the Social Security Administration, Office of International Programs, P.O. Box 17741, Baltimore, Maryland 21235-7741.

[10] Code Section 901.

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a foreign country, which were not avoidable under the provisions of a Totalization Agreement, are treated as an income tax and are thus eligible for the foreign tax credit.[11] The amount of the foreign tax credit may not exceed the proportion of total U.S. tax liability attributable to net foreign-source income.[12] Separate limitations apply to certain "baskets" of income such as capital gains, passive income, non-active royalties, etc.[13] The taxpayer's expenses and deductions (including itemized deductions) must be allocated between U.S. and foreign-source income in accordance with various rules.[14] Tax withheld can be claimed as a foreign tax credit if the amount withheld is the taxpayer's ultimate, final tax liability. Otherwise, the taxpayer may need to file a tax return in the foreign country in order to ascertain his or her final tax liability, which is then eligible for the U.S. foreign tax credit.

b. Simple Tax Rate Comparison Not Adequate.

Foreign tax credit planning is complex. One cannot simply assume that the talent can fully utilize foreign tax credits because the foreign tax rate is less than or equal to the U.S. tax rate. This is because the allocation of deduction rules can result in an unexpected reduction in net foreign-source income (especially because of the proportionate allocation of itemized deductions), and/or because, if the talent is otherwise subject to the alternative minimum tax ("AMT"), only 90% of the foreign tax credit can be used for alternative minimum tax purposes.[15]

AMT is often more than a theoretical concern, since a talent who is subject to foreign tax may not be able to furnish services through a U.S. loanout company (due to the "trapped foreign tax credit" problem discussed below), with the direct engagement in some cases resulting in an employment relationship for tax purposes. Employee status can often throw the talent into an AMT position due to the fact that he or she cannot deduct any miscellaneous itemized deductions (including employee business expenses) for AMT purposes.[16]

In each case it is necessary to run the numbers to determine whether and to what extent the talent will be in an excess foreign tax credit position. An example should illustrate these concerns. Assume that in a given year talent earns $1,250,000 of gross income ($1,000,000 net of expenses of $250,000) from rendering services in the United Kingdom, and that the talent paid $450,000 of tax to U.K. Inland Revenue on such amount. Assume further that the entertainer has $200,000 of itemized deductions, which consist of State income tax and home mortgage interest deductions, and that the entertainer earned no other income. Under these facts, the entertainer's net foreign-income would be equal to $800,000, since all of the itemized deductions would be allocated

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[11] See, e.g., P.L. 95-216, Section 317(b)(4); Rev. Rul. 79-291, 1979-2 C.B. 273 (Italian Social Security Tax); Rev. Rul. 80-94, 1980-1 C.B. 170 (German Social Security Tax); and Rev. Rul. 72-579, 1972-2 C.B. 441 (U.K.).

[12] Code Section 904(a). For this purpose, service income is sourced where the services are rendered, and royalty income is sourced at the place of use.

[13] Code Section 904(b)-(d).

[14] Reg. Section 1.861-8.

[15] Code Section 59(a)(2).

[16] Code Section 56(b)(1)(A)(i).

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to the foreign-source income. The foreign tax credit limitation would then be $316,800, which is equal to the assumed U.S. marginal tax rate of 39.6% multiplied by $800,000. Since the entertainer paid $450,000 to the United Kingdom, he or she is "out-of-pocket" for $133,200, which is the amount of the excess foreign tax credit eligible for carryback or carryforward to other years. This example proves that a substantial excess credit may follow even if the top marginal rates in both countries are roughly comparable, and underscores the point that a foreign tax credit analysis must be done in each case.

c. Method of Accounting for Foreign Tax Credits.

In general, a taxpayer's method of accounting governs when the taxpayer takes into account foreign taxes. A significant exception to this rule is found in Code Section 905(a). It allows a cash basis taxpayer to elect to account for foreign tax credits under the accrual method of accounting. Once elected, the taxpayer must compute its foreign tax credits for all later years on the accrual method. The election is made by checking the appropriate box on IRS Form 1116 (Part II) for individuals or Form 1118 (Schedule B, Part I) for corporations.

If a cash method taxpayer elects to accrue foreign taxes, the taxpayer will be entitled to claim foreign tax credits in the year of the election for both (a) taxes that accrue in that year; and (b) taxes paid in that year that accrued for a prior year during which the taxpayer used the cash method. The taxpayer's dispute of a foreign tax that has been paid doesn't prevent a U.S. foreign tax credit. However, if the taxpayer contests an unpaid foreign tax deficiency, a foreign tax credit doesn't result until the taxpayer pays the deficiency or the foreign tax is finally determined. In all events, the foreign tax credit relates back to the year for which the foreign government asserted the deficiency.[17]

The accrual method election gives the taxpayer an opportunity to match the foreign tax credit against the foreign source income, which generated the credit in the first instance. Otherwise, the taxpayer may pay the foreign tax deficiency in a later year when he or she has no foreign source income, and assuming no foreign source income in any of the carryback years, the cash method of accounting for foreign tax credits will not yield any current tax credit. The accrual method solves this problem by relating back the foreign taxes later paid to the year in which the foreign source income was generated. An added benefit of the accrual method election is that the foreign taxes are deemed to have accrued (and thus been paid) in the year in which the foreign source income was earned. This should result in the refund of the foreign tax credits (to the extent otherwise permitted), plus interest income accruing from the due date of the tax return for the earlier year through the date of refund.

Note that the accrual method of accounting for foreign tax credit accounting purposes can create adverse consequences in situations where the foreign country tax year is different than the calendar year (e.g., the U.K., Australia and New Zealand). In these situations, the IRS has ruled in a Chief Counsel Memorandum[18] that the foreign tax credit does not "accrue" until

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17 See, e.g., Revenue Ruling 84-125, 1984-2 C.B. 125; and Revenue Ruling 70-290, 1970-1 C.B. 160.

18 IRS Chief Counsel Memorandum AM2008-005 (May 9, 2008).

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the end of the foreign country tax year. Thus, as an example, for talent working in the U.K., the U.K. tax will not "accrue" until April 5th, which is the date on which the U.K. tax year ends. This can result in an unexpected one-year deferral of the foreign tax credit in situations where the U.K. taxes were withheld in the prior calendar year. In that prior year, the talent will have to pay full U.S. tax on the U.K. income, even though U.K. taxes were withheld or paid at the source, and won't be able to claim the foreign tax credit until the following tax year, thereby creating a cash flow problem in the earlier year. If the talent can't utilize the foreign tax credit in the following tax year, then the talent may be able to carryback the unused foreign tax credit to the prior year under the rules discussed in the next section.

In some countries this problem may be alleviated if the foreign tax withholding constitutes the full and final tax with no tax return required to be filed. This is certainly the case in the U.K. in situations where the talent obtains an advance withholding tax ruling from Inland Revenue. However, note that in some situations an advance withholding tax ruling may not be desirable (see discussion below).

d. <u>Carryback or Carryforward of Excess Foreign Tax Credits</u>.

Unused foreign tax credits can be carried back one year and carried forward ten years.[19] Unused foreign tax credits are carried forward or back on a basket-by-basket basis and are usable only to the extent that there is foreign tax credit limitation in excess of foreign tax credits paid or accrued in the carryover or carryback year. Excess credits are carried first to the earliest taxable year in which they can be used.

e. <u>Statute of Limitations for Refund Claims -- Ten Years</u>.

Under Code Section 6511(d)(3), a claim for refund that arises because of foreign tax credits must be filed within ten years of the date for filing the return for the year with respect to which such claim is made. This extends the normal three-year statute of limitations for ten years for refund claims relating to foreign tax credits. The ten-year limitation period begins to run from the year for which the foreign tax credit was imposed, and not from the year to which the foreign tax credits are carried or from the year in which the taxpayer pays the deficiency or resolves the foreign tax dispute.[20]

f. <u>Ways to Mitigate Excess Foreign Tax Credit Position</u>.

If it appears that the talent will not be able to take full and immediate advantage of his or her foreign tax credits, then the problem may be minimized (or eliminated altogether) through creative income allocations, a foreign tax indemnity and/or using the foreign tax credit carryback and carryforward rules. Each of these alternatives will be discussed below.

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[19] Code Section 904(c).

[20] See, Revenue Ruling 58-55, 1958-1 C.B. 266, and Revenue Ruling 77-487, 1977-2 C.B. 479, *modified by* Revenue Ruling 84-125, 1984-2 C.B. 125.

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i. Income Allocations. Contractual allocations of income can be helpful for several reasons. First of all, they may result in the reduction of the foreign tax liability in the first instance (provided that the allocation is respected by the foreign tax authority). Furthermore, they may result in an increase in foreign-source income for U.S. tax purposes, which may increase the amount of usable foreign tax credit.

Several examples of income allocations follow. To reduce foreign tax liability, a portion of the income from a particular film may be allocated to U.S. development activities, rehearsals, pre-production, post-production and publicity. Other techniques include paying the entertainer a producer-type fee, option fees, holding or exclusivity fees, and release fees. If a film is being shot in multiple jurisdictions, it is advisable to allocate as much income as is possible to the lowest-tax jurisdictions, in order to reduce the aggregate foreign taxes paid. To increase foreign-source income, it may be possible to allocate income to no-tax or low-tax jurisdictions for promotion and publicity, executive producing, etc.

Most of the allocation techniques should be incorporated into the underlying contracts. It is often helpful to bifurcate the contracts into separate agreements for each type of income. Each technique, of course, should be confirmed by the local tax advisors in each of the affected countries to make sure that the local tax authorities will respect the allocation scheme.

Note that in some situations the producer may resist any attempt to allocate income outside of the foreign country if the producer's foreign tax subsidies or incentives are limited to income sourced in that foreign country. This is a recurring problem in today's environment where "soft money" tax incentives are so critical to financing the production costs.

In addition, certain of the more popular filming jurisdictions have very sophisticated tax administrators who have promulgated rules or administrative practices that curb the talent's ability to allocate income away from that country. As an example, Canada has a formulaic approach to allocating income to actors that follows work days,[21] and Inland Revenue has very strict ruling guidelines that make it very difficult to allocate an actor's income outside of the U.K. unless attributable to actual work days during principal photography.

ii. Foreign Tax Indemnity. If all else fails, the talent may wish to ask the producer for a foreign tax indemnity. The purpose of tax indemnities is to reimburse the talent for the additional tax costs suffered as a result of being asked to render services outside the United States. Notwithstanding this understandable purpose, tax indemnity agreements come in many different forms, and often provide little to no ultimate tax relief. Some of the issues to consider when negotiating a tax indemnity agreement are set forth below:

(a) The definition of included taxes. A simple reference to "income taxes" as defined in Code Section 901 may not be adequate, as that may exclude certain social security taxes, VAT, other non-income types of taxes, and possibly withholding taxes (which technically might considered as a tax in-lieu of an income tax under Section 903).

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[21] See, http://www.cra-arc.gc.ca/tx/nnrsdnts/flm/ctrs/llctn-eng.html.

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(b) "Gross-up" provision. Since the indemnity payments will be taxable here (and possibly in the foreign country), the talent will not be made whole unless the tax indemnity payments are grossed-up to cover the taxes paid on the indemnity payments.

(c) Actual versus assumed increase in tax liability. The indemnity should be based on actual increase in worldwide tax liability, not an assumed increase based on numerous assumptions, which may not apply in the particular case. Several studio indemnity forms are limited to foreign tax rate protection only (i.e., only cover the difference between the foreign tax rate and the highest U.S. federal tax rate), and assume that the talent will fully utilize any foreign taxes paid as a current foreign tax credit.

(d) Recomputations, refunds, audits. All need to be addressed. Who pays attorney's fees for defending an audit? Who controls the audit? Are penalties and interest also covered?

(e) Conditions to indemnity. Some onerous indemnity agreements provide that the talent's covenants under the agreement (e.g., to give producer opportunity to review foreign tax returns) are express conditions to the producer's obligations. Thus, a minor failure to comply may result in the indemnity being voided. Such conditions should be converted to covenants, and narrowed as much as possible.

(f) Consider the financial strength of the indemnifying party. An indemnity from the single-purpose production company (and many other independent producers) may not be worth much, especially given how an indemnity claim may arise many years in the future after the shell production company has been liquidated or has disappeared. Try to get a guarantee, or a co-signature, from the U.S. studio or distributor.

In general, it is advisable to have experienced tax counsel review foreign tax indemnity agreements. There are many tricks and traps in most agreements, some of which were noted above, and all of which can be discovered and hopefully mitigated through careful review and negotiation.

IV. U.S. WITHHOLDING OBLIGATIONS.

a. Income Tax.

Remuneration paid to a nonresident alien for services performed outside the United States is not subject to U.S. income tax withholding.[22] Remuneration paid to a U.S. citizen working outside the United States is statutorily exempt from income tax wage withholding if (i) at the time of such payment it is reasonable to believe that such remuneration will be excluded from gross income under the foreign-earned income exclusion of Code Section

[22] Reg. Section 31.3401(a)(6)-(1)(b).

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911; or (ii) the employer is required by the law of any foreign country to withhold foreign income tax on such remuneration.[23]

Technically, U.S. income tax withholding is required on wages paid to a U.S. citizen by any employer, whether a U.S. employer or a foreign employer, unless one of the above exceptions apply. Thus, a foreign corporation not doing business in the United States theoretically could be required to withhold U.S. tax on compensation paid to a U.S. citizen performing services abroad, unless foreign tax withholding is required. Such a position would be extremely onerous and possibly unenforceable as a matter of law due to extra-territoriality concerns. For these reasons, among others, in my experience the IRS has not pursued foreign producers failing to withhold U.S. income taxes.

b. Social Security Tax.

i. General Rules. The U.S. social security taxes (including the 1.45% Medicare tax) are required to be withheld on "wages" paid with respect to "employment".[24] "Wages" are defined as all remuneration from employment.[25] "Employment" is defined to exclude services performed outside the United States unless the services are performed as an employee of an "American employer".[26] An "American employer" is defined to include any domestic corporation, certain partnerships and trusts and U.S. resident individuals.[27]

In most cases a foreign corporation or other entity will not be required to withhold U.S. social security tax on the wages paid to its U.S. resident employees working outside of the U.S., and such wages will not be subject to social security tax. One exception, which may apply, is if the foreign corporation is a "foreign affiliate"[28] of an American employer. In such event, the American employer may, if it desires, enter into a binding agreement with the IRS under Code Section 3121(1) (a "FICA Election"), whereby the American employer promises to pay the full FICA on all U.S. citizens and resident aliens employed by the foreign affiliate. The FICA Election is binding for all subsequent years, and is made on IRS Form 2032.

ii. Planning Opportunity for Non-U.S. Employment. With that background, it becomes clear that the performance of services outside of the U.S. for a non-American employer potentially allows the employer and employee to save their respective shares of the U.S. payroll taxes, including the 1.45% Medicare tax.

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23 Code Section 3401(a)(8) (this sub-section contains other exceptions to withholding which are generally not relevant to the entertainment industry).

24 Code Sections 3101(a), 3111(a).

25 Code Section 3121(a).

26 Code Section 3121(b).

27 Code Section 3121(e)(1).

28 Code Section 3121(1)(8) defines a foreign affiliate to include any foreign corporation in which the American employer owns directly or indirectly at least 10% of the voting stock.

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As is usually the case in cross-border tax planning, there are counter-veiling considerations. In order to avoid the payroll taxes, the talent must be treated as an employee under U.S. tax law. This is because there is no territoriality limitation with respect to the self-employment tax. Talent working outside the United States as an independent contractor will be subject to U.S. self-employment tax on his or her world-wide self employment income.[29] Being an employee, of course, carries with it the usual tax costs (such as the reduction of deductions as result of the "2% floor", the "3% floor", alternative minimum tax, etc.), and in some cases these costs may exceed the amount of social security taxes to be saved. Furthermore, it is possible that the exclusion of foreign services from the U.S. social security system may impact the talent's accrued number of quarters of social security coverage, and his or her accrued social security benefits (this is not likely to be a significant issue in most cases, however, since a minimal amount of income earns one quarter of coverage, and the talent can earn coverage for a particular quarter provided that his or her annual earnings exceed the statutory minimum).

To push the envelope a bit further, it may be possible for the talent to save the FICA taxes and realize loanout benefits by providing his or her non-U.S. services through a foreign loanout corporation. Under this scenario, the talent, as a technical matter, would be an employee of the loanout company (which would not be an "American employer" for FICA tax purposes), with the net compensation paid from the loanout company not being subject to the U.S. payroll taxes.[30] Since the compensation paid will be after the payment of all business expenses, there should be no loss of loanout benefits.

Before setting up a foreign loanout company, several additional issues will need to be considered. If the talent will be subject to foreign income tax withholding, the foreign loanout structure may not work since it possibly could result in the foreign tax credits being "trapped" inside the foreign corporation. In selecting a jurisdiction in which to incorporate, several foreign tax issues need to be considered, including whether or not the foreign corporation will be subject to any local income tax, VAT or any other taxes, and whether the use of that jurisdiction will impact the availability of any tax exemptions under the Tax Treaty and Social Security Totalization Agreement (if any). The use of the foreign corporation also should be integrated with the U.S. loanout corporation (if any) of the talent, so that the territorial boundaries are respected by contract. The foreign loanout company may be subject to attack by the IRS for all of the reasons currently being asserted to challenge the viability of domestic loanout corporations. The IRS also may attempt to disregard the foreign loanout company under the "rent-a-star" rulings (however those rulings specifically dealt with non-resident entertainers working in the United States, whereas this situation contemplates U.S. resident entertainers working outside the United States).

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[29] See, Rev. Rul. 62-200, 1962-2 C.B. 211 (resident alien missionary ruled subject to self-employment tax on self-employment income from U.S. and foreign sources).

[30] See discussion above regarding the foreign loanout company's possible income tax withholding obligations.

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V. USE OF LOANOUT COMPANY.

When talent works outside the United States, one question that arises is whether the foreign services should be provided through the U.S. loanout corporation. (The possible use of a foreign loanout corporation is discussed in Section 4.b.ii. above.) This decision ultimately hinges on the foreign tax liabilities anticipated in connection with that particular picture.

If no foreign taxes are anticipated, it is generally advisable to use the U.S. loanout corporation (although this will result in the payment of U.S. social security taxes, since it is an "American Employer", as discussed above). If foreign tax is anticipated, the use of a loanout company, which is a "C" corporation, is not advisable. This is because the loanout company will not be able to utilize the foreign tax credits since, as is usually the case, it will pay out all of its profits at the end of the year as compensation to its shareholder/employee, resulting in it having no tax liability against which to offset the credits.

The "trapped" foreign tax credit problem may be addressed in one of three ways.

i. The easiest and most common solution is to have the U.S. entertainer perform services directly as an individual. If the individual is treated as an employee for U.S. tax purposes, the individual's employee business expenses (including professional fees) will be recharacterized as miscellaneous itemized deductions (thus being partially disallowed because of the "2% floor" and "3% floor", and possibly creating an alternative minimum tax situation). Nevertheless, employee classification may result in the avoidance of the U.S. social security tax (including the 1.45% Medicare tax) if the entertainer is employed by a non-American employer (see discussion above).

In some cases it may be possible to treat the individual as an independent contractor for U.S. tax purposes. This characterization may be more feasible in countries which treat "above-the-line" talent as independent contractors under their own tax systems (e.g., Canada), so long as the underlying contracts confirm the independent contractor nature of the engagement and several of the other important twenty common-law factors are satisfied. In either case, the Employment Agreement between the loanout and the entertainer should permit the performance of foreign services outside of the loanout, but if that is not the case a Release Agreement should be entered into pursuant to which the loanout releases the talent from his or her exclusivity obligations with respect to that particular project, in exchange for the payment of a reasonable fee.

ii. A second possibility would be to have the C corporation elect Subchapter S status. The S corporation will flow-through any foreign tax credits to its shareholders, who can then utilize such credits against their individual income tax liability. The S corporation structure, however, carries with it some risks and disadvantages that do not apply to C corporations, and the conversion to S status may raise other issues (e.g., built-in gains tax, passive investment income issues, etc.). Furthermore, the S corporation may be subject to State income tax on its apportioned net taxable income (e.g., California 1.5% tax on S corporation taxable income)

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because, by virtue of the foreign tax being withheld, it may not have enough cash available at the end of the year to zero-out its net income.

iii. Last but not least, some foreign countries may allow the withholding arrangements to be structured so that the foreign tax is deemed to be withheld by the loanout corporation on compensation it pays to its employee, rather than as withholding at the source on the initial payment from the producer to the loanout company. This strategy is generally available in the United Kingdom, as well as several other countries, but should be used only as a last resort.

VI. ADDITIONAL PLANNING TECHNIQUES.

Several additional planning techniques should be considered on behalf of talent working outside the U.S.

a. California 18-Month Out Rule.

California determines residency status based on the facts and circumstances of each case. In general, a California resident includes (i) any person (including a non-domiciliary) who is in California for other than a temporary or transitory purpose, and (ii) any person domiciled in California who is outside the State for a temporary or transitory purpose.[31] A person who is physically present in California for more than nine months in a calendar year will be presumed to be a resident (this presumption can be rebutted by satisfactory evidence to the contrary).[32] A nonresident of California is any person who is not a California resident under these tests.[33]

In acknowledgment of the ambiguities inherent in defining and applying the "temporary or transitory purpose" rule, the California legislature sought to create a safe-harbor through enactment of Section 17014(d) of the Revenue and Taxation Code. This provision, which will be referred to as the "18-Month Rule", provides that:

> "For any taxable year beginning on or after January 1, 1994, any individual domiciled in this state who is absent from the state for an uninterrupted period of at least 18 consecutive months under an employment-related contract shall be considered outside this state for other than a temporary or transitory purpose [i.e., shall be a California nonresident]" (referred to as the "18-Month Rule").

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[31] Cal. Rev. & Tax. Code ("R&TC") Section 17014.

[32] R&TC Section 17016.

[33] R&TC Section 17015.

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The 18-Month Rule is especially attractive because it allows a California domiciliary to "drop out" of the California tax net, while retaining his or her domicile here. Thus, the individual would not need to sell/lease their California home, take their kids out of California schools, move bank accounts, change drivers licenses, voting records, wills, etc., all of which are usually required to bring about a domicile shift. Since it requires a substantial stay outside of California, the 18-Month Rule may be feasible only if the talent is doing back-to-back movies outside of California (or a single movie or series of films, such as "Lord of the Rings"), an extended non-California concert tour/recording activities, etc.

The 18-Month Rule, if applicable, will allow the individual to avoid paying California tax on his or her non-California source income which is paid or accrued while outside of California. Thus, it would clearly exempt from California taxation income from rendering personal services outside of California during that period. Less clear is contingent compensation, profit participations, residuals, etc. earned in connection with non-California services, which have not technically accrued during that period (because not all of the events had occurred to generate the income, namely the performance of the underlying picture).[34] Income which had accrued prior to leaving for, but paid during, the 18-month period, will still be taxed in California.

Eligibility to be treated as a nonresident under the 18-Month Rule is subject to the following important rules and limitations:

i. An individual can be present in California for no more than 45 days during any taxable year comprising the 18-month period.[35] This should allow the individual to be present in California for 45 days during <u>each</u> calendar year which is part of the 18-month period. The days spent in California can be for anything, work and/or pleasure.

ii. The 18-Month Rule does not by its terms apply if the individual "has income from stocks, bonds, notes or other intangible personal property in excess of $200,000 in any taxable year in which the employment-related contract is in effect".[36] The $200,000 limit should not include any "royalty" income or profit participations received by the individual (in the form of compensation paid by third parties or a loanout company) from films, records, etc., in which services were rendered on a "work-for-hire" basis. However, the $200,000 limit would include any "portfolio" income, such as interest and dividends, and may include any royalties received from film or record projects in which the individual owns all or part of the underlying rights.

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[34] See generally, R&TC Section 17554; see also, FTB Legal Ruling 132 (Dec. 5, 1958) and FTB Legal Ruling 340 (Oct. 5, 1970) (arguably stand for the proposition that percentage royalties do not "accrue" until sales [or performance of film] actually takes place).

[35] R&TC Section 17014(d)(1).

[36] R&TC Section 17014(d)(2).

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iii. The 18-Month Rule does not apply "if the principal purpose of the individual's absence from this state is to avoid any tax imposed by this part".[37] This should not present a problem in most cases.

iv. The community property rules need to be considered. If the talent's spouse stays in California during the 18-month period, he or she may still be a California resident subject to tax on worldwide income. If the couple is subject to California community property law (assume no pre-nuptial agreement), then the spouse may be subject to tax on his or her 50% share of community property income, all of which otherwise might have been exempt under the 18-Month Rule. It may be possible to do a separate property/post-nuptial agreement to address this issue, but that will have obvious economic consequences to the spouse. If the spouse accompanies the taxpayer during the 18-month period, he or she also will be considered to be nonresident during that period.[38]

v. The "employment-related contract" requirement can prove challenging. We first need to establish an employment relationship. If the talent is working through a loanout corporation, then the talent is not the "employee" of the studio/production company, and we may need to rely on the talent's employment relationship with the loanout corporation. Query whether the "employment-related contract" requirement can be satisfied when the talent is working on back-to-back foreign projects with unrelated studios.[39]

While the conditions are somewhat limiting and difficult to meet in many cases, there are occasions when the 18-Month Rule can apply and it is therefore worth considering on a case-by-case basis.

b. <u>Deferral Strategies -- Rabbi Trusts</u>.

The use of deferral techniques, such as "rabbi trusts", may be advisable in certain limited situations. A full discussion of these techniques is beyond the scope of this article. As a general rule, Rabbi trusts, and certain other non-qualified compensation arrangements, contemplate having the employer deposit into an irrevocable trust compensation payable to an employee in a later year, with the critical proviso that the trust assets must remain subject to the possible claims of the employer's creditors. This type of trust is commonly called a "rabbi trust" because an early ruling involved a trust established by a congregation for its rabbi. The employee pays no U.S. tax under such an arrangement until he or she withdraws funds from the trust.

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[37] R&TC Section 17014(d)(4).

[38] R&TC Section 17014(d)(3).

[39] See, e.g., California FTB Informational Publication 1031, which contains the following relevant examples: "Example 1 – You are a California resident. You agreed to work overseas for one year. You returned to California after the employment contract expired and stayed for three months. Then, you signed another contract with the same employer to work overseas for another year. You cannot be considered a nonresident under the safe harbor rule because your absence from California for employment reasons was not for an uninterrupted period of at least 546 consecutive days. <u>*You cannot combine the days you were overseas from the two separate contracts.*</u>" (emphasis added)

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Most U.S. studios and production companies generally will not establish these types of deferred compensation arrangements, since their income tax deduction is deferred until such time as the employee withdraws funds from the trust. From the employee's perspective, these arrangements also may be inadvisable if the employer is on shaky financial ground since any employer bankruptcy or insolvency proceeding would result in the trust assets being treated as assets of the company, potentially available to satisfy third party claims.

With that background, the use of rabbi trusts in similar arrangements in the cross-border context presents interesting opportunities.[40] First of all, the use of such an arrangement may not, under foreign law, result in the loss of the current tax deduction to the employer, thereby making the foreign producer more amenable to such an approach. Such arrangements also may be useful for a transitory U.S. resident, i.e., a non-U.S. citizen who is currently a U.S. tax resident but who anticipates giving up his or her residency in a later year. However, the bankruptcy/insolvency risk of the foreign producer in many cases may be significant, or at best uncertain, especially since it is often difficult to ascertain from the United States the level and extent of the foreign producer's financial strength.

Note that Code Section 409A must be considered in the context of offshore rabbi trusts. Section 409A(b) provides that assets set aside in a trust or other arrangement for purposes of paying nonqualified deferred compensation are treated as property transferred in connection with the performance of services at the time set aside, if the assets are located outside of the United States, or at the time transferred, if the assets are subsequently transferred outside the United States. This rule does not apply to assets located outside the United States if substantially all of the services to which the nonqualified deferred compensation relates are performed in such non-United States jurisdiction. Accordingly, holding assets with respect to vested benefits in a foreign rabbi trust will result in immediate taxation, plus a 20% additional federal tax (and possibly an additional 20% California tax) and applicable interest under Section 409A, unless the "same country" exception applies. It is also critical to comply with the other tax rules regarding deferred compensation arrangements.

c. <u>Expatriation</u>.

Many talent clients from other countries move to the U.S. for a number of years with the goal of working in the entertainment business and the intention of leaving the U.S. at some point in the future. Some of these individuals may become U.S. income tax residents (because they have a "green card" or have a "substantial presence" here) for whom many of the planning suggestions in this article are relevant. However, any U.S. citizen, or a long-term green card holder, may also be subject to a very punitive expatriation tax regime in the event they later give up their citizenship or green card. A full discussion of the expatriation rules of Code Section 877A is beyond the scope of this article, although some of the key points will be noted below.

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[40] For a good discussion of rabbi trusts in the cross-border context, see H. Ordower, *A Theorem for Compensation Deferral; Doubling Your Blessing by Taking Your Rabbi Abroad*, 47 Tax Lawyer 301 (1994). Note that this article was written before the enactment of Section 409A discussed above.

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Commencing as of June 17, 2008, a "covered expatriate" will be treated as though he or she sold all their property on the date before the expatriation at fair market value. A "covered expatriate" is an "expatriate" (defined below) whose (1) individual average annual net income tax for the period of five tax years ending before the expatriation date is greater than $145,000 (adjusted for CPI); or (2) net worth as of the expatriation date U.S. citizenship is $2,000,000 or more, or (3) the individual fails to certify under penalty of perjury that he has met the requirements of the U.S. tax code for the five preceding tax years or fails to submit whatever evidence of such compliance that IRS requires.[41] An "expatriate" is any (a) U.S. citizen; or (b) long-term resident, who is anyone who holds a green card for at least 8 out of 15 years prior to the year of expatriation (not including years in which they filed as a nonresident of the US under the tie-breaker clause of a treaty). An election is available to defer the tax triggered on the "mark to market" deemed sale, at the cost of an interest charge and subject to posting of a bond or other adequate security.[42]

For "eligible deferred compensation items", no tax is imposed under the mark to market rules and there is no deemed sale. Instead, the payor must deduct and withhold a 30% tax from the covered expatriate.[43] In order to be subject to this deferral rule, the payor must be a U.S. person and the covered expatriate must notify the payor of his or her status and waive the right to claim withholding reductions. If not an "eligible deferred compensation item", the expatriate is treated as having sold the deferred compensation for an amount equal to its present value. These rules apply to all of the expatriating talent's profit participations and contingent compensation, even for work performed outside of the U.S. The only exception is for deferred compensation that is attributable to services performed outside of the U.S. before the expatriate became a U.S. citizen or resident.

The expatriation tax regime can be extraordinarily expensive, and as a result it serves as a substantial deterrent to expatriation by U.S. citizens. The rules often surprise the temporary long-term green card holder who later wants to return to his or her home country or leave the U.S. It is imperative to consider the possible consequences of these rules prior to the talent obtaining a green card, or crossing the line and becoming a long-term green card holder. Some immigration attorneys are not familiar with these rules and may not advise the talent client as to the possible adverse tax consequences.

e. Foreign Work Permit.

While not a tax concern, the talent should obtain a work permit enabling him or her to work in the foreign country. The production company at its cost usually handles this, but it is prudent to make clear whose responsibility it is and to have the work permit in hand prior to commencing services.

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[41] Section 877A(g).

[42] Section 877A(b).

[43] Section 877A(d).

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VII. SELECTED COUNTRIES.

a. Canada.

The Canadian tax rules regarding non-resident talent working in Canada changed substantially over the past decade. The rules differ depending on whether the talent is an actor, behind-the-scenes talent, or a performing artist.

i. Actor – 23% Flat Tax. Under Article 16 of the U.S.-Canada Tax Treaty, Canada reserves the right to tax U.S. actors on their income from rendering acting services in Canada. Prior to 2001, Canada required 15% tax to be withheld on the Canadian-source acting income, with no requirement to file tax returns. This informal administrative policy was contrary to the statutory rules, which technically required the actor to file a Canadian tax return and pay tax there at the regular, graduated tax rates, which in several Canadian Provinces exceeded 50%.

In the late 1990s, the informal administrative policy was called into question. After several years of lobbying and committee discussion groups, Canada adopted a new withholding tax regime applicable to non-resident actors. Under the new rules, which commenced as of January 1, 2001, nonresident actors became subject to withholding at the rate of 23% of their gross Canadian-source acting income.

The 23% withholding tax constitutes the full and final Canadian tax liability of the actor, unless the actor elects to file a Canadian tax return and treat the 23% withholding as a payment against his or her final tax liability.[44] Absent such an election, the actor is not required to file Canadian tax returns. In most cases, it will be in the actor's best interest to accept the 23% withholding tax as the full and final tax. This may not be the case, however, for low-income actors or high-income actors with disproportionately high levels of business expenses and/or a relatively low amount of non-Canadian-source income. In each case, the actor's tax advisor should run the numbers to determine whether the flat tax on gross income is preferable to the regular tax on net income.

The 23% flat tax applies to all non-resident actors, regardless of their country of residence. Thus, for instance, the actor does not need to be a resident of a "Treaty" country in order to qualify for the flat withholding rate. Significantly, the 23% flat tax does not apply to the behind-the-scenes talent or any performing artist (such as concert touring artists). Also note that an additional 9% flat tax may apply on acting income earned in the Province of Quebec. However, the actor may be able to obtain a waiver from the Quebec 9% tax if the actor is present in Quebec for less than 183 days during the tax year concerned.

The 23% flat tax may be used whether or not the actor works directly as an individual or through an S corporation loanout company. If an S corporation is used, neither the S corporation nor the actor will be required to file Canadian tax returns, regardless of whether the S

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[44] See, http://www.cra-arc.gc.ca/tx/nnrsdnts/flm/ctrs/lctn-eng.html#electing for the procedures for an actor to elect to file a Canadian tax return, including procedures for applying for a reduced withholding tax ruling.

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corporation pays the "profit" to the actor as compensation or as an S corporation dividend. A C corporation loanout company should never be used, as that will result in a "trapped" foreign tax credit.

In general, it is preferable for the actor to furnish services in Canada through an S corporation loanout company. However, if the actor does not have an S corporation loanout and/or it is a "Canadian content" production (under the Canadian "content" rules, U.S. talent generally cannot furnish services through a non-Canadian loanout corporation), the actor may need to be engaged directly as an individual. In such event, it is generally advisable to structure the contract as an independent contractor engagement. This should not be a problem under Canadian law, since all "above-the-line" talent are treated as independent contractors.

In such cases, care should be taken to ensure that the Actor Agreement conforms to the form and substance of an independent contractor relationship. If it is not possible to confirm the independent contractor relationship in the agreements, then it is preferable to leave the employee/independent contractor status ambiguous and have the actor engaged by a Canadian production company and paid through a Canadian payroll service. That should give the actor the opportunity to report the income on Schedule C (subject to the risk of an employee characterization challenge). Note that there also may be a SAG issue if the Canadian production company is not a SAG signatory, in which case the studio should engage the actor and then assign the actor's contract to the Canadian production company, with the studio retaining the obligation to make the SAG pension, health and welfare payments.

The Canadian Revenue Agency ("CRA") intends to tax contingent compensation (profit participations, deferments, box office bonuses, residuals, etc.) earned by nonresident actors, in the same proportion as the underlying fixed income was taxed in Canada. Thus, if 80% of the fixed income were taxed in and allocable to Canadian acting services, the contingent compensation would be taxed in the same manner. However, due to significant concerns raised by the film industry, CRA is currently reconsidering its position and has placed the new rules on contingent compensation on hold. The CRA website contains a carefully crafted message in this regard as follows:

> "*Further to concerns expressed by the film industry, the Government of Canada has determined that a review of the tax treatment of certain contingent compensation payments and residuals paid to a non-resident actor in respect of services performed in Canada is warranted. This review will ensure that the concerns raised by the film industry on the taxability of residuals and contingent compensation payments under the current law are fully considered. Accordingly, the CRA will maintain the status quo in relation to this issue and defer any administrative changes pending that review*."[45]

[45] See, http://www.cra-arc.gc.ca/tx/nnrsdnts/flm/ctrs/wthhldng-eng.html

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Special rules apply to the taxation of per diems.[46] Special rules also exist with respect to the allocation of income. The general rule is that income is allocated based on the number of "work days", with certain adjustments.[47]

ii. Behind-the-Scenes Talent -- Waiver Required. Under the U.S.-Canada Tax Treaty, whether BTS talent is exempt from tax will depend on whether or not the BTS talent is an independent contractor or an employee. "Below-the-line" personnel such as technicians, cameramen, etc., are generally treated as employees for Canadian tax purposes. As such, they will be exempt from Canadian tax if they satisfy the requirements the Dependent Personal Services clause of Article 15 of the Treaty. Article 15 provides that compensation received by a U.S. resident from employment services rendered in Canada are taxable in Canada unless: (i) the remuneration does not exceed $10,000 (CN); or (ii) the recipient is present in Canada for less than 184 days and the remuneration is not borne either by an employer resident in Canada or by a permanent establishment or fixed base in Canada of a U.S. employer. Employment income not exempt by Treaty will be subject to tax in Canada at the regular, graduated tax rates.

"Above-the-line" talent such as directors, writers and producers are usually treated as independent contractors for Canadian tax purposes. As noted above, the U.S-Canada Tax Treaty analyzes independent contractor income under the Business Profits clause. Thus, independent contractor income is subject to tax in Canada to the extent it is attributable to a Canadian PE.

In addition to the general PE rules, the Fifth Protocol to the Treaty, adopted in 2008, added the concept of a Service PE (Article V(9)) which, as noted above, concludes that for service providers, a PE exists if:

(i) the services are performed by an individual who is present in the other state for a period or periods of more than 183 days in any 12-month period and, during the period or periods in which the individual is present in the other state, 50% of the active gross business revenues of the enterprise consist of income derived from the services provided by the individual in the other state; or

(ii) the services are provided for an aggregate of 183 days or more in any 12-month period and relate to the same or connected projects for customers who are resident in the other state or who maintain a permanent establishment in the other state.

If a Service PE exists, the BTS talent will be subject to tax in Canada at the regular (and very high) graduated tax rates, which will likely create an excess foreign tax credit position in the U.S. However, in many cases the BTS talent will not create a Services PE (because

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[46] See, http://www.cra-arc.gc.ca/tx/nnrsdnts/flm/ctrs/prdms-eng.html

[47] See, http://www.cra-arc.gc.ca/tx/nnrsdnts/flm/ctrs/llctn-eng.html

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they don't cross the 183-day line in a particular year). That doesn't mean the BTS talent is out of the woods -- the talent still needs to determine whether it is subject to tax under the general PE rules. This process is normally handled through a waiver process administered under Regulation 105.

CRA has developed a set of waiver guidelines for independent contractors that are administered by each of the Canadian Film Service Units.[48] A waiver will generally be granted to BTS talent who reside in the United States or another comparable Treaty country if the following conditions are met:

(a) The BTS' "presence"[49] in Canada under their contract for the "project"[50] will be less than 180 days[51]; and

(b) Either: (i) services for the current and other projects within the "period"[52] are performed in Canada at identifiably different "production sites"[53]; or (ii) the current project is determined to be not "related"[54] to the other projects; and

(c) Services are not considered to be "repetitive"[55].

The "repetitive" factor often creates the most trouble for independent contractors. Waivers are being denied for BTS talent who work in the same geographic area (say Vancouver or Toronto) on three or more occasions, even over a long period of time. (Example H and I of the waiver guidelines conclude that service in same geographic area in 1998, 1999 and

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[48] The waiver guidelines for independent contractors under Regulation 105 can be found at http://www.cra-arc.gc.ca/tax/nonresidents/trtyguid2-e.html, and the waiver guidelines for employees under Regulation 102 can be found at http://www.cra-arc.gc.ca/tax/nonresidents/trtyguid3-e.html. Note that, under current administrative practices, if the loanout corporation pays compensation to the talent, a waiver under Regulation 105 and Regulation 102 must be applied for with CRA.

[49] "Presence in Canada" – includes travel days, hiatus days, weekends, holidays, etc. Need to be outside of Canada for at least 5 days to break the presence.

[50] "Project" – means the feature film, TV pilot, series, movie, etc.

[51] "180 Days" -- includes all days in the seven-year "Period" (see below). Count all days in consecutive 12-month period (i.e., not based on the calendar year).

[52] "Period" -- consists of the current year, and the prior 3 and following 3 years (i.e., total period of 7 years).

[53] "Production Sites" -- refers to a geographic location in Canada used to undertake a project. Could be a studio, or an entire metro area if film shot on location throughout the city.

[54] "Related Projects" -- projects are related where they are the continuation of services of the previous project and are undertaken by the same production company or studio. TV series are likely to be "related", but motion pictures, TV movies, etc., even if produced for the same studio and/or under a "first look" deal, are not likely to be related.

[55] "Repetitive" -- exists where BTS provides services in Canada in the same geographic location on a routine basis, even if projects are totally unrelated and even if less than 180 days in the Period. Normally limited to situations where the BTS has provided such services in Canada in the same location, etc. for three or more previous calendar years, even if such years are not "consecutive".

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2000 is “repetitive”, but that service in same area in 1994, 1996, 1999 and 2000 is not “repetitive”).

Please keep in mind that the waiver guidelines are used by CRA as a filter for PE determinations. If a taxpayer fails to obtain a waiver, that does not necessarily mean that the taxpayer has a PE in Canada. It only means that CRA, as an administrative matter, has determined that the taxpayer did not meet the initial waiver guideline threshold and is therefore subject to 15% withholding. The taxpayer always has the right to challenge the waiver denial by filing a Canadian tax return and requesting a full refund of the 15% withholding, based on the position that the taxpayer did not have a PE. Please be aware, however, that an audit is likely to follow and the taxpayer may be required to support the factual and legal basis of this position. The refund claim may not be resolved for some period of time, and in light of the uncertainties it is imperative for BTS talent pursuing this approach to furnish his or her services as an individual or through an S corporation loanout company (i.e., so as to avoid a “trapped” foreign tax credit problem if the refund claim is denied). (Note that if the talent has a Services PE, then it will not be possible to challenge the denial of the waiver as discussed in this paragraph.)

If the waiver is granted, Canadian corporate tax returns must be filed if a loanout company is used (the Canadian tax returns are “nil” returns that report the granting of the waiver and the treaty-based return position). If the BTS talent was hired directly as an individual and the waiver was granted, no Canadian individual tax returns must be filed. The failure to file any required Canadian tax returns may result in the imposition of penalties and interest and the denial of any future waiver requests, regardless of the merits, until such time as all past-due tax returns are filed and past-due taxes paid.

The structure of the BTS talent engagement will depend on whether or not a waiver is granted. If the waiver is issued, the BTS talent can furnish services through a U.S. loanout corporation (C Corp. or S Corp.) or directly as an individual (subject to the tax return filing requirement noted above for loanout companies). If the waiver is denied, 15% tax withholding will apply and Canadian tax returns must be filed. More specifically, if the loanout company pays compensation to the BTS talent, both the loanout corporation and BTS talent will be required to file Canadian tax returns and pay taxes on their respective shares of income of Canadian-source income. The payment of compensation is especially problematic, as it requires the BTS talent to pay taxes in Canada at the regular, graduated tax rates, which in some provinces exceed 50% of net income, most likely creating a substantial unused foreign tax credit.

If a waiver is denied, one possible mitigation technique involves the use of an S corporation loanout company. A critical requirement of the plan is that the S corporation loanout must payout all of its Canadian-source net profits as an S corporation dividend, and not as compensation. The S corporation will then be required to pay tax in Canada at the regular corporate rates (federal and provincial).[56] The Canadian taxes by the S corporation should flow through the

[56] Corporate tax rates in Canada range from 25% to 31% depending on the province involved. The details are as follows: The basic rate of Canadian federal corporate tax for 2013 is 38%, but it is reduced to 15% by an abatement of 10 percentage points on a corporation’s taxable income earned in a province or territory and a general rate reduction of 13 percentage points on a corporation’s full-rate taxable income. Provincial and territorial tax rates are added to the federal tax and generally vary between 10% and 16% of taxable income.

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actor and may be claimed as a foreign tax credit on his or her U.S. tax return. As a general matter, there should not be any additional Canadian tax owing on the dividend paid to the shareholder of the S corporation. The goal behind the structure is to take advantage of the fact that the Canadian corporate rates are substantially lower than the individual rates. In essence, the structure transforms compensation taxable at the higher individual rates into S corporation dividend income taxable at the lower corporate rates. It is important to amend the Employment Agreement between the BTS talent and the loanout company to reflect that no compensation will be payable with respect to services provided in Canada. Also note that the IRS may attempt to assess U.S. payroll taxes on the S corporation dividend, if "reasonable" compensation is not paid to the BTS talent during the relevant year. Please seek the advice of a Canadian tax advisor to make sure that the plan works. Consideration also should be given to the U.S. tax consequences arising from paying out profits as S corporation dividends vs. compensation from the standpoint of payroll tax exposure and certain 409A tax issues.

iii. Performing Artists. Performing artists (such as concert touring artists and other public performers) are not eligible to take advantage of the 23% flat tax. Such artists will be subject to Canadian tax withholding (generally at the rate of 15% with the gross compensation attributable to Canadian services) and will be required to file Canadian tax returns and pay tax in Canada at the regular, graduated tax rates.

iv. GST. Canada imposes a 7% VAT-like tax called the Goods and Services Tax (GST). CRA takes the position that the temporary services of foreign actors and other entertainers are exempt from GST, and therefore they do not have to register for the GST. However, a company producing a film or promoting a concert in Canada should register for GST. It is often possible for such a company to obtain a full refund of any GST paid throughout the course of production/tour, provided that the GST registration, payment and refund procedures are properly followed.

b. United Kingdom.

Several U.K. tax issues pertaining to talent working in the U.K. are worth noting:

i. Actors and Performing Artists. Under Article 16 of the U.S.-U.K. Treaty, the U.K. reserves the right to tax U.S. resident actors and performing artists on their service income realized from working in the U.K. Under U.K. law, and absent an Advance Ruling (discussed below), the payor is required to withhold 20% of the gross income (including per diems, expense reimbursements and indirect expenses paid by the payer) arising from work in the U.K. The 20% withholding on gross income does not technically represent the actor's final U.K. tax liability. Either the actor or the U.K. Inland Revenue may review the situation at the end of the tax year. If the withholding tax deducted is too much, the actor can file a tax return and claim

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The Canadian federal government and the provincial and territorial governments may apply lower rates of tax to active small business earnings and earnings derived from manufacturing and processing. Nonresident corporations carrying on business in Canada through a branch are taxable at the full corporate rate on their net business income earned in Canada, and they must pay an additional tax of 25% on after-tax income, subject to an allowance for investment in Canadian property. This branch tax may be reduced by treaty.

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a refund at the end of the U.K. tax year, but if it is not sufficient the Inland Revenue may make an assessment and issue a demand for the difference.

Historically, it has been advisable for the talent to file an Advance Ruling Application with the Foreign Entertainer's Unit of Inland Revenue. The purpose of the Advance Ruling is three-fold: (i) to prove up the entertainer's legitimate business expenses relating to U.K. services; (ii) to establish the portion of the fees paid which relate to non-U.K. services (and which are therefore not subject to U.K. taxation); and (iii) to agree on the final U.K. tax liability, taking into account the substantiated business expenses and the agreed-upon income allocation.

The Advance Ruling Application takes the form of a projection of U.K. income and expenditures and shows the anticipated net income subject to U.K. tax. Once this projection has been reviewed and agreed upon, Inland Revenue will inform the production company of the level of withholding tax to deduct. Assuming no change in the facts set forth in the Application, the tax deducted will be the final tax liability for the year and no U.K. tax return will need to be filed. When considering an Advance Ruling Application, Inland Revenue will allow as a deduction any business expenses that are exclusively and necessarily related to the actor's trade or business. This ordinarily includes professional fees, travel and lodging costs, publicist, etc. The more problematic deductions relate to the entourage (travel and lodging for family or significant others), private jet travel and other quasi-business items such as personal trainers and personal assistants. These expenses are more likely to be accepted by Inland Revenue as legitimate deductions if the underlying contracts require the actor to hire such personnel as a condition of the engagement.

Inland Revenue does not accept substantial allocations of income outside of the U.K. for "soft" services such as promotion, publicity, post-production, rehearsals, etc. For a film shot entirely in the U.K., Inland Revenue will generally accept an allocation of only 4-8% of the income outside of the U.K. for such services. Most other countries accept a much larger allocation.

The end result of the Advance Ruling procedure is that the parties agree on a withholding rate (which will often be different than the statutory rate of 23%) which will result in the full and final amount of tax being withheld throughout the course of production, taking into account the substantiated business expenses and income allocations. By achieving closure from the U.K. side, the Advance Ruling approach also bolsters the actor's entitlement to claim a foreign tax credit for the amount withheld, regardless of his or her method of accounting for foreign tax credit purposes. The Advance Ruling procedures can take some time to complete, so advance preparation is recommended. In many cases the production company will pay for the cost of obtaining the Ruling.

Now that U.K. tax rates are falling,[57] the historical practice of filing an Advanced Ruling should be revisited. The Advanced Ruling locks in the withholding tax rate

[57] E.g., for the U.K. fiscal year commencing on April 5, 2012, the highest marginal UK tax rates dropped from 50% to 45%.

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based on the tax rates during the year of application, and if tax rates are falling the talent may not be able to take advantage of the lower tax rates in later years.[58] We are also advised that it may be possible to claim more deductions against UK source income and to allocate more income outside of the UK in the event a tax return is filed, as opposed to through the more stringent Advance Ruling process. However, the additional accounting fees must be taken into account when filing tax returns, as the Advance Ruling does not require any future tax return preparation.

ii. Behind-The-Scenes Talent. Behind-the-scenes talent working in the U.K. are generally not taxed in the U.K. under the U.S.-U.K. Tax Treaty, provided that they are present in the UK for less than 183 days in any consecutive 12-month period. The Treaty, which was amended effective as of April 1, 2003, analyzes income from BTS talent under the "Business Profits" clause of Article 7.[59] Article 7 states that business profits earned in the U.K. will not be taxable there unless the profits are attributable to a U.K. "permanent establishment".

As discussed above, a PE generally means a fixed place of business through which the business of an enterprise is wholly or partly carried on. As indicated in OECD Commentary, a general principle to be observed in determining whether a permanent establishment exists is that the place of business must be "fixed" in the sense that a particular building or physical location is used by the enterprise for the conduct of its business, and that it must be foreseeable that the enterprise's use of this building or other physical location will be more than temporary.

The "business profits" analysis is a significant change in form, but not necessarily in substance. Prior to the 2003 amendments to the Treaty, BTS talent were required to qualify for a Treaty exemption under the Independent Personal Service clause of Article 14. Under old Article 14, BTS talent were exempt from U.K. tax if they were present in the U.K. for less than 183 days in the "tax year concerned" (i.e., the U.K. fiscal year ending on April 5th) and the BTS talent did not have a U.K. fixed base. While the business profits test does not contain a 183-day threshold, the Treaty commentary refers to, and Inland Revenue administers PE determinations with reference to, the 183-day test.

Note that, unlike in Canada and Australia, BTS talent working in the U.K. do not need to apply for a waiver from tax withholding under the Treaty. The waiver eligibility process is handled directly between the talent and the payor, with no direct involvement by Inland Revenue. Also note that BTS talent who do not qualify for a Treaty exemption may consider filing an Advance Ruling Application in the manner described above for actors and performing artists.

Due to the substantial tax incentives currently being offered in the U.K., the studios and production companies have a strong incentive to push as much work as possible into the U.K., including post-production. This dynamic is resulting in many BTS talent becoming

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[58] We are advised by some UK tax advisors that it may be possible to amend an Advance Ruling to take advantage of a later drop in tax rates.

[59] The term "business profits" includes income earned by an enterprise from the furnishing of personal services.

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pulled into the U.K. tax net and being subjected to much higher tax rates than in the U.S., thereby creating unused foreign tax credits.

(a) Projects in Excess of 183 Days.

As noted above, BTS talent working in the U.K. for 183 day or more will generally be considered to have a "permanent establishment" in the U.K. As a result, the income earned by the talent's loanout corporation from the production company will likely be income "attributable to" a U.K. PE and subject to U.K. corporate income tax. Similarly, salary received by the talent from his or her loanout corporation will likely be subject to U.K. personal income tax. If and to the extent that the loanout corporation pays out all of its profits as salary to the talent, the loanout corporation will likely have no U.K. taxable income but the talent would then be subject to higher individual tax rates on the compensation.

The exception under Article 14(2) of the Dependent Personal Services clause of the U.K.-U.S. Tax Treaty should not apply to prevent U.K. taxation of the loanout salary. Such exception requires the payee (i.e., the talent) to have not been present in the U.K. for 183 days or more in the 12-month period commencing or ending in the subject tax year.

BTS talent may be involved in multiple projects through multiple loanout corporations while in the U.K. Ancillary activity associated with these other projects while in the U.K. should not rise to the level of a PE, although the issue is not free from doubt. The logic is that spending a few hours a day on these other projects (e.g., reviewing scripts and responding to phone calls) is dissimilar from the primary activity which (a) consumes the majority of the talent's attention during this period, and (b) likely involves numerous physical assets situated in the U.K. (e.g., cameras, crew, trailers, other cast members), even if such assets are not titled in the name of the loanout corporation. Note, however, that salary paid by these other loanout corporations to the talent for work performed while in the U.K. could be subject to U.K. tax as U.K-source income for which the Dependent Service clause does not provide relief as the talent will have been present in the U.K. over the 183-day threshold.

(b) S Corporation Planning.

As discussed above, U.S. residents are generally allowed a foreign tax credit for foreign income taxes paid. The foreign tax credit is limited to the amount of U.S. tax owed on such foreign-source income. Talent working overseas should always operate through a loanout corporation taxed as an S corporation (versus a C corporation), or directly as an individual, so that the foreign tax credits flow-through and may be claimed on the talent's individual Form 1040.

Typically, all income earned by a loanout corporation is paid out to talent in the form of salary for services rendered to the corporation at the end of the year. However, adverse tax consequences would result if the BTS talent's loanout corporation paid the talent salary or compensation in situations where the talent works in the UK for more than 183 days in a consecutive 12-month period. This is because the U.K. personal income tax rates are

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currently higher than the applicable U.S. income tax rates on compensation earned directly or allocated to him or her through the loanout corporation. Consequently, paying all amounts from the project to the talent as salary from his or her loanout corporation will result in a substantial unused foreign tax credit.[60]

The talent may be able to mitigate the problem by causing his loanout corporation to retain the compensation as corporate profits (versus paying it out as salary). As a result, the amounts would be subject to U.K. corporate income tax (currently 23%). Since this U.K. corporate tax rate is substantially less than the effective U.S. tax rate, full U.S. foreign tax credit relief should apply in most cases. Note that the S corporation distribution cannot be made until the UK fiscal year after the year in which the talent has departed from the UK. If the talent needs cash during this interim period, it may be possible for the loanout corporation to loan funds to the talent. This technique requires consultation with a U.K. tax advisor. Consideration also should be given to the U.S. tax consequences arising from paying out profits as S corporation dividends vs. compensation from the standpoint of payroll tax exposure and certain 409A tax issues.

(d) Anti-Avoidance Legislation.

There exists in the U.K. certain anti-avoidance laws that could be used to attack the foregoing tax credit planning for talent classified as U.K. residents. U.K. tax advisors should be consulted to determine the extent to which such legislation may apply when considering the foregoing tax planning.[61]

iii. Decentralizing Management and Control. U.K. resident companies are companies (i) that have been formed under U.K. law, or (ii) with "centralized management and control" in the U.K. U.K. resident companies are taxed on their worldwide income. Because loanout companies are usually managed and controlled by the talent, in situations where the talent is subject to UK tax (because they cross the 183-day threshold, etc.), it is important to decentralize management and control from the talent prior to arrival in the U.K. Decentralization requires removing the talent from any and all positions as a director and/or officer of the corporation, usually by replacing him or her with a trusted professional or personal contact, such as his or her business manager/entertainment lawyer, who is based in the U.S. In addition, the talent may not have veto rights over corporate decisions (i.e., the talent cannot exercise "de facto" or "shadow" control over the corporation). Note that this consideration applies to all talent (i.e., actors and BTS talent).

If the talent uses more than one loanout corporation, these other corporations should be decentralized and decontrolled as well. Otherwise, the worldwide earnings of such other corporations could be inadvertently pulled into the U.K. tax net. The talent may, however, retain and exert creative control over non-U.K. projects being undertaken by his other companies, so long as such activities do not constitute control over the management of the companies.

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[60] The excess UK taxes would result in a US foreign tax credit carryback and carryforward in such amount for 1 year and 10 years, respectively, as discussed more fully in Section VI above.

[61] See, e.g., Chapter 8 Part 2 of the Income Tax Earnings and Pensions Act 2003 (preventing the avoidance of U.K. employment taxes); Part 13 of the Income Tax Act 2007 (the Transfer of Assets Abroad Code and the Transfer of Income Streams Code); and Finance No. 2 Bill 2013 (the U.K. general anti-abuse rule).

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c. Australia.

i. Actors and Performing Artists. Under Article 17 of the U.S.-Australia Tax Treaty, Australia reserves the right to tax U.S. resident actors and performing artists on their income from rendering services in Australia. Under Australian law, and absent a Withholding Variation (discussed below), the payor is required to withhold Australian tax at the rate of 30% of gross compensation paid to loanout corporations or 46.5%[62] of the gross compensation paid directly to the actor or performing artist.

The 30% and the 46.5% rates are applied against gross income unless the taxpayer secures a "PAYG foreign resident withholding variation (FRWV) application" from the Australian Tax Office ("ATO").[63] The purposes of the FRWV are (i) to prove up the entertainer's legitimate business expenses relating to Australian services; (ii) to establish the portion of the fees paid which relate to non-Australian services (and which are therefore not subject to Australian taxation); and (iii) to agree on the final Australian tax liability, taking into account the substantiated business expenses[64] and the agreed-upon income allocation. In response to the FRWV, the ATO will calculate the amount of net income taxable in Australia and the amount of Australian taxes owing. The ATO ruling declares the amount to be withheld in a flat dollar amount (i.e., unlike in the U.K, the ruling does not express the tax withholding as a percentage of gross income). This means that the ruling will not apply to any overages or payments of additional amounts in excess of the fixed compensation provided in the ruling application, which will result in such additional payments being subject to full Australian tax withholding (again at the rate of 46.5% or 30% of gross income), unless of course a supplemental FRWV is filed. The FRWV procedures can take some time to complete, so advance preparation is recommended.

Whether a taxpayer receives a withholding variance or not, taxpayers who have suffered Australian withholding taxes must file an annual Australian income tax return.

Because of the lower corporate tax rate, actors and performing artists may want to use an S Corporation to provide services in Australia. This structure, as discussed above in the context of behind-the-scenes talent working in Canada, requires the S corporation loanout to pay its profits attributable to Australian services as an S corporation dividend and not as compensation. If properly structured and executed, this plan should reduce the effective Australian tax rate from 46.5% of net income to 30% of net income.

The S corporation structure creates two potential problems in Australia. First, in 2003 the ATO announced that "certain foreign hybrid" entities will be treated as partnerships and the profits attributed to the individual owners, who will be taxed at the higher individual tax rates. In Australia a "hybrid" entity is a company that gives the owners limited

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62 This is equal to the highest individual marginal tax rate of 45% plus a 1.5% medicare levy.

63 The FRWV is available at http://www.ato.gov.au/individuals/content.asp?doc=/content/45853.htm.

64 Note that the ATO may not allow as business expense deductions business manager and accounting fees paid to U.S. business managers or other indirect costs that are not directly linked to the production of income.

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liability protection but is treated as a "pass-through" entity for tax purposes. Although these rules could apply to U.S. S Corporations, we have been advised that the ATO is currently applying these rules only to Australian entities engaged in outbound investments.

The second potential concern regarding the use of S corporations arises from the "Alienation of Personal Services Income" rules that were adopted in 2000. If these rules apply, the entity will be disregarded for tax purposes and its owners will be taxed directly on the entity's income at the much higher individual tax rates. The alienation rules will not apply if:

a) The entity earns income in the cause of conducting a "personal service business"; or

b) The income is promptly paid to the individual owner as salary.

Where at least 20% of an entity's income in derived from more than one source, it will be treated as engaged in the "personal service business" and the alienation rules will not apply. It is unclear whether the ATO will require this test to be applied annually. It is also not yet clear whether the issue will be raised with respect to nonresident loan-out companies or will be limited to Australian corporations. Where the entity earns more than 80% of its income from one source, as may be the case for an actor appearing in a television show, the entity may request a ruling that the alienation rules do not apply.

Although an S corporation may avoid the application of these rules by paying a salary to its owner, this approach is not advisable. The payment of salary will result in the owner paying tax in Australia at the 46.5% rate, thereby defeating the purpose of the S corporation structure.

ii. Behind-The-Scenes Talent. U.S. resident talent working in Australia behind-the-camera ("BTS") are generally not taxed in Australia under Treaty articles analogous to those discussed with respect to Canada. For example, Article 14 of the U.S.-Australia Treaty provides that independent contractor income received by a nonresident from services rendered in Australia will be taxable there if either of the following two conditions are met: (i) the individual is present in Australia for a period or periods exceeding in the aggregate 183 days in the taxable year or year of income; or (ii) the individual has a fixed base regularly available to him or her in Australia for the purpose of performing such activities. Article 15 provides that the nonresident may be taxed in Australia on income received for employment services rendered here unless all of three conditions are met: (i) the nonresident entertainer is present in Australia for a period not exceeding in the aggregate of 183 days in the taxable year or year of income; (ii) the remuneration is paid by, or on behalf of, an employer who is not a resident of Australia; and (iii) the remuneration is not borne as such by a permanent establishment or a fixed base which the employer has in Australia. Entertainers working behind-the-camera who do not qualify for tax exemption under the Treaty should file an FRWV in the manner described above for performing artists.

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Prior to July 1, 2004, the ATO permitted the payor to determine whether a Treaty based tax exemption was available to nonresidents, following the U.K. self-assessment model. As of July 1, 2004, the ATO adopted procedures similar to Canada and now requires BTS talent to request a waiver in order to qualify for a Treaty exemption. The application is made using the same seven-page PAYG Foreign Resident Withholding Variation application used by artists to secure a withholding variance.

iii. Goods and Services Tax and Australian Business Number. The ATO will not accept an FRWV, and will require withholding at 46.5% of gross income, unless the foreign individual or entity acquires an Australian Business Number ("ABN"). The *Australian Business Number Act 1999* introduced the ABN as a new single business identifier that allows business to meet its regulatory obligations and access information and assistance through a single entry point to government. Taxpayers can apply for an ABN electronically at www.abr.gov.au or electronically through the Business Entry Point at www.business.gov.au. In 2004, the ATO began requiring all payors to request and receive a payee's ABN, and failing that to withhold 48.5% of the gross amounts of all payments to such payee.

Australia imposes a 10% Goods and Services Tax ("GST") on fees for services, in addition to many other things. Entertainers should avoid GST responsibility by entering into a reverse charge Division 83 agreement (this is typically handled with the assistance of the production accountant). Without such an agreement in place, the entertainer will need to register for the GST, the payor will have to add 10% GST to the agreed upon fee, and the entertainer would then be responsible for remitting the 10% GST. Where a Division 83 agreement is in place, the payor takes on the responsibility for handling all of the GST matters (i.e. the payor will show that there is a GST liability in relation to the fees and will immediately claim the appropriate credit).

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Please understand that this article contains a general discussion of some of the income tax issues relevant to international tax planning for talent, and that many of the conclusions and recommendations herein may not apply to the facts of a particular case. This is an extremely complicated area of law, and the reader is urged to undertake independent analysis and/or to engage an experienced tax advisor to determine the proper course of action in a particular case.

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