BY BRADFORD S. COHEN AND ROBIN C. GILDEN

The Taxation of Deferred Compensation in Standard Service Agreements

AT THE END OF 2004, CONGRESS ENACTED LEGISLATION that was intended to curb perceived abuses in nonqualified executive compensation plans. A prime example of these abuses involved top executives at Enron who were participants in traditional nonqualified deferred compensation plans. Under the tax rules applicable at the time, the executives were able to receive substantial payouts from those plans just prior to the collapse of Enron. After the collapse, rank and file employees who participated in Enron's qualified pension plans received no distributions from those plans. Congress enacted I.R.C. Section 409A to regulate nonqualified deferred compensation plans in order to prevent this type of abuse in the future. However these rules, as interpreted by treasury regulations that became effective on January 1, 2009, have had a profound, complex, and likely unintended effect on many standard service contracts in the entertainment industry.

Violation of these rules can result in the imposition of severe penalties, including the acceleration of the recognition of all deferred income that is payable under the nonqualified deferred compensation plan, interest on the taxes owed on the accelerated income, and the imposition of a 20 percent penalty tax on this income.[1] Notably, the California Franchise Tax Board has taken the position that it will also impose a 20 percent penalty tax on the income if the taxpayer is subject to California income or franchise taxes, even though the maximum California personal income tax rate is currently 9.55 percent.[2] These tax consequences and penalties are imposed on the person who provides service (the service provider) and not on the person for whom the services are rendered (the service recipient).

Under Section 409A, a nonqualified deferred compensation plan is defined to include any arrangement that is not a qualified pension or profit sharing plan pursuant to which a service provider may receive compensation in a taxable year later than the taxable year in which the service provider performs the services.[3] Therefore, in an entertainment industry context, any standard service agreement that provides for profit participations, box office bonuses, residuals, and other similar payments to be paid in a taxable year later than the year in which services are performed constitutes a nonqualified deferred compensation plan under Section 409A. When services are provided through a loan-out corporation, Section 409A rules will apply to both the agreement between the loan-out corporation and the service recipient and the agreement between the loan-out corporation and the service provider.

Certain short-term deferrals are not subject to Section 409A. A payment qualifies as a short-term deferral when, in the absence of an election by the service provider to otherwise defer the compensation, the payment is actually or constructively received by the service provider by no later than the latter of 1) the 15th day of the third month beginning after the end of the service provider's taxable year in which a substantial risk of forfeiture lapses or 2) the 15th day of the third month beginning after the end of the service recipient's taxable year in which a substantial risk of forfeiture lapses.[4] A right to a payment that is never subject to a substantial risk of forfeiture is considered to be no longer subject to a substantial risk of forfeiture on the first date the service provider has a legally binding right to the payment.[5]

For example, if the service provider and the service recipient both have the calendar year as their respective tax years and the payment is not subject to a substantial risk of forfeiture, then a payment is deemed to be a short term deferral if the payment is required to be paid to the service recipient no later than March 15 of the year that begins immediately after the year in which the service provider performs the services.

The rules contained in Section 409(A) and the treasury regulations issued under it are broad and complex.

Exceptions to the Rules

A "substantial risk of forfeiture" is a standard included in the IRC Section 409A rules that is used to determine whether deferred compensation should be included in the taxable income of the service provider on receipt or at same later date. A substantial risk of forfeiture exists if 1) entitlement to the amount is conditioned upon the performance of substantial future services by the service provider or 2) the occurrence of a condition related to a purpose of the compensation, and 3) the possibility of forfeiture is substantial.[6]

A substantial risk of forfeiture that relates to a purpose of the compensation includes a condition that relates either to the service provider's performance for the service recipient or the service recipient's business activities or organizational goals.[7] For example, the requirement that a service provider make certain personal appearances after the release of a motion picture in order to receive profit participations is a substantial risk of forfeiture related to the service provider's performance of substantial future services.

An example of a substantial risk of forfeiture due to a service recipient's business activities or organizational goals is a requirement that the earnings of the service recipient exceed a certain level,[8] such as a requirement that the service recipient recover its expenses in producing and advertising a motion picture from box office receipts prior to the service provider receiving a profits participation.

Bradford S. Cohen and Robin C. Gilden are partners in the Los Angeles office of Venable LLP. They both specialize in tax law and tax planning.

Some commentators have taken the view that profit participations cannot be deemed to be subject to a substantial risk of forfeiture. They support this argument based on a comment contained in the preamble to the treasury regulations issued under Section 409A:

> One commentator suggested that any right to a payment be treated as subject to a substantial risk of forfeiture until the amount of the payment is readily determinable, at least where the payment could be zero. The Treasury Department and the IRS do not believe that this standard is appropriate.[9]

However, this statement in the preamble to the treasury regulations appears to be diametrically opposed to treasury regulations that provide that a substantial risk of forfeiture can be a condition that the service recipient's earnings exceed a certain level.[10]

Another argument that profit participations are not subject to a substantial risk of forfeiture is that such payments are similar to stock appreciation rights, and stock appreciation rights are not treated as being subject to a substantial risk of forfeiture under the treasury regulations. However, the treasury regulations contain rules that provide when a stock right will no longer be subject to a substantial risk of forfeiture, thereby implying that stock rights can be subject to a substantial risk of forfeiture.[11]

Another exception to the application of Section 409A to deferred compensation is the independent contractor exception. Under this rule, a deferred compensation payment is not subject to Section 409A if in the year in which the service provider first has a legal right to a payment 1) the service provider provides service to two or more service recipients other than as an employee or a director, 2) the service provider is not related to either service recipient and the service recipients are not related to each other,[12] and 3) the service recipient receives no more than 70 percent of his or her income from any one service recipient for services performed by the service provider in that year.[13] The independent contractor exception is difficult to apply[14] and generally will not be met if the service provider performs service primarily for one motion picture studio, one record label, or one television network.

There are other exceptions to the Section 409A rules that apply to certain stock options and stock appreciation rights. However, these exceptions generally do not apply to standard entertainment industry service contracts.

The motion picture industry is apparently lobbying the Treasury Department on the application of the substantial risk of forfeiture rules to profit participations, box office bonuses, residuals, and other categories of income that may be deemed to be deferred compensation under Section 409A. The Treasury Department has not yet issued any written notices with respect to the issue.

The Section 409A Rules

If none of the exceptions to the Section 409A deferred compensation rules apply, an compensation arrangement must comply with the Section 409A rules or the income acceleration, interest, and penalty provisions will kick in. There are three sets of requirements under Section 409A. The first provides when an election to defer income must be made. The general rule is that the election to defer income must be made no later than the last day of the taxable year ending before the year in which the service provider will perform the services.[15]

If a taxpayer does not have the right to elect to defer income (which is the case with most standard entertainment industry service contracts) the election rules will be satisfied if the designation of the time and form of payment occurs no later than 1) the time the service provider first has a legally binding right to the compensation or, if later, 2) the time the service provider would be required to make such an election if the service provider were provided with an election.[16]

Since the service provider under a standard entertainment industry service contract first receives a right to receive profit participations, box office bonuses, or residuals when the service provider enters into a contract agreeing to perform the services, the election requirement will generally be met.

The second set of requirements under Section 409A covers when payments of deferred compensation can be made. Under these rules, a payment of deferred compensation can only be made at one of the following times:

1) The service provider's separation from the service.
2) The service provider becoming disabled.
3) The service provider's death.
4) A time or a fixed schedule specified under the plan.
5) A change in the ownership or effective control of the service recipient or in the ownership of a substantial portion of the assets of the service recipient.
6) The time of an unforeseeable emergency.[17]

"Separation from service," "disabled," "change in ownership or effective control," "change in ownership of a substantial portion of the asset" and "unforeseeable emergency" are all defined terms under the treasury regulations.[18] If a service provider is a "specified employee,"[19] the specified employee can receive deferred compensation that is payable on a separation from service, no earlier than six months after the effective date of the separation.

In standard entertainment industry service contracts, the deferred compensation will be payable at a time or a fixed schedule specified under the agreement. This can be a specific date (such as March 15, 2014), or at a specified time, or pursuant to a fixed schedule if objectively determinable amounts are payable at a date or dates that are nondiscretionary and objectively determinable at the time the amount is deferred.[20]

In addition, a plan may provide that a payment, including a payment that is part of a schedule, is to be made during a designated taxable year of the service provider that is objectively determinable and nondiscretionary at the time the payment event occurs. For example, a schedule of three substantially equal payments payable during the first three taxable years following the taxable year in which a master recording is delivered to a record label is such a payment plan.[21]

A plan may also provide that a payment, including a payment that is part of a schedule, is to be made during a designated period objectively determinable and nondiscretionary at the time the payment event occurs. But the designated period must begin and end within a single taxable year of the service provider, or the designated period must not be more than 90 days and the service provider does not have a right to designate the taxable year of the payment.[22]

Most standard entertainment industry service contracts that include profit participations, box office bonuses, or residuals provide that a service provider will receive an accounting no later than a certain date and the service provider will receive a payment within a certain number of days after the accounting is delivered to the service provider. If the contract provides that the service provider will receive the payment no later than 90 days after the accounting is delivered, the 90-day period spans two years, and the service provider cannot elect the year within which he or she will receive the payment, this payment arrangement should satisfy the payment date requirements of Section 409A.

The third set of requirements under Section 409A state that once an election has been made specifying the amounts and payment dates of the deferred compensation, the amounts and payment dates generally cannot be changed, except as provided in the treasury regulations. The regulations state that, except as otherwise provided in the treasury regulations, a nonqualified deferred compensation plan may not permit the acceleration of the time or schedule of any payment or amount scheduled to be paid pursuant to the terms of the plan.[23] However, a payment that is made no more than 30 days prior to its due date is not deemed to be an accelerated payment for these purposes.[24]

Additionally, if a payment is subject to a substantial risk of forfeiture and the service recipient (as opposed to the service provider) waives or accelerates the satisfaction of the condition constituting the substantial risk of forfeiture, the waiver or acceleration by the service recipient is not deemed to be a prohibited acceleration, provided that all the other rules under Section 409A applicable to such deferral of compensation (including the requirement that the payment be made upon a permissible payment event) are otherwise satisfied with respect to the deferral of compensation.[25] This exception can result in an accelerated payment of profit participations that does not violate the rules of Section 409A if the service recipient is given the option to waive or accelerate the condition constituting a substantial risk of forfeiture in the initial agreement with the service provider. The treasury regulations provide a list of other exceptions to the rule against acceleration of payments of deferred compensation.[26]

The payment of deferred compensation also cannot be deferred from the initially designated payment date, except in accordance with the rules contained in treasury regulations. Under these rules a subsequent deferral election complies with the requirements of Section 409A only if all three of the following conditions are met:

1) The subsequent deferral election cannot take effect until at least 12 months after the date on which the election is made.

2) In the case of an election related to a payment, other than a payment made on account of the disability, death, or unforeseen emergency of the service provider, the payment with respect to which such election applies must be deferred for a period of not less than five years from the date such payment would otherwise have been paid.

3) If the original payment was to be made at a fixed time or schedule set forth in the plan, the election must be made not less than 12 months before the date the payment is scheduled to be paid.[27]

Opportunity to Correct Defective Plans

In IRS Notice 2010-6,[28] the IRS provides methods under which taxpayers can voluntarily correct certain failures of a nonqualified deferred compensation plan to comply with the requirements of Section 409A, and, in certain cases, limit the amount includible in income as well as additional taxes under Section 409A. The relief provisions contained in Notice 2010-6 apply only to inadvertent and unintentional failures to comply with the requirements of Section 409A(a). The relief is not available if the failure is either intentional or directly or indirectly related to participation in a listed transaction under Treasury Regulations Section 1.6011-4(b)(2). The correction program announced in Notice 2010-6 is intended to encourage taxpayers to review nonqualified deferred compensation plans to identify and correct any provisions that fail to comply with the requirements of Section 409A.

Section III.C of Notice 2010-6 provides that the relief provided in Sections V through XI of the notice is not available for a service provider participating in a nonqualified deferred compensation plan if a federal income tax return of the service provider or a federal tax return of the service recipient is under examination with respect to nonqualified deferred compensation for any taxable year in which the document failure existed. However, Section XI.D of Notice 2010-6 provides that, when applying Section III.C of Notice 2010-6 for corrections made on or before December 31, 2011, the IRS will treat as "under examination" only a specific document failure that has been identified as an issue in the examination of a nonindividual service recipient on or before December 31, 2011. Therefore, for any document failure that has not yet been specifically identified, the requirements that the nonindividual service recipient not be under examination with respect to the plan will be treated as satisfied and the document failure may be eligible for correction under the applicable section of Notice 2010-6, provided that all other eligibility requirements are met.

The rules contained in Section 409A and the treasury regulations issued under it are broad and complex and contain many traps for the unwary. An attorney representing a service provider who may receive payment for services in a taxable year later than the year in which the services are performed should carefully review Section 409A and the treasury regulations. To the extent that an issue is not addressed in the Internal Revenue Code or the treasury regulations, a tax professional should be consulted. ■

---

[1] I.R.C. §409A(a).
[2] Rev. & Tax Code §17501.
[3] I.R.C. §409A(d); Treas. Reg. §1.409A-1(b)(1).
[4] Treas. Reg. §1.409A-1(b)(4)(i)(A).
[5] Treas. Reg. §1.409A-1(b)(4)(i)(C).
[6] Treas. Reg. §1.409A-1(d)(1).
[7] *Id.*
[8] *Id.*
[9] I.R.B. 2007-19, 1142.
[10] Treas. Reg. §1.409A-1(d)(1)
[11] Treas. Reg. §1.409A-1(d)(2).
[12] For this purpose a person is related to another person if the persons bear a relationship to each other that is specified in I.R.C. §267(b) or §707(b)(1), subject to the modifications that the language "20%" is used instead of "50%" each place it appears in I.R.C. §§267(b) and 707(b)(1), and I.R.C. §267(c)(4) is applied as if the family of an individual includes the spouse of any member of the family or the persons are engaged in trades or businesses under common control (within the meaning of I.R.C. §52(a) and (b)). In addition, an individual is related to an entity if the individual is an officer of an entity that is a corporation or holds a position substantially similar to an officer of a corporation with an entity that is not a corporation.
[13] Treas. Reg. §1.409A-1(f)(2)(i).
[14] To determine if a payment that would otherwise be considered to be deferred compensation is exempt under this rule, the adviser must determine when the service provider first obtained a legal right to the payment. This will generally be stated in the written agreement that grants the service provider the right to receive the payment. Then in applying the 70% test, only amounts received by the service provider for services performed in the year in which the service provider first had a legal right to the payment are counted. In informal discussion with the IRS, it has indicated that some leniency may apply to this rule, so that if a service provider is on the cash receipts and disbursements method of accounting, payments received shortly after the year in question for service provided in that year will be counted. However, there is no specific guidance regarding what is meant by "shortly."
[15] I.R.C. §409A(a)(4).
[16] Treas. Reg. §1.409A-2(a)(2).
[17] Treas. Reg. §1.409A-3(a).
[18] Treas. Reg. §1.409A-3(i).
[19] As defined in Treas. Reg. §1.409A-1(i).
[20] Treas. Reg. §1.409A-3(i)(1)(i).
[21] Treas. Reg. §1.409A-3(b).
[22] *Id.*
[23] Treas. Reg. §1.409A-3(j)(1).
[24] Treas. Reg. §1.409A-3(d).
[25] Treas. Reg. §1.409A-3(j).
[26] Treas. Reg. §1.409A-4(j).
[27] Treas. Reg. §1.409A-2(b).
[28] I.R.S. Notice 2010-6, 2010-3 I.R.B.