STATE BAR OF CALIFORNIA
TAXATION SECTION
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TOPIC: CALIFORNIA DOUBLING OF 20% FEDERAL TAX INCREASE UNDER IRC SECTION 409A

This proposal was prepared by Marla Aspinwall, a member of the State Bar of California Taxation Committee. The author wishes to thank Layton Pace, Williana Chang, Megan Stombock, John Arao, Ethan Lipsig and Robin Schachter for their review and valuable insights.[1]

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[1] The comments contained in this paper are the individual views of the author and do not represent the position of the State Bar of California or of the Los Angeles County Bar Association. Although the author and/or reviewers of this paper might have clients affected by Section 409A and have advised such clients on the application of Section 409A, no such author or reviewer has been specifically engaged by a client to participate in drafting this paper.

EXECUTIVE SUMMARY

Under Internal Revenue Code Section 409A ("Section 409A"), all amounts deferred under a nonqualified deferred compensation ("NQDC") plan are currently includible in income to the extent not subject to a substantial risk of forfeiture (i.e., vested) unless taxpayers comply with the extensive and complicated requirements of Section 409A. In addition to immediate taxation of vested NQDC plus interest, Section 409A increases the federal income tax rate by an additional 20%. Section 409A broadly applies to all classes of service providers, including low-level employees, directors and many independent contractors. The increased tax applies to the worker, not the employer. Section 409A penalizes often unsophisticated service providers who have little influence over the timing of payments and little ability to navigate complex tax rules. Low-level employees and small transactions are not exempt from Section 409A.

Since Section 409A's enactment in 2004, Treasury and the Internal Revenue Service ("IRS") have issued thousands of pages of guidance in an attempt to interpret and apply this broad legislation to a myriad of industries and compensation structures. Despite the volume of regulatory guidance that has been issued under Section 409A, the application of this complicated legislation to many industries, including very important California industries, remains unclear despite eight years of extensive introspection by the most highly qualified tax advisors, as well as Treasury and IRS officials.

To make matters worse, the Franchise Tax Board ("FTB") has interpreted California's automatic incorporation of federal pension rules to copy this punitive federal tax increase into the California Revenue and Tax Code, which doubles the potential tax liability of Section 409A. With the FTB's interpretation, the potential taxes, interest and penalties may exceed 100% of the total payments received. This treatment results even though California's automatic incorporation of the federal pension rules was never intended to raise taxes and was not approved by the supermajority of legislators needed to adopt a tax increase under the California Constitution.

Doubling a punitive federal tax increase on the party with the least knowledge and ability to influence compliance is neither logical nor fair. No other state has taken such action. The purpose of this paper is to request that the California legislature act to eliminate or, at least reduce, the 20% additional California income tax for violations of Section 409A.

DISCUSSION

I. BACKGROUND.

A. Reason for Enactment of IRC Section 409A.

Following the sudden demise of Enron Corporation in 2001, it became clear that numerous Enron executives had withdrawn substantial funds from Enron's NQDC plans in the months immediately preceding Enron's collapse. The Senate Finance Committee directed the staff of the Joint Committee on Taxation[2] to prepare a report that would examine (among other things) Enron's compensation arrangements, including its NQDC plans.[3] The Joint Committee's report (the "Enron Report") described various features of the Enron plans that both the Joint Committee and the Congress regarded as troubling, if not abusive.

According to the Enron Report, Enron executives deferred approximately $154 million in compensation from 1998 through 2001 through Enron's NQDC plans.[4] These plans allowed participants to change their payout elections at any time, and to elect, in advance, to defer stock option gains by deferring the receipt of stock on exercise of the options.[5] The plans also allowed participants to elect an accelerated withdrawal of all or a portion of the participant's account balance at any time, subject to a so-called "haircut" provision whereby 10% of the withdrawn funds would be forfeited.[6] The Enron Report stated that in the weeks immediately preceding Enron's bankruptcy filing, more than $53 million of early distributions from

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[2] See Letter, dated February 15, 2002, from Senators Charles E. Grassley and Max Baucus to the staff of the Joint Committee on Taxation, available at 2002 TNT 33-63 (Feb. 19, 2002).

[3] See Joint Committee on Taxation, *Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations* (JCS-3-03), February 2003.

[4] See Joint Committee on Taxation, *Written Testimony of the Staff of the Joint Committee on Taxation on the Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations* (JCX-10-03), February 13, 2003, at 33.

[5] Joint Committee on Taxation, *Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations* (JCS-3-03), February 2003, at 608, 610.

[6] Id. at 608-09. Under pre-Section 409A law governing nonqualified plans, such a provision was thought to prevent plan participants from being taxed currently on deferred amounts under the common law doctrine of constructive receipt, notwithstanding the fact that plan participants could receive up to 90 percent of the deferred funds at any time without penalty.

two of Enron's NQDC plans were made to over 100 Enron executives, presumably in accordance with this plan provision.[7]

The Enron Report concluded that the Enron NQDC plan provisions that allowed accelerated distributions and subsequent elections impermissibly "blur the distinction between nonqualified deferred compensation and qualified plans" despite not meeting the qualified plan requirements.[8] According to the report, these features should instead result in current income inclusion of the deferred amounts since participants in such plans enjoy a level of dominion and control over their deferred compensation that is inconsistent with deferred taxation treatment.[9]

To combat the perceived abuses described in the Enron Report,[10] Congress added Section 409A to the Internal Revenue Code.[11] The legislative history of Section 409A indicates that Congress shared the concerns expressed in the Enron Report regarding the perceived need to restrict the ability of executives to use NQDC plans similar to Enron's to defer compensation income while maintaining the ability to manipulate the timing of benefits and to access the amounts deferred.[12] Section 409A essentially requires that the timing of NQDC payments be established in advance of when services are performed, within strict limitations, and prohibits any acceleration or change in the timing of payments by either the employee or the employer, except under very limited circumstances.

Although the policy considerations behind the enactment of Section 409A stemmed from concerns regarding powerful executives of large companies manipulating the timing of their compensation, Treasury regulations interpret Section 409A to apply to every employee and many independent contractors without regard to their level of compensation or

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[7] See Joint Committee on Taxation, *Written Testimony of the Staff of the Joint Committee on Taxation on the Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations* (JCX-10-03), February 13, 2003, at 27.

[8] Id. at 634.

[9] Id. at 634-35. Criticism of the Enron plans also focused on the discretion of participants over the direction of investment of deferred compensation amounts. Although some early bills responding to the Enron report included limitations on the direction of investments in NQDC arrangements, these limitations were included in the final legislation.

[10] Committee Report on the American Jobs Creation Act of 2004, Pub. L. No. 108-357.

[11] American Jobs Creation Act of 2004, Pub. L. No. 108-357 (2004).

[12] Committee Report on the American Jobs Creation Act of 2004, Pub. L. No. 108-357.

ability to influence the timing or amount of their compensation. In the months and years following Section 409A's adoption, Treasury has drafted expansive regulations which appear to have been intended to stretch the application of Section 409A as far as possible. The application of these few pages of legislation has now been expounded in hundreds of pages of Treasury regulations with multiple additional lengthy IRS notices and still many areas of application have yet to be addressed.

B. Who Is Impacted by Section 409A?

The American Jobs Creation Act of 2004 established Section 409A in the Internal Revenue Code. Section 409A applies to any "plan," "agreement," or "arrangement" that provides for deferral of compensation, other than tax-qualified plans and tax-deferred annuities, IRAs, SEPs, SIMPLEs, 457(b) plans, and plans providing for vacation, sick leave, disability, compensatory time, and death payments.[13] Section 409A is not limited to arrangements traditionally thought of as retirement or deferred compensation arrangements for executives but also potentially applies to all forms of compensation arrangements, including employment and service contracts, entertainment contracts, athletic player agreements, and all types of royalty, commission and participation arrangements.[14] It is not limited to arrangements with employees, but applies also to directors and independent contractors (unless they are providing substantial services to more than one unrelated employer).[15] Final Treasury regulations exclude from the application of Section 409A only those independent contractors providing no more than 70% of their services (other than management services) to a single employer group.[16]

As a practical matter, this sweeping application of Section 409A includes far more people than Congress ever intended. Many Californians, from teachers to football players, have inadvertently come under the application of this far-reaching and confusing law. In particular, California's entertainment industry has been adversely impacted by the chilling effects of these limitations on extensions and renegotiations of the service contracts of producers, artists and entertainers. While there is still

[13] IRC § 409A(d)(1), (2); Treas. Reg. § 1.409A-1(a)(1)-(5).

[14] IRC § 409A(d)(3); Treas. Reg. § 1.409A-1(c)(1).

[15] Treas. Reg. § 1.409A-1(f).

[16] Treas. Reg. § 1.409A-1(f)(2)(i).

substantial uncertainty over the application of these rules among the most informed, technical "foot-faults" may result in the acceleration of income taxes retroactively to the date of vesting with interest plus an extra 20% federal income tax on the whole. Correction procedures and programs offer little assistance and assume a "strict liability" standard for even accidental operational failures.[17]

Far worse for Californians, the FTB has interpreted this complex, confusing and vague federal tax to have been automatically incorporated into California law. Accordingly, California law is interpreted to double the 20% punitive tax increase bringing the total federal and state tax penalty to a 40% additional income tax on top of the accelerated regular federal and state income taxes and premium interest rate. Under this interpretation, even a well-intentioned and well advised taxpayer may still end up owing almost, or in some cases, more than, 100% of a deferred compensation payment to the federal and state governments.[18]

What terrible wrong is this extreme penalty intended to protect against? What huge tax loophole is this intended to close? The purpose of the law is to prevent highly paid executives who have control of a company from manipulating the timing of their compensation. However, in most cases the timing of the receipt of compensation has no overall tax revenue impact at all because the employer receives a corresponding tax deduction for the payment of the compensation at the same time. Even assuming that policing executives is a legitimate concern of the Internal Revenue Code, California's teachers, artists and entertainers struggling to comply with these laws have no control and very little influence over the timing of their compensation. While the most influential service providers may be able to negotiate Section 409A compliant language into their contracts, the less influential have no leverage to assure compliance since all of the increased taxes under Section 409A fall only on the service provider. Thus, this vague and punitive tax, which is currently causing California businesses extensive administrative expense and hindering their ability to renegotiate arms-length business contracts, punishes primarily the less influential and serves no legitimate purpose as applied to industries like California's entertainment industry.

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[17] See IRS Notice 2008-113, 2008-2 C.B. 1305. See discussion in Chapters 29 and 30 of R. Olshan & E. Schohn, Section 409A Handbook, 825-888 (2011) .

[18] See R&TC Sections 17501 and 24601 discussed below.

II. INCORPORATION OF SECTION 409A INTO CALIFORNIA REVENUE AND TAX CODE.

A. Legislative History and Constitutionality.

The California Revenue and Taxation Code ("R&TC") automatically incorporates the federal tax rules found in Internal Revenue Code, Subtitle A, Chapter 1, Subchapter D, Part I, relating to pension, profit sharing, deferred compensation and stock bonus plans.[19] The automatic incorporation of the federal compensation rules was adopted in 2002 in AB 1122 to allow Californians to benefit from the substantial federal pension reform implemented in and around The Economic Growth and Tax Relief Reconciliation Act of 2001.[20] Thus, AB 1122 was intended to result in a tax decrease not a tax increase. It is clear that AB 1122 was never intended to result in a tax increase because the bill neither solicited nor received the necessary two-thirds majority approval in both legislative houses required by Proposition 13 to approve any tax increase under the California Constitution.[21]

In 2004 when Congress added Section 409A to Subtitle A, Chapter 1, Subchapter D, Part I of the Internal Revenue Code, there was never any legislative consideration whatsoever of the logic or desirability of the incorporation of an additional 20% tax increase into R&TC. The FTB merely interpreted R&TC Sections 17501 and 24601 to be conformed in all respects to Section 409A, adopting the 20% tax increase automatically. Accordingly, not only was the required two-thirds majority approval of both legislative houses not obtained, but the reasonableness of the adoption of the additional 20% income tax in this context was apparently never even

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[19] See AB 1122 (Ch. 35, Stats. 2002) and SB 219 (Ch. 807, Stats. 2002).

[20] The Economic Growth and Tax Relief Reconciliation Act of 2001 (Pub.L. 107-16, 115 Stat. 38, June 7, 2001).

[21] Proposition 13 or the People's Initiative to Limit Property Taxation amended the California Constitution on June 6, 1978 and is embodied in Article 13A of the California Constitution which requires a two-thirds majority in both legislative houses for increases of any state tax rates or amounts of revenue collected, including income tax rates. This means that an increase in state taxes to raise revenues generally requires 54 votes in the assembly and 27 votes in the Senate. *See* Cal. Constitution, Article XIII A, Section 3. IRC Section 409A by its terms is an increase in the income tax rate by 20 percentage points and was scored as a revenue raiser in the federal legislation. AB 1122 was a majority vote measure that attracted 43 ayes in the Assembly and 23 ayes in the Senate.

discussed. As a result, the inadvertent application of this punitive additional tax appears to violate the California Constitution.

B. Policy Discussion.

As discussed above, Section 409A is very complex, confusing and vague and has been interpreted by federal Treasury regulations to apply far more broadly than was ever intended. As a result, it has placed a tremendous administrative burden on California businesses. California law might have been interpreted to mitigate this impact by not imposing additional state income taxes for Section 409A violations. However, California law has instead been interpreted to inadvertently exacerbate the problem by piling on an additional 20% state income tax in a manner that runs afoul of its own constitutional limitations regarding the adoption of tax increases. While the additional 20% federal tax amounts to an approximately 50% penalty on the new top federal tax rate of 39.6%, the California 20% tax increase is a penalty of approximately 200% of the top California tax rate of 10.3%. A state tax penalty comparable to the federal penalty would be in the range of 5% (taking into account the temporary increase in the top California rates from 10.3% to as much as 12.3%, it would be in the range of 5% to 6%). Federal tax penalties are typically in the range of 10% to 20% of the tax owing. The highest penalty taxes such as the penalties for civil fraud or fraudulent failure to file a return are only 75% of the tax owing – both of which might be construed as criminal behavior. Non-compliance with Section 409A, on the other hand, is virtually always inadvertent. I know of no other state that imposes an additional income tax of any amount on top of the punitive 20% federal income tax under Section 409A.

C. Correction Proposal.

California law should be amended to remove or, at least reduce, the additional 20% state penalty tax for Section 409A violations. The FTB has essentially taken a very poor, confusing and in many cases truly unjust federal law and made it twice as bad by assuming its application under the R&TC, contrary to constitutional principles, without any consideration or review of the potential impact on the citizens and businesses essential to the State's fiscal stability, such as the entertainment industry. The problems being created by Section 409A might be mitigated, or at least not exacerbated, by removal of any additional income tax under California law. The taxable income acceleration and penalty interest provisions would still be applicable. The drafters therefore highly recommend that no additional punitive income tax in excess of accelerated taxation and interest charges be assessed under California law for violations of Section 409A. At a minimum, the California penalty tax should be reduced. The author of this proposal requests, therefore, that the 20% additional tax interpreted by the FTB to apply under current California law for Section 409A violations be eliminated or, at a minimum, reduced to no more than a 5% additional tax so as to make it comparable to the federal penalty tax in proportion to California's tax rate.

III. ILLUSTRATIVE INDUSTRY EXAMPLE.

A. Application to Entertainment Industry.

As discussed above, in the months and years following the adoption of Section 409A, Treasury has drafted expansive regulations extending the application of Section 409A much further than anyone imagined possible. The application of these few pages of legislation has been expounded over the eight years since enactment in over four hundred pages of Treasury regulations and multiple additional lengthy IRS notices with many issues reserved and yet to be addressed. However, after all these years, regulators and legal advisors have only just begun to understand the application and ramifications of Section 409A to the many industries and compensation arrangements to which it has been interpreted to apply. To help the reader understand the extent of the difficulties faced by Californians in attempting to apply Section 409A, I discuss below some of the problems being faced by California's entertainment industry in this regard.

In the entertainment industry, movie studios, producers and publishers, on the one hand, and actors, directors, producers and writers ("talent"), on the other hand, often enter into agreements whereby the talent provides services in one year with a contractual right under the agreement to receive compensation in a later year, upon the occurrence of one or more events (e.g., a film achieving a specified level of box office receipts). This type of conditional right referred to herein as a "contingent right" is often described as a residual, royalty or profit participation. Such arrangements may be regarded as providing for deferred compensation potentially subject to Section 409A.

There is no indication that Congress was motivated to enact Section 409A by any policy concern other than the concerns spelled out in the Enron Report, or by any concern or issue specifically related to industries like the entertainment industry. Indeed, when Section 409A was first enacted, most practitioners concluded that contingent compensation arrangements commonly found in the entertainment industry would not be subject to Section 409A. As a matter of policy analysis, it is not readily apparent why a typical talent compensation arrangement should be subject to Section 409A. Such an arrangement usually does not provide the talent/service provider with any ability to make subsequent deferrals of amounts earned under the contract, or to manipulate the form and timing of payments made under the contract.

B. Independent Contractor Exception.

The Section 409A Treasury regulations contain an exception for certain payments to independent contractors, which might be thought to provide relief in the entertainment context. Under these regulations, Section 409A generally does not apply to arrangements between a service recipient and an independent contractor if the independent contractor (1) is not related to the service recipient, (2) is actively engaged in the trade or business of providing services (other than as an employee or as a director of a corporation, or similar position with respect to a non-corporate entity) during the taxable year in which the independent contractor obtains a legally binding right to the deferred compensation, and (3) provides "significant services" to two or more unrelated service recipients.[22] In general, whether a service provider is providing significant services depends on the facts and circumstances of each case.[23] However, the Treasury regulations contain two safe harbors. Under the first safe harbor, the independent contractor is deemed to provide significant services to two or more unrelated service recipients if the revenues generated from the services provided to any service recipient (or group of related service recipients) do not exceed 70% of the independent contractor's total revenues (the "70% threshold").[24] Under the second safe harbor, if the independent contractor did not exceed the 70% threshold in each of the three immediately preceding years, he or she will be deemed to have not exceeded the 70% threshold for the current year, but only if, at the time the amount is deferred, he or she does not know

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[22] Treas. Reg. § 1.409A-1(f)(2).

[23] Treas. Reg. § 1.409A-1(f)(2)(iii).

[24] *Id.*

or have reason to anticipate that he or she will exceed the 70% threshold in the current year.[25]

At first glance, it might appear that these safe harbors would shield most compensation arrangements involving talent from the reaches of Section 409A. In fact, these safe harbors would not apply to most arrangements of this type, since it is actually quite rare for an actor or writer to work on multiple projects in the same year for producers or studios that are "unrelated." Many movies, books and television series take more than one year to produce, such that the actor or writer is often unlikely to work on more than one substantial project in a given year. Unless an actor or writer is working on multiple substantial projects in the same year, they are unlikely to qualify for these safe harbors, even if they regularly work with different service recipients. Moreover, many studios and production companies are "related" to each other, even though they operate as completely independent entities in competition with one another.

Other aspects of the Treasury regulations governing these safe harbors are unclear and add to the uncertainty regarding the application of Section 409A to many typical compensation agreements in the entertainment industry. For example, although the Treasury regulations state that a "facts and circumstances" test determines whether a service provider is providing significant services to more than one unrelated service recipient, they do not indicate what types of services should be aggregated for purposes of this analysis, nor do they shed light on whether the test should only include services for which the talent/service provider is compensated. For example, if an actor is making a movie with one studio and doing promotional activities for another movie with another studio, are the promotional activities "significant"? Should this analysis turn on the amount of time spent performing the activities, or instead on the amount of money generated by the activities? In which year(s) must the test be met – in the year the contract is entered into or the year deferred amounts are payable, or both? The Treasury regulations simply do not address these questions.

An additional problem with applying deferred compensation rules to entertainment contracts is the restriction under Section 409A regarding the renegotiation of contracts. It is very common in the entertainment industry for studios to renegotiate compensation under one

[25] *Id.*

contract while negotiating a new project or the extension of an original successful project. Thus, for example, an actor having made a successful movie may negotiate a guaranteed up-front advance for the production of a sequel. However, in most cases the new bonus will offset the actor's share of proceeds under both the sequel and the original movie. If Section 409A is applicable, this advance which was negotiated at arm's-length between two unrelated parties for valid business reasons unrelated to taxes would constitute an impermissible change in the timing of payments resulting in additional Section 409A income taxes to the talent. This is true, even though Section 409A's application in this context is completely unrelated to any policy behind Section 409A's adoption and even though there is no overall tax impact of the acceleration to the federal government due to the employer's offsetting compensation deduction for the payment.

C. Application to Contingent Rights.

One of the primary problems Section 409A raises with respect to entertainment contracts is the appropriate treatment of contingent payments.

1. *Hypothetical Example.*

Assume that an actor enters into a contract with a producer and a studio to act in a movie. The contract provides for a current non-contingent payment to the actor while the movie is being produced but also includes certain contingent rights to share in future sales or other uses of the movie after the studio and producer have received a specified return on their investment. It is well understood that for all but the most popular actors and films, contingent payments based on the studio's definition of profits is very unlikely to produce anything for the actor. On the other hand, if the contract provides that the actor receives a percentage of the "gross receipts," there is a much greater chance that contingent payments will actually occur, although the amount of such payments are completely undeterminable at the time the parties enter into the contract. It is common practice for the studio to render an accounting to the actor of receipts on the movie on a quarterly basis and to make payments generally on or before the end of the calendar quarter following the quarter in which such amounts are received by the studio. Also, it is common practice that, due to issues with data collection, inefficiency of the accounting system, etc., at least in some cases, payments will not be made in the quarter following the quarter in which it is determined that receipts exists.

2. *Are Contingent Rights Deferred Compensation?*

The first question is whether contingent rights constitute NQDC in every case. Unfortunately, a "deferred compensation plan" is defined under the Treasury regulations to include every compensation contract providing for the payment of compensation in a future year, except payments which meet specific exemptions.[26] A plan provides for the deferral of compensation if the service provider has a legally enforceable right to compensation that "is or may be payable . . . in a later taxable year."[27] Moreover, the existence of a "substantial risk of forfeiture" does not mean something is not "deferred compensation."[28] The preamble to the final Treasury regulations includes the following discussion:

> One commentator suggested that no legally binding right exists where the payment is made only upon the realization of gain from a particular investment. For example, the commentator argued that a bonus payable based upon the amount that a service provider obtains in selling property should not be treated as granting the service provider a legally binding right to the payment until the property is sold. In such a situation, however, the requirement that the property be sold is a condition to the right to the payment, but the right to the payment is still a legally binding right. The service recipient could not simply revoke the promise, sell the property, and not pay the bonus. However, the condition that the property be sold before the service provider become entitled to payment may constitute a substantial risk of forfeiture, depending on the specific facts and circumstances.[29]

Thus, the Treasury regulations apparently contemplate that if the actor has a legally binding right to payment which is contingent upon future receipts by

[26] Treas. Reg. § 1.409A–1(a).

[27] Treas. Reg. § 1.409A-1(b)(1).

[28] Treas. Reg. § 1.409A-1(b)(4).

[29] T.D. 9321, 2007-1 C.B. 1123, Preamble, Section III, B, "Legally Binding Right".

the studio, such amounts are "deferred compensation" within the meaning of Section 409A, unless they come within a specific exception.

3. *When Are Contingent Rights Earned?*

To conclude that contingent payments are not deferred compensation, they must come within a specific exception such as the "short-term deferral" exception. The "short-term deferral" exception is not really an exception as its intent is to carve out all compensation arrangements that provide for payments to be made within the same year or within 2 ½ months after the year in which the compensation is earned.[30] Unfortunately, rather than defining when the compensation is "earned," the Treasury regulations look to when the right to the compensation is not subject to a "substantial risk of forfeiture." Thus, if it is necessary that the service provider perform substantial services in order to earn the compensation, then the Treasury regulations would conclude that payments made no later than 2 ½ months after the year in which the services are performed would not be considered deferred compensation. However, even if all required services have already been performed, the right to compensation may still not be earned in the ordinary sense of the word. How can proceeds from movie sales be considered earned before the movie is even released? Nevertheless, the Treasury regulations use the historical concept of "substantial risk of forfeiture" (applicable to the vesting of stock or property received for services) to delineate the time when amounts are earned. The Treasury regulations define "substantial risk of forfeiture" as follows:

> Compensation is subject to a substantial risk of forfeiture if entitlement to the amount is conditioned on the performance of substantial future services by any person or the occurrence of a condition related to a purpose of the compensation, and the possibility of forfeiture is substantial. For purposes of this paragraph (d), a condition related to a purpose of the compensation must relate to the service provider's performance for the service recipient or the service recipient's business activities or organizational goals (for

[30] Treas. Reg. § 1.409A-1(b)(4).

> example, the attainment of a prescribed level of earnings or equity value or completion of an initial public offering). . . .[31]

This definition specifically contemplates a right to future payment based on an objective formula (unrelated to the timing of the services) related to the economic performance of the service recipient as being subject to a substantial risk of forfeiture until such condition is met. In order for the second prong of the test to be met, the possibility of forfeiture must be "substantial." However, the Treasury regulations do not indicate how to measure substantiality for these purposes. Is a 10% chance of forfeiting the payment substantial? How about a 20% chance? What if there is a 90% chance of getting 10% of the payment but only a 2% chance of getting it all? The problem is that historically, the concept of "substantial risk of forfeiture" has been applied to the transfer of assets and the issue has been the risk that the asset would have to be returned. The concept has historically been an all or nothing concept and the question has been how substantial is the risk that you must return the entire asset? This concept must be stretched to apply to contingent payments which are not yet fixed or determinable. Where there is performance based compensation that is not yet fixed or determinable, we historically have not viewed it as subject to a "substantial risk of forfeiture" but instead viewed it as having not yet been "earned." Similarly, no studio or artist would talk about the right to proceeds from the sale of a movie as being subject to "forfeiture" before the movie has been released and before any sales have even occurred. The author and reviewers suggest that it is inappropriate to apply historical concepts of "substantial risk of forfeiture" in this context.

D. Problems With Treating Contingent Rights as Deferred Compensation.

There are many practical problems with treating contingent rights under entertainment contracts as deferred compensation.

1. *Application of Timing Specification Rules.*

The most significant practical problem with the treatment of contingent rights in entertainment contracts as deferred compensation is that it is often impracticable, and sometimes impossible, for such contracts

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[31] Treas. Reg. § 1.409A-1(d)(1).

to comply with the current Section 409A Treasury regulations regarding the timing of such payments. The Treasury regulations include criteria for analyzing whether payment schedules determined by the timing of payments that the service recipient receives from an unrelated party meet the Section 409A requirements for a fixed payment schedule.[32] However, such rules do not apply to payments from one entity to another entity where both entities are treated as part of a single service recipient.[33]

The problem arises due to the fact that, in the entertainment industry, numerous often related entities appear in transactions which may generate receipts. In most cases, the timing of payments to a service provider, such as the actor in our example, is based on when the studio actually receives the proceeds, even if a related entity has received the proceeds earlier. For example, a studio may have a foreign distribution subsidiary. The subsidiary may receive the payments in December but not remit them to the studio until the following February. If this occurs, the studio would treat the receipts as occurring in February and, if, for example, payments were due quarterly to the actor, the payment to the actor would be computed in the quarter ending March 31, not the quarter ending December 31. Such an arrangement would appear inconsistent with the requirement that the timing of payments be based on when the foreign subsidiary receives the receipts.

While it may be possible to restructure the historical practice of an entire industry by basing the timing of payments upon receipts into the controlled group, what is the purpose of such an upheaval? Why not base the timing of payments on the timing of receipts by the studio, as long as such timing results from the ordinary course of business. Also, there are some circumstances in which it may be impossible to base the timing of payments upon receipts into the controlled group because another member of the controlled group is paying for the services itself. Assume in our above example that the studio is part of a controlled group and the studio's related television network pays the studio to allow it to play a movie the actor has made on television. If the contract provides that contingent payments include payments from television networks for the right to broadcast the movie, it is not clear how this can be restructured in a way that complies with a permissible payment schedule under Section 409A.

[32] Treas. Reg. § 1.409A-3(i)(1)(iii).

[33] Id.

However, there are in fact a variety of internal mechanisms within the controlled group that will cause the network and the studio to negotiate with each other on an arm's-length basis with respect to the timing and amount of payments. Thus, it makes perfect sense to allow contingent payments to be determined based on the timing of payments by the network to the studio where the payment from the network and the studio are made in the ordinary course of business on the same basis as the network makes payments to unrelated studios.

Therefore, if contingent payments are in fact treated as deferred compensation under Section 409A, it is necessary that the Treasury regulations be interpreted to allow for the timing of contingent payments to be specified based upon receipts from related parties if such amounts are received from bona fide transactions arising in the ordinary course of business under arrangements which are substantially the same in terms and practice as arrangements with unrelated entities. However, while this interpretation has been expressed to the drafters of the Treasury regulations, they have refused to express an opinion even informally or to provide any helpful guidance in this regard.

2. *Inability to Restructure Contracts for Additional Productions.*

Another problem with treating entertainment contracts in general, and contingent payments in particular, as deferred compensation subject to Section 409A is that it prevents the parties from engaging in the common practice of restructuring the compensation under a prior contract in connection with an expansion of the original project or the addition of a new project, the success of which is often inextricably tied to the performance of the first project. This is one of the most important reasons why it would be very helpful to be able to exclude contingent payments from the concept of deferred compensation. There is no clear way to allow for the renegotiation of a right to future earnings within the concepts of Section 409A once you have concluded that such amounts are the same as amounts that have already been earned and deferred. The proceeds of a movie sequel or a television series based on a movie are not compensation that has been earned once the actors have played their parts in the original movie. If the studio wants to use acceleration of payment under the original movie contract as an incentive to obtain the services of the actor while still limiting the actor's total cut, what possible purposes does the government have in restricting the rights of two unrelated parties in this arm's-length negotiation of the new contract? This is one of the most obvious reasons why it does not make sense to treat contingent payments in the entertainment context as deferred compensation. In addition, the potential and uncertain application of Section 409A in this context is having a significant chilling effect on the renegotiation of entertainment contracts.

E. Conclusion.

As discussed above, the purpose of Section 409A is to prevent executives and directors having undue influence over the service recipient from manipulating the timing of compensation payments. However, in the context of the entertainment industry, this type of undue influence is absent in most studio-talent relationships. Nevertheless, due to the broad application of Section 409A as interpreted by Treasury regulations, many studio-talent relationships are being adversely affected by uncertainty and the threat of a penalty which could exceed the amounts involved in the particular transactions. While California cannot clarify or repeal Section 409A from the Internal Revenue Code, it can and should reduce the burden on its entertainment industry and the many other similarly impacted industries by eliminating, or at least reducing, the penalty which the California R&TC has been interpreted to incorporate without specific legislative consideration or clear constitutional authority. Accordingly, the author and reviewers strongly recommend that the California legislature act to eliminate or, at a minimum, reduce the 20% additional California tax penalty for violations of Section 409A.