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Memorandum

Expect the Unexpected: How Section 409A Has Changed the Way Business Is Done in Hollywood

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At the end of 2004, Congress enacted legislation that was intended to curb perceived abuses in non-qualified executive compensation plans that were illustrated by events at Enron and several other public companies that filed for bankruptcy. Top executives at Enron were participants in traditional non-qualified deferred compensation plans. Under the tax rules applicable to those types of plans, the executives were able to receive substantial pay-outs from those plans, just prior to the collapse of Enron, subject to a relatively small ''haircut'' on the amounts distributed. After the collapse of Enron, rank and file employees who participated in Enron's qualified pension plans received no distributions from those plans. The more informed senior executives of Enron elected to receive substantially all of their deferred compensation balances, which put them in a superior position to Enron's creditors, shareholders and other deferred compensation plan participants.

The non-qualified deferred compensation rules of §409A were enacted in order to prevent this type of abuse. However these rules have had a profound, complex and unintended effect on many standard service contracts in the entertainment industry.

Section 409A has dramatically changed the way deal-making is done in Hollywood. Business practices that have been developed over many decades are now being pitched or materially modified to take into account §409A issues. Unlike the senior Enron executives, a typical Hollywood ''talent'' (e.g., an actor, writer, director or producer) is not an employee, officer, director or ''insider'' of the studio/network. Quite to the contrary, talent is usually hired as an independent contractor and provide discrete services under a contract that provides for the payment of certain fixed and contingent compensation. However, the enormous reach of §409A potentially sweeps into the net many of these time-tested and customary arrangements to compensate talent, none of which are structured like a traditional deferred compensation plan, motivated by any tax avoidance purpose, or involve any of the abuses that §409A was intended to thwart. And because the potential cost of a §409A violation is so significant, well-advised talent clients are being forced to forgo substantial economic benefits (including the payment of advances that are recoupable against contingent compensation) that the studios/networks are otherwise prepared to pay. This is a classic case of unintended consequences, which is wreaking havoc on deal-making in the bowels of Hollywood.

This article will only discuss the impact of these rules on entertainment industry talent. To be sure, many other constituents (e.g., studio executives) in Hollywood are plagued by the §409A rules, but most of their concerns are generic and not unique to the industry, and therefore will not be discussed further.

To set the stage, it is important to understand that the violation of the §409A rules can result in the imposition of severe penalties, including the acceleration of all deferred income that is payable under the non-qualified deferred compensation plan, interest on the accelerated income at a penalty rate and the imposi-

tion of a 20% penalty tax on this income.[1] These tax effects and penalties are imposed on the person who provides services (the ''Service Provider'') and not on the person for whom the services are rendered (the ''Service Recipient''). Notably, the California Franchise Tax Board (the ''FTB'') has taken the position that an additional 20% penalty tax on the income also applies if the taxpayer is subject to California income or franchise taxes, even though the maximum California personal income tax rate is currently 10.3%.[2] Thus, the total §409A penalty and income tax costs to a California tax resident can exceed 85% of the amount of the deferred compensation!

We now turn to the meaning and operation of the §409A rules.

WHAT IS A NONQUALIFIED DEFERRED COMPENSATION PLAN?

Under §409A, a ''non-qualified deferred compensation plan'' is defined to include any arrangement pursuant to which a Service Provider may receive compensation in a taxable year later than the taxable year in which the Service Provider first has a legal right to the payment, which is not a qualified pension or profit sharing plan.[3] In the entertainment industry context, any standard service agreement that provides for any form of fixed compensation or ''contingent compensation'' (e.g., profit participations, deferments, box office bonuses, residuals and other similar payments) to be paid in a taxable year later than the year in which the talent first had a legal right to the payment, constitutes a non-qualified deferred compensation plan under §409A.

Where services are provided through a loan-out corporation, the §409A rules will apply to both the agreement between the loan-out corporation and the Service Recipient and the employment agreement between the loan-out corporation and the Service Provider.

There are several possible exceptions to the application of §409A, each of which are discussed below.

Short-Term Deferral Exception

Certain short-term deferrals are not subject to §409A. A payment qualifies as a short-term deferral where, absent 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 later of (a) the 15th day of the 3rd month beginning after the end of the Service Provider's taxable year in which a substantial risk of forfeiture lapses, or (b) the 15th day of the 3rd 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 15th of the year that begins immediately after the year in which the Service Provider first has a legal right to the payment.

A ''substantial risk of forfeiture'' is a term included in the §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 some 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 the occurrence of a condition related to a purpose of the compensation, and (2) 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 to either: (1) the Service Provider's performance for the Service Recipient, or (2) the Service Recipient's business activities or organizational goals.[7] For example, the requirement that a Service Provider make certain substantial personal appearances after the release of a motion picture or perform substantial services in connection with the DVD release of the film in order to receive profit participations, may be a substantial risk of forfeiture related to the Service Provider's performance of substantial future services.

The Treasury Regulations state that a requirement that the earnings of the Service Recipient exceed a certain level or equity value or the completion of an initial public offering may constitute a substantial risk of forfeiture that relates to a Service Recipient's busi-

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[1] §409A(a). All section references in this article are to the Internal Revenue Code of 1986, as amended, except as otherwise provided, and the regulations promulgated thereunder.

[2] §17501 of the California Revenue and Taxation Code.

[3] §409A(d); Regs. §1.409A-1(b)(1).

[4] Regs. §1.409A-1(b)(4)(i)(A).

[5] Regs. §1.409A-1(b)(4)(i)(C).

[6] Regs. §1.409A-1(d)(1). Note that the definition of substantial risk of forfeiture for purposes of §409A is different than the definition of substantial risk of forfeiture under §83.

[7] Regs. §1.409A-1(d)(i).

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ness activities or organization goals.[8] Applied to the entertainment industry, a typical contingent compensation formula that conditions the payment of deferred compensation on the attainment of a certain level of earnings (measured by box office or net or gross profits) may satisfy this requirement.

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 under §409A, where it is stated:

> 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 appears to be diametrically opposed to the 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] In addition, it isn't clear whether the language in the preamble was focused on the existence of a risk of forfeiture or the substantiality of any such risk of forfeiture.

Another argument that contingent compensation is 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]

We believe that good arguments can be made to support the view that contingent compensation may be treated as being subject to a risk of forfeiture. Whether that risk is ''substantial'' is a factual determination that will be made on the facts of each case. We believe that substantiality should be measured when the Service Provider first has the legal right to payment, but this issue is not clear and further guidance from the IRS would be appreciated.

[8] *Id.*

[9] Preamble to T.D. 9321, 2007-19 I.R.B. 1123, 1142.

[10] Regs. §1.409A-1(d)(1).

[11] Regs. §1.409A-1(d)(2).

THE INDEPENDENT CONTRACTOR EXCEPTION

Another important exception to the application of §409A to deferred compensation is the independent contractor exception. As a general rule, independent contractors are not subject to §409A. A ''safe harbor'' for independent contractor classification is found in the Treasury Regulations. Under this rule, a deferred compensation payment is not subject to §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 Provider receives no more than 70% of his or her income from any one Service Recipient for services performed by the Service Provider in that year.[13]

On the surface, it would appear that the independent contractor exception would solve the §409A problem for most entertainment industry talent. Most talent furnish their personal services to the studios/networks through a corporation owned and controlled by the talent (the ''loanout corporation''). The talent is usually employed by the loanout corporation (the Service Recipient), which in turn ''loans out'' those services to the studio/networks (the Service Recipient) pursuant to an independent contractor relationship.

Unfortunately, in many cases the independent contractor exception does not provide any reliable relief, as it is difficult to apply in practice and in many cases the loanout corporation may not satisfy the safe-harbor test.[14] As an example, the 70%-of- revenue test is only applied to revenues that are earned in the tax-

[12] For this purpose a person is related to another person if the persons bear a relationship to each other that is specified in §267(b) or §707(b)(1), subject to the modifications that the language ''20%'' is used instead of ''50%'' each place it appears in §§267(b) and 707(b)(1), and §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 §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] Regs. §1.409A-1(f)(2)(i).

[14] To determine if a payment that would otherwise be considered to be a deferred compensation is exempt under this rule, the advisor 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

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able year for services performed in that year (i.e., revenues from services performed in prior years cannot be considered), and in some cases it is difficult to determine the year in which the Service Provider first had the legal right to payment. As a result, the independent contractor exception will generally not apply if the Service Provider performs services primarily for one Service Recipient (including related parties, even though they may be separate companies) in a given year. This is often a problem in the television industry, where a series ''regular'' may work for only one network and may not earn any substantial revenues from other activities, thereby failing the 70%-of-revenues safe harbor test. While the television talent may be treated as an independent contractor under general tax principles, he/she may not be eligible for the independent contractor exception for purposes of §409A, which creates very significant problems as will be discussed below.

GRANDFATHERED CONTRACT RIGHTS EXCEPTION

Another exception to the application of §409A can be found in the grandfather rules. Section 409A does not apply to the sale of a right to received nonqualified deferred compensation if the following conditions are met: (1) the right to receive the compensation was deferred in a taxable year beginning prior to January 1, 2005; (2) the contract creating the right to the nonqualified deferred compensation was not materially modified after October 3, 2004; and (3) the right to receive the nonqualified deferred compensation was not subject to a substantial risk of forfeiture that lapsed after October 3, 2004.

The grandfather rule is found in the transition rules and Treasury Regulations. Section 409A was enacted as part of the American Jobs Protection Act of (the ''2004 Act'').[15] Section 885(d)(1) of the 2004 Act provides that §409A, as enacted, shall apply to amounts deferred after December 31, 2004. Section 885(d)(2)(B) of the Act provides generally that amounts deferred in taxable years beginning before January 1, 2005, shall be treated as amounts deferred in a taxable year beginning on or after that date if the plan under which the deferral is made is materially modified after October 3, 2004.

Regs. §1.409A-6(a)(2) provides that for purposes of determining whether §409A is applicable with respect to an amount, the amount is considered to be deferred before January 1, 2005, if before January 1, 2005, the service provider had a legally binding right to be paid the amount and the right to the amount was earned and vested. A right to amount is deemed to be earned and vested only if the amount was not subject to a substantial risk of forfeiture or a requirement to perform further services.

There are other exceptions to the §409A rules that apply to certain stock options and stock appreciations rights. However, these exceptions generally do not apply to standard entertainment industry service contracts and will not be discussed further in this article.

THE CODE SECTION 409A RULES

If none of the exceptions to §409A apply, then an arrangement must comply with the §409A rules or the income acceleration, interest and penalty provisions will apply. There are three sets of requirements under §409A.

Election Rules

The first set of requirements 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.[16]

Where a taxpayer does not have the right to elect to defer income (which is generally the case with respect to most standard talent agreements) 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 such an election.[17]

Because the Service Provider under a standard entertainment industry talent agreement first receives a right to receive contingent compensation when the Service Provider first enters into a contract agreeing to perform the services, the election requirement will generally be met.

Permissible Payment Date Rules

The second set of requirements under §409A deals with when payments of deferred compensation can be made. Under these rules, a payment of deferred com-

payment are counted. In informal discussion with the Internal Revenue Service (the ''IRS''), the IRS 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] P.L. 108-357, Oct. 22, 2004.

[16] §409A(a)(4).

[17] Regs. §1.409A-2(a)(2).

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pensation can only be made at one of the following times:

(1) The Service Provider's separation from 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; or

(6) The occurrence of an unforeseeable emergency.[18]

''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.[19] If a Service Provider is a ''specified employee,''[20] then the specified employee can received deferred compensation that is payable on a separation from service, no earlier than six months after the effective date of the separation from service.

In most standard talent agreements, 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 it can be 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.[21]

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.[22]

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 one taxable year of the Service Provider or the designated period is not more than 90 days and the Service Provider does not have a right to designate the taxable year of the payment.[23]

Most standard talent agreements that include contingent compensation 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 within which year he or she will receive the payment, then this type of payment arrangement should satisfy the payment date requirements of §409A.

No Modification or Acceleration Rules

The third set of requirements under §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 Treasury Regulations state that except as otherwise provided, 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.[24] 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.[25]

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 §409A only if:

(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; and

(3) If the original payment was to be made at a fixed time or schedule set forth in the plan, the

[18] Regs. §1.409A-3(a).

[19] Regs. §1.409A-3(i).

[20] As defined in Regs. §1.409A-1(i).

[21] Regs. §1.409A-3(i)(1)(i).

[22] Regs. §1.409A-3(b).

[23] *Id.*

[24] Regs. §1.409A-3(j)(1).

[25] Regs. §1.409A-3(d).

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election must be made not less than 12 months before the date the payment is scheduled to be paid.[26]

APPLICATION OF CODE SECTION 409A TO ENTERTAINMENT CONTACTS

We will use several different but very common factual examples to illustrate the chaos being caused by §409A in customary talent negotiations.

Voluntary Advance to Motion Picture Talent

Prior to the enactment of §409A, it was a common industry practice for a motion picture studio or producer to pay talent a non-refundable advance that is recoupable against contingent compensation (e.g., a profit participation) prior to such time when the contingent compensation was otherwise earned and payable. This was often done for bona fide business reasons — e.g., the studio may use the advance payment as an inducement to sign the actor (through his/her loanout corporation) to a sequel to a successful film after a huge opening weekend or to star in another project. The payment of the advance was treated as ordinary income by the talent and taxed upon receipt, thereby accelerating the recognition of income and the payment of taxes, which highlights the absence of any tax avoidance purpose. This arrangement also did not implicate any of the perceived abuses that spawned §409A, as the talent was not in control of the decision to pay the advance and was not an officer, director, employee or control person of the studio. Unfortunately, §409A has slammed the door shut on the customary business practice of paying advances, which makes it more difficult and expensive for the studios to attach talent to future projects and has decreased the number of Ferraris idling down Rodeo Drive.

Under a captive interpretation of §409A, the payment of an advance that is recoupable against certain types of contingent compensation is likely to be treated as an impermissible acceleration resulting in a violation of §409A. This is because the advance is recoupable against amounts that constitute deferred compensation under §409A, thus resulting in an impermissible acceleration of the payment of the deferred compensation.

With ''advance'' planning, it may be possible for the studio to reserve the discretion to pay an advance without running afoul of §409A. If in the original agreement, the studio has an option to pay an advance in an amount that is objectively determinable and on a date that is a permissible payment date, the payment of such an advance may pass muster under §409A. Regs. §1.409A-3(j)(1) provides that it is not an acceleration of the time or schedule of payment of a deferral of compensation if a Service Recipient waives or accelerates the satisfaction or a conditions constituting a substantial risk of forfeiture applicable to such deferral of compensation, provided that the requirements of §409A (including the requirement that the payment be made upon a permissible payment event) are otherwise satisfied with respect to such deferral of compensation. In order to be successful, this approach requires careful drafting and coordination with the studio. The structure also needs to be included in the contract before the talent first has the legal right to payment of the deferred compensation (generally, meaning when the initial contract is signed). These provisions cannot be added later and need to be considered and included at the outset.

Television Series Deal Renegotiations

Before the arrival of §409A, it was common industry practice to use the payment of advances in the context of renegotiating a talent's deal to provide services on a television series. In the typical context, a television talent (through his/her loanout corporation) signs an initial deal that sets forth fixed and contingent compensation that apply in the event that the network/studio orders to production the pilot and the series. The network/studio typically have the consecutive option to order the series to production for multiple broadcast seasons, and if the production order is made the talent is contractually committed to provide services for the upcoming season(s) pursuant to the contractual terms negotiated at the outset. Some talent do not have sufficient leverage to negotiate favorable compensation terms when the initial deal is made, but once the series becomes a hit, the dynamics change and the talent then has the ability to negotiate additional compensation, sometimes in exchange for an agreement to give the studio/network an option to the talent's services for additional broadcast seasons (in excess of what was provided in the initial deal) and other times for no additional consideration whatsoever. The network/studio typically desires to pay talent the additional compensation in the form of a signing bonus and an increase in the talent's episodic service fees. The signing bonus and a portion of the ''bump'' in the episodic fees are typically treated as an advance against the talent's back-end compensation (from old and new episodes) in connection with the show. This age-old practice, which has been used to keep talent happily attached to many hit television shows for multiple seasons, has been tossed out the

[26] Regs. §1.409A-2(b).

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window because of how Congress reacted to a few bad seeds at Enron through the enactment of §409A. Because the advance is recoupable against the talent's contingent compensation from prior services the advance will likely violate the anti-acceleration rules of Regs. §1.409A-3(j)(1). The independent contractor exception often does not apply because the safe harbor test is not satisfied for the reasons noted above. Tax lawyers in Hollywood have bounties on their heads for having to deliver the bad news that the television renegotiation deal, which is usually the result of enormous haggling and brinksmanship, can't be implemented due to concerns over §409A.

One possible solution to the §409A problem may provide some limited relief. If the network will agree that the advance is recoupable only against contingent compensation from future episodes that have not been produced, the advance may not violate §409A. The difficulty with this approach is that the network will likely pay a smaller advance, since its recoupment base will be lower as a result of the prospective only recoupment. In addition, some networks are reluctant to bifurcate reporting of contingent compensation between ''old'' and ''new'' episodes, as it creates an accounting burden.

Some talent have requested to borrow money from the studios/networks, in lieu of taking an advance. However, talent cannot borrow against the right to receive contingent compensation because Regs. §1.409A-3(f) provides that where a Service Provider's right to deferred compensation is made subject to anticipation, alienation, sale, transfer, assignment, pledge, encumbrance, etc., the deferred compensation is treated as having been paid, which would trigger the gamut of tax penalties and costs under §409A. The talent could borrow money from the studio/network in a fully recourse manner, but the loan cannot be secured by or subject to offset against the right to contingent compensation. This significant restriction usually makes loans an unattractive option.

Estate Planning Issue

Another §409A issue can arise with respect to estate planning for contingent compensation. For example, assume that an actor with an S corporation loan-out corporation has several successful films where the right to the participation is owned by the S corporation loan-out. On the actor's death, his estate will be required to pay estate taxes on the fair market value of the income stream from the participations, reduced to present value. For many successful talent, the rights to contingent compensation may represent the largest asset in the decedent's estate and may result in the assessment of substantial estate taxes, possibly creating a liquidity crunch in the estate arising from the illiquid nature of the asset. It is likely that the right to pay the estate taxes on an installment basis under §6166 will not apply, because the ownership of the participations may not be deemed to be an active trade or business.

If the S corporation looks to sell the participations or borrow against the participations, then the S corporation will be deemed to receive a payment of the participations under Regs. §1.409A-3(f).[27] Generally, the death of the Service Provider is a permissible payment event under §409A(a)(2)(iii), and an agreement may be amended at any time to provide that deferred compensation will be paid on the Service Provider's death. However, in this case, the Service Provider is the S corporation loan-out. It is not clear whether the IRS would agree that for this purpose the death of the S corporation's sole employee should permit the S corporation to sell or to obtain a loan secured by the participations, even if the agreement between it and the S corporation loan-out corporation provided that on the death of the loaned employee of the S corporation, the S corporation could sell or borrow against the participations.

Uncertainty over the application of the §409A rules in this context makes it very difficult to develop an estate planning strategy for talent with substantial contingent compensation interests.

Other Techniques

Section 409A does not apply to Service Providers who use the accrual method of accounting on the date on which they have the first legal right to payment. While the accrual method of accounting can be useful in this context, it does complicate annual accounting and year-end closeouts for loanout corporations, which generally makes it imperative to accompany the accrual method of accounting with a Subchapter S election.

CONCLUSION

The far-reaching scope of §409A has caused enormous disruption in Hollywood talent deal-making, changing many business practices that have been developed over many decades, despite the absence of any of the policy concerns that motivated the enactment of §409A. While many industries have been burdened by general §409A compliance costs, we do not

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[27] Note that there are third-party investors in Hollywood who will purchase a talent's contingent compensation interest for a lump-sum cash payment (based on the present value of the stream of anticipated future payments of contingent compensation); however, the risk of a §409A violation sometimes serves as an impediment to these transactions.

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believe that any constituency of Service Providers has been adversely affected more than entertainment industry talent.

We encourage the Department of the Treasury and the IRS to issue guidance or amended Treasury Regulations that limit the scope of §409A within the context of the typical talent deal. Virtually all talent deals are structured as independent contractor arrangements, but the independent contractor safe harbor is not entirely clear in its application and the 70% of revenue safe harbor is often not met by talent in a particular year, especially for talent working on a television series. In addition, guidance would be appreciated with respect to the interpretation and application of the short-term deferral exception to contingent compensation payable under typical talent deals. We also encourage Congress to reconsider the broad scope of §409A in the context of any tax reform initiatives.

In the meantime, practitioners in the field must proceed with extreme caution. The rules contained in §409A and the Treasury Regulations under §409A are broad and complex and contain many traps for the unwary. A violation (even a ''footfault'') of the §409A rules can result in the imposition of penalties, taxes and interest that are confiscatory in nature. An attorney representing a Service Provider who may receive payment for services in a taxable year later than the year in which the Service Provider first had a legal right to payment, should carefully review §409A and the Treasury Regulations.

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