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Green Hasson Janks

Entertainment

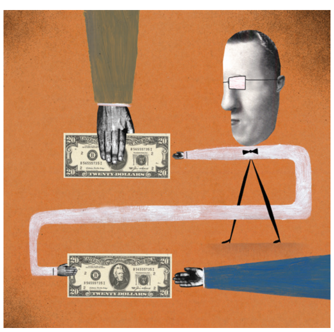
Featuring people, news and business issues for the entertainment and media industry.

In This Issue

Section 409A: What Does it Mean for Profit Participants?

In the early 2000's, public scandal related to the implosion of companies such as Enron captured the attention of the country. Facing financial problems, Enron executives accelerated deferred compensation, allowing them to "cash-out" before rank and file employees and shareholders. In response, Congress enacted Section 409A to punish unethical behavior and to make clear rules regarding the taxation of deferred income.

While the impetus for Section 409A may have been narrow, the impact was broad. Many service contracts were affected, including very common profit participation plans in the entertainment industry. Under these contracts, "talent" provides services during production where compensation for these services is spread over future years through "profit participation" arrangements. Section 409A has placed additional scrutiny on these contracts and created strict rules which regulate how agreements must be structured. "Profit participants" must be cautious when structuring compensation agreements to avoid substantial penalties.



DAVID PLUNKERT

Violation of Section 409A results in the acceleration of tax due on deferred compensation, interest on accelerated income, and a 20 percent penalty. The state of California adopted similar rules, meaning California residents that run afoul of section 409A may owe more in tax and penalties than the value of their compensation arrangement.

HOW DOES SECTION 409A WORK?

Section 409A establishes rules for deferred compensation that is not subject to a substantial risk of forfeiture. If a compensation plan is subject to Section 409A, it must meet very specific requirements in order to avoid penalties. Specifically, the plan:

1. Must provide that the deferred compensation is payable on or after the earliest of the following events (a) termination, (b) disability, (c) death of service provider, (d) change of ownership, (e) a time or a fixed schedule of payment, (f) an unforeseen emergency;

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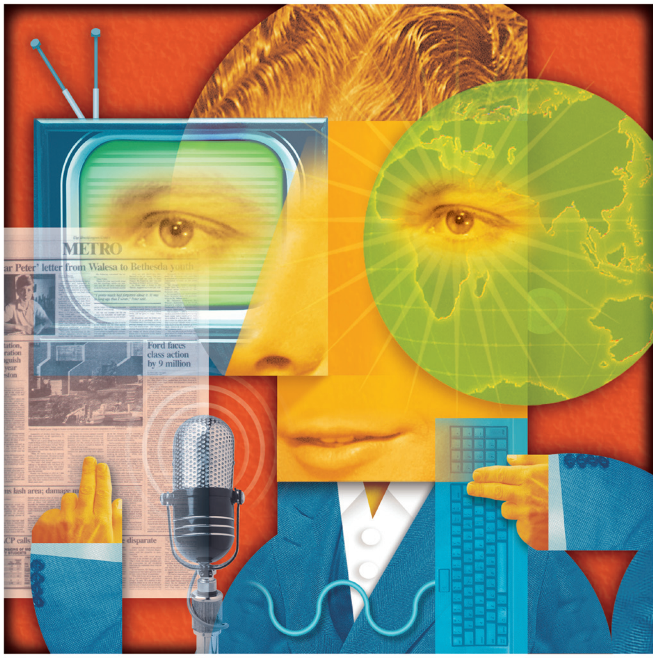
Risk Assessment Approach to Assessing the Need for a Royalty Audit

While royalty and profit participation agreements can provide tremendous income opportunities for many in the entertainment industry, ensuring they are administered fairly can be challenging. Those that license intellectual property must ensure that their property rights are protected and that royalty statements are accurate. Failure to effectively review or audit reports and payments can result in underpayment or even misuse of intellectual property.

Under licensing agreements, individuals, companies, and other entities with intellectual property rights ("licensors") receive royalty statements from production and distribution companies ("licensees"). The licensing agreements determine when, where and how the licensee can use the property and provide methods for determining payments due to licensors. But how can those who license property ensure they are being compensated correctly

> Properly identifying risk factors can help licensors focus on auditing licenses which pose the greatest risk.

A systematic plan for review of royalty statements is the only way for licensors to protect their rights and maximize income. Companies who license property to numerous parties should develop a risk assessment framework to help them monitor licensees. Well-designed risk assessment programs can identify potential problems and reveal when detailed audits of royalty and profit reports are needed.



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In addition to risk assessment programs, licensors should consider working with royalty audit experts to prevent revenue slippage and ensure the integrity of intellectual property. Properly identifying risk factors can help licensors focus on auditing licenses which pose the greatest risk.

As part of your process to assess the need for an audit, consider the following:

STATEMENT RISKS

> *Statements in the Black Pose Greater Risk*

Licensees are more likely to focus on statements once actual cash changes hands. Once you are being paid in excess of the initial advance or minimum guarantee, licensees are more likely to delay reporting of revenues or over-report deductions. New entries added soon before or immediately after the recoupment of the initial advance may represent a red flag.

> *Identify Inconsistencies with License Agreements*

There is significant risk involved in the development of statement templates by licensees. Statements are often handled by individuals who were not directly involved with drafting the license agreement, so misinterpretation of terms can be common. Licensees may also subjectively interpret terms in their favor, resulting in under-statement of royalties. Statements should be reviewed for improper application of the agreement terms.

> *Look for Unusual Entries on the Statements*

When licensees issue a high volume of statements with limited staff, quality control can suffer. Look for entries which are out of the norm such as negative revenues and unfamiliar deduction accounts. These may indicate risk that the integrity of the statement has been compromised.

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LICENSING AGREEMENTS RISKS

> *Complex License Agreements Pose Greater Risk*

More complex agreements generally have a higher risk of errors. Complex agreements should be considered for periodic royalty audit by experienced professionals.

> *Beware of Multiple Versions of Licensing Agreements*

If an agreement remains unsigned due to unresolved differences, there is risk that the licensee may be applying their preferred terms. Be aware of the differences between agreement versions, and scan statements to identify instances where the licensee has reported in a manner different from your expectations.

> *Watch Out for Expiring Audit and Tolling Rights*

Remember that the licensee is unlikely to warn you before your audit or tolling rights expire. While you may have concerns about the statements, once your audit rights expire, it may be too late. Consider evaluating the need for an audit prior to the expiration of your rights.

CHANGING MARKETS GIVE RISE TO NEW RISKS

> *New Media Reporting (If Applicable):*

In recent years there has been a growing risk of underreported new media revenues. Licensee systems and processes have yet to be upgraded to account for new media revenues. In many cases, licensing agreements do not even address new media, resulting in potential underreporting of revenues. Agreements and statements should be reviewed to ensure the accuracy of new media revenues.

> *Foreign Activity May Be Underreported*

As overseas distribution increases, the question of accuracy and completeness of foreign distribution revenues becomes more important. Foreign revenues may not be transmitted or classified properly, resulting in errors and understatement of revenues.

> *Licensee Changes Give Rise to Risk*

If a licensee is going through a significant internal change (such as a merger, lawsuit, change in leadership, or system change), their quality controls in statement issuance could be compromised. Significant change within a licensee organization may lead to increased risk and the need for an audit.

Implementing a risk assessment program will help you systematically identify these and many other risks. If any risks are present, you may want to consult with a royalty auditor to evaluate the possibility of performing an audit on your behalf.

In the News...

ILAN HAIMOFF AND OTHERS DESCRIBE THE VALUE OF PROFESSIONAL ADVISORY NETWORK (PAN) IN MPTF

The Professional Advisory Network (PAN) of the Motion Picture Television Fund (MPTF) is a dynamic group of attorneys, business managers, CPA's, financial planners, and wealth managers serving clients in the motion picture and television industry. PAN is a valuable resource that enables members to better serve their entertainment industry clients by promoting collaboration and discussion of issues facing the industry. PAN also keeps members updated on the work that MPTF does to support individuals in need within the industry.

PAN meetings are held quarterly and feature presentations by leading experts in their respective areas of interest to its members. Meetings provide education, along with valuable networking opportunities, designed to help advisors better serve their clients.

Watch IIan Haimoff and other members discuss PAN and the work of the MPTF *here*.

FIRST IN A SERIES

Producer Share Participations

Exercising Audit Rights

"Have fun stormin' the castle!"
–Miracle Max, *The Princess Bride*

by David Robinson

Producer share participations, which are a back-end stake in the financial performance of film and television productions, have long been a formal component of a producer's overall compensation. This is the first of a series of articles designed to educate and make sense of this complex area of expertise, arming you with valuable information that will enable you to maximize the value from your participation deals. In this first installment, we discuss the process of exercising your audit rights with the film studios. Exercising your audit rights is a producer's front-line defense in optimizing value from your producer share participation.

If you have a producer share participation in your film or television show, you may be wondering whether you should exercise your right to audit the studio. There are many considerations that go into a determination to audit. Among those considerations are when to audit, how to go about performing an audit, who performs the audit, and what to expect during the course of an audit.

One myth to dispel is the notion that the studio will somehow be offended at the prospect of your audit. I mean, after all, producers are always chasing that next project and wondering whether notice of an audit with a particular studio will sour studio relations. The answer is no — a typical audit is not an offense to the studios. In fact, most studios have an entire department set up just to handle these audits, as they are fully expected for product that is in the black. The studio perceives these chores as routine, even through the settlement of any audit claims raised.

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PRODUCED BY MAGAZINE

DAVID ROBINSON IN THE WINTER 2012 EDITION OF PRODUCED BY MAGAZINE

David writes about exercising your audit rights in Producer Share Participations in the Winter 2012 edition of Produced By magazine. Read more *here*.

STEVEN SILLS QUOTED:

Learn what Steven had to say about Celador's "self-dealing" case against Disney.

http://www.variety.com/article/VR1118063628/

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2. May not provide for any acceleration of payment;

3. Must be established and further it must specify the time and form of payment of deferred compensation;

4. The initial election to defer compensation must be made prior to the year in which services will be performed.

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Certain types of deferred compensation such as pension plans, profit sharing and 401(k) plans are not subject to Section 409A. Short-term deferrals are also not subject to Section 409A, nor are payments made to independent contractors, though independent contractor status is subject to strict definitions. A safe harbor provision provides that a service provider will be considered an independent contractor if they are actively engaged in providing services and provide "significant services" to two or more unrelated recipients. A service provider will also be considered an independent contractor if the revenues generated from services to any service recipient do not exceed 70 percent of the total revenues generated by the independent contractor for providing such services.

WHAT DOES SECTION 409A MEAN FOR THE ENTERTAINMENT INDUSTRY?

Entertainment industry service providers do not want to run afoul of Section 409A. The penalties, especially in California, are simply too severe. Personal service contracts can be problematic as they often provide for deferred compensation where payments are made years after services were performed.

Many service providers in the entertainment industry deliver services through wholly owned "loan-out" corporations which are set up as separate legal entities to provide legal protection and tax advantages. Typically, service providers are "employees" of their own loan-out corporation and the corporation "loans-out" the services of the owner to production companies through an independent contractor relationship.

Although the Section 409A regulations contain an "independent contractor" exception, loan-out corporations often fail the independent contractor exception of the Section 409A. Assume the loan-out corporation loans out the services of an actor to a single television network for production of a TV series. If the loan-out corporation's revenues from the production of the TV series provide more than 70 percent of loan-out corporation's revenues during the year, the loan-out corporation would fail the safe harbor test of the Section 409A regulations. If a factual showing that an employer-employee does not exist between the loan-out corporation and the network, any deferred compensation resulting from the contract would be subject to Section 409A rules.

It is also common in the entertainment industry for contracts to include a clause for a non-refundable advance royalty payment that is offset by future royalty payments. Advance royalties offset by future payments could be viewed as an acceleration of a deferred compensation, putting the arrangement in violation of Section 409A and unleashing draconian taxes and penalties.

So what's the solution? Personal service contracts need to be examined prior to execution to ensure compliance with Section 409A. A small oversight could lead to significant financial penalties down the road and dramatically affect the total value of compensation received.

If you are an individual, company stakeholder or the beneficiary of a trust or estate with profit participation rights to movies or television shows, you could be at risk for underpayment. A detailed periodic review of your distributions, such as a profit participation audit, is a great way to ensure equitable treatment.

But when should you consider a profit participation audit? Ilan Haimoff and Peter Klass have created a road map to help you assess your risk as a profit participant. Download it at greenhassonjanks.com/publications

To submit future topics or provide feedback, please contact Ilan Haimoff at ihaimoff@greenhassonjanks.com

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