

Year-End Deadline Alert: Tax Planning for Profit Participations and Other Hidden “Deferred Compensation”

By Robin Gilden

Section 409A of the Internal Revenue Code of 1986, as amended (the “Code”), imposes on the recipient a tax penalty of 20% and accelerates all income payable pursuant to a compensation plan, where such deferred compensation plan does not comply with the requirements of Code Section 409A. In addition, the California Franchise Tax Board has adopted this law and imposes its own 20% penalty.

The Code Section 409A requirements deal with elections to defer compensation, and specify certain time periods within which deferred compensation may be paid. A deferred compensation plan is defined very broadly for purposes of Code Section 409A and includes any agreement under which a service provider may receive compensation in a year later than the year in which the service provider first had a legal right to receive the compensation.

Code Section 409A will likely apply to an agreement that provides for the payment of a profit participation. If it does so apply, then acceleration of an amount that constitutes deferred compensation (for example, a unilateral decision by a movie studio to advance a profit participation prior

to the profits being earned) could violate the rules under Code Section 409A and result in an acceleration of all amounts due under the agreement as well as the penalties discussed above.

Short term deferrals are an exception to the deferred compensation rules. Accordingly, an employment agreement that provides that an employee’s salary and/or bonus for a specified year are to be determined by the board of directors on an annual basis may be structured in a manner that satisfies the short term deferral requirements.

A current window allows taxpayers to make amendments to elections regarding time and form of payment for arrangements entered into prior to January 1, 2008. However, this window closes on December 31, 2008.

The Treasury Regulations under Code Section 409A are complex and apply broadly to agreements that provide for compensation.

Our firm regularly advises clients with regard to a multitude of issues involving Section 409A matters.

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