

Unexpected Tax Penalties in Talent Contracts: Could Your Motion Picture, Recording, or Sports Contract be Subject to IRC Section 409A?

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Could your motion picture agreement, recording agreement, or sports contract be a non-qualified deferred compensation arrangement? You may think it unlikely, but a non-qualified deferred compensation arrangement refers to any agreement under which an employee or independent contractor—i.e., a “service provider”—may receive a payment in a taxable year later than the year in which the service provider had a legal right to the payment.

There are specific rules governing non-qualified deferred compensation arrangements: Code Section 409A of the Internal Revenue Code of 1986, as amended. Failure to comply with the detailed requirements of Code Section 409A can trigger the immediate taxation of deferred income and impose an additional 20% penalty tax on that income.

Any contract providing for the provision of services that provides that some payments may be made after the year that the contract was entered into may be a non-qualified deferred compensation arrangement. This is because the Internal Revenue Service takes the position that a service provider first has a legal right to payment when the contract is entered into, and this applies even if the contract requires the service provider to provide services and the services have not yet been provided.

Entertainment Industry Examples: How Code Section 409A May Apply

Motion picture contracts frequently provide top talent with a percentage of the box office as compensation for services.

In recording contracts, a new artist is generally given an advance to deliver a master recording to a record company. The record company owns the master recording, but the agreement provides the artist receives a “royalty” equal to a certain percentage of sales that will be offset against the advance that the artist received. Since the artist does not have a property right in the master recording, the “royalties” are compensation and will be subject to Code Section 409A, unless an exception applies.

Sports contracts often provide for deferred compensation in a colloquial sense. Since the payment to be received by the athlete is not a payment under a qualified retirement plan governed by ERISA, the deferred compensation will be subject to Code Section 409A unless an exception applies.

One exception to Code Section 409A is the short-term deferral exception. A payment qualifies as a short-term deferral if the payment must be made by March 15 (for a calendar year service recipient) of the year following the year in which the payment becomes vested or is no longer “subject to a substantial risk of forfeiture.” In this case, this is a short-term deferral and Code Section 409A does not apply.

Permissible Payment Events Under Code Section 409A

If a payment constitutes non-qualified deferred compensation, then there are only certain events on which the payment can be made:

- An objectively determinable time or schedule set forth in the agreement (e.g., on January 1 of a certain year or the athlete's 50th birthday)
- Death or disability
- Separation from service (with a very specific definition)
- Change of control (also a very special definition)
- Unforeseen emergency

Once the payment terms are set forth in an agreement, the terms cannot change, except in very limited circumstances. The payment can never be accelerated by more than 30 days, and there are very strict rules regarding further deferral of the payment. One of those rules is that if a payment is deferred, it must be deferred by more than 5 years from the original payment date.

Consequences of Violating Section 409A

If Code Section 409A applies and is violated, the penalties are generally imposed on the service provider. These penalties include acceleration of recognition of income for all payments to be made under the agreement in the year in which the violation occurs. Additionally, the service provider is required to pay a 20% penalty tax, as well as ordinary income tax on these accelerated payments.

Code Section 409A is complex and often overlooked in entertainment and sports agreements. But if your contract includes future payments tied to services performed now, it is worth asking whether these rules apply. Careful planning can help avoid unexpected taxes and penalties.