Tax issues in mediating entertainment cases

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The settlement of entertainment mediations, like many others, involves the exchange of cash or other valuable property, such as intellectual property. As with other types of disputes, taxes nearly always play a role whenever money or intellectual property is changing hands.

At the end of mediation, when the parties are writing up the terms of the settlement, it is important not to forget the tax issues and to deal with them if at all possible.

The tax issues could conceivably be dealt with at a later time and inevitably will need to be addressed when the defendant issues IRS Forms 1099 and/or W-2 the January after the settlement. Of course, the claimant will also need to reflect payments on his or her tax return.

Yet laying the groundwork should start early.

It is clearly better to deal with tax issues at the time the other issues are being resolved so that the parties end the mediation with a binding and enforceable agreement.

This article discusses several typical entertainment disputes and highlights the tax implications.

SCRIPT AND IDEA SUBMISSION DISPUTES

One common scenario involves a writer submitting a script or treatment, or even an oral presentation of an idea or concept, which in due course the studio or other entity rejects.

Then, after a time, the studio releases a movie or show that the plaintiff claims is identical or substantially similar to the rejected script idea.

Such cases may involve statutory claims for copyright infringement or common-law claims for expropriation of ideas or intellectual property. The tax issues related to such claims can be deceptive.

There is a significant line of authority allowing some intellectual property recoveries to be treated either wholly or in part, as capital gain rather than ordinary income.

With ordinary income taxed at 35 percent and capital gain at only 15 percent, it is nearly always advantageous to have income characterized as capital gain. Thus, it is imperative that plaintiffs understand the tax issues and negotiate for such characterization, as appropriate.

PROFIT PARTICIPATION DISPUTES

Another common scenario involves claims by a performer or other profit participant for improper calculation of profits and a resulting claim for unpaid profits in a movie or other vehicle. The claimant may be a huge star or a relatively minor player who is entitled to some share.

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The most fundamental dividing line is between gross and net profit participations. Gross profit participations are generally reserved for extremely well established and bankable stars who command large checks and who have great bargaining power. Net profit participations are far more common.

Both types of profit participation can lead to disputes, especially given the complex and often multi-page profit definitions set forth in the participant's contract.

The settlement of a participation dispute can take different forms. The defendant may settle the dispute by attributing additional revenue to the participant's "pot." In many cases, this will not result in an immediate payment to the claimant. However, it can lead to a payment in the future.

For example, in a typical net profit claim the studio may argue that the participant is "underwater," meaning that not enough revenue has been earned to generate a profit pursuant to the profit definition.

The settlement may result in the studio allocating an additional amount, say $1 million, to the participant's pot.

Depending on how deep underwater the participant's share is, the additional $1 million may not generate any *immediate* payment. That is, the participant may still be underwater even *after* the studio allocates the additional amount.

However, the additional $1 million would generally mean that the participant is now closer to a profit distribution in the future.

The tax consequences of this additional sum attributed to the participant's account should generally be neutral, meaning no additional income on which the participant would pay tax. Of course, it would affect the timing of income in the future.

The tax issues in such a case could also involve allocations between a performer and an entity.

For example, many stars have their own production company that hires them and pays them to do work. There can sometimes be flexibility whether the individual, their company or both should receive settlement money.

One of the tax variables is payroll taxes, including Social Security and other employment taxes.

With payroll taxes making up an ever larger share of U.S. taxes, it may have a significant effect on the bottom line of a settlement if a performer will or will not pay 4 percent of the recovery as payroll taxes.

Addressed properly and at the right time, there is often flexibility on such points.

In addition, a claimant may seek a tax "gross-up" under which the defendant pays an additional sum over and above the agreed-upon settlement to compensate the claimant for the taxes he or she will have to pay as a result of the settlement.

One practical impact of such a provision is that the gross-up payment *itself* will generally be taxable, so that tax impact too should be addressed.

PACKAGE DEAL ALLOCATIONS

A third kind of entertainment dispute (which is closely related to profit participation suits) involves the allocation of funds across multiple products or venues. These cases arise when a studio that has produced many films sells a group of films to a television station for a single package price.

The studio will allocate a percentage of the sale proceeds to each film, and the allocated amount will be added to the revenues of each film. It is critical that the allocation be done fairly, and not simply by giving each film equal value.

Naturally, not all films are of the same value. A profit participant might claim that his or her film was the locomotive driving the sale while the other films were of lesser value, mostly along for the ride.

The participants may claim their film was undervalued in the allocation process and that they are therefore owed additional revenues. Studios often use objective criteria, such as domestic box office gross, as the basis for the allocations.

The tax issues raised by a claimed improper allocation are similar to those raised by other participation claims, although there would be important distinctions between a claimant with a gross profits deal and one with a net profits deal.

Tax issues could also be different depending on the nature of the participant's contribution to the film. Some participants whose intellectual property was used in the film may conceivably be entitled to capital gain tax treatment as discussed earlier.

VERTICAL INTEGRATIONS

Another type of dispute relates to vertical integrations. We tend to think of this as a separate category of dispute, but it is actually a variation of a profit participation dispute. In effect, a conglomerate that has a movie studio, TV network or more has multiple pockets into which it can put profit or loss.

Put differently, the deals such a company cuts internally are often not — and cannot be — at arm's length. For that reason, extra scrutiny is required so that an outsider such as an author or actor is treated fairly.

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Such issues can matter to the conglomerate too, since they can affect how monies are booked among related entities and potentially affect unrelated third parties. As with other profit participation disputes, this kind of circumstance raises tax and accounting issues.

BASIC TAX ISSUES

Many of the tax issues one encounters in mediating entertainment disputes are not unique to the entertainment industry. As with any other dispute, there are timing questions.

For example, should the plaintiff accept (or the defendant pay) a lump sum in one tax year or spread it over several years?

These issues raise income tax as well as payroll tax concerns. If payments are spread over several years, what about security, borrowing, assignment, etc.?

In some cases, there can be large tax rate differentials depending on the nature of the claims and the way they are described in a settlement agreement. For example, in some cases it may be possible to treat some or all of the proceeds as capital gain rather than ordinary income.

The key is for the claimant's counsel to be aware of the potential tax consequences and be in a position to bargain for the most advantageous result.

Finally, entertainment disputes, like those involving professional athletes, often trigger special provisions of the tax code, such as Section 409A.

Any payments over time may be subject to special tax scrutiny under this provision. Historically, it was easy to agree money would be paid in later tax years, and such an agreement was generally respected by the IRS (it would not be taxed until received).

In 2004, however, Congress enacted Section 409A aimed primarily at high-echelon employees and independent contractors rewarded with pay that is deferred rather than currently taxed.

It may seem that these rules should not apply to settlements of disputes in the entertainment business, many of which do not have traditional deferred compensation features. However, the breadth of this law is enormous. In fact, some simple contract settlements that call for payments over time may trigger it.

If Section 409A is triggered, any pay that is not "subject to a substantial risk of forfeiture" (a technical tax term) must be taken into income (and taxed) then, even if the cash is not paid until a later year!

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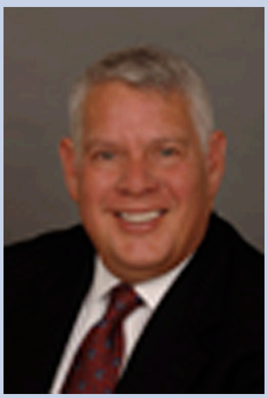
For this reason, having a tax adviser review the original contracts and any settlement agreement before it is signed is a good idea.

CONCLUSION

As with other disputes, those in the entertainment industry raise tax issues. Whether you are a plaintiff or defendant, you should consider such issues before you resolve a case and document it. Often, you can improve your tax result and therefore your financial outcome.

Although allocation provisions and tax language in settlement documents are not binding on the IRS or the courts, it is your best opportunity to influence the tax result and put yourself in the best possible tax light. WJ



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REUTERS/Mike Segar

SECONDARY TICKET SALES

Fan swings, misses in Yankees ticket-resale case

In a major victory for the ticket-resale marketplace, a California federal judge has thrown out a lawsuit brought by a baseball fan who alleged that ticket reseller StubHub Inc. ripped her off on New York Yankees tickets.

Weinstein v. eBay Inc. et al., No. 10-8310, 2011 WL 2555861 (S.D.N.Y. June 27, 2011).

Andrea Weinstein, who accused StubHub, parent company eBay Inc. and the Yankees of deceptive business practices, maintained that secondary ticket sellers should disclose the original prices on their tickets.

But U.S. District Judge John F. Keenan of the Southern District of New York said Weinstein's claim assumes consumers have a "level of stupidity that the court cannot countenance."

There is no way the Yankees can police every third-party ticket sale to ensure it has the same face-value information as when the team originally issued it, he wrote in his June 27 order.

The way Weinstein sees it, the Yankees should be liable "any time a scalper standing on the street corner sells a ticket with altered or no established price information," the judge said.

Weinstein said she visited the Yankees' website seeking tickets for a July 25, 2010, game against the Kansas City Royals at Yankee Stadium. Although no tickets were available, the site redirected her to StubHub, where she spent $198 on six tickets for seats located in the Grandstand outfield. She paid $33 for each ticket, $19.80 in fees and a $4.95 fee to receive the tickets electronically.

The tickets actually carried a face value of $20 each, but the tickets themselves did not display the face value price. Weinstein says she might not have purchased the tickets had she known they had been marked up.

Her suit alleged StubHub's failure to disclose the face value of resold tickets is a deceptive sales practice under New York law.

Judge Keenan disagreed, noting that third-party ticket marketplaces or broker websites like StubHub disclose that resold tickets sometimes sell for above face value.

The defendants did not trick Weinstein into paying more because she did not have to make the purchase if she did not want to pay the increased price and fees, the judge explained.

He noted that tickets for bad seats, last-minute listings and those for unpopular games sometimes sell on StubHub for less than face value.

"If sellers using StubHub's website successfully charge prices above face value, they can do so because of the law of supply and demand, not because StubHub allegedly withholds price information from consumers," Judge Keenan wrote. WJ

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Defendants: David Lender, Eric Hochstadt and Mark Fiore, Weil, Gotshal & Manges, N.Y.

Related Court Document:
Opinion: 2011 WL 2555861

See Document Section B (P. 23) for the opinion.