

## California Reduces Additional Tax on Section 409A Noncompliance

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*On October 4, 2013, Governor Jerry Brown signed into law Assembly Bill (“AB”) 1173, which reduces from 20 percent to 5 percent the additional California tax on nonqualified deferred compensation that fails to comply with Section 409A of the Internal Revenue Code (“Section 409A”). This rate reduction is effective January 1, 2013.*

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Section 409A applies to nonqualified deferred compensation that an employee or other service provider earns or has a legally binding right to receive in one tax year, but that is not payable until a later tax year. In order to avoid unfavorable tax treatment, such compensation arrangements must meet certain requirements, including advance elections as to the form and time of distribution, restrictions on distribution events, and a 6-month delay of severance payments to key employees of public companies.

If these requirements are not met, the deferred compensation will become subject to ordinary federal income tax as of the date on which the payment is no longer subject to a substantial risk of forfeiture. Section 409A also imposes a 20 percent additional federal income tax and an additional federal interest-based tax.

Prior to the enactment of AB 1173, California generally followed Section 409A, including the 20 percent additional tax for Section 409A noncompliance. Doing so effectively doubled the additional tax for nonqualified deferred compensation arrangements that do not comply with Section 409A. This has been widely viewed as unfair since the additional 20 percent California tax greatly exceeded the regular California income tax rate.

Furthermore, in combination with the already high additional federal tax imposed by Section 409A, California’s conforming additional tax was largely seen as punitive, given that service providers, who ultimately bear the cost of any Section 409A noncompliance, typically have little control over the timing and payout of their compensation. Even if the service provider had not yet been paid any of the compensation in question, Section 409A can trigger a taxable event and result in taxation.

The reduction of California’s additional state income tax rate on Section 409A noncompliance from 20 percent to 5 percent is welcome relief to California taxpayers. However, the relief provided by AB 1173 is

limited to this additional tax rate reduction, and does not reduce California's interest-based tax or other consequences resulting from Section 409A violations.

*This material is not intended to constitute a complete analysis of all tax considerations. Internal Revenue Service regulations generally provide that, for the purpose of avoiding United States federal tax penalties, a taxpayer may rely only on formal written opinions meeting specific regulatory requirements. This material does not meet those requirements. Accordingly, this material was not intended or written to be used, and a taxpayer cannot use it, for the purpose of avoiding United States federal or other tax penalties or of promoting, marketing or recommending to another party any tax-related matter.*

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