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California Reduces Rate of Section 409A State Excise Tax

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In a positive development for employees, California recently reduced its excise tax rate for failures to comply with the California analog to Section 409A of the Internal Revenue Code of 1986, as amended (“Section 409A”). California Assembly Bill 1173, which was signed into law on October 4, 2013, provides that, for taxable years beginning January 1, 2013, the excise tax rate imposed by California for non-compliance with California’s equivalent of Section 409A has been reduced from 20% to 5%.

Section 409A governs nonqualified deferred compensation plans. In general, a nonqualified deferred compensation plan is an arrangement that provides for the payment of compensation in a year later than the year in which the compensation was earned. Specifically excluded from the definition of nonqualified deferred compensation plans, and therefore not subject to Section 409A, are tax-qualified retirement plans, such as 401(k) plans, and bona fide vacation leave, sick leave, compensatory time, disability pay, and death benefit plans. Plans, agreements, and arrangements that could provide for payments that are subject to Section 409A include employment agreements, severance agreements, change in control agreements, other compensation agreements providing for deferred payments, discounted stock options, and other phantom equity arrangements, such as restricted stock units. If a nonqualified deferred compensation plan does not comply with Section 409A, individuals eligible to receive payments under the plan may be subject to federal and state income tax before compensation under the plan is paid (with punitive interest imposed if the individual does not correctly recognize the compensation and pay the related income tax), and the individual will be subject to an additional 20% Section 409A federal excise tax.

California implemented its own version of Section 409A, which generally mirrors the Federal version. Prior to the Assembly Bill 1173 rate reduction, if a California taxpayer received or earned a payment in violation of its analog to Section 409A, the individual would be subject to aggregate excise taxes at the rate of 40% (a 20% Federal excise tax and

a 20% California state excise tax) on that payment – in addition to ordinary federal and state income taxes. As a result of the reduction in the rate of California Section 409A excise taxes, the aggregate excise tax rate for a California taxpayer who receives or earns a payment in violation of Section 409A now will be 25% (reflecting a 20% Federal excise tax and a 5% California state excise tax) instead of 40%.

Even considering the reduction, the combined 25% excise tax rate still results in a significant penalty for violation of the payment timing and other complex regulations that govern the taxation of non-qualified deferred compensation. Companies should continue to exercise care in implementing, documenting, and administering compensation arrangements in order to avoid running afoul of these rules.

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This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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