

Client Alert

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California Reduces Section 409A Penalty

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In a victory for California employers and employees, on October 4, 2013, Governor Edmund G. Brown Jr. signed into law California Assembly Bill 1173 (“Bill 1173”), which reduces California’s additional tax on income for noncompliance with Section 409A of the Internal Revenue Code (“Section 409A”) from 20 percent to 5 percent for taxable years beginning January 1, 2013.

As noted in a previous Morrison & Foerster alert, compensation arrangements potentially subject to Section 409A include traditional deferred compensation plans, payments under severance agreements, employment agreements, change in control and retention agreements, discounted stock options, and other forms of equity compensation such as restricted stock units or “phantom” stock.

Any such arrangements that are not in compliance with Section 409A’s draconian restrictions may cause the underlying compensation to be taxed before it is paid and cause the individual to incur an additional 20 percent federal tax. Prior to Bill 1173, California’s Revenue and Taxation Code incorporated a parallel state income tax of 20 percent, which increased the total additional income tax imposed on California taxpayers for Section 409A noncompliance to 40 percent (and, if applicable, interest). Bill 1173 reduces California’s additional state income tax from 20 percent to 5 percent for taxable years beginning January 1, 2013. The combined 25 percent additional federal and California state tax remains significant.

WHAT SHOULD EMPLOYERS DO?

Employers with Section 409A noncompliant arrangements that gave rise to California income taxes in 2013 should revisit their calculations.

QUESTIONS?

Please contact your MoFo attorney or any member of the Compensation, Benefits + ERISA Group.

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