

Executive Compensation and Employee Benefits Alert: Update on California's Additional Tax Relating to Noncompliant Deferred Arrangements

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On October 4, 2013, California reduced the additional California state income taxes levied on deferred arrangements that violate Section 409A of the Internal Revenue Code. For taxable years beginning on January 1, 2013, California will levy a 5% additional state income tax on such deferred arrangements (instead of the 20% additional state income tax in place during prior years). Please see Assembly Bill 1173 ("AB 1173"), hyperlinked [here](#), which implements this reduction.

Section 409A of the Internal Revenue Code regulates discount options and other deferred arrangements, where a legally binding right to compensation arises in one taxable year, but provides for payment in a future taxable year. If such a deferred arrangement violates the restrictions under Section 409A, the taxpayer may be required to recognize income prior to the actual payment under that deferred arrangement. Furthermore, the recognized income will be subject to extra taxes (i.e., an extra 20% federal income tax and, following passage of AB 1173, an extra 5% California income tax). The effect of the passage of AB 1173 reduces the aggregate excess tax rate for California taxpayers of a noncompliant deferred compensation arrangement from 40% extra combined state and federal tax to 25% extra tax.

Note that employers still have an obligation to report and withhold taxable income that is recognized under noncompliant deferred arrangements.

Employers with deferred arrangements that may not comply with Section 409A should consult with their counsel to evaluate the potential liability under the new California tax provisions.

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