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On October 4, 2013, California signed into law an amendment to the California Revenue and Taxation Code that reduces from 20% to 5% the additional state income tax penalty imposed on non-compliant deferred compensation arrangements governed by Section 409A of the Internal Revenue Code of 1986, as amended and the regulations thereunder (collectively, "Section 409A"), with such reduction effective for taxable years beginning on or after January 1, 2013 (the "California Amendment").

Section 409A regulates the time and form of payment of non-qualified deferred compensation, which generally is defined as compensation paid under any arrangement whereby an employee or service provider obtains a legally binding right to compensation in one year and such compensation is or may be payable in a subsequent taxable year. As noted in previous *Alerts*, while this definition covers traditional salary and bonus deferral arrangements, it may also apply to compensation arrangements such as employment agreements, severance arrangements, change in control "carveout" plans, retention bonuses, taxable reimbursements, discounted stock options, restricted stock units and other equity compensation awards.

Given the complexity of the non-qualified deferred compensation regulations and the breadth of compensation arrangements covered, such arrangements may inadvertently run afoul of the Section 409A requirements. While the penalties for violating the provisions of Section 409A are still harsh, the California Amendment greatly reduces the burden on California taxpayers for non-compliance. Previously, if a non-compliant non-qualified deferred compensation arrangement did not otherwise qualify for the relief afforded under applicable correction programs, California taxpayers could find themselves subject to immediate federal and state ordinary income tax inclusion on the non-compliant amounts, a 20% federal income tax penalty, a 20% California state income tax penalty,¹ and interest at the applicable underpayment rate plus 1%, resulting in an aggregate tax rate approaching 100% in some instances. Although the penalties for non-compliance remain steep, for taxable years beginning on or after January 1, 2013, California taxpayers will be subject to a combined 25% federal and state income tax penalty (rather than the previously applicable 40% combined penalty) on non-compliant compensation arrangements subject to Section 409A.

Companies with non-compliant non-qualified deferred compensation arrangements that resulted or will result in the imposition of Section 409A penalties on California taxpayers during 2013 and later taxable years should use these revised tax rates in calculating amounts due to the applicable taxing authorities.

NOTES

1. Section 17501(a) of the California Revenue and Taxation Code provides that "Subchapter D of Chapter 1 of Subtitle A of the Internal Revenue Code, relating to deferred compensation, shall apply, except as otherwise provided." California Assembly Bill 1173 adds Section 17508.2 to the California Revenue and Taxation Code to substitute "five percent" in lieu of the phrase "20 percent" in Section 409A(a)(1)(B)(i)(II) and Section 409A(b)(5)(A)(ii) of the Internal Revenue Code of 1986, as amended.

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