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Bill that would correct inadvertent tax hike passes House

By Marla Aspinwall

This month, the California House of Representatives approved Assembly Bill 1173, which is intended to provide partial relief from the additional 20 percent state penalty tax for violations of Internal Revenue Code Section 409A. Hopefully the bill will be approved by the Senate as the action is long overdue.

Section 409A applies broadly to any compensation paid more than a short period of time after the services are performed and the right to the compensation vests (i.e., when it is no longer subject to a substantial risk of forfeiture). Under Section 409A, if deferred compensation in not covered by a qualified plan and does not meet the extensive and complicated requirements of Section 409A, it will be taxed at the time services are performed or, if later, when the compensation vests. In addition to immediate taxation of the compensation, Section 409A imposes a 20 percent additional income tax on the deferred amount. While Section 409A was originally intended to prevent top executives from manipulating the timing of their compensation, it has been interpreted to apply broadly to all classes of service providers, including lower level employees, directors, teachers, athletes, actors and musicians. It is the employee who must pay the 20 percent penalty, not the employer, even though the employee may have no influence over the timing of payments or understanding of the complex tax rules.

Since Section 409A was adopted in 2004, the Department of Treasury and the Internal Revenue Service have issued thousands of pages of guidance interpreting and applying the legislation to various industries and compensation arrangements. Despite the volume of regulatory guidance that has been issued under Section 409A, the application of this complicated legislation to many industries remains unclear despite eight years of thoughtful analysis by the most highly qualified tax advisors, as well as the Department of Treasury and IRS.

To make matters worse, California's automatic incorporation laws have been interpreted to impose an additional 20 percent penalty tax on Section 409A violations, raising the aggregate penalty to 40 percent (i.e., 20 percent federal and 20 percent state) for California employees on top of the normal federal and state taxes and interest charges. Thus, for employees in California, the potential taxes, interest and penalties may exceed 100 percent of the total payments received.

The California Revenue and Taxation Code (R&TC) automatically incorporates the federal tax rules found in the IRC relating to pension, profit sharing, deferred compensation and stock bonus plans. The automatic incorporation of the federal compensation rules was adopted in 2002 via AB 1122 to allow Californians to benefit from the substantial federal pension reform included in legislation like the Economic Growth and Tax Relief Reconciliation Act of 2001. AB 1122 was intended to accomplish a tax decrease, not a tax increase. It is clear that AB 1122 was not intended to result in a tax increase because the bill did not solicit or receive the necessary two-thirds majority required by Proposition 13 to approve any tax increase under the state constitution.

In 2004, when Congress added Section 409A to the pension sections of the IRC, there was never any consideration whatsoever by California legislators of the logic or desirability of the incorporation of an additional 20 percent tax increase into the R&TC. The Franchise Tax Board merely interpreted R&TC Sections 17501 and 24601 to be conformed in all respects to Section 409A, adopting the 20 percent tax increase automatically. Accordingly, not only was the required two-thirds majority approval of both legislative houses not obtained, but the reasonableness of the adoption of the additional 20 percent income tax in this context was apparently never even discussed. The inadvertent application of this punitive additional tax is inconsistent with the state constitution's limitation on tax increases.

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Section 409A is very complex, confusing and vague, and has been interpreted by federal treasury regulations to apply far more broadly than ever intended. As a result, it has already placed a tremendous administrative burden on California businesses. California law might have been interpreted to mitigate this impact by not imposing additional state income taxes for Section 409A violations. However, California law has instead been interpreted to inadvertently exacerbate the problem by piling on an additional 20 percent state income tax in a manner that runs afoul of its own constitutional limitations regarding the adoption of tax increases. While the additional 20 percent federal tax amounts to an approximately 50 percent penalty on the new top federal tax rate of 39.6 percent, the California 20 percent tax increase is a penalty of approximately 200 percent of the top California tax rate of 10.3 percent. A state tax penalty comparable to the federal penalty would be in the range of 5 percent, the penalty currently proposed under AB 1173.

It is neither logical nor fair to double the federal tax penalty on employees who have the least knowledge and ability to influence compliance. No other state imposes such an additional penalty for Section 409A violations. Federal tax penalties are typically in the range of 10 percent to 20 percent of the tax owing. The highest penalty taxes such as the penalties for civil fraud or fraudulent failure to file a return are only 75 percent of the tax owing — both of which might be construed as criminal behavior. Violation of Section 409A, on the other hand, is virtually always accidental. Other California penalties are a fraction of the comparable federal penalties. For example, IRC Section 72(t) imposes a 10 percent penalty for premature distributions from qualified pension plans; California's penalty tax for this type of violation is 2½ percent under R&TC Section 17085. The 5 percent penalty proposed in AB 1173 would be based on the same reduction factor.

For these reasons the author strongly supports AB 1173. However, even if the bill is enacted this year, it will only apply to tax years beginning in 2013 and thereafter. Section 409A has been effective since Jan. 1, 2005, and plans have been required to be in written compliance with final regulations since Jan. 1, 2009. In light of the fact that the bill is correcting what is really an inadvertent incorporation error, it really should be applied retroactively, at least with respect to calendar year 2012 for which returns are still being filed.

Marla Aspinwall *is a Los Angeles-based tax partner at the law firm of Loeb & Loeb LLP, where she heads the Compensation and Benefits department. She has been a leader in building private sector support for Bill 1173, which was inspired by the proposal Marla wrote and presented during the Sacramento Delegation of the State Bar Tax Section last February. She can be reached at maspinwall@loeb.com.*