



California Enacts 409A Legislation Reducing State Tax Penalty

California Governor Jerry Brown signed into law AB1173 on Oct. 4, 2013, reducing the California 409A tax penalty from 20% to 5% for taxable years beginning January 1, 2013. The bill, a victory for California businesses and employees alike, was inspired by a white paper submitted through the State Bar Sacramento Delegation last January by Loeb & Loeb LLP partner [Marla Aspinwall](#) and was brought to the state legislature by Assemblyman Raul Bocanegra (D-Los Angeles).

Under Internal Revenue Code Section 409A, nonqualified deferred compensation is taxed at the time services are performed or, if later, when the right to it vests, unless taxpayers comply with the extensive and complicated requirements of Section 409A. In addition to immediate taxation of the deferred compensation, Section 409A imposes a 20% additional income tax penalty on total deferrals. The 20% penalty is paid by the worker, not the employer. California law provides for the automatic incorporation of the federal pension rules into state law. As a result, California law automatically imposed an identical 20% penalty tax on 409A violations, raising the aggregate penalty to 40% (i.e., 20% federal and 20% California) for California employees on top of the normal federal and state taxes and interest charges. For employees in California, the potential taxes, interest and penalties may exceed 100% of the total deferred payments, a result that was considered by the California legislature to be neither logical nor fair. AB1173 reduced the California portion of the penalty from 20% to 5%, bringing the California penalty into relative proportion to the top California tax rate.

In addition to reducing the 409A tax penalty, AB1173 also clarifies the scope of the California Motion Picture Tax Credit utilization and simplifies the process by which certain nonprofit organizations may obtain tax-exempt status in California.

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