ANALYSIS OF AMENDED BILL

Franchise Tax Board

Author:	Bocanegra	Analyst:	Scott McFarlane	Bill Number:	AB 1173
Related Bills:	None	Telephone:	845-6075	Introduced Date: Amended Date:	February 22, 2013 March 21, 2013
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Additional Tax on Income from Nonqualified Deferred Compensation Plans

SUMMARY

This bill would reduce California's additional tax on certain nonqualified deferred compensation.

RECOMMENDATION

No position.

Summary of Amendments

The March 21, 2013, amendments removed language that would have made a technical, non-substantive change to the Revenue and Taxation Code, and replaced it with the provisions discussed in this analysis.

This is the department's first analysis of the bill.

REASON FOR THE BILL

The reason for the bill is to reduce the rate of additional tax that is imposed on certain nonqualified deferred compensation to more closely approximate the difference between California and federal tax rates.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately and operative for taxable years beginning on or after January 1, 2013.

Board Position:			Executive Officer	Date
________ S	________ NA	___X___ NP		
________ SA	________ O	________ NAR	Selvi Stanislaus	04/17/13
________ N	________ OUA			

Background

Deferred Compensation Arrangements

In general, a deferred compensation arrangement allows an owner or an employee to set aside a portion of their income to be paid out at a future date. These arrangements are broken down into two basic categories, “qualified” and “nonqualified” deferred compensation arrangements, as discussed below.

“Qualified” Deferred Compensation Arrangements (Qualified Plans)

Qualified deferred compensation arrangements (also known as “qualified plans”) are plans that comply with the Employment Retirement Income Security Act of 1974 (ERISA). ERISA imposes specific rules on qualified plans, including nondiscrimination requirements that prohibit an employer from providing disproportionate benefits to its employees, and limitations on the amount of contributions that can be made to the plan. However, qualified plans also provide certain tax benefits: employers are allowed to deduct contributions when they are made, employees may make tax-deferred contributions, earnings of the plan may be tax deferred until they are actually paid, and distributions are generally eligible to be transferred to another qualified plan, thereby allowing further tax deferral.

Qualified plans include IRC section 401(k) plans (for non-government organizations), IRC section 403(b) plans (for public education employers), IRC section 501(c)(3) plans (for non-profit organizations and ministers), and IRC section 457(b) plans (for state and local government organizations).

“Nonqualified” Deferred Compensation Arrangements (Nonqualified Plans)

Nonqualified deferred compensation arrangements (also known as “nonqualified plans”) are not subject to ERISA, and differ from qualified plans in many ways. Employers are allowed to discriminate by only offering plans to its key employees (e.g., senior management and highly-compensated employees), employer contributions are not limited, and employers may not deduct plan contributions until they are paid.

Nonqualified Plan Rules

Prior to 2005, the determination of when amounts deferred under a nonqualified plan were includible in the income of the individual earning the compensation depended on the facts and circumstances of the plan. A variety of tax principles and Internal Revenue Code (IRC) provisions were relevant in making this determination, including the doctrine of constructive receipt, the economic benefit doctrine, the provisions of IRC section 83, relating generally to transfers of property in connection with the performance of services, and provisions relating specifically to nonexempt employee trusts and nonqualified annuities. Other than the general rules discussed below, the IRC did not include rules specifically governing nonqualified deferred compensation, and there were no significant reporting requirements.

The time for income inclusion of nonqualified plans generally depends on whether the plan is unfunded or funded. If the plan is unfunded, then the compensation is generally includible in income when it is actually or constructively received. If the plan is funded, then income is includible for the year in which the individual's rights to the compensation are transferable or not subject to a substantial risk of forfeiture.

In general, a nonqualified plan is considered funded if there has been a transfer of property under IRC section 83. Under that section, a transfer of property occurs when a person acquires a beneficial ownership interest in such property. The term "property" is defined very broadly for purposes of IRC section 83. Property includes real and personal property other than money or an unfunded and unsecured promise to pay money in the future. Property also includes a beneficial interest in assets (including money) that are transferred or set aside from claims of the creditors of the transferor; for example, in a trust or escrow account. Accordingly, if, in connection with the performance of services, vested contributions are made to a trust on an individual's behalf and the trust assets may be used solely to provide future payments to the individual, the payment of the contributions to the trust constitutes a transfer of property to the individual that is taxable under IRC section 83. On the other hand, deferred amounts are generally not includible in income if nonqualified deferred compensation is payable from general corporate funds that are subject to the claims of general creditors, as such amounts are treated as unfunded and unsecured promises to pay money or property in the future.

As discussed above, if the plan is unfunded, then the compensation is generally includible in income when it is actually or constructively received. Under IRC section 451, income is constructively received when it is credited to an individual's account, set apart, or otherwise made available so that it may be drawn on at any time. Income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions. A requirement to relinquish a valuable right in order to make withdrawals is generally treated as a substantial limitation or restriction.

Rabbi Trusts

A "rabbi trust" is an arrangement that was developed in an effort to provide employees with security for nonqualified deferred compensation, while still allowing deferral of income inclusion. A "rabbi trust" is a trust or other fund established by the employer to hold assets from which nonqualified deferred compensation payments will be made. The trust or fund is generally irrevocable and does not permit the employer to use the assets for purposes other than to provide nonqualified deferred compensation, except that the terms of the trust or fund provide that the assets are subject to the claims of the employer's creditors in the case of insolvency or bankruptcy.

As discussed above, for purposes of IRC section 83, property includes a beneficial interest in assets set aside from the claims of creditors, such as in a trust or fund, but does not include an unfunded and unsecured promise to pay money in the future.

In the case of a rabbi trust, terms providing that the assets are subject to the claims of creditors of the employer in the case of insolvency or bankruptcy have been the basis for the conclusion that the creation of a rabbi trust does not cause the related nonqualified deferred compensation arrangement to be funded for income tax purposes.[1] As a result, no amount is included in income by reason of the rabbi trust; generally income inclusion occurs as payments are made from the trust.

The IRS has issued guidance setting forth model rabbi-trust provisions. Revenue Procedure 92–64 provides a safe harbor for taxpayers who adopt and maintain grantor trusts in connection with unfunded deferred compensation arrangements. The model trust language requires that the trust provide that all assets of the trust are subject to the claims of the general creditors of the company in the event of the company's insolvency or bankruptcy.

Congress Becomes Aware of Abuses of Nonqualified Plans[2]

From the time that the concept of rabbi trusts was developed, nonqualified plans were designed to attempt to both protect the assets from creditors despite the terms of the trust, and allow deferred amounts to be available to individuals, while still purporting to meet the rabbi-trust safe-harbor requirements set forth by the IRS.

By 2004, Congress became aware of the popular use of nonqualified plans by executives to defer current taxation of substantial amounts of income. Executives often used nonqualified plans that allowed deferral of income, but also provided security of future payment and control over amounts deferred. For example, nonqualified plans often contained provisions that allowed participants to receive distributions upon request, subject to forfeiture of a minimal amount (i.e., a "haircut" provision).

Congress also became aware of techniques that had been used that attempted to protect the assets from creditors despite the terms of the trust. For example, the trust or fund would be located in a foreign jurisdiction, making it difficult or impossible for creditors to reach the assets.

While the general tax principles governing deferred compensation were well established, the determination whether a particular arrangement effectively allowed deferral of income was generally made on a facts-and-circumstances basis. With limited specific guidance with respect to common nonqualified plans, Congress believed that it was appropriate to provide specific rules regarding whether deferral of income inclusion should be permitted.

Moreover, Congress believed that certain arrangements that allowed participants inappropriate levels of control or access to amounts deferred should not result in deferral of income inclusion, and that certain arrangements, such as offshore trusts, which effectively protected assets from creditors, should be treated as funded and should not result in deferral of income inclusion. As a result, Congress enacted specific rules to govern nonqualified plans in the American Jobs Creation Act of 2004, as discussed below under "Federal Law."

---

[1] This conclusion was first provided in a 1980 private ruling issued by the IRS with respect to an arrangement covering a rabbi; hence, the popular name "rabbi trust." Private Letter Ruling 8113107 (December 31, 1980).

[2] JCS-5-05, General Explanation of Tax Legislation Enacted in the 108th Congress, prepared by the staff of the Joint Committee on Taxation.

ANALYSIS

FEDERAL/STATE LAW

Federal Law

In the American Jobs Creation Act of 2004,[3] Congress enacted IRC section 409A, that generally provides that all amounts deferred under a nonqualified plan for all taxable years are currently includible in income to the extent not subject to a substantial risk of forfeiture and not previously included in income, unless certain requirements are satisfied, including permissible-distribution rules, requirements with respect to elections, and a prohibition on the acceleration of distributions.

- Permissible-distribution rules provide that distributions from a nonqualified plan are allowed only upon separation from service, death, a specified time (or pursuant to a fixed schedule), a change in control of a corporation, an occurrence of an unforeseeable emergency, or if the participant becomes disabled.

- With respect to elections, a nonqualified plan must provide that compensation for services performed during a taxable year may be deferred at the participant's election only if the election to defer is made no later than the close of the preceding taxable year, or at such other time as provided in Treasury regulations. In the case of any performance-based compensation based on services performed over a period of at least 12 months, such election may be made no later than six months before the end of the service period.

- No acceleration of distributions may be allowed. In general, changes in the form of distribution that accelerate payments are subject to the rule prohibiting acceleration of distributions. However, it is intended that the rule against accelerations is not violated merely because a plan provides a choice between cash and taxable property if the timing and amount of income inclusion is the same regardless of the medium of distribution.

If amounts deferred under a nonqualified plan are not subject to a substantial risk of forfeiture and the requirements of the American Jobs Creation Act of 2004 are not satisfied, in addition to current income inclusion, interest at the underpayment rate plus one percentage point is imposed on the underpayments that would have occurred had the compensation been includible in income when first deferred, or if later, when not subject to a substantial risk of forfeiture. The amount required to be included in income is also subject to a 20-percent additional tax.

IRC section 409A is generally effective for amounts deferred in taxable years beginning after December 31, 2004.

Amounts deferred are generally required to be reported to the IRS on an annual basis. Such amounts are required to be reported on an individual’s W-2 (or federal Form 1099) for the year deferred even if the amounts are not currently includible in income for that taxable year.

[3] Section 885 of Public Law 108-357, enacted October 22, 2004.

State Law

California conforms to Part 1 of Subchapter D of Chapter 1 of the IRC, containing IRC sections 401 to 420, without regard to taxable year to the same extent as applicable for federal income tax purposes,[4] meaning that California automatically conforms to federal law changes within those sections. As a result, when IRC section 409A was added to the IRC in 2004, California automatically conformed to it, including the 20-percent additional tax on amounts deferred under a nonqualified deferred compensation plan that are includible in gross income because they are not subject to a substantial risk of forfeiture and they do not meet the requirements of the American Jobs Creation Act of 2004.

THIS BILL

This bill would modify the state's conformity to IRC section 409A by reducing the rate of additional tax from 20 percent to 5 percent of any amount deferred under a nonqualified deferred compensation plan that is includible in income because it is not subject to a substantial risk of forfeiture and does not meet the requirements of the American Jobs Creation Act of 2004.

IMPLEMENTATION CONSIDERATIONS

Implementing this bill would not significantly impact the department's programs or operations.

OTHER STATES' INFORMATION

The states surveyed for tax treatment of deferred compensation under IRC section 409A include *Florida*, *Illinois*, *Massachusetts*, *Michigan*, *Minnesota*, and *New York*. These states were selected due to their similarities to California's economy, business entity types, and tax laws.

With the exception of *Florida*, a review of these states' laws found that they follow the federal income inclusion rules of IRC section 409A, but do not impose additional tax on such income. *Florida* does not impose personal income tax; therefore, rules for income inclusion of deferred compensation of individuals are not applicable.

FISCAL IMPACT

This bill would require some changes to existing tax forms and instructions and information systems. As the bill continues to move through the legislative process, costs will be identified and an appropriation will be requested, if necessary.

[4] Revenue & Taxation Code section 17501.

ECONOMIC IMPACT

Revenue Estimate

Estimated Revenue Impact of AB 1173 As Amended March 21, 2013 For Taxable Years Beginning On or After January 1, 2013 Assumed Enactment After June 30, 2013 ($ in Millions)		
2013-14	2014-15	2015-16
- $4.7	- $3.2	- $3.4

This estimate does not account for changes in employment, personal income, or gross state product that could result from this bill.

SUPPORT/OPPOSITION

Support: None provided.

Opposition: None provided.

ARGUMENTS

Proponents: Some could argue that reducing the rate used to determine the additional tax on taxable income from nonqualified plans would be consistent with other federal additions to tax that California conforms to; for example, when federal law imposes a 10-percent additional tax on early distributions from retirement plans, California law imposes a 2½-percent additional tax on such distributions.

Opponents: Some could argue that the additional tax rate on the amount of income includible in gross income from nonqualified plans should remain at 20 percent to discourage such plans from deviating from the anti-abuse rules enacted by Congress in 2004.

LEGISLATIVE STAFF CONTACT

Scott McFarlane	Mandy Hayes	Gail Hall
Legislative Analyst, FTB	Revenue Manager, FTB	Legislative Director, FTB
(916) 845-6075	(916) 845-5125	(916) 845-6333
scott.mcfarlane@ftb.ca.gov	mandy.hayes@ftb.ca.gov	gail.hall@ftb.ca.gov