

January 11, 2008

NEA and NSBA Joint Guidance on the Tax Consequences of Deferred Compensation – Section 409A of the Internal Revenue Code

In the summer of 2007, various media reported that under new Internal Revenue Service (“IRS”) regulations under section 409A of the Internal Revenue Code (the “Code”), any school employee who works less than 12 months, but receives his/her salary over a 12-month period, may have to pay an additional 20% income tax. *That is not accurate.* Under the new rules, if the school district allows employees who work less than 12 months (hereafter “10-month employees”) to “elect” to be paid over 12 months, such employees have to submit a written election form to the school district in order to avoid any additional tax of 20% on the compensation deferred from one year to the next. Additionally, if the school district pays employees over a 12-month period without allowing the employees the option of being paid over 10 months, minimal recordkeeping requirements may apply. These new rules become applicable in 2009. However, the IRS has not yet stated whether full compliance is required by the beginning of the 2008-09 school year. To clarify the impact of the new rules, the National Education Association and the National School Boards Association have jointly issued this guidance.

Although the IRS rules refer specifically to “teachers” and “school districts,” these terms are merely illustrative. The rules also apply to other school district employees and to higher education employees. Accordingly, in this guidance, we use the broader terms “school employees” and “employers.”

10-month employees paid over 10 months

Many school employees who work 10 months are paid over a 12-month period so that they receive a paycheck each month. This is a form of deferred compensation, also known as an “annualized salary.” However, if a 10-month school employee is paid over a 10-month period, the new rules do not apply because no compensation is deferred. In other words, there is no possibility of additional income tax under section 409A of the Code, and neither the employer nor the employee is required to take any action. According to the IRS, employers are not required to offer 10-month employees the option of an annualized salary.

10-month employees electing to be paid over 12 months

If a 10-month school employee – either by virtue of a state law, an employer policy, or a collective bargaining agreement – is given an option of being paid over 10 or 12 months and chooses a 12-month payment period, he/she must give the employer advance written (or electronic) notice of his/her 12-month election to avoid paying additional income tax on the amounts deferred. We have drafted a sample notice of election form entitled

NOTICE OF ELECTION FOR ANNUALIZED SALARY, which is attached to this guidance.

The election notice must describe how the payments will be paid out (*e.g.*, ratably over the 12 months starting with the beginning of the school year on a monthly or bi-monthly basis). The notice must be given to the employer *before the school employee starts working for the school year*. If the notice is submitted after the employee starts working for the school year, the employee may have to pay additional income tax—even if the notice is submitted before the employee receives his/her first paycheck. The election to receive deferred compensation is “irrevocable” for the school year in question, *i.e.*, it may not be changed after the school year begins.

The duration of the election may be for a single school year or for all subsequent school years until changed. An open-ended election may only be changed prior to the beginning of each school year. Also, the notice providing for an open-ended election should expressly state that the election will continue year-to-year until it is affirmatively changed.

The election must also describe any additional payments earned during the school year that would be owed to the employee upon separation from service, and state when such payments will be made, including any portion of the employee’s per diem salary that has been deferred but not yet paid at the time of separation.¹ Likewise, the writing must include a definition of “separation from service” that is consistent with the definition set forth in the section 409A regulations. (Generally, the regulations state that an employee “separates from service” with the employer if the employee “dies, retires, or otherwise has a termination of employment with the employer,” subject to exceptions for certain kinds of temporary leave.) This definition may be incorporated by reference, as we have done in the attached sample notice of election form.

10-month employees required to be paid over 12 months

Some employers – either by virtue of a state law, an employer policy, or a collective bargaining agreement – pay all 10-month employees over a 12-month payment period without offering employees the option of being paid over 10 months. An IRS publication entitled “Frequently Asked Questions: Sec. 409A and Deferred Compensation,” discussed further below, states that the election requirements described in the above

¹ For example, suppose that a 10-month employee who has elected to be paid over 12 months has an annual salary of \$54,000. Under the 12-month payment schedule, the employee is entitled to \$4,500 per month. However, if the employee were paid over the 10 months that the employee actually works, the employee would be entitled to \$5,400 per month. If the 12-month employee separates from service after 3 months, he/she must be paid for the days he/she has actually worked but has not yet been paid for. This amount is \$2,700 (the \$900 difference between \$5,400 and \$4,500, multiplied by 3 months).

section of this document do not apply where the employer *requires* 10-month employees to be paid over 12 months.²

Regardless, we have been advised informally that the IRS now considers these arrangements subject to section 409A in most cases. A 10-month employee paid over 12 months who separates from service in the middle of a 12-month payment period is generally entitled to an additional amount corresponding to the portion of his/her per diem salary that has been deferred but not yet paid (see footnote one for an example). Section 409A applies any time an employee has a right to payment that is or may be payable in a future tax year, so the right to this extra per diem amount makes these arrangements subject to section 409A.

According to the IRS, where the employer requires 10-month employees to be paid over 12 months, the employee is not required to complete an election notice form. However, employers must set forth in writing a description of how 10-month employees are to be paid. No specific type of “plan document” is required, so long as the written description states the dates or schedule on which the school employees are to be paid and the total amount of the payments, so that it can be determined that the employee will be paid over 12 months. For example, this requirement would be satisfied if an individual employee’s annual salary and the fact that the employee is paid in equal bi-monthly installments over a 12-month period can be determined from the writing. The writing may be in electronic form, and may be satisfied by multiple documents in the aggregate. We have drafted a sample writing entitled WRITTEN NOTICE OF HOW 10-MONTH EMPLOYEES ARE TO BE PAID.

As discussed above, the writing must describe any additional payments earned during the school year that would be owed to the employee upon separation from service and state when such payments will be made, including any portion of the employee’s per diem salary that has been deferred but not yet paid at the time of separation. Also, the writing must include a definition of “separation from service” that is consistent with the definition set forth in the section 409A regulations. School employers should refer to the definition we have used in the attached sample writing.

Timing of compliance

The IRS has issued a document entitled “Frequently Asked Questions: Sec. 409A and Deferred Compensation” (hereafter FAQ) available on the IRS’s website at: <http://www.irs.gov/newsroom/article/0,,id=172883,00.html>. The FAQ states that districts that offer elections should “set forth in writing how teachers are to be paid for the compensation earned for the rest of the scheduled work period (for example, the remainder of the school year)” by January 1, 2008. The FAQ further states that for the

² The FAQ states: “[A] school district may provide that all teachers will have their pay spread over 12 months, without providing any election to the teachers. In that case, the election rules discussed below would not apply and no additional taxes would be imposed under section 409A.”

2008-09 school year, school employers and employees offering the election option must be fully compliant with the requirements discussed above.

Subsequent to issuing the FAQ, the IRS issued transitional guidance stating that the section 409A regulations do not become applicable until January 1, 2009. This guidance is available on the IRS's website at http://www.irs.gov/irb/2007-46_IRB/ar11.html. It is not clear from the transitional guidance whether full compliance with the regulations is required by the beginning of the 2008-09 school year. However, we recommend that, pending further guidance or relief from the IRS, school districts implement a proper notice of election system by the 2008-09 school year. Taking these steps should protect school districts under the "reasonable, good faith compliance" safe harbor set forth in the transitional guidance.

Several attorneys have requested specific guidance regarding the following two scenarios:

1. Early Paycheck. Some school employers allow employees to receive an "early" or "extra" paycheck in December that would normally be paid in January. *All* employees given the option to receive an early paycheck must make the election to receive this early paycheck *before* the employees begin work for that school year. Any employee who fails to make an election before work has begun for that school year must not have the option to receive an early paycheck; otherwise, the early paycheck will be subject to income and employment taxes in the earlier year under the doctrine of "constructive receipt," regardless of whether the employee actually opts to be paid in December. The constructive receipt doctrine is unrelated to section 409A and therefore applies to *all* employees given the option to receive an extra paycheck regardless of whether section 409A applies to such employees. However, due to the timing restrictions of section 409A, employees subject to section 409A will incur additional penalties if this election is not properly made at the time the "notice of election form" is filed. The attached sample notice of election form for an annualized salary contains an election to receive an early paycheck. School employers should provide to all school employees given the option to receive an early paycheck an "early paycheck" election form prior to the beginning of the school year, even if the employer does not provide for an annualized salary election. School employers will have to devise a separate notice to receive an early paycheck for employees who are not required under section 409A to complete a notice of election for an annualized salary. We have drafted a sample election to receive an early paycheck entitled NOTICE OF ELECTION TO RECEIVE EARLY PAYCHECK.
2. Lump Sum Payment in June. Some school employers that pay 10-month employees on a 12-month pay schedule allow employees to elect to receive a lump sum check in June that includes pay for June, July, and August. We have been advised informally that the IRS believes such a lump sum payment is subject to all the restrictions on changes in the time or form of payment under section 409A, even if a lump sum election would not in fact affect the tax year in which

an employee receives the compensation. Therefore, if a school employer wants to allow employees to receive a single lump sum in June, but wishes to retain the flexibility to pay this amount over June, July, and August, it must proceed carefully to avoid a violation of the rules. The notice of election form or other writing should state that payment for the months of June, July, and August will generally be made in a single lump sum in June, but that the employer retains discretion to decide to pay this amount in monthly or bi-monthly installments through the end of the summer. Otherwise, the school employer must pay 10-month employees according to the precise schedule set forth in writing under the requirements discussed above, without allowing the employees the option to change this schedule.

Note: This guidance is intended to inform our members of recent legal developments that may be of interest to them. It is not intended, nor should it be used, as a substitute for specific legal advice; such advice can be given by legal counsel only in response to inquiries regarding particular situations. Further, this guidance is not intended to be and should not be construed as tax advice. For such advice, members should consult their tax advisors.