
FOR YOUR INFORMATION

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News For School Clients

Teacher Election to Annualize Compensation under IRC § 409A

Internal Revenue Code (“IRC”) § 409A applies to compensation that employees earn in one year but that is deferred and not paid until a future year. In general, deferred compensation that does not meet the requirements of § 409A is subject to immediate income taxation and a 20% additional income tax, among other penalties. Section 409A has no effect on FICA tax.

Compensation deferred under the following situations is not subject to the rules of § 409A: (1) qualified retirement plans (WRS), (2) 403(b) retirement plans, (3) 457(b) plans, (4) bona fide vacation leave, sick leave, death benefits or disability benefits, and (5) medical insurance, HRA benefits, or other tax-free benefits.

IRC § 409A may apply where it is not expected. For example, where an employee may choose to be paid over 12 months rather than 10 months (sometimes referred to as annualization of compensation), there is a deferral of compensation subject to § 409A. The IRS has taken the position that a school district employee (e.g., a teacher) who is generally paid over the school term but can elect to receive payment over a 12-month period has deferred compensation. The IRS provides the following example: Assuming a teacher earns \$54,000 per year, if the teacher were paid over 10 months, the teacher would

receive \$27,000 in 2007 for the first 5 months of August through December, and would receive \$27,000 in 2008 for the 5 months of January through May. If, instead, the teacher was paid over 12 months, the teacher would receive \$4,500 per month. The teacher would receive only \$22,500 in 2007 for the first 5 months of August through December and would receive \$31,500 in 2008 for the 7 months of January through July. In this example, the IRS concludes that \$4,500 of the teacher’s salary earned in 2007 is actually paid in 2008. In other words, \$4,500 of 2007 wages is deferred until 2008 and the arrangement is considered to defer compensation, which is subject to the new IRS § 409A rules.

The IRS guidance published on August 7, 2007, makes it clear that § 409A does not require that an employee be provided any election regarding how the employee is paid. Therefore, a school district may require that all employees shall have their pay spread out over 12 months. If that is the case in your District, no action is required in connection with § 409A. However, when such an election is offered to employees to be paid compensation over 12 months, whether by policy or collective bargaining agreement provision, then § 409A and its regulations require the following in order to avoid tax implications:

1. The employee must give a written (or electronic) election to the employer that notifies the employer that the employee wants to spread out the compensation over 12 months.

2. The election must be made before the beginning of the work. (For example, before the first day of the school year for which the employee is paid, which may be before the first day students arrive for class).

3. The election must be irrevocable and cannot be changed during the school year.

4. The election must state how the compensation is going to be paid if the election is made (for example, ratably over the 12 months starting with the beginning of the school year).

5. No particular form is necessary for the election and it does not have to be filed with the IRS.

If an employee does not submit an election or submits an election after the deadline, the employee must be paid in the same way as the other employees who do not make an election. Often employees who do not submit an election are paid ratably over 12 months. Such payments are not subject to §409A.

The election must be made in writing, but it may be made electronically. For example, if the teacher signs an election form containing the necessary information, the election may be submitted electronically, such as by email.

The election may provide that a pre-existing election will remain in place until the employee elects a change. For example, a teacher could elect to receive his or her

salary over 12 months, and that election could remain in effect indefinitely until the teacher changed the election. However, if the teacher wants to change his or her election, the change must be made before the beginning of the school year in which the change applies. A teacher cannot change the method of payment in the middle of the school year.

The §409A regulations are effective January 1, 2008. By that time, school districts that offer elections must have set forth in writing how the teachers are to be paid for the compensation earned for the rest of the 2007-2008 school year. For the 2008-2009 school year, school districts must meet the requirements set forth above relating to elections to annualize compensation, if such an election is provided to employees.

When teachers and other district employees are represented by a labor organization, the school district must remember that the manner of paying the employees is a mandatory subject of bargaining. Therefore, depending upon what has already been bargained, any changes to the manner in which district employees are paid for the 2007-2008 school year and beyond may need to be negotiated with the labor organization representing each bargaining unit in the district.

The IRS will not impose additional taxes for failure to meet the deferral election timing and written plan requirements with respect to annualization of compensation for the 2007-2008 school year. However, the IRS may impose such penalties for the 2008-2009 school year and beyond.

If you have any questions regarding this topic or would like assistance in drafting the written election or written policy statement, please call David Weller, of Lathrop & Clark LLP, at 608-286-7235. Attorney Weller provides counsel in the areas of taxation and employee benefits among other areas.

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