
FOR YOUR INFORMATION

July 2008
News for School Clients

Update: New IRS Notice Exempts Most School District Employees From Deferred Compensation Rule

In our June 2008 monthly newsletter, we reminded our readers that an Internal Revenue Service (IRS) rule related to employees' deferred salary compensation would require school districts to contact employees working less than 12 months in a work period (e.g., a school year) and require them to complete paperwork prior to their first workday of the new work period if they intended to spread their salary payments over 12 months. Compensation earned in one year but paid in a subsequent year is generally considered deferred compensation.

However, the IRS has just issued new guidance that will exempt most school district employees from the requirements of the IRS rule, commonly referred to as § 409A of the Internal Revenue Code (IRC). Specifically, under the new IRS guidance in Notice 2008-62, issued on July 2, 2008, if the amount of an employee's salary that is deferred from one tax year to the next through the annualization of pay does not exceed \$15,500 for 2008, then the employee's annualization of pay will not be subject to the IRC § 409A rule. In practical terms, unless your school district has an employee who works part of the year (less than 12 months), is allowed to annualize compensation, and earns in excess of

\$186,000 for the year, the annualization of employees' compensation will not be subject to IRC § 409A. Prior to the new IRS Notice, each school district employee that was allowed to annualize his or her compensation was required to make a timely written election to annualize compensation or risk a 20% tax penalty from the IRS.

The IRS provides the following examples in the new Notice related to school district employees:

Example No. 1 (work period begins September 1). A school district employee works during a school year that begins on September 1, 2008, and ends June 30, 2009 (a 10-month school year), and is paid over the 12-month period beginning September 1, 2008. The employee would not have deferred compensation for purposes of § 409A if he or she earns less than \$232,500 for the school year. Since four months of the school year are in 2008 and six months of the school year are in 2009, an employee whose salary for the school year is \$232,500 earns \$93,000 in 2008 and \$139,500 in 2009. Under the 12-month payment schedule, the employee receives \$77,500 in 2008 and \$155,000 in 2009. Because the amount the employee earns during 2008 that

is paid in 2009 (\$93,000 less \$77,500, or \$15,500) does not exceed the limitation under IRC § 402 (g)(1)(B) for 2008 (i.e., \$15,500), the arrangement would not be subject to the deferred compensation rules under § 409A.

Example No. 2 (work period begins August 1). A school district employee works during a school year that begins on August 1, 2008 and ends May 31, 2009 (a 10-month school year), and is paid over the 12-month period beginning August 1, 2008. The employee would not have deferred compensation for § 409A purposes if he or she earns less than \$186,000 for the school year. Since five months of the school year are in 2008 and five months of the school year are in 2009, an employee whose salary for the school year is \$186,000 earns \$93,000 in 2008 and \$93,000 in 2009. Under the 12-month payment schedule, the employee receives \$77,500 in 2008 and \$108,500 in 2009. Because the amount the employee earns during 2008 that is paid in

2009 (\$93,000 less \$77,500 or \$15,500) does not exceed the limit under IRC § 402(g)(1)(B) for 2008 (\$15,500), the arrangement would not be subject to the deferred compensation rules under § 409A.

The IRS Notice describes a new rule that the Treasury Department and the IRS anticipate will be part of a change to the regulations under § 409A. The IRS Notice states that until further guidance is issued, taxpayers may rely on the rule described in the Notice for purposes of § 409A beginning with the first taxable year that includes July 1, 2008. As a result, an irrevocable written election to annualize compensation will not be required for the 2008-2009 school year and beyond, as long as the employee earns less than the amounts provided in the examples above.

The IRS Notice 2008-62 can be obtained from the following website:
<http://www.irs.gov/pub/irs-drop/n-08-62.pdf>.

If you have any questions regarding this topic or if you would like assistance in determining the application of IRC § 409A to school district employees, please call David Weller of Lathrop & Clark LLP at 608-257-7766. Attorney Weller provides counsel in the areas of taxation and employee benefits to our school law clients.