

Frequently Asked Questions: Sec. 409A and Deferred Compensation

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The questions and answers below explain that, for purposes of section 409A:

- School districts are not required to offer their employees an election between being paid over the school year and being paid over a 12-month period
- School districts that choose to offer such an election need not make any changes prior to 2008 and their employees will not be subject to additional taxes
- Any changes required for 2008 are likely to be minor

The following questions and answers are intended to help explain how section 409A may apply to these types of arrangements, and similar arrangements of taxpayers with part-year work periods. For convenience of reference, the questions and answers refer to school districts and their employees, although certain other taxpayers are also covered.

What is section 409A?

Section 409A was enacted in October 2004 and was generally effective on Jan. 1, 2005. Section 409A applies to compensation that workers earn in one year but that is not paid until a future year. This is referred to as nonqualified deferred compensation. However, section 409A does not apply to qualified plans (such as a section 401(k) plan) or to a section 403(b) plan or a section 457(b) plan.

How does coverage under section 409A affect an employee's taxes?

If deferred compensation covered by section 409A meets the requirements of section 409A, then section 409A has no effect on the employee's taxes. The compensation is taxed in the same manner as it would be taxed if it were not covered by section 409A. If the arrangement does not meet the requirements of section 409A, the compensation is subject to certain additional taxes, including a 20% additional income tax. Section 409A has no effect on FICA (Social Security and Medicare) tax.

How does a teacher's ability to have his or her salary spread over 12 months create deferred compensation?

Generally, deferred compensation arises in an arrangement under which compensation earned in one year is paid in a later year. For example, assume a school year starts Aug. 1, 2007, and ends May 31, 2008 (10 months), and that a teacher earns \$5,400 per month (\$54,000 per year). If the teacher were paid over 10 months, the teacher would receive \$27,000 in 2007 for the five months of August through December, and would receive \$27,000 in 2008 for the five months of January through May. If instead, the teacher were paid over 12 months, the teacher would receive \$4,500 per month. The teacher would receive only \$22,500 in 2007 for the five months of August through December and would receive \$31,500 in 2008 for the seven months of January through July. In this example, \$4,500 that the teacher earned in 2007 is paid in 2008. In other words, the \$4,500 of 2007 pay is deferred until 2008 and the arrangement generally would be considered deferred compensation that is subject to section 409A.

Does section 409A require that an employee be provided an election?

No, section 409A does not require that an employee be provided any election regarding how the employee is paid. For example, 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.

What does section 409A require if an election is offered?

Section 409A generally establishes deadlines for when employees have to make their elections to defer compensation. The general rule under the law is that an employee who wants to defer payment of compensation to be earned in one year until a later year must make an election to do that not later than the end of the prior year. In other words, if an employee wanted to defer some of his or her salary that would be earned in 2007, the employee would have to make the election not later than Dec. 31, 2006. Congress gave the IRS and Treasury Department authority to provide additional rules for elections, however. Under final section 409A regulations issued in April, special rules allow teachers (or other taxpayers with similar part-year work periods) to make an election to spread their compensation out for up to 12 months, if their employer is willing to give them that choice. Generally, the regulations require the following:

- The teacher (or other employee) must give a written (or electronic) election to the employer that notifies the employer that the employee wants to spread out the compensation.
- The election must be made before the beginning of the work period (for example, before the first day of the school year for which the teacher is paid, which may be before the first day students arrive for class).
- The election must be irrevocable, so that it can't be changed after the work period begins.
- 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).
- No particular form is necessary for the election and it does not have to be filed with the IRS.

What if an employee doesn't submit an election, or misses the deadline?

If an employee doesn't submit an election, or submits an election after the deadline, the employee must be paid in the same way as other employees who do not make an election. For example, a school district may provide that if a teacher submits an election on time, the teacher will be paid ratably over 12 months starting with the beginning of the school year, but if the teacher is late or never submits an election, the teacher will be paid during the school year only.

If a school district provides for an election, must the election requirements be met in writing?

Yes. But section 409A does not require any specific type of plan document. For example, if the teacher signed an election form with the required information, that would be sufficient. In addition, an election can be made electronically, such as by e-mail. Other rules, such as the inability to change the election and the deadlines for the election, can be provided in any other applicable document, such as an employee handbook or school board rules and regulations.

Is an employee required to make this election every year?

No. An arrangement 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 to which the change applies, and could only apply to that future school year. A teacher generally cannot change the method of payment in the middle of the school year.

Do school districts and their employees need to make any changes now?

No. The IRS has decided not to require school districts and their employees to make any changes now to the way teachers or other employees elect to annualize their pay.

What changes do school districts that offer elections need to make for 2008?

The final regulations are not applicable until Jan. 1, 2008. By then, 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 scheduled work period (for example, for the remainder of the school year). In addition, for a work period or school year starting after 2007, employers and employees will need to meet the requirements set forth above for any elections to annualize compensation (for example, for the 2008-2009 school year).

Will the IRS impose any additional taxes if a school district and its employees fail to meet the requirements of the final regulations for school years beginning before 2008?

No. The IRS will not impose additional taxes for failure to meet the deferral election timing and written plan requirements with respect to the annualization of compensation for work periods or school years beginning before Jan. 1, 2008. This relief applies only to compensation that qualifies for the special deferral election timing rule in the 409A regulations applicable to elections to annualize recurring part-year compensation, and only to the extent the compensation is paid on or before Dec. 31, 2008.

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