To: Office of Schools and Centers, School Principals and Administrators
From: Christopher Rajk, Executive Director of Human Resources
Date: February 13, 2008
Subject: Teacher Deferred Compensation

Many of our schools and centers have provided the option for employees to receive wages for the contracted period of work over an extended “12 month” pay schedule. New government regulations require that certain condition be met in order to do this. These regulations are not applicable if the pay schedule is not optional and a choice by the employees. If the hiring entity publishes a single pay schedule applicable to all school year employees, these rules do not apply. However, if your entity does provide an option to the employees to defer income, you must follow the rules.

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
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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 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 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 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.