

New Notice on Recurring Part-Year Compensation for Teachers

The Internal Revenue Service (IRS) has issued a new notice (Notice 2008-62, 2008-29 IRB) regarding proposed regulations (regs) that will prevent most teachers (and other school employees or independent contractors) from facing tax problems as a result of recurring part-year compensation.

Background - Under current tax rules, deferred compensation that is not the result of an eligible deferred compensation plan, generally must be included in the gross income of the individual for the first tax year in which there is no "substantial risk of forfeiture" of the rights to the compensation - unless certain requirements are met. Noncompliance with those requirements would subject the taxpayer to potentially significant interest and penalties.

Potential problem for schoolteachers - School teachers are paid recurring part-year compensation, namely compensation earned during a service period consisting of a school year comprising 9 or 10 months that begins in one calendar year and ends in the next calendar year. Under a common arrangement, the school district pays all of its teachers (or allows individual teachers to elect to be paid) based on a 12-month payment schedule, so that some of the compensation the teacher earns for working during one calendar year is paid in the next calendar year at or after the end of the school year. Without a specific escape hatch, such recurring part-year compensation might be treated as ineligible deferred compensation or an improper deferral under current IRS rules.

Proposed solution for schoolteachers - The proposed regs will specify that an arrangement in which an employee or independent contractor receives recurring part-year compensation (as defined above) will not constitute ineligible deferred compensation if:

- (1) the arrangement does not defer payment of any part of the compensation beyond the last day of the 13th month following the beginning of the service period; and
- (2) does not defer from one tax year to the next, payment of more than the applicable (IRS) dollar amount in effect for the calendar year in which the service period begins (\$15,500 for 2008).

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Illustration: A school district employee works during a school year that begins on Sept. 1, 2008 and ends on June 30, 2009 (a 10-month school year), and is paid over the 12 month period beginning Sept. 1, 2008. He would not have deferred compensation under the new rule if he earns less than \$232,500 for the school year. Since four months of the school year are in 2008 and six months 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 - \$77,500, or \$15,500) does not exceed the applicable dollar limit for 2008 (\$15,500), the arrangement would not present a deferred compensation problem for the employee.

IRS anticipates that this new rule should cover most arrangements for public school teachers and other school-year employees under which they are permitted to annualize school-year compensation (whether or not they are given individual elections).

Taxpayers may rely on guidance - Until further guidance is issued, taxpayers may rely on this new notice beginning with the first tax year that includes July 1, 2008.

Note: While earlier (more informal) guidance from the IRS focused on when and how schoolteachers met the annualization election, there was no discussion of a dollar limit on the amount that could be “deferred” under such an arrangement.

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