

IRS Guidance on Compensation Paid Over a Period Longer Than Earned

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On July 1, 2008, the Internal Revenue Service (IRS) issued Notice 2008-62, which provides interim guidance and effectively eliminates potential deferred compensation complications for most school teachers or other employees who spread their compensation over a full calendar year, even if that compensation is earned in a period less than a year (such as a nine- or 10-month school year).

The IRS previously identified that:

- > spreading compensation over a full calendar year when the actual work year is a shorter period than the full calendar year can push income earned in one year into a subsequent tax year; and,
- > this could trigger application of deferred compensation rules to that amount deferred into the next tax year, giving rise to significant tax issues

To resolve this issue, many employers required that teachers paid over a 12-month period sign deferred compensation agreements. In IRS Notice 2008-62, the interim guidance, which resolves this issue for many individuals, including most if not all school employees, indicates that further guidance is expected in the form of proposed regulations under Code Section 457(f).

Example: A school teacher is paid \$36,000 for a school year that runs from September 1, 2008 to May 31, 2009, which is effectively a nine-month school year, that has four months in 2008, and five months in 2009. This teacher is considered to have earned four-ninths of that salary, or \$16,000, in 2008 and the other five-ninths, or \$20,000, in 2009. However, if the teacher's salary is spread over twelve months, she receives only four-twelfths of that salary in 2008, or \$12,000. The result is that she could be considered to have deferred \$4,000 of compensation (\$16,000 minus \$12,000) into 2009.

Under the interim guidance from the IRS, the amount in this example will not be considered to be deferred compensation unless it exceeds the basic deferral limit in effect for that year under Code Section 402(g), which is \$15,500 for 2008. Since the difference between the salary actually earned in 2008 but paid in 2009 in this example is less than \$15,500, it would not be considered deferred compensation. In fact, for the amount deferred into 2009 to be considered deferred compensation, in this example, the teacher's salary would need to be more than \$139,500. (At a salary of \$139,500, and using the same periods as in the example, \$62,000 would be earned in 2008; however, only \$46,500 would be paid in 2008, a difference of \$15,500.)

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If employees with compensation levels in excess of those provided for in the interim IRS guidance are permitted to spread their compensation over a longer period than it is actually earned, and if that longer period crosses over the end of a tax year, then such amounts would need to conform to applicable deferred compensation rules. The chart below illustrates some thresholds where a 12-month salary for a shorter work year will not be considered compensation. The chart contains some but not all variations.

Salary below which 12-month salary for shorter work year will not be considered deferred compensation

		Total months in school or work year				
		6	7	8	9	10
Actual months worked in year one	3	\$62,000	\$86,800	\$124,000	\$186,000	\$310,000
	4	\$46,500	\$65,100	\$93,000	\$139,500	\$232,500
	5	\$37,200	\$52,080	\$74,400	\$111,600	\$186,000

For work year/school year beginning in 2008 and ending in 2009 and based upon \$15,500 deferral limit under Code Section 402(g) for 2008. The left axis reflects the months actually worked in year one to end of the calendar year. For example, "5" on the left axis represents the month of August, "4" on the left axis represents the month of September.

Of course the IRS guidance is not limited to school teachers, and can be applied both to employees and independent contractors of both public and private employers, starting with the first tax year that includes July 1, 2008.

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VC 22655 (07/2008) J74561 EE

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