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**PROPOSED REGULATIONS PROVIDE A SAFE HARBOR FOR ANNUALIZED  
TEACHERS' SALARIES UNDER INTERNAL REVENUE CODE SECTIONS 457(F)  
AND 409A**

Following the enactment of Internal Revenue Code Section 409A and the issuance of the corresponding Treasury Regulations, many school districts and teachers expressed concern that Section 409A may result in teacher's salaries being subject to additional taxes where the salaries were paid out over a period of twelve months for a service period of less than twelve months. The IRS recently announced plans to issue proposed regulations which would eliminate the possibility of additional taxes under Sections 457(f) and 409A for most teachers and provided a safe-harbor that can be relied upon to avoid such taxes until the proposed regulations are issued.

Under Sections 457(f) and 409A, unless certain requirements are met, amounts deferred under a nonqualified deferred compensation plan are currently includible in gross income unless they are subject to a substantial risk of forfeiture. In addition, Section 409A imposes a twenty percent penalty tax and interest on deferred compensation which is payable by the employee.

The proposed rule provides that a payment arrangement will not result in deferred compensation (and, therefore, Sections 457(f) and 409A will not apply) if both of the following requirements are met:

- The arrangement does not defer payment of any of the recurring part-year compensation beyond the last day of the thirteenth month following the beginning of the service period. For example, for a service period beginning in August 2008, all payments must be made prior to September 30, 2009.
- The total amount of the deferred compensation is less than a statutorily prescribed limit. For 2008, this amount is \$15,500.

The amount of the deferral is determined by comparing the amount of income earned during each part-year service period to the amount of income actually received during the corresponding part-year payment period. For example, assume a teacher has a ten-month contract for \$60,000 beginning on September 1, 2008 and ending on June 30,

2009. The contract specifies that the teacher will be paid in twelve monthly installments of \$5,000 with the first payment to be made on September 30<sup>th</sup> and the last payment to be made on August 31, 2009. Four months of service are performed in 2008 and six months of service are performed in 2009. The salary attributable to service is \$24,000 in 2008  $((\$60,000/10) \times 4)$  and \$36,000 in 2009  $((\$60,000/10) \times 6)$ . Because the payments are made in twelve equal installments, \$20,000  $(\$5,000 \times 4)$  is received by the employee in 2008 and \$40,000  $(\$5,000 \times 8)$  is received in 2009. The amount earned in 2008 that is paid in 2009 is \$4,000  $(\$24,000 - \$20,000)$ . Under the proposed rule, Sections 457(f) and 409A would not apply to the \$4,000 because both of the requirements set forth above have been satisfied.

The IRS has determined that for contract periods beginning August 1<sup>st</sup> and ending on July 31<sup>st</sup>, only school employees making more than \$186,000 would have deferred compensation subject to additional tax under the provisions of Sections 409A and 457(f). Similarly for a school year that begins on September 1st and ends on June 30<sup>th</sup>, the additional taxes imposed by Sections 409A and 457(f) would apply only to employees earning more than \$232,500.

The IRS has warned, informally, that even \$1 of deferred income in excess of the \$15,500 limit will cause the entire amount of the deferral to be “deferred compensation” within the meaning of Sections 457(f) and 409A. Failure to comply with the safe harbor, therefore, could have a significant tax impact on employees who would be required to pay taxes on amounts earned in the current year which will not be received until the following year. More importantly, failure to comply with the safe harbor could expose employees to the twenty percent penalty tax and interest if their employment agreements do not satisfy the requirements of Section 409A.

The IRS anticipates issuing the proposed regulation in the fall. As set forth in the announcement, employers may rely upon the proposed rule set forth in Notice 2008-62 immediately.

If you would like to discuss the implications of Section 457(f) and Section 409A on your compensation arrangements with your employees, please do not hesitate to contact Deirdre Mitacek at (516) 296-9136 or [dmitacek@cullenanddykman.com](mailto:dmitacek@cullenanddykman.com).