IRS provides new guidance on 'spreading' academic-year salaries

The IRS has issued new guidance, Notice 2008-62, regarding faculty salaries earned during the academic year but paid over a longer period. The Notice may create tax and payroll challenges for many schools and colleges.

<u>The Problem, as Perceived by the IRS</u>. The salary arrangement that is the subject of the IRS Notice occurs when faculty members earn income over an academic year (typically nine months) but automatically or at their election have the payments spread over a longer period (typically 12 months). Assume, for example, that a faculty member's annual salary is $144,000 – $12,000 per month when paid over the 12-month period, but $16,000 if paid only during the nine-month academic year. The IRS views making the payments over a 12-month period as a deferral of $4,000 of compensation for each month in the first calendar year (typically September, October, November and December) into the next calendar year.

<u>Section 409A</u>. The IRS first focused on this issue under new Section 409A of the Internal Revenue Code, which places restrictions on deferred compensation elections and payouts. In the final Section 409A regulations published in April 2007, the IRS required that an election to spread an academic-year salary over 12 months must be made before any of the relevant services are provided.

<u>Second Shoe Drops – Section 457(f)</u>. The IRS has now turned its attention to Section 457(f) of the Code, under which deferred compensation paid by tax-exempt and governmental employers is taxed as soon as the right to receive it is not subject to a substantial risk of forfeiture. In the example above, the "deferral" of $4,000 from each of the months of September, October, November and December to the following year results in tax in the initial year on those $4,000 monthly amounts, <u>unless</u> the faculty member would forfeit those amounts by leaving mid-year. In order to relieve most academic-year employees from the potential accelerated tax, Notice 2008-62 states that the IRS intends to provide in regulations under Section 457(f) that there will be no "deferred compensation" unless the total amount moved from year one to year two exceeds the $15,500 limit (as adjusted in the future) that applies to voluntary retirement deferrals. The IRS intends to propose a similar exemption from the definition of "deferred compensation" under Section 409A.

Those exceptions, if proposed and finalized, should solve the tax problems of salary spreading for most faculty members. However, Notice 2008-62 <u>does not</u> solve the problem in the example above. In that case, even automatic (nonelective) spreading appears to result in an additional $16,000 being taxable in year one (*i.e.*, the full $16,000 for each of September, October, November and December, rather than the $12,000 per month actually paid), unless the deferred amounts remain subject to forfeiture. Where spreading is elective, even forfeitable deferrals from year one would apparently be taxed in year one. Faculty members with higher salaries will be affected more significantly by having taxes due on salary that has not yet been paid.

<u>Impact</u>. Some colleges and universities may have a large number of affected faculty in spite of the IRS "relief." Salary-payment schedules should be examined carefully, because some spreading arrangements may not defer any amount from one year to the next. Institutions with employees working on an academic-year schedule should compile data on how many people may be affected, consider preparing guidance and communications for affected employees, and think through the impact on payroll and other administrative functions.

What to do? The policy justification for the IRS's new position is unclear. It is not obvious why the IRS is invoking both Sections 409A and 457(f) to address a very common, non-tax driven salary arrangement for teachers from kindergarten through graduate school. While Notice 2008-62 remains the IRS's position, however, options for practical compliance are limited. Waiting for transition relief to evolve is a risky course now that the IRS has made its views known. An institution whose current practices are vulnerable could simply begin to pay academic-year salaries during the academic year, as earned, with no spreading, or could adjust the spreading arrangement so that payments are moved only within the same tax year. Finally, an institution could comply with prior guidance under Section 409A regarding the timing of elections (if any), or continue to spread automatically academic-year earnings over 12 months, but then report the "deferred amounts" as income in year one and as tax-free when paid in year two. However, these last alternatives may not be administrable for many institutions.

Contact Information

For help in answering any questions you might have, please contact your regular Ropes & Gray attorney or one of the following: **Bill Jewett**, **Dave Raish** or **Lorry Spitzer**.