



Please note that this analysis is based on the best information currently available. The Internal Revenue Service and others will undoubtedly issue further information. We will attempt to keep you updated as much as possible. Note also that this guidance is not intended, nor should it be used, as a substitute for specific legal advice; such advice can be given by legal counsel only in response to inquiries regarding particular situations. Further, this guidance is not intended to be and should not be construed as tax advice. For such advice, members should consult their tax advisors.

TO: PASBO Members
PSEA Local Presidents and PSEA UniServs

FROM: William L. McGill, RSBA, PASBO Director of Technical Assistance
Lynne L. Wilson, PSEA General Counsel

DATE: January 30, 2008

RE: **409A Election Form for Annualization of Teacher Salaries**

The purpose of the memo is to provide assistance to PASBO and PSEA members and their local educational agencies in addressing issues arising under section 409A of the Internal Revenue Code (the “Code”) regarding the payment of salary.

Earlier this year, the Internal Revenue Service issued final regulations under section 409A. These final regulations impact school districts that, either as a general policy or pursuant to a collective bargaining agreement, pay teacher or other employee salaries over a period longer than the period the employee actually works (e.g., pay salary over 12 months for employees who work 10 months). The regulations state that this type of arrangement, also known as an “annualized salary,” will be treated as a deferral of compensation under section 409A. As such, if the regulations are not complied with, the

amounts deferred will be taxable in the year the employee has a vested right to future payment, and will be subject to an additional 20% income tax.

PSEA and PASBO are in agreement regarding the following points:

1. Section 409A will not impact elections to annualize salary in the 2007-08 school year. The regulations become effective on January 1, 2009, and the general writing requirements described below must be satisfied by that time. However, pending further clarification from the IRS, we advise that districts that allow 10-month employees to elect whether to be paid over a 10-month or 12-month period should implement written election systems (as described below) prior to the beginning of the 2008-2009 school year.
2. If a district pays its teachers or other employees who work 10 months over a 10-month period, with no option to be paid over a 12-month period, section 409A does not apply, and no action is required. Districts are not required to offer employees the election to be paid over a 12-month period.
3. If a district pays its teachers or other employees who work 10 months over a 12-month period, but does not give its employees the option to choose between these two payment schedules, section 409A applies, but the only requirement is that the district set forth in writing the schedule on which the employee is to be paid. The writing or other district policy should provide that employees who separate from service prior to the end of the school year may be paid in a lump sum at the time of separation for any remaining salary owed to them as of the date of their separation from service, and must include a definition of "separation from service" that is consistent with the definition set forth in the regulations under section 409A of the Code. (Generally, the regulations state that an employee "separates from service" with the employer if the employee "dies, retires, or otherwise has a termination of employment with the employer," subject to exceptions for certain kinds of temporary leave.) Please refer to paragraph 7 for the suggested language regarding separation from service.
4. If a district offers teachers or other employees who work 10 months a choice between payment over a 10-month or 12-month period, the following requirements must be met:
 - A. The district must establish a written procedure for the election of payment. This procedure can be stated in a document such as an employee handbook or a school board regulation. The procedure must state what will happen if a proper election is not made.
 - B. Each employee must provide a written election to the employer that identifies how the employee wishes to be paid (see paragraph 6 below).

- C. The election by the employee must be made before the first day that the employee works in the school year for which that employee is paid. For the majority of employees who are employed prior to the start of a school year, the election must be made prior to their first day of work. An employee hired after the first day of the school term must make an election prior to his or her first day of actual work.
 - D. The election must be irrevocable and may not be changed after the school year begins.
 - E. An election need not be made for each school year. An election may remain in place until the employee elects a change prior to the beginning of another school year unless the district's policy provides otherwise. If such a policy is followed, this must be stated in the election form.
 - F. If an employee does not submit an election, or misses the deadline for submitting an election, the employee will be paid the same way as other employees who do not make an election, as stated in the district's policy. This may be for payment either over a 10-month or 12-month period depending on the district's default payment schedule as set forth in the district's policy.
 - G. Before the beginning of each school year, districts should remind employees that they must timely submit a new election form if they wish to change their choice regarding the manner of payment. If no new election is made, the prior election may remain in effect indefinitely unless the district's policy provides otherwise.
5. The written election form should state that employees who separate from service prior to the end of the school year are to be paid in a lump sum at the time of separation for any remaining salary owed to them as of the date of their separation from service. The election form must also include a definition of "separation from service" that is consistent with the definition set forth in the regulations under section 409A of the Code. (As mentioned in paragraph 3, the regulations generally state that an employee "separates from service" with the employer if the employee "dies, retires, or otherwise has a termination of employment with the employer," subject to exceptions for certain kinds of temporary leave.) It is acceptable to incorporate this definition by reference, as we have done in paragraph 7.
6. Some districts that pay 10-month employees on a 12-month schedule allow employees to elect to receive a lump sum check in June that includes pay for June, July, and August. We have been advised informally by the IRS that such lump sum payments are subject to all the timing restrictions of section 409A of the Code, including the prohibition on acceleration of deferred compensation payment schedules, even if the payment of a lump sum in June would not change

the tax year in which an employee receives the money. Therefore, any school district that pays its 10-month employees on a 12-month schedule and that wishes to have the flexibility of paying such lump sums in June, must proceed carefully to avoid a violation of the rules. Such a school district must state in writing that payment for the months of June, July, and August will generally be made in a single lump sum in June, but that the employer retains discretion to decide to pay this amount in bi-monthly installments through the end of the summer. Districts that allow employees to elect their payment schedules must state this policy on the notice of election form (as we have done on the sample notice in paragraph 7).

7. An election does not have to take any particular form and can be made electronically (via email). PASBO and PSEA suggest the following wording:

I, [Employee], hereby elect to be paid my annual salary by the [District] for this school year and each school year thereafter, until this election is changed, as follows:

Select one:

10-month payment option

_____ Payment over ten months in equal installments every two weeks beginning in September or on the date specified in any applicable collective bargaining agreement.

12-month payment option

_____ Payment over twelve months in equal installments every two weeks beginning in the month of September or on the date specified in any applicable collective bargaining agreement.

12-month payment option with lump sum payment in June

_____ Payment over twelve months in equal installments every two weeks beginning in the month of September or on the date specified in any applicable collective bargaining agreement, with the final single lump sum payment in June encompassing all remaining payments due for the final three months of the 12-month payment period. Such option shall be agreed to by the District or provided for by any applicable collective bargaining agreement, but the employer shall retain full discretion to pay the amount of this lump sum in the form of equal bi-monthly payments over the final 3 months of the 12-month payment period.

This notice is irrevocable for any particular school year, and may not be changed or withdrawn after the beginning of the school year in which I am working. This notice will be effective for all years following the 2008-2009 school year, unless I

choose to change my election. If I choose not to have my salary deferred in any future school year and be paid only during the period that I actually perform services, I will so notify the employer in writing prior to beginning work for that school year.

This notice shall have no effect if not submitted prior to the time I begin working for the 2008-2009 school year.

In the event a separation from service occurs before the end of the 12-month payment period, I will be entitled to an additional payment for the amount I have actually earned from the beginning of the 12-month pay period until the date of my separation from service, but which has not yet been paid. This additional payment will be included in my final paycheck. For this purpose, "separation from service" shall have the same meaning as that term is defined in section 1.409A-1(h) of the Treasury Regulations.

8. Note that some collective bargaining agreements may contain other options for payment that should be included in the election form, in addition to the lump sum option. Examples are:
 - A CBA provides for a choice of payment over 12 months with the option of an extra pay prior to December 15th if requested. As with the annualized salary election, the election to use such an option must also be made before the first day that the employee works in the school year for which that employee is paid.
 - A CBA provides for a choice of payment over 12 months with the option to receive half of the annual increase on the 1st pay in December and the other half on the 2nd pay in July, rather than spread over the 12 months. As with the annualized salary election, the election to use such an option must also be made before the first day that the employee works in the school year for which that employee is paid.