

## Part III - Administrative, Procedural, and Miscellaneous

### Interim Guidance on the Application of § 457(f) to Certain Recurring Part-Year Compensation

Notice 2008-62

This notice describes a rule that the Treasury Department and the Internal Revenue Service (IRS) anticipate will be included in regulations to be proposed under § 457(f) of the Internal Revenue Code.

The regulations to be proposed are expected to address certain types of arrangements involving recurring part-year compensation, including common arrangements involving public school employees who provide services during a 10-month school year and elect to be paid ratably over 12 months. It is expected that the regulations would provide that if certain conditions described below are satisfied, § 457(f) would not apply to such arrangements. It is also expected that a conforming change will be proposed for regulations under § 409A, so that § 409A also will not apply to such arrangements if such conditions are met.

Section II of this notice describes the rule expected to be included in the proposed regulations. Taxpayers may immediately rely on the rule described in Section II of this notice.

#### SECTION I. BACKGROUND

Section 131 of the Revenue Act of 1978, Public Law 95-600 (92 Stat. 2779), added § 457 to the Internal Revenue Code of 1954. On July 11, 2003, final regulations under § 457 (TD 9075) were published in the **Federal Register** (68 FR 41230) (2003 § 457 regulations). The 2003 § 457 regulations provide guidance on deferred compensation plans of tax-exempt entities and state and local governments, including plans that are subject to § 457(f). Compensation deferred by participants under ineligible § 457(f) plans of tax-exempt entities and state and local governments, including public schools, is generally included in the participant's gross income for the first taxable year in which the compensation is not subject to a substantial risk of forfeiture.

In Notice 2007-62 (2007-32 IRB 331), the Treasury Department and the IRS announced their intention to issue guidance under § 457, including providing guidance on the definitions of a bona fide severance pay plan under § 457(e)(11) and a substantial risk of forfeiture under § 457(f)(1)(B). This guidance will also address other topics under § 457(f), including the particular types of arrangements that are subject to § 457(f).

Section 885 of the American Jobs Creation Act of 2004, Public Law 108-357 (118

Stat. 1418), added § 409A to the Internal Revenue Code. Section 409A generally provides that, unless certain requirements are met, amounts deferred under a nonqualified deferred compensation plan for all taxable years are currently includible in gross income to the extent not subject to a substantial risk of forfeiture and not previously included in gross income.

On April 17, 2007, final regulations under § 409A were published in the **Federal Register** (73 FR 19234). The § 409A final regulations provide guidance regarding the definition of a nonqualified deferred compensation plan subject to § 409A and set forth the requirements to comply with the rules governing deferral elections and payment timing under § 409A. The final regulations are applicable for taxable years beginning on or after January 1, 2009. See Notice 2007-86 (2007-46 IRB 990).

## SECTION II. GUIDANCE REGARDING RECURRING PART-YEAR COMPENSATION

The Treasury Department and the IRS anticipate that the regulations to be proposed under § 457(f) will specify that an arrangement in which an employee or independent contractor receives recurring part-year compensation (as defined in § 1.409A-2(a)(14)) does not provide for deferred compensation for purposes of § 457(f) if: (1) the arrangement does not defer payment of any of the recurring part-year compensation beyond the last day of the 13<sup>th</sup> month following the beginning of the service period and (2) does not defer from one taxable year to the next taxable year the payment of more than the applicable dollar amount under § 402(g)(1)(B) in effect for the calendar year in which the service period begins (\$15,500 for 2008).

In a typical case of a school teacher, the recurring part-year compensation consists of the compensation the teacher earns 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 system pays all of its teachers (or allows individual teachers to elect to be paid) based upon a 12-month payment schedule, so that some of the compensation that 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. Under the anticipated rule in this situation, none of the compensation paid to a teacher would be deferred compensation if the amount the teacher earns during the first calendar year that is paid in the second calendar year does not exceed the dollar amount under § 402(g)(1)(B) applicable for the first calendar year (\$15,500 for 2008).

For example, assume a school district employee works during a school year that begins on August 1, 2008 and ends on May 31, 2009 (a 10-month school year). Assume further that the employee is paid over the 12-month period beginning August 1, 2008 (either because the school system pays over a 12-month period or because the employee may elect to be paid over the 12-month period and has made such an election). Under these facts and circumstances, the arrangement would not provide for deferred compensation for purposes of § 457(f) unless the employee earns more than \$186,000 for the school year. Since five months of the school year are in 2008 and five

months are in 2009, an employee whose salary for the school year is \$186,000 earns \$93,000 in 2008 and \$93,000 in 2009. Under the 12-month payment schedule, the employee receives \$77,500 in 2008 and \$108,500 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 amount under § 402(g)(1)(B) for 2008 (\$15,500), the arrangement would not provide for deferred compensation for purposes of § 457(f).

Similarly, a school district employee working during a school year that begins on September 1, 2008 and ends on June 30, 2009 (a 10-month school year), that paid the employee over the 12 month period beginning September 1, 2008, would not provide for deferred compensation for purposes of § 457(f) if the employee 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 amount under § 402(g)(1)(B) for 2008 (\$15,500), the arrangement would not provide for deferred compensation for purposes of § 457(f).

The Treasury Department and the IRS also anticipate that a change to the regulations under § 409A will be proposed, which would provide that the arrangement described in the first paragraph of section II of this notice is not a nonqualified deferred compensation plan for purposes of § 409A (including an arrangement that is not covered by § 457(f) because the service recipient is not an eligible employer under § 457(e)(1)). However, the proposed regulations are not expected to affect the application of any other Code provisions or federal tax doctrines that may affect the taxation of these arrangements.

The Treasury Department and the IRS anticipate that these rules should exclude from coverage under §§ 457(f) and 409A 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).

### SECTION III. EFFECTIVE DATE AND RELIANCE

Until further guidance is issued, taxpayers may rely on the rule described in section II of this notice for purposes of both §§ 457(f) and 409A beginning with the first taxable year that includes July 1, 2008.

### SECTION IV. DRAFTING INFORMATION

The principal authors of this notice are Pamela R. Kinard and Stephen Tackney of the Office of the Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). For further information regarding this notice, contact Ms. Kinard at (202) 622-6060 regarding § 457(f) and Mr. Tackney at (202) 927-9639 regarding

§ 409A (not toll-free numbers).