Deferred Compensation under Semesters
Frequently Asked Questions
September 2012

What’s the background of this issue?

- The Internal Revenue Code’s Section 409A, part of the American Jobs Creation Act of 2004, resulted in regulations that affected the University due to semester conversion. IRC Section 457 also covers deferred compensation rules.
- These regulations prohibit an employee from deferring from one tax year to the next any compensation in excess of a “safe-harbor” amount (currently $17,000). In other words, compensation earned in one calendar year should generally be paid in that calendar year (so that it can be taxed in that year), and if it is not, the amount deferred must be less than the safe-harbor amount; otherwise, a tax penalty will be levied on the deferred amount that exceeds the safe harbor.

Who will be affected by the plan to address IRS requirements?

- Only faculty with 2-semester (“9-month”) appointments are affected.
- Of those, only faculty earning base pay (coded 0FAC-Faculty Salary) and administrative stipends (0ADM-Salary 2) totaling more than $102,000 per academic year are currently affected. That threshold is determined through a calculation of the safe harbor, which the IRS periodically adjusts.
- Employees on 12-month appointments will not be affected.
- Currently about 270 UC faculty will be affected.

What is the University’s plan for addressing the IRS requirements?

- For the affected faculty, the University will increase that person’s monthly pay for the paychecks from September through December and will decrease the monthly pay for the eight paychecks from January through August. The total of all monthly paychecks will equal the faculty member’s annual salary and administrative stipend (if any).
- The four fall-semester paychecks will not be increased sufficiently to equal all compensation accrued in fall, but they will come close enough to ensure that the deferred compensation does not exceed the safe-harbor amount.
- See the example at the end of this document.

What would happen if UC just ignored the issue and continued to pay in 12 equal monthly installments?

- The affected faculty would be subject to a 20% penalty on that portion of the deferred compensation that exceeds the safe-harbor amount.

Will those affected be notified and will they have to do anything?
\begin{itemize}
\item In 2012, affected faculty will receive notification but not in future years because of timely information being made to all faculty in fall 2012. Individual faculty who are affected by a pay adjustment whereby their base pay (coded 0FAC-Faculty Salary) and administrative stipends (0ADM-Salary 2) totals more than $102,000 per academic year should use the “409A Calculator” that will enable them to calculate the distribution of their annual pay over the academic year.
\item They will not have to do anything. Payroll will automatically adjust the pay distribution for those who are affected.
\end{itemize}

May faculty opt out of this process if they wish to take their chances with the IRS?
\begin{itemize}
\item No
\end{itemize}

What about those faculty not affected?
\begin{itemize}
\item The large majority of full-time faculty (about 2000) will see no change in their pay. They will continue to receive 12 equal installments of their annual pay across the year.
\item If a faculty member receives a salary increase or stipend that would result in a deferral that exceeds the safe-harbor amount, he/she should use the “409A Calculator” that will enable them to calculate the distribution of their annual pay over the academic year.
\end{itemize}

May an affected faculty member avoid the uneven pay distribution by increasing tax withholding in fall to match the amount of that year’s accrued income?
\begin{itemize}
\item No, the regulations apply to the deferral of compensation, not to the deferral of taxes.
\end{itemize}

Why hasn’t this been an issue before now?
\begin{itemize}
\item When UC was on the quarter system, a faculty member with a 9-month appointment earned one-third of his/her annual salary in the fall and received one-third in the fall; no pay from fall was deferred into the next calendar year. Those faculty received their pay in 12 equal monthly installments without a problem.
\item On semesters, a faculty member with a 9-month appointment will earn one-half of his/her salary in the fall semester but will receive only one-third of his/her annual pay installments in fall, resulting in a deferral of about 17% of his/her annual compensation from one tax year to the next. If that 17% exceeds the safe-harbor amount, the employee will incur a penalty.
\end{itemize}

What types of compensation will be affected?
\begin{itemize}
\item Of the 17 wage types that faculty may earn, only two will be affected: (0FAC)-Faculty Salary and (0ADM)-Salary 2; so only when those two types of pay exceed $102,000 will this process come into play.
\item Extra compensation from grants (EXC) and from non-grant sources (EXN, ADL) will not be affected because they will generally not be deferred.
\item Note that Government Cost Compliance will change the schedule of reporting work effort (through the LVS) under semesters. After a special report for July and August 2012, reporting will change from four to three times per year to align with the year’s three semesters.
\end{itemize}

Will this adjustment affect benefits or STRS service credit?
\begin{itemize}
\item No, the adjustment will not affect the monthly credits or deductions for benefits.
\item No, the adjustment will not affect STRS service credit, but variations in monthly pay will cause STRS monthly contributions to vary; total STRS annual contributions will not change.
\end{itemize}

Why didn’t I have to deal with this at my previous university?
Several circumstances may account for different experiences at other universities:

- The regulations were not enforceable at UC until fall 2009.
- Because the IRS has been saying for several years that it will issue new regulations addressing deferred compensation issues raised by 409A and 457 in the very near future, some universities may have decided to wait for final regulations before implementing changes.
- IRS guidance related to the currently existing regulations is complicated, confusing and, at times, contradictory.

Note that UC sought guidance on the matter from outside counsel specializing in compensation tax law. We are following his advice because this approach best protects faculty from the possibility of facing a substantial tax penalty.
Will this adjustment of monthly pay happen only in 2012?

- Based on current law, no, this will be an annual adjustment because the accrual and payment of compensation will be the same each year.

**Example**, assuming annual base pay of $125,000

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<th>BASE ON:</th>
<th>$125,000.00</th>
<th>System- Created Adjustment</th>
<th>Actual Pay</th>
<th>Monthly Earned versus Paid</th>
<th>Accumulated Earned versus Paid</th>
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<td>Earned</td>
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<td>Actual Pay²</td>
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<tr>
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<td>$958.33</td>
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<tr>
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<tr>
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</table>

**Notes:**

1. Base pay remains unchanged. This column shows an equal distribution of annual base pay across 12 monthly installments.
2. Actual pay, month by month. This column shows actual pay in each month of the year. After adjustment to meet safe-harbor requirements, this pay rate allows the least change in the monthly pay.
3. The current safe-harbor amount. This is the maximum compensation that may be earned but not paid from one tax year to the next.

**For further information, contact:**

Your Department/College Business Manager
OR
Human Resources Service Center
513-556-6381