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HUMAN RESOURCES & PAYROLL

A Look at Deferred Compensation Plans

For many employees, generous benefits are more important than pay raises. There are many benefits options you can offer to attract and retain employees, including deferred compensation plans.

Mike Kappel • Jun. 01, 2018

For many employees, generous benefits are more important than pay raises. There are many benefits options your small business clients can offer to attract and retain employees, including deferred compensation plans.

What are deferred compensation plans?

Deferred compensation is a portion of an employee's compensation they earn in one year but receive in a later year. Deferred compensation plans are small business employee benefits that let employees reduce their immediate tax liabilities.

Both employers and employees can contribute to deferred compensation plans. Deferred comp can be broken down into two categories: nonqualified and qualified deferred compensation plans.

Nonqualified vs. qualified deferred compensation plans

Nonqualified and qualified deferred compensation plans have key differences. The employer and its must understand the deferred compensation rules.

Qualified deferred compensation plans are more strictly governed than nonqualified plans. There are contribution limits, meaning an employee can only contribute a certain amount per year. And, there are nondiscrimination rules, which means if the employer offers a qualified plan, it must open it up to all employees and ensure all employees benefit equally. Qualified plans are also more protected than nonqualified plans, meaning the money the employee defers is secured in a trust account.

The best known qualified deferred compensation plans are 401(k) plans. A deferred compensation retirement plan lets employees contribute funds to their accounts and also defer the tax payments on that compensation. The contribution limit for a 401(k) plan is $18,500 for 2018.

Nonqualified deferred compensation (NQDC) plans are more flexible than qualified deferred compensation plans. NQDC plans have no contribution limits. And, an executive deferred compensation plan can reward only highly compensated or key employees. Further, nonqualified deferred compensation plan contributions do not need to be placed in a trust. The employer can keep the deferred money with your regular business funds. However, this means funds are not secure. Creditors could claim an employee's nonqualified deferred compensation if the business goes through small business bankruptcy.

Employees and employers must enter a deferred compensation agreement that outlines rules for receiving the compensation. For example, an employee might not get their deferred compensation if they switch jobs.

Like qualified deferred compensation plans, NQDCs also include employee retirement plans. One example of a nonqualified deferred compensation plan is a supplemental executive retirement plan (SERP). There is no contribution limit for contributing to this type of retirement plan.

Deferred compensation plan benefits

Here are some benefits to offering deferred compensation plans:

1. Deferred compensation plans can help you attract employees. And, they can help retain key employees. Nonqualified deferred compensation plans, for example, are known as "golden handcuffs" because they are valuable benefits with the intention of keeping top employees. If an employee leaves before fulfilling the deferred compensation agreement, they lose their money.
2. Offering nonqualified deferred compensation plans can also help when it comes to increasing cash flow. Since it is not necessary to put the funds in a trust account, the business has access to the fund until the deferred compensation is due.
3. If the business provides qualified deferred compensation plans, it can receive tax benefits. For instance, it can immediately claim tax deductions for an employee's compensation as well as any contributions that were made. As for nonqualified plans, the business can receive tax benefits once the employee receives their deferred income.

Deferred compensation taxation

As stated, employees who defer part of their compensation also defer taxes on that income. Employees do not immediately owe federal income tax when they defer compensation. Instead, they pay federal income tax when they actually receive the deferred income.

Generally, deferred compensation is subject to Social Security and Medicare (FICA) taxes at the time of deferral. However, if employees are required to perform future services to receive their deferred compensation in an NQDC plan, FICA tax is not owed until the specified service has been performed.

Deferred compensation accounting

When an employee defers a portion of their compensation to a nonqualified plan, you owe them in the future. In accounting, the amount you owe them but have not paid them is known as accounts payable.

Accounts payable represent a liability, or an amount you owe. Liabilities are increased by credits. For accurate accounting books, the business must credit accounts payable the amount of the deferred compensation. This creates a record representing that you still owe the employee money.

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