

# How Deferred Comp Plans Can Help Pass-Through Businesses

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Insights for pass-through employers, including S-corporations, partnerships, or LLCs.

Retaining top talent in a competitive job market is challenging for any company; for many pass-through employers, keeping key employees can be a critical difference maker, especially in view of the high cost of replacing them. As companies deal with the impact of the Tax Cuts and Jobs Act, they must also factor in the cost to replace an employee.

“Turnover costs are often estimated to be 100 to 300 percent of the base salary of replaced employee.”

—Society for Human Resource Management (SHRM)

“For high-level or highly specialized employees, you’re looking at 400 percent of their annual salary.”

—Talent Management and HR, ERE.net



# Finding the Right Benefits for You and Your Key Employees

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Solutions that provide flexibility and potential tax savings for pass-through entities

## Overview

Your business can play an important role in providing additional retirement income for you and your key employees. If you're an owner of a pass-through entity, such as an S corporation, a partnership, a limited liability partnership (LLP), or limited liability corporation (LLC) that has elected to be taxed as a partnership, then you're taxed as a pass-through entity. You have unique needs and considerations to think about when providing retirement income for you and your key employees. A non-qualified deferred compensation plan can help solve your challenges and serve your company's needs.

## Benefits for key employees

Deferred comp plans can be a valuable benefit for your key employees. These plans can be an effective way to recruit, retain, and reward them. The use of company contributions with vesting schedules based on service or performance can be helpful in rewarding key employees and keeping them with you for the long term. But it's important to know when a deferred comp plan may not be as advantageous for you as an owner of the company.

## When owners may not benefit

Pass-through entity owners may decide to not take advantage of deferred comp benefits for the following reasons.

- Deferred comp benefits are tax deductible only when paid, so any increase in taxable income due to owner deferrals at the entity level flows directly through to the owner. Any decrease in personal income (W-2) due to the deferral is completely offset by the increase in business income (K-1).





- In multi-owner scenarios, the use of deferred comp can cause a disproportionate taxable income effect if owners defer amounts not in proportion to their ownership interest.

## Considerations for owners

- Impact on basis - The basis will increase by the additional amount of taxable income flowing through due to employee deferrals and will decrease by tax deductible distributions from the plan. Basis will affect capital gains calculations if an owner sells his/her stake in the business.
- Future tax benefit - The current value of your interest in the business will increase because of the value of the future tax deduction that will be available when the deferred comp benefit is paid. If you sell your interest in the business before benefits are paid, you should include the value of this future tax benefit in selling-price negotiations.
- Taxes and financing - All taxable income flows through to your personal return. Financing with taxable mutual funds will generate ordinary and capital gain income. And financing with corporate-owned life insurance (COLI) will grow taxdeferred, and with the right planning, offer tax-free benefits to you and your business.

## Alternative solutions for owners

If you choose not to participate in your company's deferred comp plan, you have other options that offer tax advantages. Some other solutions to consider are:

- Bonus arrangement for S owners – A plan allowing owners of S corporations to move cash from the business to the owner, personally. Depending on the funding method used, S owners can also diversify and leverage their personal income tax liability.
- Bonus arrangement for LLC members – Allows members (owners) of limited liability companies (LLCs), taxed as a partnership, to accumulate wealth and/or create retirement income above what's allowed by their qualified plans. Depending on the funding method used, LLC members can also diversify and leverage their personal income tax liability.

You want to ensure you and your key employees have enough income to enjoy your retirement years.

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