Deferred Compensation 101: What it is and why you should consider it

By Gary Pattengale, CFP®, Advanced Tax Specialist

For high-earning executives and key employees, traditional 401(k) plans often fall short of meeting long-term financial goals. Strict IRS contribution limits restrict how much you can save in a tax-advantaged way.

That's where deferred compensation plans come in. These offer a powerful way to contribute significantly more than a 401(k), reduce current tax liability, and enhance retirement income.

What is it?

Deferred compensation is a supplemental retirement plan typically offered to high-earning executives and key employees. It allows you to postpone receiving a portion of your salary or bonus until a future date — usually retirement. This strategy can reduce your current tax bill while helping you build wealth on a tax-deferred basis.

How it works

Deferred compensation plans are in many ways similar to traditional 401(k) plans:

- Contributions are made on a pre-tax basis.
- Investments grow tax deferred.
- Distributions are taxed as ordinary income.
- Some plans may offer employer matching contributions.

Key differences

However, there are important distinctions:

- **No contribution limits:** Nonqualified Deferred Compensation (NQDC) plans are not subject to IRS contribution caps.

- **Payroll taxes still apply:** You'll still owe Social Security and Medicare taxes on deferred income.
- **Lack of ERISA protection:** These plans are not protected under ERISA, making them unsecured liabilities of the employer.
- **No IRA rollovers:** You typically cannot roll over NQDC assets into an IRA to continue tax deferral if you leave your employer.

Election timing

You must elect your deferral amount and payout schedule — usually in the calendar year prior to when the compensation is earned. Once made, these elections are often irrevocable or very difficult to change.

Risks to consider

- **Creditor risk:** Because NQDC plans are unsecured, your deferred funds could be at risk if your employer becomes insolvent.
- **Liquidity risk:** Ensure you have sufficient liquidity to meet your financial needs while deferring income.
- **Investment risk:** Poor investment choices can offset the tax advantages of deferral.
- **Limited portability:** If you leave your job, you generally cannot transfer these funds to an IRA.

Who should consider it?

Deferred compensation plans may be a good fit for:

- Executives who have maxed out their 401(k) and want to save more.
- Individuals expecting to be in a lower tax bracket during retirement.
- Employees with long-term plans to stay with their employer and confidence in the company's financial stability.

As you can see, there are many complexities. Your dedicated Mesirow Wealth Advisor can help you navigate the nuances and make informed decisions.

About the Author

Gary is a Wealth Advisor and Advanced Planning specialist in our Highland Park, Illinois office, serving clients in the Chicago area and nationwide. He has deep experience with executive and stock-based compensation plans, including stock options, restricted stock, and deferred compensation. He combines his tax knowledge, executive compensation experience and capital markets expertise to help clients reduce their tax burdens and achieve their unique goals. Contact Gary Pattengale at 847.681.2333 or gary.pattengale@mesirow.com.