The importance of employee retention plans.

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American businesses have long offered employee retention plans to encourage key employees to remain with the company. These plans became even more important during 2019-2022 when resignations and job openings were both at record highs, making it a seller's market for workers. Some economists dubbed this period the "Great Resignation," although perhaps a better term would have been the "Great Upgrade," because most of those who quit their jobs were looking to find a better job rather than leaving the labor force. Moreover, improved technology has made it easier for employees to find a new job, and although concern about a recession may make employees reluctant to leave their current jobs, retaining good employees continues to be a key priority for business owners.

Why are employee retention plans important? Losing employees imposes substantial replacement costs on a business.

Ramp up costs - The longer people work at a job, the more proficient they become at performing it. They learn about the products, the systems, and how to work together. They do the job more efficiently, make fewer mistakes, and build a team environment. In other words, they are appreciating assets. When experienced employees are lost, this process must start all over again.

Recruiting costs - Recruiting new employees is expensive and time consuming. Expenses can include fees paid to advertising agencies, screening, background checks, interviewing, entertaining, and sign-on bonuses. According to the Society for Human Resource Management, the average cost just to recruit a new hire was almost $4,700 in 2021 and the process took an average of 41 days.

Training costs - When experienced workers leave, they take their knowledge, skills, and institutional memory with them. These attributes may be difficult or impossible to replace. Using experienced workers to train new workers reduces the productivity of the current workforce and outside training also may be required.

Costs of Employee Retention

On the other hand, there may also be important costs to keeping key staff members. When employees are with a company for many years, they expect annual raises and benefits. Over time, these salaries and benefits might exceed their value to the company. A new hire with a more recent education and a lower salary might provide more productivity at a lower price. Nevertheless, employee retention continues to be a key issue for businesses.

Why do employees look for other opportunities?

Exit interviews reveal that the primary reason workers leave is inadequate compensation, both for present needs and for retirement. Other reasons include:

- Limited opportunity for career advancement.
- The desire for a better work/life balance.
- Unhappiness with management.
- Feeling overworked or under-appreciated.
- Lack of competitive perks and benefits.
- Concerns about the company's future.
- Better opportunities at other companies.
- Lack of recognition.
- Lack of job security.

Employee retention plans are structured to address these common concerns. Effective plans may include some of the following elements:

- Opportunities for professional development and career advancement.
- Flexible work arrangements.
- A positive and supportive work culture.
- Seeking feedback about employee concerns and addressing the concerns promptly.
- Providing team building activities.
- Providing perks like snacks, free lunches, wellness programs, relaxed dress codes, or gym memberships.

- Incentive bonuses.
- Training managers to act as mentors for employees.
- Giving workplace awards.
- Promoting from within.
- Providing childcare support.
- Emphasizing teamwork.

Non-Qualified Deferred Compensation Plans

A non-qualified deferred compensation (NQDC) plan is any plan that allows an employee to earn salary or bonuses in one year but defer receipt of the income and the tax on that income to a later year. This may enable the employee to reduce taxable income in high earning working years and defer it until the employee is in a lower tax bracket after retirement. The employer gets a tax deduction in the year the employee takes the deferred amount into income.

These strategies for retaining employees are complex and require more extensive knowledge. The following is provided to help financial professionals understand both the benefits and the potential disadvantages of NQDC plans.

Deferred Compensation Plans

NQDC plans include supplemental executive retirement plans (SERPs), Restricted Stock Units (RSUs), stock appreciation rights (SARs) and phantom stock plans. They are designed for high earners for whom qualified plans like a 401(k) don't provide the desired level of retirement income.

There are two general categories of NQDC plans, elective and non-elective plans.

Elective plans are initiated by employees who elect to defer compensation that would otherwise be received currently. Non-elective plans, also known as "golden handcuffs," are initiated by employers and structured as fringe benefits.

NQDC Plans vs. Qualified Plans

NQDC plans provide important advantages for employers compared with qualified plans. One advantage is that they offer greater flexibility. Unlike qualified plans, NQDC plans have no non-discrimination rules so they can be offered only to highly compensated employees. They also improve a company's current cash flow because compensation payments can be deferred. The company can get a return on the funds between the date they are credited to the employee and the date they are paid. The company's tax deduction for the payments is also deferred.

For employees, NQDC plans have both advantages and disadvantages compared with qualified plans. The most important advantage is that, unlike qualified plans, there are no contribution limits. A second advantage is that they aren't subject to qualified plan funding and reporting requirements.

The disadvantages for employees are that, first, distributions must be scheduled in advance and cannot be taken before the designated date. Second, NQDC plans do not have ERISA protections from creditors. Third, to provide tax deferral, the NQDC plan must be unfunded, appearing only as a liability on the employer's balance sheet. If the employer's financial condition deteriorates, the employee may have to stand behind other creditors and the NQDC amount may never be paid.

Stock Options

One of the best ways to encourage employees to stay with a company and to make it profitable is to offer stock options that reward employees for increases in the company's value. Two kinds of options can be offered, incentive stock options and non-qualified stock options.

Although a detailed discussion of how these options work is beyond the scope of this article, their basic tax consequences are summarized below.

Incentive Stock Options (ISOs)

ISOs are employee stock options subject to special tax rules under Internal Revenue Code Section 421. The tax consequences are as follows:

- Grant—No tax consequences .
- Exercise—No regular income tax consequences. May be subject to alternative minimum tax (AMT).
- Sale of underlying stock—Capital gain equal to sale price minus exercise price.

Example

Ellen is a taxpayer in the 20% capital gain tax bracket.

At a time when employer stock is selling for $200/share, her employer grants Ellen incentive stock options giving her the right to buy its stock at $200/share.

Two years later, when the stock is worth $300, Ellen exercises the option by paying the option price of $200.

She sells the stock for $500 three years later.

Ellen:

- Has no gross income when the option is exercised.
- Recognizes capital gain on the sale of $300 ($500 amount realized, less $200 option price).
- Pays a capital gains tax of $60 (20% of $300).

The employer has no deduction at the time of exercise or sale.

Non-Qualified Stock Options (NQSOs)

A NQSO is any option granted to an employee for services rendered that don't qualify as incentive stock options. They have the following tax consequences:

- Grant—No tax consequences unless option has ascertainable value (which is rarely the case).
- Exercise—Ordinary income equal to full market value (FMV) minus exercise price.
- Sale of underlying stock—Capital gain equal to sale price minus exercise price.

Example

Everett receives an NQSO with a strike price of $100 on July 2, 2023. Everett's combined state and local ordinary income tax rate is 40% and his combined state and local long-term capital gains rate is 20%.

Everett exercises the option on July 2, 2024. The FMV of the stock on this date is $120. Everett recognizes $20 of ordinary income as of the date of exercise. There are no further tax consequences until the underlying stock is sold.

Everett sells the stock on July 3, 2025, when the FMV of the stock has increased to $200. At this time, Everett recognizes capital gain equal to the difference between the amount of the sale proceeds ($200) and his basis in the stock ($120), or $80.

Thus, Everett has $20 of ordinary income and $80 of capital gain. The total tax payable is $24 [(0.4 x $20) + (0.2 x $80)].

Conclusion

The historically strong current labor market with unusually low unemployment has given employees increased bargaining power and improved job search technology has made it easier for them to find new employment. This seller's market for labor and the high cost of replacing employees have made employee retention plans more important than ever.

The reason for leaving a job may not always be the desire for greater compensation, but any time a key employee departs, it's costly for the business. Offering deferred compensation and/or stock options can keep employees happier in their current roles and thereby support mutual success.

About the author.

Robert S. Keebler is partner at Keebler & Associates, LLP, and was named by CPA Magazine as one of the Top 100 Most Influential Practitioners in the United States. His practice includes family wealth transfer and preservation planning, charitable giving, retirement distribution planning, and estate administration. Bob frequently represents clients before the National Office of the IRS in the private letter ruling process and in estate, gift, and income tax examinations and appeals. He has authored many articles, columns, books, and treatises on wealth transfer and taxation, and has been a speaker at national estate planning and tax seminars for more than 20 years.

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