Accounting guidelines for Deferred Compensation – SERP plans

The accounting principles that apply to this deferred comp plan are outlined below. Employers should consult with their accountants and tax advisors to determine the accounting treatment that will be used for financial reporting for their particular plan.

With for-profit employers, accounting for this deferred comp plan is made up of two separate sets of entries:

1. The first set of entries is to account for deferred comp as compensation expense and to record the deferred comp account(s) as a liability.
2. The second set of entries is to account for the informal financing of the deferred comp plan using life insurance policies.

GAAP guidelines

The Financial Accounting Standards Board (FASB) is responsible for establishing non-governmental U.S. Generally Accepted Accounting Principles (GAAP). Effective for accounting periods ending after September 15, 2009, the FASB Accounting Standards Codification (ASC Codification) is the single source of authoritative U.S. GAAP. For convenience, these accounting guidelines include both pre- and post-codification references to GAAP.

Expense and liability

Deferred comp accounts are contractual obligations from the employer to pay the key employee(s) in the future and are treated as a long-term liability. This plan liability is accounted for under "Compensation – General" at ASC 710-10-25 (APB 12).

Life insurance

If corporate-owned life insurance (COLI) is used to informally finance a deferred comp plan, ASC 325-30-35 (TB 85-4 and EITF 06-5) entitled "Accounting for Purchases of Life Insurance" should be your reference.

The employer owns the contract, pays the premium, and records the policy as a corporate-owned asset according to ASC 325-30-35 (TB 85-4 and EITF 06-5) and FASB Technical Bulletin No 85-4. In this plan, the employer may offer a pre-retirement death benefit for the key employee through the use of an endorsement split dollar arrangement. (Please see Endorsement Split Dollar Accounting) for journal transaction examples for this feature.) The employer must meet the notice and consent requirements of IRC Section 101(j). Each year the company must file a completed IRS form 8925 and include its employer-owned life insurance policies.

Income taxes (SFAS 109)

The deferred comp liability is an expense that's deductible for tax purposes, but only when it's paid to the key employee. The liability would be grouped with all other deductible temporary differences to compute the deferred tax asset. However, flow-through entities (S corporations and partnerships), do not record a deferred tax asset. Owners will receive tax benefits at the time the deferred comp payments are paid to the key employee.

The deferred tax asset is accounted for under ASC 740-10-25 (SFAS 109). A deferred tax liability is recognized for temporary differences that result in taxable amounts in future years. These deferred tax accounts are based on ASC 740-10-25 guidance.

Expense and liability entries

Journal transaction example

The following hypothetical examples are for illustrative purposes only.

1. The employer that is a C corporation contributes $100,000 for the benefit of the key employee, and the employer then sets up and credits a deferred comp liability account and debits a salary or deferred comp expense account.
2. Accounting for the earnings credited to the deferred comp account, assuming a hypothetical 4% rate of return. This cost may be partially or fully offset by the earnings in an employer-owned life insurance policy used to informally finance the plan.
3. Paying out the key employee with cash and closing out the deferred comp liability account. The payment is currently deductible for tax purposes, which closes the deferred income tax asset.

	Balance Sheet		Income Statement	
Expense and liability entries	**Debit**	**Credit**	**Debit**	**Credit**
1. Creating the deferred comp account Salary expense			$100,000	
Deferred comp liability		$100,000		
2. Crediting earnings to the deferred comp account Deferred comp expense			$4,000	
Deferred comp liability		$4,000		
3. Distributing the deferred comp liability account to the key employee and closing the accounts Deferred comp liability	$104,000			
Cash		$104,000		

Journal transaction example

1. The employer may book the tax effect (assuming a 25% combined federal and state tax rate ($100,000 x .25 = $25,000) of the deferred income tax asset. Cash is decreased because $25,000 in tax was paid on the $100,000 contribution (since the contribution is not deductible in the current year.
2. The employer may book the tax effect (assuming a 25% combined federal and state tax rate ($4,000 x .25 = $1,000) of the increase in the deferred comp account, but since it is not currently deductible, it increases the deferred income tax asset.
3. Paying out the key employee with cash and closing out the deferred comp liability account. The payment is currently deductible for tax purposes, which closes the deferred income tax asset.

	Balance Sheet		Income statement	
Tax effects	**Debit**	**Credit**	**Debit**	**Credit**
1. Nondeductible deferred comp expense Deferred income tax asset	$25,000			
Cash		$25,000		
2. Nondeductible effect of earnings credited to the account Deferred income tax asset	$1,000			
Tax expense				$1,000
3. Deductible effect on the distribution Cash	$26,000			
Deferred income tax asset		$26,000		

Journal transaction example for financing the deferred comp plan

1. Employer contributions are used to pay a premium into the life insurance contract.
2. The cash surrender value (CSV) is accounted for as an asset and offsets the life insurance premium expense.
3. The employer can withdraw money from the CSV in the form of a surrender or loan and deposit into employer cash to pay a deferred comp benefit to the key employee.
4. When the key employee dies, the employer receives the death benefit proceeds and recognizes the non- taxable income and closes the CSV account.

	Balance Sheet		Income Statement	
Life insurance entries	**Debit**	**Credit**	**Debit**	**Credit**
1.Employer pays premium into insurance contract				
Life insurance premium expense			$42,000	
Cash		$42,000		
2. CSV in the insurance contract				
Life insurance CSV	$42,790			
Life insurance premium expense				$42,790
3. Partial withdrawal of CSV (Surrender or loan) and deposit into cash				
Cash	$10,000			
Life insurance CSV		$10,000		
4. Insured key employee dies at end of year with $1,000,000 death benefit				
Cash	$967,210			
Life insurance proceeds				$967,210
Cash	$32,790			
Life insurance CSV		$32,790		

Tax effects

1. No tax effect-Life insurance premiums are not tax deductible.
2. No tax effect-Life insurance cash values grow tax-deferred.
3. No tax effect-Return of cost basis from a life insurance policy is non-taxable.
4. No tax effect-Proceeds from death benefits are non-taxable.

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