Key Employee Retention Plans:
A Fort Worth Owner's Guide

How closely-held business owners can retain critical non-family talent without opening the cap table.

Palmer Wealth Group™ *August, 5, 2026*

Every closely-held business owner we work with can name the two or three people whose departure would seriously wound the company. A chief operating officer who runs the plant. A controller who understands the books cold. A rainmaker whose client relationships are personal. In today's job market, competitors are increasingly willing to offer real equity to poach top talent, and structured employee retention programs give owners a way to counter without opening the cap table. (The capitalized term "Key Employee Retention Program" refers to a distinct court-approved arrangement used in Chapter 11 bankruptcy under Section 503(c) of the Bankruptcy Code, which governs retention payments during a corporate restructuring process and requires Court Approval; that is not what we address here.)

Why Key Employee Retention Plans Matter for Fort Worth Owners

The Cost of Losing a Critical Non-Family Employee

Gallup research published in 2019 estimated that voluntary employee turnover costs U.S. businesses approximately $1 trillion each year. The Society for Human Resource Management places the replacement cost of an individual employee at 50% to 200% of that person's annual salary, with C-suite employees and specialized roles at the high end of the range. Owners who conduct exit interviews when key employees resign often discover that compensation structure, not company culture, drove the decision.

Why Real Equity Is Often the Wrong Tool for Closely-Held Firms

Most owners of closely-held businesses have durable reasons for keeping the cap table closed. Real equity dilutes voting control, introduces minority-shareholder rights, and creates potential valuation disputes at every future capital event. It can also complicate an eventual sale, trigger securities-law obligations, and create tax friction for the recipient. Pearl Meyer, an executive-compensation consultancy, notes that private companies typically favor cash-settled vehicles to preserve control while still delivering long-term upside. Owners focused on running the business often under-invest in structured retention design, a pattern we examined in [The Entrepreneur's Blind Spot](#).

How Closely-Held Companies Actually Structure Long-Term Incentives Today

Talent management for a closely-held business rests on more than one lever, but compensation is the lever most often mispriced. WorldatWork's 2021 survey of privately held companies found that among firms offering long-term incentives, 65% used performance or cash plans, 36% used real equity, 21% used nonqualified deferred compensation (arrangements that pay compensation in a later year than it is earned), and 15% used phantom equity (contractual awards that track company value without transferring shares). Industry estimates from FMI Corporation indicate phantom equity appears in roughly 19% of private-company plans, rising to 29% among family-owned firms. The Plan Sponsor Council of America's 2025 survey found nonqualified deferred compensation participation reached 70% of eligible executives, up from 61.2% in 2024. In its 2024 survey, 85.2% of sponsors cited a competitive benefits package as the primary reason, and 59% cited retention of top talent.

The Three Building Blocks: Phantom Stock, SERPs, and NQDC

Phantom Stock: Cash-Settled Value Without Dilution

Phantom stock is a contractual promise to pay an employee a cash amount tied to the value of the company at a future date or event. It transfers no shares, confers no voting rights, and produces no dilution. According to RSM US, phantom units come in two forms. Full-value units pay the entire value of a hypothetical share at the payout event. Appreciation-only units pay only the increase in value from grant to payout. Both are settled in cash and taxed as ordinary income when paid.

Supplemental Executive Retirement Plans (SERPs): Employer-Funded Deferred Benefits

A SERP is an employer promise to pay an executive a defined benefit or account balance at a future date, usually retirement. Unlike a qualified pension, the SERP is an unfunded, unsecured contractual promise. If the company sets money aside, those assets typically remain reachable by the company's general creditors. SERPs are usually structured as top-hat plans, limited to a select group of management or highly compensated employees. They can restore benefits lost to qualified-plan contribution caps, layer benefits on top of a 401(k), or reward long service.

Nonqualified Deferred Compensation (NQDC): Voluntary Salary and Bonus Deferral

An NQDC plan allows a select group of executives to defer salary or bonus into a future tax year, with earnings credited on the deferred balance. The Plan Sponsor Council of America's 2025 survey found participants deferred an average of 10% of base salary and 23% of bonus pay. Nearly 80% of sponsoring employers contribute, with roughly half offering a "restoration match" that replaces the match lost when compensation exceeds qualified-plan limits. NQDC is not subject to the annual dollar caps that apply to 401(k) plans. More than 90% of sponsors setting assets aside use a rabbi trust as the funding vehicle.

Table 1. Comparison of Key Employee Retention Vehicles

Feature	Phantom Stock	SERPs	NQDC
Primary purpose	Reward long-term value creation	Provide retirement income above qualified-plan limits	Enable pre-tax deferral above 401(k) caps
Primary funder	Employer promise	Employer promise	Employee deferrals; employer contributions optional
Owner dilution	None	None	None
Employee taxation	Ordinary income at payout	Ordinary income at payout	Ordinary income at distribution
Section 409A applies	Yes	Yes	Yes
Typical vesting	3 to 5 years, cliff or graded	Service-based, often 5 to 10 years	Employee deferrals typically 100% vested
Best fit for	Sharing value with key non-family executives	Retaining senior executives through retirement	High earners who have maxed qualified plans

The Regulatory Framework That Shapes Plan Design

Section 409A: The Six Distribution Triggers and the 20% Penalty

Internal Revenue Code Section 409A governs virtually all nonqualified deferred compensation, including SERPs, phantom stock, and stock appreciation rights. Distributions are permitted only on six events:

- Separation from service
- Disability
- Death
- Change in control
- Unforeseeable emergency
- A specified time fixed at the deferral election

Deferral elections generally must be made before the beginning of the year in which the compensation is earned. Section 409A requires both documentary and operational compliance. According to Meridian Compensation Partners and IRS Publication 5528, a compliance failure accelerates income tax on all vested deferrals, adds a 20% additional tax, and adds premium interest, all payable by the executive rather than the employer.

ERISA Top-Hat Exemption and the DOL Filing Owners Miss

Under ERISA, unfunded plans maintained primarily for a select group of management or highly compensated employees are exempt from ERISA's participation, vesting, funding, and fiduciary-responsibility rules, the fiduciary duties that otherwise apply to qualified plans. To qualify for the annual Form 5500 filing exemption, the sponsor must file a one-time top-hat statement with the Department of Labor within 120 days of the plan's effective date under DOL Regulation 2520.104-23. Electronic filing has been mandatory since August 16, 2019. There is no regulatory definition of "select group," making it a facts-and-circumstances determination. Per the 2020 DOL ERISA Advisory Council report, failing to file the top-hat statement can subject the plan to ERISA's full reporting requirements.

FICA Timing, Employer Deduction, and the Section 457(f) Confusion

Under the FICA special timing rule at Treasury Regulation Section 31.3121(v)(2)-1, deferred compensation is subject to Social Security and Medicare taxes at the later of when services are performed or when there is no substantial risk of forfeiture. FICA is often paid at vesting, years before income tax is due at distribution. A non-duplication rule prevents the same amounts from being taxed for FICA again at payout. The employer's income-tax deduction is timed to the year the executive includes the amount in gross income. Section 457(f), which some owners confuse with SERPs, applies only to governmental and tax-exempt employers. This article is educational and not tax or legal advice.

Funding, Vesting, and Payout Mechanics

Rabbi Trusts and Corporate-Owned Life Insurance as Informal Funding

A rabbi trust is a grantor trust used to informally fund a nonqualified plan, with IRS model language provided in Revenue Procedure 92-64. Its defining feature is also the source of a common misconception: assets held in a rabbi trust remain subject to the claims of the employer's general creditors in a Chapter 11 or Chapter 7 filing. Participants hold an unsecured contractual right, not a preferred claim on trust assets. IRS Notice 2000-56 confirms that offshore rabbi trusts trigger taxation under Section 409A(b). Corporate-owned life insurance is the leading informal funding vehicle for NQDC obligations, used by roughly three-quarters of plans that set assets aside, per PLANSPONSOR and Newport survey data.

Vesting Schedules and Payout Triggers That Actually Retain

Phantom stock and NQDC vesting schedules typically range from three to five years, structured as cliff vesting (100% at a fixed date) or graded vesting (equal annual tranches, often 25% per year with a one-year cliff). According to Sofer Advisors and RSM US, awards can be time-based, performance-based, or both. Common payout triggers include separation from service, change in control (defined at Treasury Regulation Section 1.409A-3(i)(5) as a greater-than-50% ownership shift, a greater-than-30% effective-control shift, a board-majority change within 12 months, or a sale of substantial assets), a specified date, and death or disability. Unvested units are typically forfeited on voluntary departure, termination for cause, or breach of restrictive covenants.

Managing the P&L and Cash-Flow Impact at Payout

Phantom stock and full-value NQDC create a balance-sheet liability that grows as the company grows. That obligation becomes a cash payment at the payout event, which can strain liquidity when the company least wants it. Sofer Advisors and Pearl Meyer both note that phantom stock is most practical for companies with predictable cash flow or a defined liquidity event able to fund the payout. Owners should model the projected liability under reasonable growth assumptions before adopting a plan.

Common Missteps and When Simpler Alternatives Win

The Misconception That Phantom Stock Creates Real Dilution (and the Tax Mistake)

Owners often assume phantom stock behaves like real stock. It does not. Phantom units transfer no shares and create no dilution. The tax treatment is also different from that of incentive stock options (ISOs). Phantom stock and NQDC payouts are taxed as ordinary income when paid, with a matching ordinary-income deduction to the employer. There is no capital-gains treatment regardless of holding period. Because phantom stock is cash-settled, it also avoids the concentration risk that comes with real equity, a topic we cover in Managing Concentrated Stock Positions.

When a Rolling Cash Retention Bonus Outperforms a Formal Plan

Not every closely-held business needs a formal deferred-compensation structure. Compensation is only one lever, and it works alongside employee engagement, performance management, career development, and the broader employee experience the company delivers day to day. Investment in employee development and employee well-being through training programs and a disciplined onboarding process reduces pressure on any single retention tool. For smaller companies, a deferred cash retention bonus can deliver comparable retention with less administrative cost. Industry publications including NASBP and EP Wealth describe rolling bonus structures, such as paying 50% of an annual bonus on a three-year rolling ladder, as a legitimate competing option. A qualified financial professional can help model the trade-offs.

How Section 409A Penalties Fall on the Executive, and Why Documentation Matters

The most consequential compliance risk in this area is that Section 409A penalties fall on the executive. The plan meant to reward the key employee can trigger the tax bill that punishes them. We coordinate with qualified ERISA attorneys and tax advisors when designing these structures to help reduce the risk of an inadvertent Section 409A failure.

Coordinating Retention Design with the Rest of Your Wealth Plan

How NQDC Coordinates with 2026 Roth Catch-Up Rules and Qualified Plan Design

Under SECURE 2.0, participants age 50 and older who earned more than $145,000 (adjusted for inflation) in the prior year must make 401(k), 403(b), and governmental 457(b) catch-up contributions on a Roth (after-tax) basis, effective for the 2026 plan year. That change removes some of the pre-tax capacity high earners previously relied on. NQDC remains uncapped and pre-tax at the participant level, subject to the plan's terms and Section 409A rules. Coordinating an NQDC plan with the company's 401(k) is a Commercial Wealth conversation we routinely have with owner-CEOs, and it dovetails with our overview of 401(k) solutions and exit planning for business owners.

How Retention Planning Connects to Eventual Exit and Succession

A key employee retention plan is often the bridge between the owner-led business and the institutional business that survives an eventual sale process or a formal succession plan. Change-of-control provisions directly affect deal economics, and buyers routinely require the seller to address them before closing. Owners who build the second layer of leadership early tend to receive stronger valuations at exit. We explored that theme in Building Institutions That Outlast Their Founders, and it recurs across the sub-ultra-high-net-worth families we serve in The $5–30 Million Gap.

Frequently Asked Questions

Q: Does phantom stock dilute company ownership?

Phantom stock does not dilute company ownership. A phantom stock plan is a contractual promise to pay a cash amount tied to the value of the company at a future event, and it transfers no shares. Existing owners retain their full ownership percentage, voting rights, and share of distributions. According to RSM US, phantom stock delivers value-linked upside without changing the cap table. Owners can grant phantom units to non-family executives without triggering minority-shareholder rights or complicating a future sale process.

Q: Does a rabbi trust protect key employees if the company goes bankrupt?

A rabbi trust does not protect key employees if the company becomes insolvent. Assets held in a rabbi trust remain subject to the claims of the sponsoring employer's general creditors in bankruptcy, per the IRS model language at Revenue Procedure 92-64. Participants hold an unsecured contractual right, not a preferred claim on trust assets. A rabbi trust protects the employee against a change of heart by the company or a hostile change of control. It does not shield the benefit from creditor claims in Chapter 11 or Chapter 7 proceedings.

Q: How is phantom stock taxed compared to stock options?

Phantom stock is taxed as ordinary income to the employee when paid, with a matching ordinary-income deduction to the employer. There is no capital-gains treatment regardless of how long the units are held. Incentive stock options (ISOs) can qualify for long-term capital-gains treatment if the recipient meets specific holding-period requirements. Nonqualified stock options are taxed as ordinary income at exercise on the spread between the exercise price and fair market value. Per RSM US and Sofer Advisors, this difference is a common point of confusion for owners weighing phantom stock against option-based alternatives.

Q: What is the penalty for a Section 409A violation?

A Section 409A violation accelerates income tax on all vested deferred amounts, imposes a 20% additional tax on those amounts, and adds premium interest, all payable by the executive rather than the employer. IRS Publication 5528 and Meridian Compensation Partners confirm these penalties. Section 409A requires both documentary and operational compliance, meaning the plan document must be correctly drafted and administered exactly as written. A documentation error alone can trigger the penalty even without an operational failure. Because the penalty falls on the executive the plan was designed to reward, correct drafting and disciplined administration are essential.

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No representation is made that any strategy discussed will produce specific results. Outcomes from key employee retention plan design depend on plan terms, company financial condition, executive behavior, market conditions, and regulatory change, among other factors.

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Research Methodology: *This article was prepared with the assistance of AI tools that supported research synthesis and initial drafting. AI tools do not exercise professional judgment and may have gaps in current regulatory or market information. All content was independently reviewed by qualified Palmer Wealth Group™ professionals. The analysis and guidance expressed here represent the professional judgment of Palmer Wealth Group™, not AI outputs. Palmer Wealth Group™ assumes full editorial and compliance responsibility for this content.*