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THE COMMUNICATOR

BUSINESS USES OF DISABILITY INSURANCE

Wage/Salary Continuation Plans (a.k.a. qualified sick pay plans) Part I

WARNING!

Getting sick or hurt can cost a person his/her job!

Salary or Wages paid to a disabled employee who is disabled and therefore not currently performing services for the employer are not deductible as a business expense - - - - unless the firm had a *Qualified Salary Continuation Plan* in force prior to the disablement of the employee.

A person not covered by a *Qualified Salary Continuation Plan* before disability begins is considered an EX-EMPLOYEE. Money paid to an EX-EMPLOYEE is not considered salary or wages and therefore is not a deductible business expense to the firm. The money received by the EX-EMPLOYEE is described by the Federal Tax Court as “Ad Hoc Payments”, or payment without a plan and are therefore subject to taxation as gifts or dividends.

A case in point.

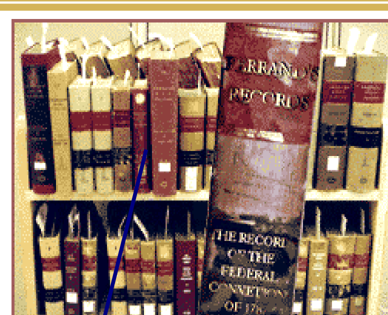
Estate of Chism v. Comm., T.C. Memo 1962 – P-H ¶ 62,006; Affirmed, 322 F.2d 956 (9th Cir. 1963)

This landmark Tax Court decision Dramatically demonstrates the need for a business firm to establish a Qualified Salary Continuation Plan.

In this case, the Tax Court agreed with the IRS and ruled that the Chism Ice Cream Co., which had no formal sick pay plan, be Denied a tax deduction for the salary paid to a disabled shareholder/employee because:

1. ***The plan was not set up in advance;***
2. ***The details of who received what, beginning when, and for how long were not communicated to the employees; and***
3. ***The details of the plan were not put in writing.***

As a result, the firm had to pay five years of additional corporate income tax, plus interest and penalties



Estate of E. W. CHISM, Deceased
Clara Chism, Executrix, and Clara Chism, Petitioner,
vs.
COMMISSIONER OF INTERNAL REVENUE,
Respondent
U.S. Court of Appeals,
Ninth Circuit

And the Estate of the deceased employee was assessed back taxes and interest on the payments received from the firm. It was reported that the combined collections by the IRS from the Estate and the Chism Company nearly exceeded the money paid to the employee during his five years of disability.

A BUSINESS FIRM HAS SOME CHOICES

1. An employer can do nothing. If this be the choice, the employer is limited to paying salary or wages to a disabled employee only for the firms sick leave period (usually five days per year), and any incurred but unused vacation time, (usually 10 days per year). Upon exhaustion of any unused sick leave and vacation time, and if there is no existing *Qualified Salary Continuation Plan* in effect, the employer is faced with recognizing the disabled person as an EX-EMPLOYEE and making no more sick leave payments to the former employee, or making some payments which are categorized by the IRS as "Gifts" or "Dividends". Gifts and dividends are not tax-deductible business expenses; the employer loses. The "gift" or dividends" receive by the EX-Employee are taxable as income to the employee.

2. **Establish A *Qualified Salary Continuation Plan***

- The Plan must be adopted by the Partners in a Partnership or by the Board if a Corporation and a written recording of such agreement placed in the firms file or minute book.
- A Plan Letter describing the Plan should be delivered to each employee. The rules may differ for different classes of employees. If insurance is to be implemented, the policy or certificate should be attached and the firms Employee Handbook should be updated to include the plan.
- Disability Insurance designed to fund the Salary Continuation Plan is optional. The Employer may decide not to provide an insurance plan, or to provide an insurance plan to certain employees, or to provide an insurance plan to all employees.

OTHER CONSIDERATIONS

1. The adoption of an employer provided *Qualified Salary Continuation Plan* commits the employer to continuing payments for a prescribed period of time whether funded by disability insurance or not. In a sense the employers now is in the disability insurance business, liable for the benefits, but not receiving premiums. An employer may feel bullish about paying benefits out of cash flow feeling only one employee at a time will be disabled. This is hopeful thinking. Employees go to lunch together, play golf and go bowling together

and often they travel together. Multiple injured persons from a car wreck could strap the firm with multiple payments over many months.

As opposed to assuming such pulverizing risks, the disability insurance required to fund the plan is available at reasonable, budgetable costs.

2. Or, the Employer may sponsor a voluntary insurance plan in which the employer provides the convenience and service of payroll deduction of premium and a multiple lives premium discount. The plan design could be pre-set or subject to individual choices. This is a personal insurance plan, paid for by the employee with tax-free benefits flowing to the employee at claim time. Under this concept, the Employer should distribute the fact that there will not be any Salary Continuation for disabilities that last longer than accumulated sick leave plus vacation time. The Employer is incurring the expense of payroll deduction administration and by sponsoring a multiple lives plan, the firm is affecting a discounted premium for the advantage of the employees.
   The Employer can pay all, or part of, the premium for a disability plan, deduct the payment as a business expense and the employee does not include the paid premium as taxable income. Employee will pay tax on benefits received from any Plan or portion thereof that is paid and gifted to the employee. The employee received tax-free benefits on the plan, or portion of a plan on which he/she paid the premiums personally.

TAX ADVANTAGE

Premium on Policy	$2,000 annually
Corporate Tax Bracket – 39%	800
Net Cost to Corp.	$1,300

Benefit to Employee @ $4,000 month

25 years	$1,200,000
20	$ 960,000
10	$ 480,000
5	$ 240,000
2	$ 96,000

Even a 2 year plan is a big benefit.

ESTABLISHING A SALARY CONTINUATION PLAN

If a firm wishes to provide a "SALARY CONTINUATION PLAN" and such plan is maintained only informally, a tax burden may be placed on the business in addition to the financial burden of continuation of non deductible payments to a disabled employee.

Under the tax laws, Compensation paid to employees is deductible as a business expense, but, money given to a disabled employee is not compensation because the employee is no longer rendering services to the employer in return for those funds.

Unless the payments are made under a formal *Qualified Salary Continuation Plan*, such payments are not deductible and must be paid with after tax dollars.

To establish a *Qualified Salary Continuation Plan*, the plan must be:

☒ Established before a disability occurs,
☒ In writing, and
☒ Communicated to the employee
☒ It does not have to be insured

Payments made without a formal sick pay plan in effect are 1) not a deductible expense to the Employer and 2) subject to taxation of the Employee.

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