



EMPLOYEE BENEFITS

Having a qualified sick-pay plan in place can keep companies from falling into a tax trap.

# "Planning" for DISABILITY

BY KENNETH A. HOROWITZ

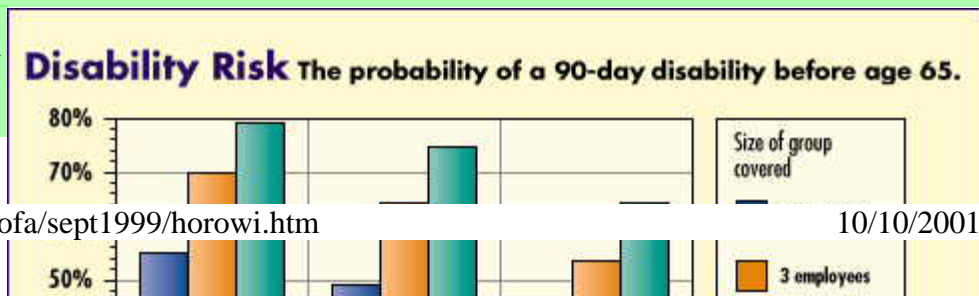
EXECUTIVE SUMMARY

- A BUSINESS THAT WANTS TO CONTINUE PAYING WAGES to a key employee in the event of sickness or disability can do so only under an IRC section 105 qualified sick-pay (QSPP). If a business doesn't have such a plan in place, wage payments are not tax deductible
- IRC SECTION 105 ALLOWS A BUSINESS OWNER TO cover selected employees and to vary benefits for employees. This means a company may cover only key employees or some employees a greater percentage of their salary while they are disabled.
- REQUIRED DOCUMENTATION FOR A QSPP IS SIMPLE. It includes a plan resolution and a plan letter informing employees of the details of the plan.
- AFTER ADOPTING A QSPP, A BUSINESS MUST DECIDE if it wants to self-insure or transfer the risk. If the company elects to transfer the risk to an insurance company, it can do so through a group plan, with policies or a combination of both. Premium payments are tax deductible.
- WITH THE AVERAGE DISABILITY LASTING THREE YEARS for men and almost four years for women, having a QSPP in place is for a business. Most companies could not sustain the potential loss of revenue, profit and productivity if a key employee was disabled for long period of time and unable to work.

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Ask any business owners if they would continue paying their own salary in the event they became sick or disabled and couldn't work, and the answer is likely to be a resounding "Yes." By doing so, however, a company could fall into a tax trap with serious consequences. A Under





IRC sections 105 and 162, a business cannot deduct wages paid to a disabled employee. The key word is wages. IRC section 106 requires that a company pay wages only to employees who render services. However, a company can pay wages to disabled employees under a section 105 qualified sick-pay plan (QSPP), described below. Businesses that have not yet adopted such a plan may wish to do so before disaster strikes and they must sacrifice valuable tax deductions to pay disabled employees.

### IT'S SIMPLE

A QSPP is a simple arrangement that allows a business to continue paying some portion of an employee's wages during disability—and deduct the payments as usual. Any entity (corporation, partnership, professional corporation or sole proprietorship) can establish such a plan; but if you wait until the key employee becomes disabled to do so, it will be too late. For the benefits to be considered wages, the IRC says the company must establish the plan before an employee becomes disabled [see *E. W. Chism Estate v. Commissioner*, 322F. 2nd 956 (9th Cir. 1963)]. Under ERISA, the plan must be in writing, and each covered employee must be aware of its terms. Fortunately, the required documentation is not complicated, and many insurance companies have prototype documents available for a company's legal counsel to use in drafting the plan. If more than 100 employees are to be covered under the sick pay plan, then the plan documents must be filed with the Department of Labor. Otherwise, the documents are kept on file in the company's offices and included in the corporate minutes.

### LIFE WITHOUT A QSPP

According to the IRS, the status of a disabled employee in a company without a QSPP is that of "ex-employee." The IRS does not consider any payments the company makes to an ex-employee wages; instead, they are "ad hoc" payments, which are not tax deductible. At age 40, the average duration of a long-term disability is approximately three years for men and almost four years for women. That can be a long time for someone to be out of work without pay. That threat alone should be an incentive for a company to put a plan in place to cover employees who become disabled. In assessing the need for a QSPP beyond securing a tax deduction, business owners—and the CPAs who work for or advise them—should ask themselves these questions:

- What would happen to the business if a key employee was sick or hurt and unable to work?
- Could the business sustain the potential loss of revenue, profit and productivity in the event a key employee was disabled?
- Could the business afford to continue paying the disabled person's salary and pay a replacement—without the benefit of a tax deduction?

Although no one can predict the future, an unexpected disability can create a serious dilemma for most small to medium-size companies. Fortunately, the solution is simple. Adopting a QSPP just formalizes what the business owner would do anyway—pay "wages" to the disabled employee.

### HOW IT WORKS

The requirements for a QSPP include two documents: the plan resolution and a plan letter. Exhibit 1 shows a sample board of directors resolution. Exhibit 2 is a sample of a plan letter. The company first adopts a plan resolution in which it formally creates the QSPP and names the employees who will be covered by the plan. Then the company issues a plan letter to each covered employee defining the extent of benefits under the plan, including

- How much the plan pays.
- When payments begin.
- How long payments last.

For example, a plan may pay all eligible employees—full-time employees with at least one year of service who have been disabled for 30 days—70% of their salary and continue those payments for two years.

**An added bonus.** One of the benefits of a QSPP is the flexibility it offers business owners. Unlike most qualified plans, section 105 allows a company to cover only selected employees chosen at the company's discretion. The level of benefits among covered employees may also vary. Other employees need not be covered at all. For example, the plan can pay employee A 70% of her salary until age 65 and pay employee B 50% of his salary for five years. In this way, a QSPP is similar to a nonqualified retirement plan where benefits are provided only to selected employees without violating ERISA.

**Exhibit 1: Sample Board of Directors Resolution\***

A special meeting of the board of directors of \_\_\_\_\_ was held at \_\_\_\_\_ on \_\_\_\_\_, 19\_\_\_\_, at \_\_\_\_\_ o'clock. The following directors, constituting a quorum, were present: The president of the corporation acted as chairman of the meeting; the secretary of the corporation acted as secretary of the meeting. The chairman stated that the purpose of the meeting was to consider the adoption of Qualified Sick Pay Plans for certain key employees. After due discussion and upon motion made, seconded and approved, the following resolution was duly adopted:

WHEREAS it is the desire of the corporation to establish Qualified Sick Pay Plans for certain key employees by providing any such employee with an income during disability due to sickness or injury, and thereby providing any such employee with an added incentive to continue his or her services to the corporation.

BE IT RESOLVED that Qualified Sick Pay Plans for certain key employees are hereby adopted in accordance with the terms of the forms exhibited at the meeting, attached to these minutes, incorporated herein by this reference and made a part hereof as if fully set out herein, covering the following key employees:

BE IT FURTHER RESOLVED that the appropriate officers of the corporation be, and they hereby are, authorized and directed to take such steps as they deem necessary to establish said Qualified Sick Pay Plan and to make payments from the funds of the corporation each year as may be required thereunder.

There being no further business before the meeting, the same was, upon motion made, seconded and carried, duly adjourned.

\_\_\_\_\_

Dated

\_\_\_\_\_

Secretary

\*Sample for illustration purposes only. Seek the advice of an attorney in preparing an actual resolution.

**Exhibit 2: Sample Plan Letter\***

(Name of employee)

In consideration of your valuable services to the company, the board of directors has approved a Qualified Sick Pay Plan for you in the event you are disabled as the result of sickness or injury.

Your Qualified Sick Pay Plan provides that:

1. During the first month of disability, you will receive your regular wages from this company.
2. If your disability lasts longer than one month, you will then receive the proceeds of policy # \_\_\_\_\_ with the (Insurance Company) which is enclosed with this letter for your safekeeping.
3. Premiums for the policy will be paid by this company while you are employed by it and while the plan is in effect.
4. This company shall be responsible for and have full discretion with regard to the operation and management of the plan and any of its assets, except that the insurance company shall have responsibility with regard to those aspects of the plan which are governed by the terms of the insurance contract.
5. If a request for benefits under item 1 is denied, this company will provide you with a written notice stating the reasons for denial and an explanation of the procedure by which such denial may be reviewed. Upon request for such review, you or your representative will be permitted to review pertinent plan documents and submit issues and comments in writing.
6. If a request for benefits under the insurance contract is denied, you or your representative must contact the insurance company for details and review of such denial.
7. This plan may be amended by a duly authorized vote of the board of directors, and any such amendment shall be effective immediately.

Sincerely yours,

\*Sample for illustration purposes only. Seek the advice of an attorney in preparing an actual plan letter.

**RETAIN OR TRANSFER RISK**

Once a business establishes that wages will continue for certain key employees in the event of their disability, the critical decision is whether the company retains the risk or transfers some portion of it to another entity, such as an insurance company. A company that retains the risk and self-insures generally pays benefits out of company reserves as needed—perhaps from a fund set aside for this purpose. A company that decides to transfer the risk typically obtains disability insurance coverage on covered employees through an insurance carrier.

In deciding whether to self-insure or transfer the risk, there are five basic issues a company should consider. These are described in detail in exhibit 3. A company has the option of insuring through a group plan, with individual policies or with a combination of both. A group policy would identify employees by their occupational class or title. If the owner has no intention of providing coverage for his or her employees, company-sponsored voluntary employee plans are available. At least the employer does a good deed by providing employees with the opportunity to purchase individual insurance policies at a discount through convenient payroll deductions.

**Exhibit 3: Managing the Risk: Insurance and Self-Insurance Issues**

| <u>Consideration</u>  | <u>Self-Insure</u>   | <u>Use Insurance</u>        |
|-----------------------|----------------------|-----------------------------|
| 1. ERISA requirements | Company must provide | The disability policies and |

|   |   |  |
|---|---|--|
|   | summary plan documents (written plan description).  | plandocuments provide the company with acceptable plan documentation.  |
| 2. Claims determination   | Company sets up its own claims department to approve and administer claims.   | The insurance company's claim department administers all claims.   |
| 3. Last payment   | Company determines when the employee is no longer disabled and discontinues benefits.   | The insurance company's claim department monitors whether an employee has fully recovered and when benefits should stop. |
| 4. Cost/Timing  | Company may have to pay large sick-pay plan checks at the worst possible time for the employee-short business.  | The company pays smaller, budgetable premiums.   |
| 5. FASB Statement no. 112, <i>Employers' Accounting for Postemployment Benefits</i> (if the company follows GAAP) | Company must take a charge against earnings for the net present value of all existing benefit claims in addition to the net present value of all future payments. | The insurance company shows any benefits liability on its financial statements.  |

### TAX ADVANTAGES

If the tax advantages of having a QSPP in place—deductible wage payments—are not enough to sell the idea, the tax advantages of funding a plan also make it attractive. Section 162 allows an employer to deduct premiums without having them considered taxable income to the employee. When disability insurance is funded with employer-deductible premiums, benefits are taxable to employees when they receive them. When insurance is provided for S corporation shareholder/employees or to partners and sole proprietors, premiums are not tax deductible. Instead, the benefits they receive will be income-tax-free under IRC section 104 because premiums are paid with aftertax dollars.

In addition to the tax benefits, an insured QSPP offers other advantages.

- The insurance company-provided disability policy or policies and the two plan documents satisfy most ERISA requirements. This is reassuring to businesses that might otherwise shy away from this type of benefit plan because of the complexities of adhering to ERISA.
- The insurance company acts as a claims representative and determines when payments terminate, relieving the company of this burdensome task. This eliminates the need to appoint a plan administrator and fiduciary.
- For a predictable cost, the company transfers the enormous liability of providing disability benefits to an insurance company.

### FILLING THE GAP

Although companies may already carry insurance policies that cover the risk of disability, they still may need a QSPP to provide them with full coverage in the event of disability. A company may wish to have the business pay some portion of an employee's wages under two circumstances:

1. Before insurance policy benefits begin. Under most disability policies, there is usually a waiting period of 30 to 180 days.
2. To replace the 30% to 40% balance of lost wages not paid by insurance policies. A typical disability policy reimburses between 60% to 70% of earnings.

### ADOPTING A FORMAL PLAN

There are many advantages for a company that formalizes a wage-continuation plan for its disabled employees. Most important, by establishing a section 105 QSPP, companies can maintain the tax deductibility of wages paid to disabled employees—resulting in considerable savings. Companies that continue to pay wages without a formal plan are inviting trouble. When a disabled employee files for Social Security disability benefits, alarm bells may start ringing at the IRS. Companies that don't have a QSPP in place may suddenly find tax deductions—past and present—called into question. The result could be costly.

