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A Producer's Guide to Understanding Salary Continuation Plans



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Salary Continuation Plans

Many businesses have become successful because of their key employees. The savvy employer knows they have to take care of these individuals, not only with competitive salaries and incentive compensation, but also in times of need.

Disability due to an illness or accident can be financially devastating. A salary continuation plan shows your employees you care about them.

What is a Salary Continuation Plan?

A Salary Continuation Plan describes in writing, prior to any disability, what employers will do in the event an employee becomes disabled. The employers can decide to do nothing or, with the plan, can continue paying all or part of the employee's salary. Employers usually divide employees into classes so benefits may vary from class to class. Benefits must be consistent within each class.

To confirm the existence of a salary continuation plan, prior to any disability, the plan should be in writing and must be provided to covered employees. While not an absolute requirement, *having the plan in writing protects all parties and is strongly advised.*

How does a Salary Continuation Plan work?

The Plan should specify for each employee class the percentage of salary that will be continued following a disability and for how long. It is not uncommon for corporate business owners to continue to receive 100 percent of their salary for three to six months, followed by 75 percent of their salary for three months, and 60 percent of their salary thereafter until age 65. The funding for such an arrangement would be partially from business earnings and partially from a Standard Insurance Company disability income insurance policy. All these details would be addressed in the Salary Continuation Plan.

In some employee groups, the benefit may be only a few days or weeks of sick pay. A disability income insurance policy from The Standard would begin to pay the salary for a disabled employee after an elimination period. In both cases, the benefit is paid for by the employer with premiums deductible to the business. The cost of this coverage is not considered income to the insured, although the benefits are taxable to the employee.

Before a sale of disability income insurance can begin, ask your business client three questions:

1. Do you have any key employees?
2. Do you have a salary continuation plan?
3. How is the plan funded?

The answers to these questions will help determine which course of action to take.

A salary continuation plan creates a win-win situation.

- The employer builds loyalty and retains key employees.
- The employee feels a sense of caring and appreciation.
- The producer sets the stage for a possible multi-life disability insurance sale.

Salary Continuation Plans may be set up to benefit all employees, including owners in a C corporation. Owners of sole proprietorships, partnerships, S corporations and limited liability companies who are not considered employees are ineligible for benefits under a salary continuation plan.

What happens if an employer does not have a written Salary Continuation Plan?

One of the consequences of not having a written Salary Continuation Plan is that any payments made to an owner/employee may be construed as corporate dividends, non-deductible to the business and taxable to the recipient as ordinary income. Without a written plan in place, payments made to an employee may be considered *ad hoc* non-deductible gift distributions, taxable to the employee. *Ad hoc* payments are those made by employers to sick or injured employees on a *discretionary basis and not according to a pre-existing plan*.

After a disability begins, it is too late to establish a salary continuation plan. Perhaps one of the most difficult tasks for a business owner is delivering the last paycheck to a long-time and trusted employee.

A Salary Continuation Plan forestalls many difficulties.

What happens when a Salary Continuation Plan is established?

When a Salary Continuation Plan is established, it is automatically considered funded by the employer, whether or not there is a source of funding. If disability insurance is not used for at least a portion of the funding, the entire burden of salary continuation payments under the plan falls to the business. Should an unfunded plan be subjected to a valid claim, the requirements of FASB 112 may impact the financial standing of the business and impede or prevent the business from obtaining loans.

What is FASB 112?

FASB 112 is a Statement of the Financial Accounting Standard Board requiring employers who provide self-funded benefits, including salary continuation benefits payable to disabled employees, to recognize and account for those benefits. The requirements of FASB 112 strongly compel an employer to purchase disability income insurance to fund a salary continuation plan.

Would your business clients choose to pay the cost of a qualified insured sick pay plan or would they roll the dice and be subject to FASB 112 and the burden of making disability payments themselves?

What does FASB 112 require?

Under FASB 112, companies that are obligated to pay an uninsured disability benefit to an employee must account for the liability of disability benefits to be paid in the future. This accounting does not address the possibility of recovery or premature death. An uninsured disability benefit obligation then becomes a current liability and an expense equal to the present value of future benefits. This uninsured disability benefit obligation must be accounted for on the company's financial statement.

How FASB 112 would affect an employer

An example: A 40 year old disabled employee who receives a \$5,000 monthly benefit is expected to live to age 65 when a retirement plan might take over. At a present value of five percent, the employer would be required to account for a reserve of more than \$850,000. Most business owners are probably unaware of this potential liability. In addition, the business must pay the benefit to the employee with the resulting negative cash flow impact.

Does FASB 112 have tax effects?

Companies with no qualified sick pay plan receive no tax deduction for disability compensation paid to employees. For shareholder employees, such compensation may be considered a dividend. Compensation paid to non-shareholder employees is considered "ad hoc" or "gift payments" and is not deductible.

If FASB 112 applies to an unfunded plan, the business's auditor would be unable to give an unqualified opinion on the business's financial statements used for credit and other transactions. This may be true even where there is an established qualified sick pay plan, unless the employer is using disability income insurance to fund a portion of the plan.

Not only does insurance satisfy the financial reserve requirements of FASB 112, it provides a set benefit in a cost-effective manner. FASB 112 is another reason why employers should strongly consider insured qualified sick pay plans.

Internal Revenue Code Section 105 allows the establishment of qualified sick pay plans. Section 162 permits deductibility of funds spent on the sick pay plan and Section 106 states that if the plan is funded with insurance the premiums are not considered part of the taxable income of covered employees.

Why is it so important to have a written salary continuation in place before a disability occurs?

Chism Ice Cream Company v. Commission of Internal Revenue¹ is one of many federal tax court rulings that show ad hoc payments are not tax deductible.

E.W. Chism founded Chism Ice Cream Company in 1905 and was the driving force behind the business throughout his life.

Mr. Chism became the primary shareholder of the company when it was incorporated in 1933, and served as president of the company until his death in 1956.

Mr. Chism was seriously incapacitated in 1952 and was no longer able to run the day-to-day operations of the company. Despite his incapacity, the company continued to pay Mr. Chism either the same or increased amounts of salary. Because Chism Ice Cream Company had an informal policy of paying employees while they recovered from illnesses and injuries, the company's management assumed there was a sick pay plan in place. The company continued to deduct the payments to Mr. Chism as a legitimate business expense, and these payments were treated by the company as "salary" on its books and in its corporate income tax returns.

The IRS did not agree. Instead, the Service denied the deductions claimed by the company for post-employment salary paid to Mr. Chism. The company appealed to the Tax Court, which held in favor of the IRS. The Tax Court ruled that no sick pay plan had ever been put in place, no employees had been notified or advised of the existence of any such plan, nor did they have the right to demand benefits under such a plan. In other words, a portion of the "salary" paid to Mr. Chism represented excessive compensation for services rendered, which is not-deductible by the company.

The end result? Instead of deductible salary, the company had paid Mr. Chism non-deductible excessive compensation and dividends from 1952 to 1956. As a result of these non-deductible payments, the IRS collected a combined total of \$45,000 in back taxes, penalties and interest. (This equalled approximately \$312,500 in 2004.)

A long line of Federal court rulings support the IRS position on *ad hoc* payments. The underlying message of these rulings is clear:

- If you intend to deduct payments made to a disabled employee, you need to have a Salary Continuation Plan in place before the payments begin.

¹ Chism v. CIR, T.C. Memo. 1962-6, aff'd 322 F.2d 956 (9th Cir. 1963)

Salary continuation plans:

- Must be set up in advance
- Must be communicated to employees
- Must be authorized in writing by a company resolution or other adequate documentation
- Should be in writing

Why is this ruling so significant?

Substantial additional corporate and personal tax had to be paid in the Chism case because:

- (1) no salary continuation plan was set up in advance;
- (2) the details of who received what, beginning when, and for how long were not communicated to the employees;
- (3) the details of the plan were not put in writing (while the regulations did not require that a plan be in writing, a written plan was *essential* to establishing that a plan existed prior to any disability).

What are some of the other rulings?

In *Larkin v. Commissioner of Internal Revenue*¹, the Tax Court held that payments were not deductible to the employer as payments under a sick pay plan. The court found that no plan had been communicated to employees and the *ad hoc* payments made by the company benefited shareholders rather than employees.

In *Occhipinti v. Commissioner of Internal Revenue*², the Tax Court denied any tax deduction for payments to an employee under a company accident or health plan. The court found that there was complete absence of evidence of a plan, formal or informal, maintained by the company for paying its employees during an illness.

Samples

The following pages include samples of salary continuation plan resolutions, a memo outlining the adoption of a salary continuation plan and a letter notifying an employee that a salary continuation plan is in effect.

These materials are sample documents. Only attorneys who are familiar with your clients' business practices and are knowledgeable about federal and state laws and regulations governing qualified sick pay plans, should draw up salary continuation plan resolutions and other related documents.

1. *Larkin v. CIR*, 48 T.C. Memo. 629, aff'd 394 F.2d 494 (1st Cir. 1968).

2. T.C. Memo. 1969-191.

Sample Salary Continuation Plan Resolution

Resolution of Board of Directors

A special meeting of the Board of Directors of _____ was held at _____ on _____, 20____ at ____ o'clock. The following directors, constituting a quorum, were present: _____

The president of the corporation acted as chairman of the meeting, and 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 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 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, and

WHEREAS a method for accomplishing this purpose is provided for under Sections 105, 106 and 162 of the Internal Revenue Code, the Employee Retirement Income Security Act of 1974 (ERISA), the Tax Reform Act of 1976, the Social Security Amendments of 1983, and all rules, regulations and amendments pertaining to the aforesaid Code and Acts,

BE IT RESOLVED that Sick Pay Plans for certain key employees are hereby adopted in accordance with the aforesaid Code, Acts, rules, regulations and amendments, subject to the terms of the forms exhibited to the meeting, attached to these minutes, incorporated herein by this reference and made part hereof as if fully set out herein, and 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 Sick Pay Plans 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.

Date

Secretary

Sample Salary Continuation Plan Resolution

The undersigned secretary of _____, does hereby certify that:

A special meeting of the Board of Directors of _____, was held at the office of the Corporation at _____, on _____, 20__ at ___ o'clock for the purpose of acting upon a proposal that the Corporation establish a Salary Continuation Plan for certain employees of the firm.

_____ was Chairperson of the meeting and _____ acted as Secretary.

The meeting was called to order by the Chairperson and minutes were recorded by the Secretary. A waiver of notice of the meeting, duly executed and dated _____, 20__ was presented. A quorum of Directors was present.

The Chairperson stated that the purpose of the meeting was to authorize and direct that the necessary steps be taken to place in operation a Salary Continuation Plan for certain valuable employees. Discussion followed, and thereafter, upon motion duly made and seconded, the following resolution was adopted by unanimous vote.

RESOLVED, that the Corporation establish a Salary Continuation Plan to pay the following benefits to the following eligible employees:

Group I Employees: [list employee names]

The Corporation will pay all employees in Group I full (100%) salary for the initial ___ weeks/months of total disability and three-fourths (75%) salary for the next ___ weeks/months of continuing total disability and one-half (50%) salary for the next ___ weeks/months of continuing total disability.

Group II Employees: [list employee names]

The Corporation will pay all employees in Group II full (100%) salary for the initial ___ weeks/months of total disability and one-half (50%) salary for the next ___ weeks/months of continuing total disability.

Group III Employees: [list employee names]

The Corporation will pay all employees in Group III full (100%) salary for the initial ___ weeks/months of total disability and ___ % salary for the next ___ weeks/months of continuing total disability.

BE IT FURTHER RESOLVED, that the Corporation shall satisfy these obligations by purchasing appropriate disability income insurance policies from Standard Insurance Company, on the lives of all eligible employees who are insurable at rates not exceeding _____ % of standard premiums. If an eligible employee is not insurable, the Corporation shall create a sinking fund for future use by periodically contributing an amount equal to _____ % of standard premiums on that employee. Corporate officers are authorized and instructed to pay the premium on all policies as they become due.

Also, any insured employee shall be notified that he or she has the option of having all, or part, of the cost of any such policies on his or her life treated as additional compensation. Should this option not be selected by the employee, it shall be made clear that all premium payments will be made as part of this plan and not treated as additional compensation. Benefits paid to the employee in this case will be taxable.

For purposes of this plan, the definition of total disability shall be as defined in the above policies.

The funds necessary to pay benefits under this plan shall come from disability income insurance contracts and the general assets of the Corporation, as necessary. Each insured employee shall be the Owner and Loss Payee of all insurance contracts purchased under this plan.

Dated _____, 20__ Secretary _____

On this date I have read and understand the above plan and the benefits provided for me.

Dated _____, 20__ Employee _____

Sample Memo

Date:

To: Business File of <Business Name>

Subject: Employee Salary Continuation Plan
(Sole Proprietorship/Partnership)

On _____, 20____, a Salary Continuation Plan was adopted for <Business Name>. As stated in letters the current covered employees (copies attached), full salary will be paid for _____ weeks of total disability caused by a sickness or accident. Following that, nothing will be paid except as might be provided by disability policies written on eligible employees.

<Business Name> will pay the premiums for these disability policies during the continuance of full-time employment of the employee at <Business Name>. When employees leave <Business Name>, they will have the right to assume payment of premiums and to continue this valuable insurance protection on their own.

As new full-time employees join <Business Name>, it is our intent to apply for similar policies on these employees. To the extent the insured portion of this plan is an employee-benefit plan under ERISA, the disability income policy will serve as a summary plan description.

Sample Letter

Date:

Name
Address
City, State, ZIP

Dear _____:

This letter will serve as notification of the disability salary continuation plan in effect for <Business Name>. The Plan's effective date is _____, 20_____.

Under this Plan, <Business Name> will continue your full salary for _____ weeks in the event your sickness or accident causes you to become disabled as defined in the policies issued under the Plan.

Documentation of this sickness by a medical practitioner will be at my discretion. Disabilities lasting longer than _____ weeks will not be compensated by the continuance of salary. After _____ weeks and for the continuation of your disability <Business Name> will pay no continuing salary. After _____ days of total disability as determined by Standard Insurance Company, Portland, Oregon, policy #C_____, disability benefits will be paid according to the terms of the policy. Those benefits are defined in the policy and subject to any exclusions in the policy. To the extent the insured portion of this plan is an employee-benefit plan under ERISA, your policy will serve as a summary plan description.

Premiums for this disability policy will be paid by <Business Name> until further notice. Should you terminate your employment with <Business Name>, you have the right to continue the payment of premiums on this policy on your own.

We are pleased to provide this Salary Continuation Plan for you.

Owner

Date

Received : _____
Employee

Date



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