Understanding Salary Continuation Plans

One of the most difficult challenges an employee can face is becoming unable to work due to an illness or injury. A salary continuation plan can help alleviate financial stress for employees by assuring them that if they become disabled, they will continue to receive at least a portion of their pre-disability income. Salary continuation plans can help build loyalty and assist with employee retention.

The term "salary continuation plan" is often used generically to refer to several kinds of benefits for employees and business owners, ranging from sick pay to supplemental long-term disability for executives. But technically, a salary continuation plan is a fringe benefit, also known as a qualified sick pay plan, that is provided by an employer. *Owners generally are not eligible to participate in a salary continuation plan, except in the case of C corporations.*[1]

For owners and top executives, an executive bonus disability income plan is sometimes a viable alternative. This plan can be funded with individual disability insurance coverage, and can be a supplement to a group plan, or established on a standalone basis.

A salary continuation plan typically provides a disability benefit from a specified time after the employee becomes sick or hurt, until the point when a long-term disability benefit becomes payable. To address the time before this plan would provide a benefit, employers can self-insure sick pay and short term disability needs, purchase group coverage, and/or purchase individual disability insurance products.

Frequently, salary continuation plans cover most or all employees, but a plan can discriminate somewhat by covering "classes" of employees without covering all. For example, a plan could cover all employees at or above a specified title, such as director, or those who meet a minimum service period. The "class of employees" can be defined as the employer chooses, but all employees in that class must be covered.[2] In contrast, with an executive bonus plan, the employer can pick and choose who will be covered.

In a salary continuation plan, premiums are generally deductible to the employer and can be included by the employees,[3] for a tax-free benefit. The premiums can be grossed up so the employee has no out of pocket expense. Having a documented plan can help the employer demonstrate that the sick pay or disability payments are a deductible business expense. Sick pay and short term disability payments can be entirely self-insured and integrated with paid time off, vacation pay, etc., or they can be partially funded with a short-term disability contract.

The following table distinguishes the features of a salary continuation plan from those of an executive bonus plan:

Characteristic	*Salary continuation (fringe benefit)*	*Executive bonus*
What kind of disability insurance coverage is used?	*Group coverage, individual coverage, or both (e.g., IDI for select employees can supplement group disability coverage)*	*Individual disability insurance*
Is the premium deductible to the employer?	*Yes*[4]	*Yes*[4]
Do employees have a choice whether to be taxed on premiums (thus having a tax-free benefit)?[3]	*Yes*	*No*
Is the benefit taxable to employees?[3]	• *To extent employee pays or is taxed on premium: no* • *To extent employee has excluded premiums from income: yes*	*No*
Can owners be covered?	• *Sole proprietors and passthrough owners: No (except S corporation owners of 2% or less)* • *C corporation owners: yes*	*Yes*
Can it discriminate?	*Somewhat: class of employees can be defined as desired, but must include all employees in that class. But, a plan covering only owners is unlikely to be viewed as an employee benefit plan*[2]	*Yes, employer can pick and choose even within a class, but a plan covering only owners is unlikely to be viewed as an employee benefit plan*[2]
Is a plan document required for the employer to deduct premiums?	*Yes*	*A plan document is not required unless the plan is designed as a welfare benefit plan.* [5]

Covering business owners

Owners of passthrough businesses (who generally are not eligible to participate in fringe benefit salary continuation plans) can be covered in an executive bonus arrangement. However, if owners are covered, it must be in their capacity as employees rather than because they are owners.[2] Generally, this means that at least some key employees must be covered as well, for it to be considered an employee benefit plan. For example, the plan could cover all employees who have 10 or more years of service, and that class could happen to include all the owners. But if the class of covered employees is defined so that it covers *only* the owners, it is unlikely to be considered an employee benefit plan. Instead, the premiums could be treated as distributions or dividends to the owners.

Sample documents

Principal offers a sample document for each of these plan types. Business owners may share the sample document(s) with their local counsel as an example of what they wish to offer. In the event the employer utilizes a group disability product, the plan contract becomes the plan document for the portion of the coverage that is insured by the group disability contract.

[1] This means that it is not available to sole proprietors, partners, or owners of more than 2% of an S corporation (nor to owners of LLCs taxed as a sole proprietorship, partnership or S corporation unless the S corporation owner owns 2% or less of the company). C corporation owners may participate as employees.
[2] A plan covering a class of employees that includes only owners is unlikely to be viewed as an employee benefit plan. See, e.g., *Est. of John J. Leidy*, TC Memo 1975-340; *Alan B. Larkin*, 48 TC 629 (1967). If the class of covered employees is defined so that it covers only the owners, the premiums could be treated as distributions or dividends to the owners.
[3] "Employee" for this purpose does not include sole proprietors or passthrough owners (except S corporation owners owning 2% or less of the company). For additional details on the employee's choice to include (or not include) premiums as income, and a 3-year lookback rule, see How taxes can impact the benefits you choose (GP58784).
[4] For example, regardless of the type of salary continuation plan, the benefits it promises must be established and made known to the employees in advance of a disability. Without an established plan, payments made to a sick or injured employee may be nondeductible.
[5] Discuss with local counsel whether a plan document is required.

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