

SECTION 105 QUALIFIED SICK PAY PLANS

Many firms do not realize that the IRS can disallow the deduction of income paid to a disabled employee because such payments are not considered a deductible business expense unless that income is paid pursuant to the terms of a Qualified Sick Pay Plan (under Section 105).

Qualified Sick Pay Plans enable firms to continue to pay income to a disabled employee and still be able to treat those payments as a deductible business expense, and also to entitle both the firm and the disabled employee to exemption from FICA tax after six months of disability (Publication 15, Circular E, Employer's Tax Guide).

If the plan is funded with Disability Insurance, the firm may deduct the premium paid for the policy on the employee as a deductible business expense (under Section 162) and the amount of the premium is not taxable as earned income to the employee (under Section 106) and is also not subject to FICA taxes by either the firm or the employee.

Policy proceeds paid to a disabled employee are taxable as ordinary income (Publication 15, Circular E, Employer's Tax Guide).

TWO MINUTES ON SECTION 105 QUALIFIED SICK PAY PLANS

1. Q: When can money paid to a person be called Wages?
A: Only when the person is an Employee.
2. Q: When is a person considered to be an Employee?
A: Only when the person is currently performing services.
3. Q: When an Employee becomes disabled, is he or she still classified as an Employee?
A: No. Such a person would be considered an Ex-Employee.
4. Q: If income is paid to a disabled Ex-Employee, is that money a Deductible Business Expense?
A: Not unless that income is paid pursuant to the terms of a Qualified Sick Pay Plan (Under Section 105 of the Internal Revenue Code).
5. Q: What is a Qualified Sick Pay Plan?
A: It's a simple agreement providing for a Firm to continue some portion of an Employee's income during a disability.
6. Q: What kind of Firms may adopt such a Plan?
A: Any C Corporation, S Corporation, Limited Liability Company, Limited Liability Partnership, Partnership, Sole Proprietorship, or 501(c)(3) Nonprofit Corporation.
7. Q: Is money paid to a disabled Ex-Employee under a Plan classified as a Deductible Business Expense to the Firm?
A: Yes, such Plan Payments are a Deductible Business Expense to the Firm (under Section 162 of the Internal Revenue Code).
8. Q: When must a Plan be adopted by the Firm?
A: Before the Employee becomes disabled.
9. Q: Must the Plan be in writing?
A: Yes, and the Employee must be aware of its terms (as required by ERISA).
10. Q: Is the necessary documentation required for a plan a complex arrangement?
A: No, it consists of adopting a simple Plan Resolution and then providing the Employee with a simple Plan Letter.
11. Q: If no Plan exists, and income is paid to a disabled Ex-Employee, is that money a Deductible Business Expense to the Firm?
A: No, the Federal Tax Court has described such money as Ad Hoc Payments and ruled that such payments are not a Deductible Business Expense to the Firm.
12. Q: Suppose a Firm does not have a Qualified Sick Pay Plan, and then an Employee becomes disabled, and the Firm decides to continue to pay some income to the Ex-Employee, and let's suppose the Firm fails to disclose that it is paying income to a disabled Ex-Employee - - how is this likely to come to the attention of the Internal Revenue Service?
A: When the Ex-Employee applies for the Social Security Disability Benefit, or when an audit is conducted by the Internal Revenue Service, the subterfuge will be obvious.