DON'T LET DISABILITY DERAIL RETIREMENT SECURITY

By David Kaleda and Anna Rappaport

Prior to the rise to prominence of defined contribution retirement plans, traditional benefit planning focused on the mitigation against risk and the design of benefit programs that worked together as an integrated whole. The programs considered loss of income from retirement, disability and death as well as health care expenses, which in many cases would be catastrophic but for the integrated program. It was common for disability to be recognized through a combination of salary continuation benefits, disability provisions embedded in defined benefit pension plans, waiver of premium provisions in life insurance plans, and at times, continuation of medical benefits to disabled employees. However, with the shift away from DB plans to DC plans the disability provisions that protected retirement security have often been lost, significantly increasing the risk that mid- or late-career disability will derail retirement security.

While the problem (and the solutions) might seem straightforward, both DB and DC plans are subject to extensive regulation. This article sets forth the conceptual and regulatory issues involved in providing disability benefits embedded within or as an add-on to DC plans in the United States, from an ERISA regulatory standpoint.

The 2012 Department of Labor ERISA Advisory Council studied the topic of disability and how it relates to retirement security. The testimony presented to the council laying out the concerns of witnesses representing different perspectives can be obtained from the ERISA Advisory Council. The authors served on the ERISA Advisory Council during 2012 and worked on the disability topic. This article draws on testimony submitted to the council as well as the authors' research. This article represents the views of the authors and not that of the council or of the Department of Labor, or any organization with which either of the authors is affiliated.

While many actuaries and other benefits professionals work with retirement programs and disability programs, the intersection of disability risk and retirement security is often not on the retirement security radar screen, and the issue is often forgotten. In fact, the professionals who structure retirement programs often are not the same people who deal with disability risk. This is particularly unfortunate since only 31 percent of the labor force is covered by long- term disability benefits, and disability risk is underestimated by many Americans.

When employees turn to employer-sponsored programs for benefits and risk protection, disability is often far down on their list of priorities because they do not understand how financially devastating an extended disability can be to an individual and his/her family. Not only does the employee experience a loss of income by not working, but other family members may also need to curtail or abandon their own job(s) in order to care for the disabled family member at the same time as the disabled employee's medical costs escalate. Moreover, the employee and possibly other family members stop saving for retirement because DC plan benefits meaningfully accrue only during periods of active employment. We hope that this article will encourage all who read it to thoughtfully address the issues surrounding disability and retirement security in light of the increased prominence of DC plans.

Differences between DB and DC Disability Benefit Practices

The U.S. pension laws recognize the need for disability benefits in retirement plans, but that need is not adequately supported by appropriate regulations with regard to DC plans. Both ERISA and the Internal Revenue Code allow for a "qualified disability benefit," defined as a benefit at normal retirement age that does not exceed the benefit the plan participant would have earned had he or she not become disabled.[1] A qualified disability benefit may be included in either a DB plan or a DC plan. While some sort of disability retirement benefits are a common feature in DB plans, employers have not been as willing to implement disability retirement income benefit features within or next to their DC programs. This lack of "take up" by DC plan sponsors may be tied to how such plans work in comparison to DB plans and to the fact that DC plans generally transfer a sizeable portion of retirement benefit funding risk to plan participants. In addition, lack of clarity in applicable regulations makes implementation of disability retirement programs in DC plans unattractive for employers who may otherwise be interested in doing so.

Defined Benefit Plans

In a DB plan, the plan provides for a pension benefit payable to a participant at normal retirement age with some plans offering reduced benefits on earlier retirement. The plan sponsor bears the risk of investment loss and thus whether sufficient assets are held by the plan to pay the promised benefits. Disability retirement benefits may be offered through the DB plan in a number of ways. The following are some examples:

- Continued Benefit Accruals during Periods of Disability: The plan may provide that participants will continue to accrue benefits while disabled. For example, the plan may continue counting accrual service during the disability period. In this case the plan usually assumes that the participant will earn compensation during the disability period at the same rate he or she was compensated immediately before the disability occured.[2]

- Disability Retirement Pension Benefits: The plan may provide that a participant will begin to receive his or her accrued pension benefit upon becoming disabled prior to normal retirement age. In many cases, the benefit is subsidized by the employer. This means that the participant may immediately begin receiving the same benefit (or a significant portion thereof) that he or she would have received at normal retirement age (e.g., 65) if he/she had left the company at the point of disablement. The disability retirement pension is paid until the participant dies, with a death benefit payable to his or her spouse.[3]

- Supplemental Payments during Disability: The plan may provide for a supplemental retirement benefit as a set dollar amount per month (such as $100) for the disability period until normal retirement age or, if earlier, upon the participant's becoming eligible for Social Security Disability Income (SSDI). This supplemental benefit is paid in addition to the early retirement benefit described in the immediately preceding bullet

point and bridges the gap between becoming unable to work by reason of a disability and becoming eligible for SSDI.

Effectively, in all of the above examples, the disability retirement benefit is built into the plan's benefit formula and allows the participant to keep accruing a benefit or to receive benefits during the disability period as well as have the opportunity to receive benefits at normal retirement (generally age 65). The employer bears the risk for this benefit and the funding of such benefits is included in the plan's actuarially-determined annual funding requirements. If the plan is contributory, the cost is typically split in some fashion between employer and employee.

Defined Contribution Plans

In a DC plan, the employer and/or the participant make contributions to an individual account within the plan on behalf of the participant. The participant bears the risk of investment loss. Contributions are typically based upon compensation (e.g., a percentage of a participant's compensation) though other allocation methods may be applied (e.g., flat dollar). The total retirement benefit available to the participant at retirement (or some other permitted distribution event) is based upon his or her account balance, which consists of employer and participant contributions and any investment gains realized on those contributions. Whereas at one time, DC plans were most often supplemental plans operating next to DB plans, today's DC plans are often the primary or even the only employee retirement benefit. Logically, it makes sense to offer the equivalent of a waiver of premium provision and include continued savings in the DC plan or in a separate fund, but this is not usual practice. This issue is much more important when the DC plan is the primary retirement vehicle.

Any period during which a participant cannot continue contributing to his or her account balance can have a significant impact on the participant's savings at retirement. An employee who is disabled from ages 50 to 55 will lose five years of retirement savings that he will not be able to restore over his remaining working career. Furthermore, unlike in a DB plan in which benefits are in most cases paid as a stream of monthly benefit payments (e.g., an annuity), most DC plan benefits are paid in the form of a single lump sum. Thus, even if the DC plan provides for payment of benefits upon disability, many participants receive the lump sum at which point they may spend that money to meet current expenses thereby making those funds no longer available for their retirement years.

Some plan sponsors and their advisors have recognized that an extended period of disability can have a very severe negative impact on employees' retirement savings and have implemented different strategies to help participants to continue to accrue benefits. The following are some examples of approaches that can be used to make up the lost savings:

- Continue Contributions during Disability Period: To the extent permitted under Section 415(c) of the Code[4], the plan provides that the employer may continue to make contributions to a participant's account during a period of total and permanent disability.

- Implement Alternative Savings Option Outside of DC Plan: The employer purchases additional Long Term Disability (LTD) insurance (i.e., current income replacement insurance) on behalf of its employees. Upon the occurrence of a disability and the subsequent triggering of payments under the LTD policy, the proceeds from this additional coverage are invested in an annuity or IRA on behalf of the participant. The proceeds of such annuity or IRA would then supplement the retirement benefit otherwise accumulated under the defined contribution plan. The intent of this arrangement is to make up for the contributions that would have been made to the defined contribution plan absent the disability.

- Purchase of "LTD 401(k) Insurance" as an Investment in the DC Plan: The participant elects to have a portion of his or her own contributions (e.g., pre-tax deferrals) and possibly employer contributions (matching contributions, profit sharing contributions, etc.) to purchase LTD coverage that is offered as an investment option under the plan. Such insurance is funded either through a LTD policy issued by an insurance company or through a Voluntary Employee Benefits Association (VEBA) established by or on behalf of one or more employers. In the event the participant becomes disabled, the insurance carrier pays cash to the participant's account in the amount of the contributions he or she was making (and possibly the employer was making) prior to disability.[5] These arrangements were presented as "LTD 401(k) Insurance" in testimony to the Council and are referred to as such throughout this report.

From an actuarial point of view, each of these approaches works well but none is trouble free in the current regulatory environment. The issues linked to each approach are discussed below.

Regulatory Barriers to Defined Contribution Plan Disability Benefits

Section 415 Limits of the Code

While Section 415 of the Code permits employers to make contributions on behalf of participants who are disabled, the ability to take advantage of this is limited because Section 415 permits such contributions only if the participant is "permanently and totally disabled" as defined in Section 22(e)(3) of the Code, which in essence requires that the disability cause the person to be unable to work in any occupation[6]. This definition of disability is not consistent with the definition of disability in many LTD plans, which often provide only that the disability result in the employee's inability to work in his or her own occupation. Thus, while the employee may be eligible for LTD income replacement benefits offered by the employer, he or she in many cases will not qualify for disability replacement contributions under Section 415 of the Code.[7]

Challenges to Implementing Options Outside of the DC Plan

As stated above, some plan sponsors have implemented an arrangement designed to make up for the lack of accrual of disability benefits under a DC plan with an "out of plan" option. A portion of LTD insurance benefits paid by an insurer was contributed to an IRA or individual retirement annuity from which benefits could be paid at the time the employee retired. Another

idea would be for an insurer to issue a LTD policy that is designed to provide both current income and retirement income. However, both of these arrangements pose administrative or legal issues.

Payments made pursuant to a LTD insurance policy used to fund an IRA or individual retirement annuity pose administrative and compliance issues including the following:

- The transmission of LTD payments from the insurance company to the IRA provider can be administratively difficult because a mechanism for transmitting payments from an insurance company to an IRA or annuity provider, without first paying the money to the participant, typically does not exist.

- The receipt of the disability benefit payments by an IRA or annuity provider could result in prohibited transaction issues under ERISA and the Code if such provider is an affiliate of the insurer providing the insured LTD benefits.

- An employer offering an arrangement whereby payments pursuant to a LTD insurance policy were directed to an IRA or annuity may result in the IRA/annuity being viewed as part of an "employee benefit plan" for purposes of ERISA, thus causing the IRA to be viewed as an ERISA-governed employer-sponsored plan. This raises issues regarding whether ERISA's trust and other fiduciary requirements can be met, whether Form 5500 reporting is required, what participant disclosures must be satisfied, and other ERISA-related issues.

- Some or all of the LTD benefit payments may be includible in income during the year of payment even if they are then immediately contributed to an IRA. Furthermore, the Code's limits on contributions to IRAs and individual retirement annuities may limit an employee's ability to make the contributions on a pre-tax basis or even an after-tax basis. In either case, the effectiveness of the arrangement is very limited when compared to the tax advantages of a qualified retirement plan that allows for continued accruals during periods of disability.

The above administrative and compliance issues were key reasons why plan sponsors and service providers turned to "in plan" options such as the LTD 401(k) Insurance option discussed earlier.[8]

Another possible solution is for an employer-sponsored LTD arrangement, whether insured or self-insured, to be designed to provide disability retirement income replacement benefits (i.e., lost retirement benefits), not just current income replacement benefits (i.e., lost wages). However, a concern about this idea is that an insured or self-insured arrangement that by its terms provided post-retirement LTD benefits could be viewed by the DOL as a "pension benefit plan" rather than a "welfare benefit plan." If the former were the case, the arrangement would be subject to certain ERISA provisions that do not apply to welfare plans, such as minimum participation and coverage, vesting, funding, and other requirements. In this case, such an arrangement would not be attractive to most employers. (The authors understand that riders are available to be added to individual disability coverage to provide added coverage to replace retirement savings, but such riders are rarely used.)

Lack of Clarity on Tax Treatment of "LTD 401(k) Insurance" Arrangements

The position taken by the IRS in two private letter rulings[9] (the "Rulings") is conducive to employers implementing LTD 401(k) Insurance or similar products within defined contribution plans. However, some proposed regulations issued by the IRS in 2007 have called into question the IRS' position in the Rulings and have stymied the implementation and growth of such arrangements. The authors' understanding is that prior to the 2007 proposed regulations some employers implemented this type of program, but that new implementations have in large part stopped until the regulations are further clarified. Trade associations representing both plan sponsors and the financial service industry support such clarification. For example, the American Benefits Council indicated their support for such clarification in testimony to the ERISA Advisory Council.

In the Rulings, the IRS effectively took the position that the LTD insurance was an investment option offered under the plan. As a result, contributions used to pay premiums were not taxed at the time of such payment and the payment of LTD insurance benefits by the insurer to the participant's plan account did not result in current taxable income to the participant[10]. In addition, amounts paid pursuant to the LTD policy were not counted as contributions for Code limits on tax-qualified plans such as those found in Sections 415 and 402(g) of the Code. As a result, the IRS' position in the Rulings reduced the significant tax and recordkeeping consequences that would result if the portion of the plan contributions used to pay premiums were taxed at a different time than when the participant received a distribution from the plan or if payments under the policy counted against IRS limits.[11]

However, the Treasury Department subsequently proposed regulations in 2007 addressing the tax effects of using defined contribution plan assets to fund non-retiree health benefits[12]. These proposed regulations suggested to the plan sponsor and practitioner communities a possible shift in how the IRS would now rule on LTD 401(k) Insurance offerings. In such regulations, the IRS concluded that DC plan contributions used to pay health insurance premiums would be included in income in the year such payments were made. In addition, any benefits payable under the health benefits policy would be treated as contributions subject to the Code limits mentioned above. The proposal, in effect, required an income tax result exactly the opposite of what was established in the Rulings pertaining to LTD 401(k) Insurance.

While the Proposal was directed at the funding of health benefits, language in the Preamble indicated that the IRS may be considering changing its position with respect to payment of "in plan" LTD benefits such as LTD 401(k) Insurance. The resulting regulatory uncertainty appears to be responsible for a decline in service provider and plan sponsor interest in developing and implementing LTD 401(k) Insurance and similar arrangements.

The 2012 ERISA Advisory Council made recommendations to the DOL designed to secure clarification of the unresolved regulatory issues and to educate the public and plan sponsors about concerns related to disability protection. The report is available on the ERISA Advisory Council website.

What Actuaries Might Do to Enhance Security in a DC World

It is important for actuaries and consultants working with DC plans to think beyond the plan. What are the goals of the program? Are there risks that are not being protected against? Ideally, plan sponsors will be able to provide more employee-friendly direct disability benefits integrated within DC plans, but in the interim, there are some possible strategies to be considered:

- Provide a generous after-tax group LTD program, and encourage employees to make contributions to a tax qualified plan and an IRA up to the applicable limits.

- Provide a voluntary disability benefits program to purchase added coverage on an individual basis to make up retirement savings. Encourage that the money be saved for retirement.

- Communicate with employees about the importance of not dipping into retirement savings during disability.

None of these strategies are ideal in and of themselves. These ideas are presented with the hope that practitioners, sponsors, and employees will engage in a dialogue around this issue, and that better ideas will emerge in so doing. In addition, more people may add voices to those who are already trying to get the regulatory issues unscrambled.

Conclusion

The authors' research indicates that the continued accumulation of retirement benefits in employer sponsored DC plans during extended periods of disability is very important, but also difficult. They hope that this will change but that in the meantime, the issue will not be ignored. While DB plans commonly offered disability benefits so that the program would not fail on disability, these plans are in decline. The reality of the employer marketplace today, which continues to move toward offering only DC plans, requires employers who wish to provide employees with the opportunity to have adequate retirement benefits in the event of disability to consider additional options such as the "in plan" and "out of plan" options discussed above. The authors hope that the Federal regulatory agencies will issue guidance to clear up the uncertainties surrounding this topic, and hope that the readers of this article will focus on these issues along with the system stakeholders they serve.

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[1] I.R.C. § 411(a)(9); ERISA § 3(22).

[2] These provisions are often designed to work side-by-side with LTD plans providing current income replacement benefits. They are analogous to the waiver of premium provisions commonly found in life insurance programs.

[3] These provisions might be offered in lieu of LTD plans providing current income replacement benefits, or coordinated with such benefits (e.g., the disability pension benefit is offset against the LTD plan benefit).

[4] Section 415(c) of the Code limits the amount of allocations, which include contributions, to a participants defined contribution plan account during a measurement period (generally, the calendar year) to the lesser of (i) 100% of the participant's compensation, as defined under Section 415 of the Code or (ii) a dollar amount that is indexed to inflation ($50,000 in 2012). Because a participant is disabled and not actively employed, he or she does not receive "compensation" as defined for purposes of the Section 415 limits. Thus, the Section 415 limits effectively prevent any contributions being made on behalf a participant that does not receive compensation from the employer.

[5] Testimony presented to the 2012 ERISA Advisory Council suggests that there is a considerable amount of flexibility available in such an arrangement. For example, employee contributions and/or employer contributions could be used to purchase the insurance. In addition, to mitigate against the costs associated with adverse selection, the plan could be designed to make up contributions based upon the participant's contribution rate effective during the immediately preceding plan year rather that the contributions made immediately before the disability period began.

[6] Specifically, Section 22(e)(3) of the Code provides that the person "is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or which has lasted or can be expected to last for a continuous period of not less than 12 months."

[7] We also note that Section 415 of the Code does not permit such contributions to be made on behalf of highly compensated employees. Thus, employees who made over $115,000 in 2012 or owned more than 5% of his or her employer in 2013 or 2012 could not make or receive contributions even if they were in fact "permanently and totally disabled."

[8] LTD disability retirement benefits paid pursuant to an insured or self-insured LTD plan (offered outside of a defined contribution retirement plan) are taxable pursuant to Section 105 of the Code and the underlying Treasury Regulations. Disability income benefits are subject to income tax to the extent that the cost of the coverage was born by the employer and has not been included in the income of employees. So, where coverage is paid for entirely by the employer, the benefit is fully taxable. It is also fully taxable if the entire cost of coverage is paid for by employees on a pre-tax basis (i.e. through a cafeteria plan under IRC § 125). Conversely, the disability income benefit is not subject to income tax when paid if it is paid for by employees on a post-tax basis (conventional payroll deduction).

On the other hand, in a LTD 401(k) Insurance arrangement, the disability benefits are treated more favorably from an income tax standpoint. As a general rule, contributions made by an employee to a defined contribution plan are made on a pretax basis. Thus, such contributions made to the plan (and any investment gains thereon) are not included in income for federal income tax purposes until they are distributed to the employee. Under the LTD 401(k) Insurance arrangement, a portion of those pretax contributions are used to purchase LTD insurance premiums. Under the above-cited Private Letter Rulings, the use of those assets to purchase premiums does not result in current income tax inclusion with respect to such assets. Furthermore, in the event of disability, payments

pursuant to the LTD policy used to make additional pretax contributions to the employee's plan account for the disability period are not included in income at that time even though the insurance was purchased with pretax dollars. Rather, the employee recognizes income only upon taking a distribution from the plan just as if he or she made or received pre-tax contributions throughout both the period of employment and the period of disability.

[9] *See* Private Letter Ruling 200031060 & Private Letter Ruling 200235043.

[10] More specifically, in the Rulings, the IRS concluded the following:
The portion of the contributions used to pay for LTD insurance premiums was not currently included in the income of the participants;
Benefits paid by the insurer to the plan account (i.e., contributions) pursuant to the LTD insurance policy were not includible in the participant's income or subject to the Code section 415(c) limits on contributions at the time such benefits were paid; and
Distributions from the plan, which would include the benefits (i.e., contributions) paid to the plan pursuant to the LTD insurance policy would be taxed just like any other distribution from the plan.

[11] *See* Footnote below for further discussion regarding taxation of disability benefits.

[12] 72 Fed. Reg. 46421 (August 20, 2007).

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