



# BENEFIT *Advisor*

## In This Issue

*In this ninth issue of the McGrawWentworth Benefit Advisor for 2007, we will review three tricky areas of disability coverage. Disability coverage does not typically garner the attention of the medical plan, but it is a very important benefit for your employees.*

*Certain employers are impacted by state-mandated disability coverage. It is important to understand if your organization needs to address any state-mandated disability requirements and your options in dealing with these state plans. Contract provisions under disability contracts can vary widely. It is important when reviewing alternative disability vendors to make sure the contract provisions for the options reviewed are consistent with your current plan. Finally, we will discuss the taxability of long term disability premiums and benefits.*

*We welcome your comments and suggestions regarding this issue of our technical bulletin. For more information on this Benefit Advisor, please contact your Account Manager or visit the McGrawWentworth web site at [www.mcgrawwentworth.com](http://www.mcgrawwentworth.com).*

## “Disability Coverage”

Most employers offer their employees short- and long-term disability coverage - valuable protection for employees if an illness or injury prevents them from working. Some disability plans replace a portion of income and others replace the entire amount.

Nowadays medical plans receive the most attention because their cost and complexity has grown exponentially over the last decade. However, disability policies have changed over the last decade as well. Although employees do not use disability insurance as often, when they do become disabled, they need to understand this important coverage.

To help you manage your disability plan properly, this *Benefit Advisor* explores three challenging areas of disability coverage:

1. State-mandated disability requirements.
2. Key provisions of disability contracts.
3. Taxation of disability benefits.

This *Advisor* addresses these three key areas to help your organization better understand your disability benefits.

### State-Mandated Disability Requirements

State-mandated disability requirements do not affect all organizations. In fact, state-mandated disability plans apply for the most part only to people working (not necessarily living) in:



- California
- Hawaii
- New Jersey
- New York
- Puerto Rico
- Rhode Island

Unfortunately, each of these states has different rules. If you have any employees working in any of these states, your organization will need to meet the applicable state requirements. Review your disability plans and make sure your organization is tracking all the key areas governed by state-mandated disability requirements:

- **Benefit amounts, elimination periods and maximum benefit periods:** Your organization must keep track of these state-mandated limits. First, benefit levels vary from state to state. State plans cap benefits at different weekly amounts; many replace only 50% to 66% of weekly earnings. Second, different plans have different

maximum benefit periods. Finally, you need to keep tabs on state benefit limits because states adjust some benefit limits for inflation every year.

Your current disability carrier can update you on state disability plans. Be sure to explain how your plan coordinates with various state disability plans in your summary plan description.

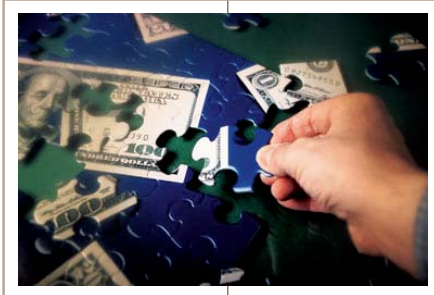
- **Payment for state mandated disability coverage:** Most

state disability plans are

funded through payroll taxes. The employer collects any necessary payroll taxes and pays them

to the appropriate state agency. Although many state plans have mandatory employer payroll taxes, other state plans allow optional employee payroll taxes.

- **Delivering the state-mandated benefit:** State agencies manage all state-mandated disability plans. However, several states allow various approved insurance carriers or administrators to administer the state plan. If you have employees in states that allow insurance carriers to administer state-mandated plans, your



carrier can handle all state-mandated reporting requirements as well.

Not all disability carriers are approved to administer the state-mandated benefit plans, and not all states will allow disability carriers to administer the state plan. If you have employees located in the affected states, discuss this issue with your disability carrier. If you are considering a new carrier, you need to ask whether the carrier can

administer state-mandated disability benefits.

Some states will not allow carriers to administer the state plan. In these cases,

you need to make sure to pay the required payroll contributions and understand the process your employees need to follow to apply for benefits under the state plan. If you have a sizable number of employees in a state where the state disability plan is paying most of the disability benefit, your disability carrier may discount your rate accordingly.

- **Supplementing state mandated disability amounts:** In some cases, the state mandated disability benefit is less than the benefit the employer

provides to employees working in states without state mandated disability benefits.

Depending on the requirements of the state mandated plans, some states will allow your organization to deliver your benefits if they meet and exceed all the requirements of the state mandated plans. If your employees work in a state that requires the state plan pay benefits, your plan may include the state mandated benefits as an offset when calculating any additional disability benefit. Other plans will simply write the contract to pay a supplemental benefit, in addition to the benefits payable by the state plan. If your organization has employees working in states where the state plan will pay a benefit, it is important for your employees to understand they may be eligible for benefits under the state plan in addition to benefits from your disability benefit plan.

All state-mandated disability plans are different with different benefit plans and different employer requirements. Because organizations must comply with state laws, you need to keep an eye on any employees working in a state that requires disability coverage.

If any of your employees are affected, investigate your options for administering the state-mandated plan and keep informed of yearly changes in the state rules. In addition, if you change disability carriers, assess that carrier's ability to manage any state plan.

## NOTABLE THOUGHTS

**A GOOD LISTENER IS NOT ONLY POPULAR EVERYWHERE,  
BUT AFTER A WHILE HE GETS TO KNOW SOMETHING.**

**WILSON MIZNER**

Continued on Page 3

## Key Provisions of Disability Contracts

Disability contract provisions have changed in many ways over the last ten years. If you are looking for a more competitive rate on disability coverage, make sure your organization compares benefit calculations and contract provisions to make sure your current plan and any proposed plans are similar. Contract provisions specify the terms under which a benefit is paid.

If you are contemplating changing carriers, pay special attention to the following:

- **Definition of disability:** The definition of disability can vary widely carrier to carrier. First, you want to examine the timeframe you need to be disabled in



“your own occupation” to qualify for a benefit under the plan. Some plans have 24 month “own occupation” definitions; others have the “own occupation” definition until age 65. It is important when comparing cost to make sure the own occupation protections in the definition of disability are equal.

The next thing to look for is how a disability is determined. Some carriers use a loss of ability to perform the duties of the occupation **and** a corresponding income loss. Some definitions define disability as the inability to perform key duties **or** the loss of income (typical income loss must exceed 20%). Partial

and residual disability provisions are important as well. These provisions address how the benefit is handled if an individual is able to work on a part-time basis.

- **Other Important Aspects of Definition of Disability:** Some contracts now specify “maximum capacity or optimum ability” because some employees opt to return to work in a position well below their ability. Another key aspect in defining disability (especially where earnings loss is a consideration) is what is considered a normal work

week. Surprisingly, some contracts do not define a normal work week. A normal work week may be defined as 40 hours in the contract, but if a claimant normally works 60 hours and has an injury that allows him or her to work only 40 hours a

week, the condition is not considered disabling since the normal work week contractually is 40 hours.

- **Exclusions:** All disability contracts specify exclusions. Most contracts exclude self-inflicted injuries, acts of war, commission of felony or attempt to commit a felony, and so on. When you review disability contracts, look at the exclusions listed under each contract to make sure they are similar.
- **Limitations:** Most disability contracts cover certain conditions only for a limited time. For example, contracts commonly have a 24-month lifetime limit on mental and

nervous conditions or substance abuse. The mental and nervous limit is typically extended if a claimant is still hospitalized when the 24 months is exhausted. In this case, benefits are usually extended until the claimant is released from the hospital. However, more restrictive time limits have become commonplace for “subjective, soft tissue or self-reported symptom” illnesses or injuries. Some carriers limit benefit payments for these types of disabling conditions to 24 months. These limits are intended to curtail claims for disability in cases where there is no medically verifiable health condition, such as certain back injuries, chronic fatigue and others.

Almost all carriers word their contracts differently. Some carriers have very broad limits; others have very narrow limits. It is important to review these limits when examining different disability contracts.

- **Benefit Offsets:** Almost all long-term disability contracts offset other sources of income an individual receives while disabled. Offsets for social security disability income and workers’ compensation benefits are common. Offsets for individual disability coverage and salary continuation are now becoming more prevalent as well.

Some of your employees will secure additional disability coverage independently. This is more common in professional organizations. If you change carriers and the new carrier offsets individual

disability benefits, this may have a significant impact on some employees. You may choose not to move carriers if the new contract offsets for individual disability benefits.

- **Rehabilitation Requirements:** Some long-term disability carriers are more aggressive than others in helping claimants return to work. Aggressive carriers may require claimants to participate in a physician recommended rehabilitation program. Claimants who fail to participate in such a program lose their benefits under these aggressive contracts. Other contracts are less aggressive and either allow claimants to go to rehabilitation programs voluntarily or offer claimants financial incentives to encourage participation in these programs.



These are only a few of the contract options that can vary from carrier to carrier. When you review alternative quotes for disability coverage, you need to compare contract provisions as well as the rates. Contract provisions can vary widely and affect the quoted rates. If you consider only rates, you could be purchasing a much more restrictive contract.

## Taxation of Disability Benefits

Taxes on disability benefits can be complicated. Once an individual becomes disabled and is eligible to receive benefits, the tax question becomes very important. The difference between a taxed benefit and a tax-free benefit can be sizable.

To determine whether the benefit is taxable, consider how the premium for the disability coverage is paid. If the disability insurance is paid for with after-tax dollars, the benefits are not taxable. If the disability coverage is paid for with pre-tax dollars, the benefits are taxable.

Employers do not always understand their options regarding disability insurance payments. Following are three common ways to pay for disability benefits and their corresponding tax rules.

### 100% Employer Paid

In many cases, employers pay 100% of the disability coverage premium. The IRS views employer money as tax-free dollars and therefore if benefits are received from a 100% employer-paid plan, typically, the benefits would be taxable.

There are a couple of exceptions to this general rule. One exception is if an employer includes the cost of the premium in the employee's gross income. In this case the employee is paying income tax on the premium amount; the disability benefit, therefore, becomes tax-free.

The government clarified the taxability of disability benefits in Revenue Ruling 2004-55. This rule established another way employers could pay for disability benefits and allow employees to be taxed on the disability premium so that the disability benefit is tax-free.

Employers may allow employees to make an irrevocable choice every year allowing the employer to tax disability coverage premiums. The employer must meet the following three requirements:

1. Plan must be written on a non-contributory basis.
2. ERISA plan must be amended to reflect this annual option.
3. Employees elect this option in writing before the beginning of the plan year.

It seems simple, why wouldn't an employer allow this election? There are some hidden costs associated with this approach. First, your long-term disability carrier may increase your rates up to 15% if you allow employees to pay tax on disability premiums. Why? When the premium is taxed, the benefits are not taxed. The result is the disabled employee's income replacement ratio is typically much higher. In many cases, the tax-free disability benefit approaches the employee's actual post-tax working income. Thus the employee has no real financial incentive to return to work as soon as possible.

Continued on Page 5

## NOTABLE THOUGHTS

**FOCUS ON THE GOOD. TURN YOUR FACE TO THE SUN  
AND THE SHADOWS FALL BEHIND YOU.**

**MAORI PROVERB**

Another hidden cost is the employer tax consequence. Employers also have to pay FICA and FUTA taxes on the value of the disability premiums. The premium payments are basically added to the employee's income and becomes taxable income for the employee and the employer.

### **100% Employee Paid**

Some employers offer disability benefits on a voluntary or employee-pay-all basis. In this situation, employers can allow premiums pre- and post-tax. Some

employers will offer the disability plan on a post-tax basis. This means if the employee ever becomes disabled the benefit will be tax-free. Other employers offer the employee the choice of paying for the benefit on a pre- or post-tax basis. Some employers believe the tax-saving on the premium will allow this benefit to be more affordable to more employees. Ultimately the tax treatment of the benefit, if received, will be determined by how the premium was paid.

### **Employer-Paid and Employee-Paid**

Some employers pay for a core level of benefits for their employees and allow employees to purchase additional coverage or a "buy-up" level of benefits. Some employers will require employees to pay the "buy-up" premiums with post-tax dollars. Other employers allow employees to choose whether they want to pay for the buy-up with pre- or post-tax dollars.



In its 2004 Revenue Ruling the IRS clarified how the disability benefit should be taxed when the employer pays a portion of the premium and the employee pays a portion of the premium with post-tax dollars. If your employee elects pre-tax premium payments, the whole benefit is taxable. If your employee has paid a portion of the disability premiums with post-tax dollars, the three year look back rule applies to determine what portion of the employee's benefit is taxable.

The three year look back rule does not look at the employee's specific premium payment for the

previous three years but rather the employer's premium payment history. The plan would need to determine the following:

Three Year Employer Premium  
Contribution

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Total Three Year LTD Premiums  
(employee and employer  
contributions)

This ratio is the percentage of the benefit that is considered taxable.

These tax rules are complicated. If you are unsure of the tax consequences of your disability arrangement, consult a professional tax advisor.

### **Concluding Thoughts**

Unfortunately, disability coverage often takes a back seat to the health plan. Although disability insurance is quite complicated, it is a very valuable benefit to employees unable to work because of an illness or an injury. If you are looking at disability coverage as part of your annual benefits review, make sure you analyze competitive contracts in detail. Disability contracts have become more complex over the last 10 years, and contract provisions vary depending on the carrier. The difference in rates among various contracts may be inconsequential compared with the difference in contract provisions.

If you have any questions regarding disability coverage, please contact your McGraw Wentworth Account Director. **MW**

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