In this first issue of the McGraw Wentworth Benefit Advisor for 2013, we discuss disability benefits. Many employers offer some level of income replacement when their employees are unable to work due to illness or injury. These plans seem simple but can be quite complicated. It is important for employers to understand their plan benefits.

In addition, employers should be mindful of continuing health coverage during a disability leave. The FMLA in some cases will require employers to extend coverage. If an employer extends coverage beyond what is permitted by the health plan contract, the employer could be faced with liability for medical expenses not covered by the plan.

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 McGraw Wentworth web site at www.mcgrawwentworth.com.

“Disability Benefits”

Most employers offer their employees disability benefits. Although these benefits do not always receive the same level of attention as medical plans, disability coverage is important. It replaces some of an employee’s income if the employee is unable to work because of an illness or injury. These benefits seem straightforward, but the plan provisions can be complex. Employers need to understand the plan’s benefits to handle issues relating to disabled employees.

This Advisor reviews the following:
- Short Term Disability Benefits
- Long Term Disability Benefits
- Tax Status of Disability Benefits
- Disability Benefits and FMLA
- Health Coverage During Disability Leaves

Short Term Disability Benefits

Short-term disability benefits differ from employer to employer. These plans pay a benefit or replace a portion of income if an employee is unable to work because of a non-work-related illness or injury. The typical plan design establishes the length of time an employee must be disabled before receiving benefits. For example, a plan may pay benefits as of the first day of disability following an accident and as of the eighth day after an illness. Some plans may pay benefits as of the first day an employee is admitted to a hospital.

Once an employee qualifies for benefits, the plan specifies the benefit level. Some plans will pay a flat weekly benefit, such as $300 a week. Another common plan design replaces a percentage of income. For example, a benefit may be 60% of weekly earnings up to $800. Finally, some plans approach short term disability benefits by continuing the employee’s salary. In many cases, these plans continue salary at 100% of earnings during a short term disability.

The plan establishes the length of time that benefits are paid. Benefits are paid for the maximum benefit period as long as the employee remains disabled. The maximum benefit period varies among plans. If the employer also offers long-term disability benefits, the maximum benefit period for the short-term disability plan typically dovetails with...
the elimination period for the long term disability plan. A common maximum benefit period is 26 weeks. If an employer does not offer long term disability benefits, the maximum benefit period may be longer.

In order to be eligible for benefits, the employee must satisfy the plan’s definition of disability. Short term plans typically define disability as an employee being unable to perform the key functions of the employee’s job.

**Insured/ Self-Funded**

The liability under most short term disability plans can be manageable. Some employers fully insure their short disability programs, while others prefer to self-fund their plans.

If your organization insures the benefit, the carrier will evaluate claims based on the contract. For example, how does the contract define disability? Does it depend on whether the claimant can perform the specific job? How will benefits be treated if the claimant is capable of working part-time during the disability leave?

You must also know the key provisions of the contract when you bid the coverage. If a carrier is offering a significantly lower rate, you need to be sure that the benefits quoted are the same as the current benefits of your plan.

The administrative process may challenge organizations that self-fund their short term disability plans. Years ago, it was not uncommon for employers to self-fund the plan and administer the claims in-house. The employee would be required to provide a doctor’s note indicating the dates of disability. In most cases, the in-house administrator did not have the tools to evaluate whether or not the disability claim was legitimate. As a result, many employers realized that some employees were taking advantage of this loose approach to disability administration.

Employers can still choose to self-fund this benefit. However, for cost-control purposes, it makes sense to hire an administrator. With short term disability benefits, employers can consider two possible options. The first is “advice to pay.” In this arrangement, the administrator reviews the claim and lets the employer know whether to pay it. The second is a traditional administrative services arrangement. In this arrangement, the administrator reviews the claim and pays the benefits directly to the claimant. The employer merely funds the benefits.

**Mandated Short Term Disability Benefits**

State-mandated disability benefits are not an issue for all organizations. In general, they apply only to people working in (but not necessarily living in):

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

Each program has different rules. If you have employees working in any of these states, your organization needs to meet the state program’s requirements. Review the following key areas of your plan:

- **Benefit amounts, elimination periods and maximum benefit periods:** Your organization must keep track of the state-mandated limits. First, benefit levels vary from state to state. State plans cap benefits at different weekly amounts, with several replacing 50% to 66% of weekly earnings. Second, different state plans have different maximum benefit periods. You must stay aware of this, because states adjust some benefit limits for inflation every year.

  Your current disability carrier can update you on state disability plans. Your summary plan description should explain how the employer disability plan coordinates with the various state disability plans.

- **Payment for state-mandated disability coverage:** Most state disability plans are funded through payroll taxes. The employer collects any necessary payroll taxes and then pays them to the appropriate state agency. While many state plans have mandatory employer payroll taxes, some states allow optional employee payroll taxes.
• **Delivering the state-mandated benefit**: State agencies manage all 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, then your carrier may be able to handle all state-mandated reporting requirements.

Some states allow disability carriers to administer the state-mandated plan. Some carriers in the state may not be approved to administer the state benefit. 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 find out whether that carrier can administer the state-mandated disability benefits.

Other states will not allow carriers to administer the state plan. In these cases, the employer needs to pay the required payroll contributions. You must also understand the application process for benefits under the state plan. If you have a sizable number of employees in a state where the mandated disability plan is paying most of the total benefit, your disability carrier may discount the rate for your employer plan accordingly.

In some cases, the state mandated disability benefit is less than the benefit the employer provides to employees who work in states without mandated disability benefits. Some states will allow your organization to deliver your benefits if they meet or exceed all the state-mandated requirements. If your employees work in a state that requires the state plan to pay benefits, then any benefit your plan pays should be offset by the state-mandated benefit amount. Other plans will simply write the contract to pay a supplemental benefit, in addition to the benefits the state plan pays. If your organization offers a supplemental benefit, your employees need to understand that they may be eligible for benefits under both the state plan and your disability benefit plan.

Plan designs and employer requirements vary among state-mandated disability plans. Because organizations must comply with state laws, you need to keep an eye on any employees working in a state with mandated disability coverage. For those employees, investigate the state-mandated plan options and stay informed on yearly design and requirement changes. In addition, if you change disability carriers, make sure the new carrier can manage state-mandated plans.

**Payroll practice or ERISA Benefit**

When employers self-fund a short term disability plan, they are often confused about whether or not it is subject to ERISA. In general, if an employer is subject to ERISA, then the employee welfare benefit plans they sponsor are also subject to ERISA. However, there are a few exceptions, and self-funded short term disability benefits may be one of them. The Department of Labor has established a safe harbor from ERISA compliance for “payroll practices.”

To determine whether a self-funded short term disability plan is a payroll practice or an ERISA plan, you need to consider a number of key administrative issues:

- **How are benefits paid?** If the benefits are unfunded and paid from the employer’s general assets, the plan is likely to be considered a payroll practice.
- **Will percentage of income replacement matter?** Even if the plan only replaces a percentage of weekly income, such as 60%, it can still be considered a payroll practice.
- **Does the employer use a vendor for claims administration?** It doesn’t matter because the issue is how the plan is funded, not who administers it.
- **Does the plan pay former employees?** Paying benefits to former employees may require an employer to treat the short term disability plan as an ERISA plan. This may be a concern if your organization has a long benefit period. For example, a company may have a plan with a two-year benefit period. The company formally terminates disabled employees after 12 weeks of disability. This arrangement would be viewed as providing benefits to former employees. If this is the case, the plan would be subject to ERISA.
If you are unsure whether your self-funded disability plan is an ERISA plan or a payroll practice, you should consult an attorney. If your plan is subject to ERISA, you must comply with all ERISA requirements, including communication and claim determinations. The federal court system usually handles disputes under ERISA plans. State courts usually handle payroll disputes if the plan is a payroll practice.

**Long Term Disability Benefits**

Long term disability plans pay benefits to employees unable to work for an extended period. An employer will generally design the long term disability plan such that benefits dovetail with the short term disability plan. For example, if the maximum benefit period for the short term disability plan is 13 weeks, then the elimination period for long term disability will generally be 90 days. In this way, an employee who continues to be disabled, according to the terms of the policy, will move from short-term to long-term disability, with no gap in benefits.

Like short term disability plans, long term disability plans partially replace income when an employee is unable to work because of an illness or injury. These benefits differ from short term disability plans in several important ways. Nearly all long term disability plans are insured. In general, the liability with these plans can be substantial because of the potentially long benefit period. Many disability plans will pay benefits until age 65 if the claimant remains disabled. For example, if an employee becomes totally disabled at age 30, the plan may be required to pay benefits for an additional 35 years. Most employers insure the plans to transfer not only the risk, but also the responsibility for managing the claim, which could last decades.

You need to know the key provisions of your long term disability benefit plan, which dictate how claims are reviewed. This is critical if your organization is shopping for a new disability carrier. These provisions affect the cost of your disability coverage. An alternative carrier may offer very attractive rates, but if the contract has more restrictive provisions, then you’re not comparing “apples to apples.”

Key provisions include:

- **Definition of Disability:** Disability is defined in terms of a claimant’s own occupation or any occupation suited to the claimant’s education or training. A very generous contract may have an own occupation definition of disability to age 65. An any occupation definition of disability to age 65 would be the most restrictive. Most plans offer a blended definition, such as a plan that includes an own occupation definition for the first five years of disability. After five years, the claimant would have to be disabled for any occupation in order to continue being eligible for benefits. In addition, the claimant may also be required to experience a loss of income. Typically, there must be at least a 20% income loss associated with the disability.

Newer contracts may use terms such as “maximum capacity” or “optimum ability.” This wording protects the insurance carrier when a disabled employee returns to work in a different occupation. If claimants lose income because they choose to return to work in positions well below their capabilities, the carrier may be required to continue to pay benefits. The term “maximum capacity” assures that if claimants can return to positions in line with their capabilities, there is no disability benefit if claimants choose to work positions below their capabilities.

- **Plan Exclusions:** All plans will exclude certain disabilities from coverage. Typical exclusions include self-inflicted injuries, acts of war and injuries during the commission of a felony. You should understand what situations are explicitly excluded in the contract.

- **Benefit Limitations:** Many disability contracts limit the benefits payable for certain conditions. For example, it is common for a disability plan to have a 24-month benefit limit on disabilities caused by mental health conditions and substance abuse. A plan will usually extend benefits if claimants are in the hospital when they reach the time limit. Benefits typically continue until the claimant leaves the hospital. Plans also commonly limit the time they will pay

Continued on Page 5
benefits for subjective, soft-tissue or self-reported illnesses or injuries. Generally, they limit benefits to 24 months for these claims.

- **Benefit Offsets:** Almost all long-term disability plans offset benefits with a claimant’s other sources of income, such as workers’ compensation or Social Security disability benefits. Disability plans may also offset benefits for salary continuation or by any amounts received from an individual disability plan.

- **Rehabilitation Requirements:** Contract provisions vary in terms of rehabilitation requirements. Disability claims can last a long time. It is to the carrier’s advantage for a claimant to return to work as soon as possible. Studies show that the longer a disabled person is out of work, the more difficult it is to get the claimant back to work. Aggressive contracts will require claimants to participate in physician-recommended rehabilitation programs. Claimants lose benefits if they fail to participate in the rehabilitation program. Some contracts will have a less aggressive provisions. These may allow claimants to participate voluntarily in rehabilitation. Other contracts will offer financial incentives that encourage claimants to participate in rehabilitation programs.

These provisions typically vary from contract to contract. Employers must understand the importance of these provisions when they explain benefits and consider new vendors.

### Tax Status of Disability Benefits

The tax on disability benefits can be somewhat complicated. Disabled employees will want to know if their benefits are considered taxable income.

The tax on the benefit depends on who pays the premium and whether payment is pre- or post-tax.

#### 100% Employer-Paid

If the employer pays 100% of the premium, the benefits are taxable. The IRS views the employer’s payment as made with pre-tax dollars.

There are some exceptions to this rule. First, if an employer adds the cost of disability insurance to employees’ gross income, then any future benefit would not be taxable. In this instance, the employee pays taxes on the coverage premiums. No taxes are deducted from the disability benefit itself.

Another exception involves disability coverage offered through the Section 125 plan. The employer still funds the premiums, but the employee can choose whether the benefit is paid pre-tax or post-tax. If the employee elects a pre-tax premium, then any future benefit received is taxable. If the employee elects to pay with post-tax dollars, then any future benefit is tax-free. Employers need to meet specific administrative requirements if they intend to allow a pre- or post-tax election:

1. The choice must be irrevocable for the 12-month plan year. Employees can change their election every year during annual enrollment, but cannot change their election mid-year.
2. The disability plan must be written on a non-contributory basis. All employees will receive coverage.
3. The ERISA plan must be amended to reflect this annual choice.
4. Employees must make this election in writing before the beginning of the plan year.

If the employee is disabled in a plan year that premiums were paid post-tax, the benefit is tax-free.

This option may seem like a simple, positive employee benefit change. Employers, however, may incur some costs if they allow it. The rate impact for allowing a pre- or post-tax election could be as much as 15%.

Why would this affect employer rates? If employees pay premiums with post-tax dollars, then the benefits they receive are not taxable. In this situation, the actual tax-free benefit results in a higher income replacement ratio. The more income a disability plan replaces, the less financial incentive there is for the employee to return to work. Depending on the benefit plan, a tax-free disability benefit may approach the employee’s post-tax working income.
Employers may incur additional tax responsibility if they allow this choice. The employee's taxable income increases by the premium amount the employer pays for the disability coverage. For post-tax premiums, both the employee and the employer will pay tax on the additional income.

100% Employee-Paid

Some employers offer completely voluntary disability benefits. Employees pay the full cost of coverage. Some employers require employees to pay the premium with pre-tax dollars, because they think the benefit becomes more affordable. However, employers could also allow employees to choose between pre- and post-tax payment, as long as the rules in the above section are followed.

Employer- and Employee-Paid

In some cases, the employer pays for base coverage and allows employees to purchase additional or “buy-up” coverage. The employer generally allows employees to pay the buy-up premium pre- or post-tax.

This option does complicate the tax status of any future benefits. If the employee makes buy-up contributions pre-tax, then the entire benefit will be taxable. But if the employee pays the buy-up premium post-tax, then the buy-up portion of the benefit is non-taxable. However, the employer-paid core portion of the benefit is still taxable.

Disability Benefits and FMLA

Sometimes human resource professionals confuse Family Medical Leave Act (FMLA) and disability benefits. These two benefits have different purposes. Disability plans replace income when an employee is unable to work because of a disabling illness or injury. The FMLA protects an employee's job if he or she cannot work because of a serious health condition. The FMLA also guarantees continued employer-sponsored health coverage at the same cost active employees pay.

These benefits, in most cases, need to be managed independently. The definition of “disability” can vary widely among plans. Employer plans pay short- and long term disability benefits based on the plan’s definition of disability. In order to qualify for an FMLA leave, however, the employee must suffer from a “serious health condition.” A serious health condition could encompass a range of illnesses that would not be considered disabling. For example, a flu virus that causes an employee to see his or her doctor for treatment and to miss a week of work would be a serious health condition.

Pregnancy often involves disability leave. In general, a short term disability vendor will cover six weeks for a normal pregnancy claim. The FMLA, however, permits 12 weeks. In this situation, the disability plan replaces the woman’s income for six weeks. If she is eligible for all 12 weeks of the FMLA, then she is entitled to have her job protected and to have continued access to employer-sponsored health care for six weeks after the disability payments end.

Be careful when you administer disability plans and the FMLA. The key provisions are different and distinct. If you administer these programs separately, you are more likely to manage both types of leave properly.

Health Coverage During Disability Leaves

Employers should also be careful when they manage an employee’s health coverage during a disability leave. When FMLA applies, you must continue health coverage at the same cost active employees pay. Because this is federal law, both insurance carriers and stop loss carriers recognize that employers must continue this coverage.

Issues can arise when employers decide to continue health coverage for disabled employees beyond what is required in the plan’s documents. Extending coverage beyond what is mentioned in the insurance contract or summary plan description can create a liability for the employer. The health plan defines employees’ eligibility for coverage usually depending on hours worked. For example, the plan may cover employees working 30 hours or more a week. Thus disabled employees would not be eligible, based on hours worked.
If an employer continues to cover an ineligible employee, the insurance carrier may terminate the coverage retroactively. Similarly, if a plan is self-funded, the stop loss carrier may decline a claim if the employee was not eligible under the terms of the contract.

Employers can be more generous than the FMLA. However, the additional disability continuation period must first be spelled out in their plan documents. The insurance carrier or stop loss carrier should agree in writing to allow extended coverage for disabled employees. The other option employers can consider is simply to fund some or all of the disabled employee’s COBRA premiums. With this approach, the employee must elect COBRA. The employer should clearly communicate the period during which the employer will pay the COBRA premiums. The employer should communicate when the employee will be responsible for COBRA premiums.

Concluding Thoughts

Employees do not always fully appreciate the value and importance of their disability benefits. Certainly, medical benefits are used more frequently than disability benefits. However, if an employee becomes unable to work because of an illness or injury, disability benefits are critical to his or her financial wellbeing.

These benefits are more complex than many employers realize. Employers need to understand the benefits their contract offers. You must be familiar with the contract’s key provisions when you evaluate new vendors. If a vendor has a very competitive rate, make sure the vendor offers the key provisions in your contract.

If you have any questions about disability benefits, please contact your McGraw Wentworth Account Director. MW