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WILL DISABILITY ALSO HARM MY RETIREMENT SECURITY?

*By Jack Towarnicky**

(Editor's note: In case the reader is distracted by the author's refreshingly out-of-the-ordinary narrative style, this paper discusses the impact of long-term disability on pension and other welfare benefits in the U.S. occupational/regulatory qualified plans environment.)

From the Plan Sponsor's Corner ...

A welfare benefit plan solution to continue retirement benefit accruals for workers who become disabled before completing their preparation for retirement.

Feb. 16, 2008

It was a little better than most Saturdays in February. High 40, low 20, partly cloudy. I was in the office working off my perennial backlog of email.

My employer at that time, a Fortune 150 financial services firm with 35,000+ workers, had just reduced the workforce by about 3 percent via a layoff. While 2007 was profitable, it was already clear 2008 would be quite rough for the enterprise. And, it wasn't only revenue and expense issues. Our retirement benefits were in a state of flux as well. We offered a defined-benefit pension plan with a final-average-pay formula, a retirement savings plan (a 401(k) plan) and retiree medical coverage with company financial support. We had recently made changes to add automatic features to the 401(k) plan, changed the defined-benefit pension plan to add a cash balance formula, and changed our retiree medical coverage supplement to Medicare into a different program, something called a Medicare Advantage Open Fee for Service plan.

Internal Revenue Code Section 402(a)

So, against that backdrop of change, and looking at that email backlog, on that February 2008 day, I considered but declined to attend a Washington, D.C. meeting to discuss proposed regulations under Internal Revenue Code Section 402(a). Back on Aug. 20, 2007, the Treasury Department

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(Internal Revenue Service, or IRS) had proposed regulations (Prop. Reg. § 1.402(a)) focused on the continuation of defined-contribution retirement plan accruals for employees on long-term disability (LTD). The proposed regulations would, among other things, limit the use of plan assets to fund/insure continued retirement benefits accruals during LTD. Unfortunately, the regulations were in conflict with past IRS private letter rulings.[1] Once finalized, the regulations could create a situation where a worker might be currently taxed on coverage purchased with plan assets. The new regulations also added complex administrative requirements which, if violated, could endanger the plan's tax qualification.

Retirement preparation for disabled workers was a topic of discussion before I arrived in 1985 and from time to time thereafter. But, with everything else, it just wasn't a top priority in February 2008—even though too many Americans underestimate the potential for disability [2], and too many overestimate their ability to maintain their standard of living after disability. [3] Our workers were no different than other Americans as just over 50 percent were actually enrolled in LTD coverage in our welfare benefits plan.

Here's my Feb. 16, 2008 email response to the invite:

"Can't be there. Interested in continuing 401(k) and pension accruals during periods of LTD—clarification under 402(a) would be good.... That said, there are other alternatives if using plan assets is precluded under 402(a) by the final IRS regs.

Clarification (thumbs up or down) would likely spur us to action. Probably more important for folks like (other employer) to be there—as they already have this in their 401(k) plan (if I remember correctly)."

So, we would wait. But could participants wait?

2010 New Retirement Benefit Designs

Well, 2008 turned out worse than anticipated, for our enterprise AND for America. And disability claims skyrocketed by some measures—for example, the Social Security Administration had applications of almost 750,000 (second quarter 2010), up 50+ percent from four years earlier. [4] Against that backdrop of expense management and increased risk of disability claims, we made some changes our defined-benefit pension plan ... including eliminating disability pension accruals for those disabled after Dec. 31, 2009. [5]

To fill the gap, during 2008 and 2009, we considered a number of options —such as the defined-contribution disability programs that had been in place in some 401(k) plans for a number of years [6]; however, the IRC 402(a) regulations were still not final. We had never added disability coverage or continued accruals in the 401(k) plan before, so there was no precedent to add such coverage now. Instead, we decided to improve existing LTD benefits in the welfare plan:

Disabled Before Jan. 1, 2010:
- Savings plan (401(k) accruals stop once LTD starts (6 months)).
- Defined-benefit pension plan accruals continue if worker is enrolled in welfare plan, qualifies for LTD benefits under that plan, AND qualifies for Social Security disability benefits.

Disabled After Dec. 31, 2009:
- Savings plan (401(k) accruals stop once LTD starts (6 months)).
- Defined-benefit pension plan accruals stop once LTD starts.
- Add a new component to existing LTD welfare plan coverage based on foregone retirement accruals, paid once LTD benefits stop.

For those who became disabled after the Dec. 31, 2009 change, company-paid pension accruals stopped, lowering company-paid expense. And, starting Jan. 1, 2010, those who enrolled in LTD coverage saw a significant increase in their contributions to fund the new disability benefits. However, for those who became disabled after Dec. 31, 2009, the new *associate-paid* disability benefit would reflect much of the lost income replacement from stopping accruals in both the defined-benefit pension plan and the 401(k) plan.

It's Not Enough To Continue Retirement Benefit Accruals!

The enterprise also took other actions to ensure more and more workers would have adequate benefits should they become disabled—it was "paycheck insurance," disability benefits to replace lost wages, but it was also post-employment medical and long-term care (custodial, daily living expenses) coverage:

- First, in 1997 with the increased prevalence of incentive compensation, we expanded the definition of covered compensation to include variable pay (annual bonus, overtime, shift differential, etc.).

- Second, in 1994, LTD coverage was now available on a pre-tax or after-tax contribution basis, so that those who needed a greater income replacement rate could receive 60 percent of pay free of income taxes.

- Third, in 2005, we added a Health Savings Account to allow workers to save on a tax-preferred basis for post-employment medical costs and long-term care insurance and out-of-pocket expenses.

- Fourth, in 2008, we changed the LTD coverage default so new hires were automatically enrolled in after-tax LTD coverage unless they opted out or affirmatively chose the pre-tax LTD coverage.

- Fifth, in 2010, the new disability benefit was made part of existing LTD coverage, so enrollment in "paycheck insurance" automatically included the amounts paid after disability ended.

- Sixth, and finally, the enterprise continues its past practice of accruing eligibility service for retiree medical coverage while LTD/income replacement benefits are in a payable status.

Not too surprising, changing the default to coverage, and specifically to after-tax LTD coverage, helped to ensure that more workers:

- Enrolled for LTD coverage,

- Received higher income replacement, tax-free benefits funded with after-tax contributions, [7] and

- Prepared for a financially successful retirement after an extended disability.

Welfare Benefit Plan Disability Coverage

New Hire Enrollment

	Before 2009		After 2008
Waived LTD	49%		24%
Enrolled in LTD	51%		76%
Increase		25%	
Percentage Improvement		49%	

Anyway, it would surely be a lot easier to incorporate a default retirement benefit accrual option to continue accruals for a future retirement if we could use a disability policy within the pre-tax 401(k) or Roth 401(k) or employer-match source buckets of a 401(k) plan. And, for those who don't have access to a 401(k) plan, the same disability benefit coverage policy might be extended to Individual Retirement Accounts—to continue accruals in those plans in the event of disability.

Thanks for the opportunity to share this story.

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** The comments presented in this article are those of the author and do not necessarily reflect the views of any employer, nor any trade association or other agency or group with which he is affiliated, past, present or future.*

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[1] See LTR 200031060 and LTR 200235043.

[2] See, for example, "The Disability Divide," Council for Disability Awareness, January 2011. March 2010 research confirmed 90 percent of respondents rated their ability to earn an income as more valuable than any other resource in maintaining financial security; however, only 37 percent had thought about taking steps to protect their income.

[3] "The Disability Divide" confirmed that 65 percent of survey respondents indicated that they could sustain their current standard of living for at most one year; however, few workers, even those with LTD coverage, understand how a disability benefit with 60 percent pay replacement would impact their financial status. Few consider the impact on purchasing power from inflation. Many have ongoing increased medical costs. Too many find themselves removing assets from their 401(k) plan, not adding retirement savings. Finally, it should be noted that both the 2009 and 2010 American Payroll Association surveys, "How America Gets Paid," confirmed that over 70 percent of Americans live paycheck to paycheck where even a two-week delay in a paycheck would create a financial hardship.

[4] Selected data from the Social Security Disability program, see: http://www.ssa.gov/oact/STATS/dibStat.html.

[5] Prior to 2010, defined-benefit pension accruals continued during a disability in two ways: first, we continued participation service accruals (or pay credits in the cash balance formula), and, second, we indexed covered compensation by up to 2.5 percent per year. To continue, a participant needed to meet the definition of disabled in both the LTD welfare benefit plan and Social Security.

[6] See, "Corporate Compensation Plans Says Treasury torpedoes Key 401k Benefit," Business Wire, June 2, 2010; or http://www.corpcompinc.com/401kabout.aspx; or: http://www-01.ibm.com/employment/us/benefits/ipb01.shtml. [7] Until the change to default to coverage at hire (instead of defaulting to no coverage), after-tax LTD was not available; the chart below shows a comparison of the last 12 months prior to the change in default against the first 12 months after the change in default, where new hire enrollment increased 49 percent, and 73 percent were covered on an after-tax basis, while 27 percent affirmatively selected pre-tax coverage!
