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# Addressing the Risk of Long-Term Disability on Retirement Income

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Wolters Kluwer

The historic shift from defined-benefit (DB) pension plans to defined-contribution (DC) plans has created a hidden threat to the retirement security of millions of American workers, in the form of long-term disability. Many workers and employers alike are unaware of the danger disability can pose to participants of DC plans such as 401(k)s; fortunately, recent regulatory changes[1] have made it possible for long-term disability (LTD) insurance to cover retirement plan contributions.

## A FORMIDABLE THREAT MOST PEOPLE AREN'T AWARE OF

Disability is shockingly common in the US. During their working career, 1 in 8 workers will be disabled for five or more years,[2] with 90 percent of disability due to illness or chronic conditions. Moreover, disability is becoming more frequent. According to the Social Security Administration, 1 in 4 of today's 20-year-old individuals will become disabled before reaching retirement age.[3]

The shift from DB to DC plans has exacerbated this vulnerability for the vast majority of Americans. While defined-benefit plans certainly had their drawbacks (expensive and risky for the employer), they included a crucial feature that is missing from DC plans: Defined-benefit plans usually continued accruing retirement benefits on behalf of disabled employees. In addition to differing in other important respects, DC plans have historically, for the reasons enumerated further below, failed to include comparable protections against disability.

As many are aware, 401(k) plans transfer 100 percent of the investment risk to the employee. The average worker does not have the time or resources to become an investment expert, and if a worker makes a poor investment decision it has the potential to derail his retirement savings. Additionally, workers may need to pull money out of retirement plans to buy a home or pay for college. In the case of disability, workers also have to pay for any expenditures (such as medical bills) not covered by their LTD benefit plan, which generally totals only about 65 percent of pre-disability income. A long-term disability has the potential to leave a worker with little or no retirement savings at all.

Most employers have not adequately addressed this issue. This lapse was partly due to the fact that regulations didn't permit effective remedies. But in light of recent regulatory changes, making disability coverage for retirement contributions available to employees should become a priority.

## IRS FINALLY OPENS THE DOOR TO SOLVING THE PROBLEM

In 2014, the IRS and Treasury Department released regulations[4] that cleared a path to protect retirement contributions directly within DC retirement plans, including 401(k) plans. Under the new regulations, disability insurance covering plan contributions is considered a plan investment, therefore, crucially, premiums and benefit payments are not taxable to the participant (*i.e.*, until withdrawn at retirement).

It is essential to note that these regulatory changes alone do not solve the problem of the gap in disability coverage; rather, they only make it possible for employers to finally address this coverage gap in a manner integrated with the retirement plan.

There are three approaches available to employers to tackle the risk disability poses to retirement savings:

1. Employers can effectively "self-insure" by amending their 401(k) plan to state that the employer will continue contributions on behalf of disabled employees;

2. They can purchase coverage outside of the DC plan; or

3. They can provide coverage directly within the DC plan. This last approach is the only approach that can, when structured correctly, comply with the new regulations.

The following case studies, while not covering every possible scenario, strongly suggest that providing coverage within the plan will usually be highly advantageous to employees and most cost efficient.

## CASE STUDIES

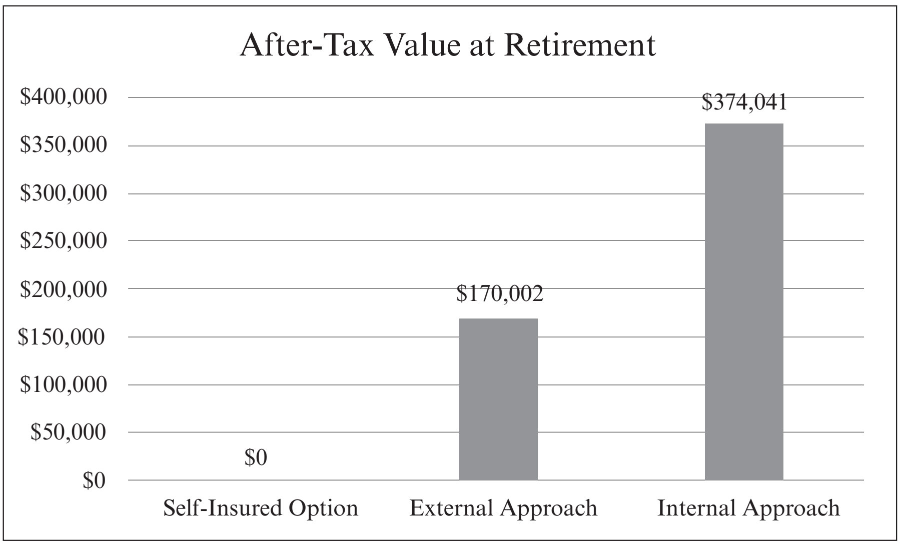
Under certain circumstances, such as in the event of a permanent disability, any one of these options is better than none.

To illustrate the differences in probable outcomes under each approach—what happens if the employer self-insures, purchases coverage external to the DC plan, or purchases insurance within the plan—we've created the case study detailed below, which involves a hypothetical employee who becomes disabled. In all three scenarios, we've assumed our hypothetical employee has adequate underlying group LTD coverage to cover daily living expenses.

The case study illustrates the potential impact on future retirement savings as a result of the disability event. Our underlying financial, investment return, and cost assumptions are detailed below.

Our hypothetical employee, a 35-year-old, experiences a disability of 82 months (the average length of a disability[5]) then returns to work. Basic assumptions include the following:

| | |
|---|---|
| Age at disability | 35 |
| Length of disability | 82 months |
| Retirement age | 65 |
| Retirement plan contributions | $12,000 per year |
| Personal income tax rate | 30% |
| Premium rate for coverage | 1.25% |




**Self-Insured Option**

This case study reveals a major weakness in the self-insured approach: In order to qualify for continuing contributions, employees must meet the Social Security definition of disability. This definition, which requires the disability to be total and permanent, is far more severe than the definition used by most private disability insurance. As shown in the model, under the self-insured approach, the employee's retirement plan contributions would drop to zero during the disability, because being disabled for 82 months would fail to meet the "total and permanent disability" threshold. In addition to failing to protect our hypothetical employee's retirement nest egg (our stated goal), such a scenario also has the potential to harm employee relations and morale.

Consider the likely reaction of our hypothetical employee (and her colleagues) if they are considered disabled under the base LTD plan, but not under the self-insured model (something quite likely given the duration of the average disability).

**External Approach**

Under the second approach, because coverage under this model is provided outside of the DC plan, it need not comply with the new IRS regulation. However, this means disability benefits cannot be contributed to the employee's 401(k) plan, necessitating careful tax planning. On top of taxes due on the growth of the assets received as benefits, this money will also, in all likelihood, be subject to higher investment management fees than those charged in the qualified retirement plan.

In order to compare this external approach to insuring the risk directly within the plan on an "apples to apples" basis, we have to make a number of assumptions. First, we assume that after-tax money is used to pay premiums, which is necessary to assure benefits are tax-free when received. However, because premiums are paid from after-tax funds, there are 30 percent less dollars available to pay premiums. (We could alternatively have shown premiums being paid with pre-tax dollars, but then all benefits would become taxable during the period of disability.) Either way, the result is less net coverage when targeting a uniform budget of 1.25 percent of contributions. In the end, we only have enough after-tax dollars to purchase $8,400 of coverage as opposed to $12,000.

Next, to replicate that tax-deferred growth in a retirement plan, we assume that the proceeds are invested in a variable annuity (one that allows our disabled participant to make investment selections and periodic reallocations in similar fashion to the 401(k) plan) that defers taxes until retirement.

Lastly, we assume the insurer will require the benefit proceeds, regardless of how they are invested, to be held in an individual trust so that the employee cannot use the extra coverage to pay for current expenses (such trust requirement is commonly required by insurers offering external coverage). The assumed gross return of growth is 8 percent per annum. Combined annual costs of the annuity charges, investment management fees within the annuity, and trust fees are assumed to average 2.75 percent of annual growth, yielding a net growth rate of 5.25 percent. These charges approximate available industry statistics.[6]

In the external coverage model, the employee's retirement savings fair markedly better than in the self-insured approach. At the end of the disability period, the contributions made to the plan total $57,400—approximately 30 percent less than what would have been made had our hypothetical employee never become disabled. Under the modeling investment return assumptions, these benefit contributions would grow to $170,002[7] by retirement. While this is far better than in the self-insured instance, it still means our hypothetical employee loses over half the retirement savings he otherwise would have accrued.

### Coverage within the DC Plan

In the third model, we take advantage of the new IRS regulation to purchase coverage within the plan, making benefits payable directly to the employee's DC plan account. The insurance coverage offered within the plan typically looks like the following. The plan makes available as an investment option under the plan a group long term disability policy or, possibly, in the case of very small plans, a number of individual long term disability policies. The plan participant elects to have a small portion (≤ 5 percent of overall contributions) of his or her own contributions (*e.g.*, pre-tax deferrals) and possibly employer contributions (*e.g.*, matching contributions, profit sharing contributions, etc.) used to purchase long term disability coverage under the policy. In the event the participant becomes disabled, the insurance carrier pays cash to the participant's plan account in the amount of the contributions he or she was making (and possibly the employer was making) prior to disability.

In our case study, we assume that, at the end of the disability, contributions paid by the carrier to the plan total $82,000—the same amount had the employee not become disabled. However, because these benefits are treated as regular contributions to the DC plan, they continue to grow (at 8 percent, the same assumed gross rate of return as the annuity) along with the rest of the contributions until the time of retirement. At that point, the benefits total $534,344[8], which, after taxes, yields $374,041. This is 100 percent of what the employee would have accumulated had she not suffered a disability.

In this scenario, we assumed investment management fees within the plan average 0.87 percent of assets annually. This assumption is likely in keeping with smaller plans, but is too high for very large plans, where IMFs tend to be relatively lower.

## THE PATH FORWARD: INSURING RETIREMENT DISABILITY COVERAGE SHOULD BE A PRIORITY

The new IRS regulations are only the first step in mitigating the effects of long-term disability on retirement savings. Making disability coverage for retirement contributions available to employees should now become a priority among employers. In light of the fact that the premiums for this coverage represent only a small fraction of the cost of matching contributions and other employee benefits (*e.g.*, medical), a strong case can be made for employers to consider picking up the entire cost of providing it. Others should consider sharing in the cost (*e.g.*, paying for the portion to cover employer contributions to the plan). Understandably, this can be a challenge for many employers due to the universal focus and concern regarding rapidly rising medical costs. Fortunately, methods such as making insurance available on a voluntary basis, or auto-enrolling employees in such a program (*i.e.*, with the option to opt out), for example, represent new ways to address employees' risk with little or no cost to the employer. (Of course, for those workers who don't have *any* form of long-term disability insurance, the most pressing need is to educate employees about their risk of long-term disability and their options for addressing it.)

The onus is now on employers to determine which approach best balances their needs with those of their employees. As the case studies demonstrate, there are a number of ways to address the disability conundrum in the DC plan environment and, in our view, coverage provided within the plan (the third model) can yield substantially better results. Not only does it eliminate extraneous costs and extra tax planning, it also ensures that contributions will continue to be made to the DC plan and will continue to grow on a tax deferred basis, meaning the employee's retirement plans can stay on track.

By helping disabled employees continue saving for retirement, employers can help their employees protect the security of an entire family whose financial future would otherwise be derailed. In light of the above analysis, we believe that employers should seriously consider offering their employees the option to ensure their retirement savings against disability risk, particularly when this can be done at little to no cost to employers.

## NOTES

1. TD 9665. 79 Fed. Reg. 26838 (May 12, 2014).
2. Commissioner's Disability Insurance Tables A and C, assuming equal weights by gender and occupation class. (Cited on the Council for Disability Awareness Web site, *http://www.disabilitycanhappen.org/chances_disability/disability_stats.asp*, accessed March 7, 2016.)
3. U.S. Social Security Administration, Fact Sheet, February 7, 2013. (Cited on the Council for Disability Awareness Web site, *http://www.disabilitycanhappen.org/chances_disability/disability_stats.asp*, accessed March 7, 2016.)
4. TD 9665 provides for an exemption for the purchase of LTD insurance within a defined contribution plan where the insurance covers lost contributions to the plan due to the disability event.
5. Council for Disability Awareness, Personal Disability Quotient (PDQ) calculator. *http://www.disabilitycanhappen.org/chances_disability/disability_stats.asp*, accessed March 7, 2016.

6. While these fees vary, insurance and administrative fees alone for annuity products average 1.50 percent, according to the Barrons: Top 50 Annuities.
7. Growth assumes a gross investment return of 8 percent and a net return of 5.62 percent, after deduction of investment management fees of 1 percent, trustee fees of 0.25 percent and annuity fees of 1.5 percent.
8. Growth assumes a gross investment return of 8 percent and a net return of 7.13 percent, after deduction of investment management fees of 0.87 percent.