How does disability relate to retirement security? The rise of DC plans and decline of DB plans has brought in-plan out out-of-plan options to the fore.

The Role of Pre-retirement Disability in Retirement Security

BY DAVID C. KALEDA AND ANNA RAPPAPORT

hen employees turn to employer-sponsored programs for benefits and risk protection, disability is often far down on the list of priorities because they do not understand how financially devastating an extended disability can be to a family. Disability risk is underestimated by many Americans. Not only does the employee experience a loss of income by not working, but other family members may also stop working in order to care for the disabled family member and medical costs incurred by the employee may be very high. Often, different professionals work with retirement programs and disability programs, so that intersection of disability risk and retirement security is often not on the retirement security radar screen. The issue is often forgotten. In fact, long term disability coverage is extended to only 31% of the labor force.

Actuaries, pension consultants and administrators are concerned about structuring programs that will provide retirement security at

a reasonable cost, minimize risk to plan sponsors and provide for stable plan operations. In recent years, this had lead to an increased focus on defined contribution retirement plans. In general, defined benefit plans traditionally have provided more extensive risk protection than DC plans, and the employer has borne more of that risk. In the move to DC plans, risk has shifted to individuals or separate programs outside of the retirement program. The risks covered by DB plans included loss of income from retirement, death and, in many cases, disability.

However, in the shift to DC plans, the disability provisions that protected retirement security after disability have often been lost, so that there is a significantly increased risk that mid- or late-career disability will derail retirement security.

The protection of retirement income for DC participants during extended periods of disability involves two goals: participants must continue saving for retirement during disability, and participants must refrain from using accumulated retirement funds to replace income lost during disability rather than saving those funds for their retirement years. While the problem is seemingly straightforward, DC plans are subject to extensive regulations that are not as conducive to meeting those goals as the regulations applicable to DB plans.

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. It addresses plans covered by the Employee Retirement Income Security Act (ERISA).

WHAT CONSULTANTS MIGHT DO TO ADDRESS DISABILITY RISK 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 entire compensation and benefits program? Are there risks that are not being protected against? How does the DC plan fit into the compensation and benefits scheme? Are there adequate protections against loss of current income and retirement benefits in the event of disability?

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:

- Encourage employees of employers without disability programs to purchase individual coverage and when setting up their program, not to forget about providing a benefit adequate to protect retirement savings. This is probably the best strategy for small employers.
- 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 program to purchase added coverage on 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 is ideal. These ideas are presented with the hope that practitioners, sponsors and employees will engage in a dialogue about this issue, and that better ideas will emerge. In addition, more people may add voices to those who are trying to get the regulatory issues unscrambled.

SMALL VS. LARGE EMPLOYER ISSUES

Large employers are much more likely to offer employer sponsored long-term disability on a group basis to all employees and to get directly engaged in offering programs to provide for security on disability. Employees of smaller employers are more likely to depend on individual long term disability if they have coverage at all. Some individual disability insurance carriers offer added coverage through riders to provide coverage for DC contributions lost. For small employers, the main focus should be on encouraging employees to purchase individual disability coverage and to think broadly about disability risk. An advisor (such as an agent or broker) who is knowledgeable about the risk and who will consider the related retirement issues will be important in making a good decision about what to buy.

DIFFERENCES BETWEEN DB AND DC DISABILITY BENEFIT PRACTICES

The U.S. pension laws recognize the need for disability benefits in retirement plans, but that recognition is not adequately supported with

DOL's ERISA Advisory Council

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 report can be found at http://www.dol.gov/ebsa/publications/2012ACreport2.html. 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. It article represents the views of the authors and not that of the Council or of the Department of Labor, or any organization either of the authors is affiliated with.

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appropriate regulations with regard to DC plans. Both ERISA and the Internal Revenue Code allow for a "qualified disability benefit," which is 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. However, disability retirement benefits appear to be a much more common feature in a DB plan. Employers have not been as willing to implement disability retirement income benefit features within or next to their DC retirement 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 fact that DC plans generally transfer most retirement benefit funding risk to plan participants. In addition, lack of clarity in applicable regulations make implementation of disability retirement programs in DC plans unattractive for employers who are interested in this topic.

Defined Benefit Plans

In a DB plan, the plan provides for a benefit payable to a participant at normal retirement age with some plans offering early retirement benefits that are reduced from the amount paid at normal retirement. Disability retirement benefits may be offered through the DB plan in a number of ways. For example:

- **Continued Benefit Accruals During Periods of Disability:** The plan may provide that participants will continue to accrue a benefit while disabled.[2]
- **Disability Retirement Pension Benefits:** The plan may provide that a participant will receive his or her accrued pension benefit under the plan upon becoming disabled prior to normal retirement age. In many cases, the benefit is subsidized by the employer. 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 SSDI.

When the disability retirement benefit is built into the plan's benefit formula, 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.

Defined Contribution Plans

Any period of time during which a participant cannot continue contributions 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 recover over his remaining working career. There is an added problem in DC plans. If benefits are paid as a lump sum on disability, then the benefits may be spent to meet current expenses rather than retained to meet retirement needs.

DC plans today are generally employees' primary retirement vehicles. In a DC plan, the employer and/or the participant make contributions to an individual account within the plan on behalf of participant while the individual is working. 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.

Arguably, 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. Some plan sponsors

1 Code §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).

and advisors to plan sponsors have recognized the issue 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.

Here 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 Defined Contribution Plan:** The employer purchases additional 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 on behalf of the participant 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 the arrangement is to make up for the benefits that would have been made to the defined contribution plan but for the disability.
- **Purchase of "LTD 401(k) Insurance" as an Investment in the Defined Contribution Plan:** The participant elects to have a portion of his or her own contributions (e.g., pre-tax deferrals) and possibly employer contributions (e.g., 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 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.

BARRIERS TO DC PLAN DISABILITY BENEFITS/ REGULATORY ISSUES

While Code Section 415 permits employers to make contributions on behalf of participants who are disabled, the ability to take advantage of this is limited because Section 415 only permits such contributions if the participant is "permanently and totally disabled" as defined in Code Section 22(e)(3), 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 not being able 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 pursuant to Section 415 of the Code under the defined contribution retirement plan.[7]

Challenges to Implementing Options Outside of a DC Plan

As stated above, some plan sponsors implemented an arrangement designed to make up for the lack of accrual of disability benefits under a DC plan during a disability with an "out of plan" option. A portion of LTD insurance benefits paid by an insurer were contributed to an IRA or individual retirement annuity from which they could be paid at the time the employee retired. Another idea that may be possible is for an insurer issuing a LTD policy that is designed to provide both current income and retirement income. However, both of these arrangements pose administrative and legal issues. The 2012 ERISA Advisory Council testimony from Richard Shea and Louis Mazawey provides insight into some of the challenges. The testimony can be obtained from the ERISA

4 Code Section 415(c) 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 either: (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.

6 Specifically, Code Section 22(e)(3) 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 Note that Code Section 415 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."

Advisory Council (see sidebar on page 39).

Another possible solution is that an employer-sponsored LTD arrangement, whether insured or self-insured, could 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 that provided post-retirement LTD benefits could possibly be viewed by the DOL as "pension benefit plan" rather than a "welfare benefit plan." (The authors understand that riders are available to be added to individual disability coverage to provide added coverage to replace retirement savings, but that such riders are not used very often.)

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

The position taken by the IRS in two private letter rulings[8] 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 understand 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 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. The ERISA Advisory Council report and testimony provide more information on these issues (see sidebar on page 39).

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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. We hope that this will change, but 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 realities of the employer marketplace today, which continues to move toward only offering DC plans, requires employers who wish to provide its employees with the opportunity to have adequate retirement benefits in the event of disability to consider other 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 discussed above. We hope that the readers of this article will focus on these issues with the system stakeholders they serve. PC

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8 See Private Letter Ruling 200031060 and Private Letter Ruling 200235043.