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DISABILITY INSURANCE DUE DILIGENCE

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According to multiple surveys, approximately 90% of employers offer long-term disability (LTD) insurance to their employees. Designed to protect the assets of someone who is unable to earn a paycheck due to accident or illness, most everyone can agree that such a benefit is critical to reduce the risk of financial disaster. This coverage is extremely important for both young and seasoned professionals, especially considering the current leading cause of bankruptcy is attributable to medical expenses.

However, LTD benefits are often given too little attention, by both employers and their employees. Perhaps this is to be expected when so much attention (and expense) is focused on health insurance challenges. In addition, because LTD policies typically have an extended waiting or elimination period before benefits are paid, the frequency of claims is usually very low. Correspondingly, very few people take the time to truly understand the underlying insurance contract; because the policies have many moving pieces and confusing terminology, there is a lot to learn.

Here are some things to consider when reviewing a disability contract, which can significantly impact your employees receiving the protection they need.

DEFINITION OF "DISABILITY"

There are many factors to consider in evaluating the term "disability." Opt for a contract that:

- Covers both total and partial disabilities,
- Defines the job as that which the employee actually performs ("own occupation"), not "any occupation,"
- Will not penalize an employee for attempting to return to work, either for a brief period or on a reduced capacity basis

ELIMINATION PERIOD

The elimination period is the time that an individual must be disabled before benefits begin. The waiting period is designed to be short enough that people can get by on their vacation, sick, or PTO days, but long enough that the premiums will be kept reasonable; the longer the elimination period, the smaller the premiums. Some key questions to ask are:

- Does the average employee have enough in savings to cover their expenses during the elimination period?
- Will a partial disability reset the elimination period?

- Does the elimination period count against any "own occupation" limits?
- If the company also offers short-term disability (STD), does the STD benefit period dove-tail with the LTD elimination period?

BENEFIT LIMITS

All disability policies have a monthly cap on how much can be claimed, both in a percentage and fixed dollar amount. The percentage is usually between 50 and 70%, but the fixed amount can vary widely. For higher wage earners, there is a real possibility that the benefit amount will cap out at an amount below the listed percentage.

EXAMPLE

LTD POLICY
60% benefit to a maximum of $6,000 per month.

In the case of someone earning $12,000 per month, 60% of $12,000 is $7,200, so this person would only receive $6,000 per month, or 50% income replacement.

There are a couple of ways to enhance the LTD benefit to insure the higher income earners can receive the full and intended income replacement. One is to simply raise the benefit limit. Though simple and direct, the downside to this approach is that it raises the rate the employer must pay for all employees' coverage. The second is to layer on top an individual disability policy that provides an additional benefit for the higher income earners. This results in key employees receiving a higher level of income replacement without affecting the cost of the group disability program, in addition to providing a policy that may be fully portable and non-cancellable (benefits and premiums can't be changed).

EARNINGS

Even what counts as income can be broadly or narrowly defined in a contract. Considering base wages as the definition of earnings could be inappropriate for a commission based sales person, or for a company that uses bonuses as a large piece of employee compensation. The definition of earnings can be just as problematic for partners; any definition that does not include K-1 or shareholder distributions is not insuring full income.

TAXATION

As an employer provided fringe benefit, disability benefit premiums, which are paid for by the employer, are not considered income and therefore taxable to the employee. From a benefit standpoint, however, this creates the problem that any payout received will be considered taxable income. This means the disability benefit, which is supposedly 60% of income, may actually be closer to 45% once federal (and potentially state) income taxes are withheld. Employers who wish to avoid this scenario and provide a higher income replacement can design their plans to be employer paid, but result in a tax-free benefit. A "salary gross up" plan is when the employer increases the employee's salary by the amount of the premium, and the employee pays for the coverage by making an equivalent post-tax premium deduction. As a result, the employee pays taxes for their portion of the premium, but any benefit received will be paid on a non-taxable basis.

There are many other features in any group disability policy that should be considered to make sure that your employees receive the benefits they need. Taking the time to go through the details to understand the contract and making sure it responds to the needs of your company can be life changing and well worth the effort.