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Do Your Employees Understand Your Company's Disability Plan? Do You?

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Human resource (HR) professionals and employees sometimes do not understand their group Long Term Disability (LTD) Plan, which can lead to problems and unfulfilled expectations when there is a claim. This article explores the pitfalls of disability plans and shows how to avoid them.

The basic function of a group LTD insurance plan is to provide your employees with income replacement in the event they are unable to work due to an accident or illness. The need for such coverage is clear: According to a recent study, two thirds of American households are living paycheck to paycheck,and the average American family cannot make it more than four weeks without income.[1] That said, most employees, and even some employers, do not understand what criteria will determine whether or not someone actually qualifies for benefits. Also not clear in advance is how much benefit an employee will actually receive if he or she is determined to be disabled under the terms of the LTD contract. Claim time is the wrong time for your employees to reach a full understanding of how their company's LTD plan works. Below are a number of group disability plan features and pitfalls to be aware of—don't let them go unnoticed until it's too late.

Disability Defined

The definition of disability is a good place to start in understanding your company's group coverage. Because a disability claim is based on someone's functional capabilities, defining the duties of their occupation is a key element of the contract. Insurance carriers break this into two basic categories: own occupation and any occupation. Under the "own occupation" scenario, an employee would be eligible for benefits if he were unable to perform the specific duties of the job he was performing at the time of his disability. In order to be eligible for benefits under the "any occupation" scenario, an employee would have to be unable to perform the material duties of any occupation for which he is reasonably suited given his training and experience.

Here's an example of this distinction in practice. Suppose a surgeon lost the use of his index finger and was no longer able to perform surgery. Under an own occupation definition, his inability to perform surgery would qualify him for benefits. However, if his contract had an any occupation definition, there is a high probability that he would not qualify for benefits, as there are numerous occupations in the medical field for which he is suited that do not require the same level of function as a surgeon.

Most LTD contracts are written with own-occupation coverage for two years and any-occupation coverage from two years through the life of the claim. The higher quality own-occupation coverage carries a more expensive rate than its any occupation alternative.

Benefit Taxability

Benefit taxability is not necessarily a pitfall, but all employees should be made aware of the potential for their LTD benefits to be subject to taxation. When an employer pays the full cost for this coverage and an employee becomes disabled and receives payments, this benefit is taxed at the same rate as ordinary income. So while the employee is receiving a benefit at no cost, the amount of claim dollars he or she receives is slightly diminished. The key phrase here is "employer pays."

If, on the other hand, the *employee* pays the premium, then when he receives benefit payments, he does *not* pay taxes on them. Instead, the premiums are handled as an after-tax payroll deduction and are reflected on each pay stub.

Long term disability is a relatively low cost insurance when a group plan is purchased. Most employers pay the full cost of the benefit and then all eligible employees are covered. Most employees do not realize they are receiving a taxed benefit until they receive their first claim check. Most employers take care to make this point clear in the communication materials described in the LTD plan.

Covered Earnings Defined

This is typically a detail in a contract that most people do not understand. It is important for employees to be aware of whether the plan covers base salary only, or includes other types of income such as bonuses and commissions. Your company must think this area through carefully when the LTD plan is implemented, as it can dramatically affect someone's benefit in relation to total compensation.

That fact that all types of earnings are not covered is another fact that is often not understood until someone is on claim. Many employees receive multiple forms of income—base salary, bonus, commissions, etc. Quite often, only base salary is covered by the LTD plan. While an employee may believe that *all* of his compensation is covered, that is often not the case. Suppose you have an employee with an annual base salary of $60,000 and commissions of $40,000. If your company provided an LTD plan that covered 60 percent of base salary to a maximum of $3,000/month, this employee would receive $3,000 monthly. With commissions, this employee's actual monthly earnings are $8,333 ($100,000/12). Since this employee's commissions are not covered under the LTD plan, this employee's actual disability benefit is 36 percent of total pre-disability income—not 60 percent.

Another common misunderstanding is the notion that if you put more compensation into the definition of covered earnings, a larger benefit will be received. This can be true in some circumstances, but such a tactic can also cause claim problems depending on the timing of bonus and commission payments, the company's tax entity status, and whether any income will be derived *after* the start date of a claim. Particulars on all these issues are found in the general area of "offset to earnings" in a group LTD contract.

Monthly Maximum Benefit of a Group LTD Plan

An overwhelming majority of disability plans in America have an income replacement ratio of 60 percent. What many HR professionals and employees do not understand, however, is that there is a monthly maximum or cap. Therefore, the maximum benefit can cause the income ratio to be an amount lower than 60 percent.

For example, your company might have an LTD plan design of 60 percent of monthly base salary to a maximum of $3,000/month. So, an employee earning a salary of $100,000 would receive $3,000/month. As you can see, the monthly base salary is $8,333 ($100,000/12). Sixty percent of this would be $5,000/month, but the company's LTD plan has a monthly maximum of $3,000. In practice, the employee would receive an amount closer to one-third of his pre-disability income.

Because most employees do not understand how their benefit is calculated, they end up misinterpreting what they will receive on claim. This can result in confusion and dissatisfaction from both the employer's and employee's perspective.

As you can see, there are a number of factors to consider in designing your company's LTD plan. Clearly, the monthly maximum or type of covered earnings would be two of the pitfalls mentioned above. There are programs within the disability industry that deal with the concept of "exposed income," which can involve earnings above a certain cap, or bonus and commission dollars not covered in the definition of earnings. These are generically called supplemental disability programs and can take on many different design options.

In conclusion, remember that many underlying factors determine how much benefit someone will get paid, or if they qualify for benefits at all under the terms of your LTD plan provider's contract. We have outlined some of the more important features to consider.

Different types of companies require different LTD coverages. No matter what type of employee you represent, make sure you have addressed the areas outlined above to ensure that your plan provides the benefit in the manner you desire. There are many things to consider, and claim time is the wrong time to figure them out. ✪

Note

1. "Is the American Dream Still Possible?" Parade Magazine, April 23, 2006.

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