

Group Disability Income Insurance

Learning Objectives

An understanding of the material in this chapter should enable the student to

- 6-1. Describe the nature of disability income insurance, and explain why it is important to employees.
- 6-2. Describe the characteristics of sick-leave plans.
- 6-3. Describe the characteristics of insured disability income plans.
- 6-4. Explain the tax treatment of group disability income premiums and benefits for the employer and the employees.

The purpose of *disability income insurance* is to partially (and sometimes **disability income insurance** totally) replace the income of employees who are unable to work because of sickness or accident. Although an employee may miss a few days of work from time to time, there is often a tendency to underestimate both the frequency and severity of disabilities that last for longer periods. At all working ages, the probability of being disabled for at least 90 consecutive days is much greater than the chance of dying. One out of every three employees will have a disability that lasts at least 90 days during his or her working years, and one out of every ten employees can expect to be permanently disabled prior to age 65.

All too often, the importance of adequate disability income coverage is overlooked. In terms of its financial impact on the family, long-term disability is more severe than death. In both cases, income from employment ceases. In the case of long-term disability, however, family expenses—instead of decreasing because of one less family member—may actually increase because of the cost of providing care for the disabled person.

Employers are less likely to provide employees with disability income benefits than with either life insurance or medical expense benefits. Thus, many employees may need to buy individual policies on their own. It is difficult to estimate the exact extent of disability coverage because often benefits are not insured and workers are sometimes covered under overlapping plans. However, a reasonable estimate would be that nearly three-quarters of all full-time employees have some form of short-term employer-provided protection, and only about one-third of full-time employees have employer-provided protection

for long-term disabilities other than Social Security. This does not mean that almost all employees have some sort of disability income coverage, because many employees have both short-term and long-term protection and thus are included in both estimates. These estimates are also somewhat misleading because most employees have long-term disability income coverage under Social Security as well as coverage for certain types of disabilities under other government programs.

Group disability income protection consists of two distinct products:

**short-term disability (STD)
income plans**
**long-term disability (LTD)
income insurance**

- *short-term disability (STD) income plans*, which provide benefits for a limited period of time, usually 6 months or less. Benefits may be provided under uninsured sick-leave plans or under insured plans, often referred to as *accident and sickness insurance* or weekly indemnity benefits.
- *long-term disability (LTD) income insurance*, which provides extended benefits (possibly for life) after an employee has been disabled for a period of time, frequently 6 months

An important task in designing and underwriting insured group disability income plans is to coordinate them with each other (if both a short-term and a long-term plan are provided for employees). An equally important task is to coordinate them with other benefits to which employees might be entitled under social insurance programs, uninsured sick-leave plans, and employer-sponsored retirement plans. A lack of coordination can lead to such a generous level of benefits for employees that absences from work because of disability might be either falsified or unnecessarily prolonged. Alternatively, a lack of coordination can lead to an employee having a gap in coverage from the time a short-term plan ends until a long-term plan or Social Security benefits begin.

SICK-LEAVE PLANS

sick-leave plan

Employers use two approaches to provide short-term disability benefits to employees: sick-leave plans and short-term disability income insurance plans. A *sick-leave plan* (often called a *salary continuation plan*) is uninsured and generally fully replaces lost income for a limited period, starting on the first day of disability or a short time later. In contrast, a *short-term disability income insurance plan* (which is covered in the next section of this chapter) usually provides benefits that replace only a portion of an employee's lost income and often contains a period of time before benefits start, particularly for sickness. It is impossible to obtain precise statistics, but surveys indicate that about half of the employees with short-term coverage obtain benefits under sick-leave plans, about one-quarter under insured plans, and about one-quarter under plans that combine the two approaches.

Traditionally, many sick-leave plans were informal, with the availability, amount, and duration of benefits for an employee being discretionary on the part of the employer. Although some plans used by small firms or for a limited

**paid time off (PTO)
program**

number of executives still operate this way, informal plans are generally inappropriate. There is a possibility that the IRS will consider benefit payments to be either a gift or a dividend and therefore not tax deductible by the employer. In addition, an informal plan increases the likelihood of suits brought by persons who are disabled but who do not receive benefits. As a result, most sick-leave plans are now formalized and have specific written rules concerning eligibility and benefits.

In recent years, a few employers have combined their sick-leave plans with other types of payments for time not worked, such as vacations, holidays, and personal leave into a single *paid time off (PTO) program*. One rationale for such programs is that many employees view sick days as a right and will take the maximum number of days available, whether sick or not. With a PTO, an employee is given a specified bank of days off with full pay and can take this paid time off for any reason. The bank of days is usually slightly less than the total number of days under the prior programs, but within the range of the number of days that most employees took off.

PTO programs have generally had the effect of lowering the number of days that employees call in sick, because these days can be used for other purposes. This lowers an employer's benefit costs and minimizes other problems associated with unscheduled absences.

However, there is also a negative side of PTO plans for an employer. Some employees who should stay home may come to work when they are sick. Their productivity may be impaired, and they may sicken other employees by spreading germs.

Eligibility

Almost all sick-leave plans are limited to regular full-time employees, but benefits may also be provided for regular part-time employees. Most plans also require that an employee satisfy a short probationary period (commonly 1 to 3 months) before being eligible for benefits. Sick-leave plans may also be limited to certain classes of employees, such as top management or nonunion employees. The latter is common when the union employees are covered under a collectively bargained, but insured, plan.

Benefits

Most sick-leave plans are designed to provide benefits equal to 100 percent of an employee's regular pay. Some plans, however, provide a reduced level of benefits after an initial period of full pay.

Several approaches are used in determining the duration of benefits. The most traditional approach credits eligible employees with a certain amount of sick leave each year, such as 10 days. The majority of plans using this approach allow employees to accumulate unused sick leave up to some maximum amount, which rarely exceeds 6 months (sometimes specified as 180 days or 26 weeks). A variation of this approach is to credit employees with an amount of sick leave,

such as one day, for each month of service. Table 6-1 is an example of a benefit schedule that uses this variation.

Table 6-1
Sick Leave Benefit Schedule

Length of Service	Amount of Sick Leave*
Less than 3 months	None
3 or more months	1 day at full pay for each month of service (retroactive to date of employment)
*Maximum unused sick leave: 130 days	

Another approach, illustrated in Table 6-2, bases the duration of benefits on an employee's length of service.

Table 6-2
Sick Leave Benefit Schedule

Length of Service	Maximum Days of Sick Leave per Year
Less than 3 months	0
3 months to 1 year	5
2 years	10
3 years	15
5 years	20
7 years	25
10 years	30

An alternative to this approach provides benefits for a uniform length of time to all employees, except possibly those with short periods of service. However, benefits are reduced to a level less than full pay after some period of time that is related to an employee's length of service. Table 6-3 is an illustration of this increasingly common approach.

In some instances, an employee is not eligible for sick-leave benefits if he or she is eligible for benefits under social insurance plans, such as workers' compensation. However, most sick-leave plans are coordinated with social insurance programs. For example, if an employee is entitled to 100 percent of pay and receives 60 percent of pay as a workers' compensation benefit, the sick-leave plan pays the remaining 40 percent.

A problem for the employer is how to verify an employee's disability. In general, the employee's word is accepted for disabilities that last a week or less. Most sick-leave plans have a provision that benefits for longer periods are paid only if the employee is under the care of a physician, who certifies that the employee is unable to work.

Table 6-3
Sick Leave Benefit Schedule

Length of Service	Weeks of Sick Leave per Disability		Total Weeks
	100% of Pay	50% of Pay	
Less than 6 months	0	0	0
6 months to 1 year	2	0	2
1 year	4	22	26
2 years	8	18	26
3 years	12	14	26
4 years	16	10	26
5 years	20	6	26
6 years or more	26	0	26

INSURED DISABILITY INCOME PLANS

As mentioned, insured disability income plans consist of two distinct products: short-term coverage and long-term coverage. In many respects, the contractual provisions of both short-term and long-term disability income contracts are the same or very similar. In other respects—notably, the eligibility requirements, the definition of disability, and the amount and duration of benefits—there are significant differences.

Eligibility

The eligibility requirements in group disability income insurance contracts are similar to those found in group term insurance contracts. In addition to being in a covered classification, an employee usually must work full-time and be actively at work before coverage commences. Any requirements concerning probationary periods, insurability, and premium contributions must also be satisfied.

Short-term and long-term disability income insurance plans frequently differ in both the classes of employees who are eligible for coverage and the length of the probationary period. Employers are more likely to provide short-term benefits to a wider range of employees, and it is not unusual for short-term plans to cover all full-time employees. However, these plans may be a result of collective bargaining and apply only to union employees. In this situation, other employees frequently have short-term disability benefits under uninsured sick-leave plans.

Long-term disability plans often limit benefits to salaried employees, but they may include employees with commission-based income such as stock brokers and other sales-related occupations. Claims experience has traditionally been less favorable for hourly paid employees for a number of reasons. Claims of hourly paid employees tend to be more frequent, particularly in recessionary times when the possibility of temporary layoffs or terminations increases. Such claims also tend to be of longer duration, possibly because of the likelihood that these employees hold repetitive and nonchallenging jobs. Some long-term plans also exclude employees below a certain salary level because this category of employees, like hourly paid employees, is considered to have a reasonable level of benefits under Social Security.

Long-term disability income plans usually have longer probationary periods than short-term disability income plans. Although the majority of short-term disability plans (as well as group term insurance plans and medical expense plans) either have no probationary period or have a probationary period of 3 months or less, it is common for long-term disability plans to have probationary periods ranging from 3 months to 1 year. Short-term plans only require that an employee be actively at work on the date he or she is otherwise eligible for coverage, but long-term plans sometimes require that the employee be on the job for an extended period (such as 30 days) without illness or injury before coverage becomes effective.

Definition of Disability

partial disability

Benefits are paid under disability income insurance contracts only if the employee meets the definition of disability as specified in the contract. Virtually all short-term disability income insurance contracts define disability as *the total and continuous inability of the employee to perform each and every duty of his or her regular occupation*. A small minority of contracts use a more restrictive definition, requiring that an employee be unable to engage in any occupation for compensation. Partial disabilities are usually not covered, but a few plans do provide such benefits. *Partial disability* is usually defined to mean that an employee is neither permanently nor totally disabled but can perform only some of the duties of his or her job. For example, an employee with a sprained back might work part time.

The majority of short-term contracts limit coverage to nonoccupational disabilities, because employees have workers' compensation benefits for occupational disabilities. This limitation tends to be most common when benefits under the short-term contract are comparable to or lesser in amount than those under the workers' compensation law. In those cases, where workers' compensation benefits are relatively low and the employer desires to

own-occupation definition of disability
dual (split) definition of disability

provide additional benefits, coverage may be written for both occupational and nonoccupational disabilities.

A few long-term disability income contracts use the same liberal definition of disability that is commonly used in short-term contracts. However, the term *material duties* often replaces the term *each and every duty*. These often are referred to as an *own-occupation definition of disability*. Some other contracts define disability as *the total and continuous inability of the employee to engage in any and every gainful occupation for which he or she is qualified or shall reasonably become qualified by reason of training, education, or experience*. However, most long-term disability contracts use a *dual (or split) definition of disability* that combines these two. Under a dual definition, benefits are paid for some period of time (usually 24 or 36 months) as long as an employee is unable to perform his or her regular occupation. After that time, benefits are paid only if the employee is unable to engage in any occupation for which he or she is qualified by reason of training, education, or experience. The purpose of this combined definition is to require and encourage a disabled employee who becomes able after a period of time to adjust his or her lifestyle and earn a livelihood in another occupation.

Another popular definition of disability found in long-term contracts contains an occupation test and an earnings test. Under the occupation test, a person is totally disabled if he or she meets the definition of disability as described in the previous paragraph. However, if the occupation test is not satisfied, a person is still considered disabled as long as an earnings test is satisfied. This means that the person's income has dropped by at least a stated percentage, typically 20 percent, because of injury or sickness. This definition makes a group insurance contract similar to an individual disability income policy that provides residual benefits.

The definition of disability in long-term contracts may differ from that found in short-term contracts in several other respects. Long-term contracts are somewhat more likely to provide benefits for partial disabilities. However, the amount and duration of such benefits may be limited when compared with those for total disabilities, and the receipt of benefits is usually contingent upon a previous period of total disability. In addition, most long-term contracts provide coverage for both occupational and nonoccupational disabilities. Finally, short-term contracts usually have the same definition of disability for all classes of employees. Some long-term contracts use different definitions for different classes of employees—one for most employees and a more liberal definition for executives or salaried employees.

Exclusions

exclusion

An *exclusion* is a provision in an insurance contract that indicates situations that the insurer does not intend to cover. Under certain circumstances, disability income benefits are not paid even if an employee satisfies the definition of disability. Common exclusions under both short- and long-term disability income contracts specify that no benefits are paid

- for any period during which the employee is not under the care of a physician
- for any disability caused by an intentionally self-inflicted injury
- unless the period of disability commenced while the contract covered the employee. For example, an employee who previously elected not to participate under a contributory plan cannot obtain coverage for an existing disability by deciding to pay the required premium.
- if the employee is engaged in any occupation for remuneration. This exclusion applies in those situations when an employee is totally disabled with respect to his or her regular job but is engaged in other employment that can be performed despite the employee's condition.
- if (or to the extent) benefits are payable under workers' compensation or similar laws

Long-term contracts often contain additional exclusions. These commonly deny benefits for disabilities resulting from

- war, whether declared or undeclared
- participation in an assault or felony. Some insurers have recently expanded this exclusion to include the commission of any crime.
- mental disease, alcoholism, or drug addiction. However, many contracts provide employees with benefits but limit their duration (such as for 24 months per disability); other contracts provide benefits for an employee who is confined in a hospital or institution that specializes in the care and treatment of such disorders
- preexisting conditions

Until the passage of the Pregnancy Discrimination Act, it was common for policies to exclude disabilities resulting from pregnancy. Such an exclusion is now illegal under federal law if an employer has 15 or more employees. Employers with fewer than 15 employees may still exclude pregnancy disabilities unless they are subject to state laws to the contrary.

**preexisting-conditions
provision**

The exclusion for preexisting conditions is designed to counter the adverse selection and potentially large claims that could occur if an employer established a group disability income plan or if an employee elected to participate in the plan because of some known condition that is likely to result in disability. Although variations exist, a common *preexisting-conditions provision* excludes coverage for any disability that commences during the first 12 months an employee is covered under the contract if the employee received treatment or medical advice for the disabling condition both (1) prior to the date the employee became eligible for coverage and (2) within 90 consecutive days prior to the commencement of the disability.

When coverage is transferred from one insurance company to another, it is not unusual, particularly in the case of large employers, for the new insurance company to waive the limitation for preexisting conditions for those employees who were insured under the previous contract. This situation is often referred to as *prior coverage credit* or a *no-loss no-gain provision*. In some instances, the provision is modified so that benefits are limited to those that would have

been provided under the previous contract, possibly for a specified period, such as one year. Note that a transfer of coverage has no effect on the responsibility of the prior insurance company to continue paying benefits for claims that have already occurred, except in rare instances in which some arrangement is made for the new contract to provide benefits.

Benefits

A discussion of the benefits under disability income contracts is more complex than a discussion of the benefits under group life insurance contracts. A similarity exists in that there are benefit schedules that classify employees and specify the amount of disability income the policy will provide. However, the relationship between an employee's earnings and the employee's potential benefits is more important in disability income insurance than in group life insurance. In addition, disability benefits are subject to several provisions not found in group life insurance contracts. These pertain to the length of time that benefits are paid and the coordination of benefits with other available types of disability income.

Benefit Schedules

As in group life insurance, there is a variety of benefit schedules found in group disability income contracts. Benefits may be available to all employees or limited to specific groups of employees. In addition, benefits may be expressed as flat-dollar amounts, varying dollar amounts by classification, or a percentage of earnings.

A major difficulty in disability insurance is determining the appropriate level of benefits to provide. Absenteeism is encouraged and the incentive to return to work is diminished if a disabled employee is given a level of income that is comparable to his or her regular earnings. In general, disability income plans are designed to provide a level of benefits that replaces between 50 and 70 percent of an employee's gross income. Although this may appear to represent a substantial reduction of regular earnings, it should be remembered that a disabled employee does not have the usual expenses associated with working, such as transportation costs. In addition, disability income benefits are not subject to Social Security and Medicare taxation after a period of time and, depending on the source and amount, may be free of income taxation. Despite the logic in providing a reduced level of income, some short-term disability income plans provide employees with 100 percent of their predisability earnings. In most cases, this level of benefits is either a result of collective bargaining or an effort by employers to provide nonunion employees with a level of benefits that is comparable to that of union employees.

Many short-term disability income plans and the majority of long-term plans base benefits on a single percentage of regular earnings (excluding bonuses, overtime, commissions, and other incentive-based income). This percentage varies widely for short-term plans, and benefits as low as 50 percent or as high as

100 percent are not unusual. However, many insurers are reluctant to underwrite plans that provide benefits higher than 70 percent of earnings. In some instances, short-term plans, like sick-leave plans, may use different percentages, such as 100 percent of earnings for 4 weeks and 70 percent of earnings for the remaining benefit period. The length of time for which the plan provides the higher level of benefits may also be a function of the length of an employee's service.

Long-term plans typically provide benefits that range from 50 to 70 percent of earnings, with 60 and 66 2/3 being the most prevalent percentages. Some plans also use a sliding scale, such as 66 2/3 percent of the first \$5,000 of monthly earnings and 50 percent of earnings in excess of \$5,000.

It is common for plans that determine benefits as a percentage of earnings to also place a maximum dollar amount on the benefit for any employee, regardless of earnings. For example, a short-term plan covering hourly employees may have a benefit equal to 70 percent of earnings that might be subject to a maximum of \$500 per week. Similarly, a long-term plan might provide benefits equal to 66 2/3 percent of earnings, but might be subject to a monthly maximum that may vary from \$3,000 or \$4,000 for some small groups to as much as \$6,000 to \$10,000 for large groups. A few plans for large groups of well-paid executives may, however, have limits of up to \$25,000. The purpose of such a maximum is to prevent the absolute benefit from being so high that an employee, by adjusting his or her lifestyle, could live comfortably on the disability income benefit and thus have no financial incentive to return to work.

Other types of benefit schedules are found in short-term disability income plans, particularly when these plans are designed for hourly paid employees. If the weekly earnings of most employees fall within a narrow range, the benefit might be expressed as a flat-dollar amount. For example, if all employees earn between \$400 and \$500 per week, a benefit of \$270 per week might be used. If earnings vary widely, a benefit schedule like the one in Table 6-4 might be used.

Table 6-4
Short-Term Disability Income Benefits

Weekly Earnings	Weekly Benefit
\$341 to \$380	\$250
\$381 to \$420	280
\$421 to \$460	310
\$461 to \$500	340
Over \$500	370

A similar approach is occasionally used in long-term disability income plans, as shown in the Table 6-5 benefit schedule for salaried employees earning in excess of \$18,000 per year.

Table 6-5
Short-Term Disability Income Benefits

Monthly Earnings	Monthly Benefit
\$1,500 to \$2,500	\$1,200
\$2,501 to \$3,500	1,800
\$3,501 to \$4,500	2,400
\$4,501 to \$5,500	3,000
Over \$5,500	4,000

Period of Benefits

To determine the period for which disability income benefits are paid, it is necessary to determine when benefits begin and how long they are paid. In both respects, there are differences between short-term and long-term plans.

waiting (elimination)
period

Short-Term Plans. Short-term disability income contracts commonly contain a *waiting period* (often referred to in such contracts as an *elimination period*). The waiting period is the length of time for which an employee covered under the contract must be disabled before benefits begin. In the typical short-term contract, there is no waiting period for disabilities resulting from accidents, but a waiting period of 1 to 7 consecutive days applies to disabilities resulting from sicknesses. However, some plans have a single waiting period that applies to disabilities from either accidents or sicknesses; a few plans have no waiting periods for either. Waiting periods longer than 7 days are occasionally used, particularly when there is a sick-leave plan to provide benefits during the initial portion of a disability. Besides lowering the cost of a disability income plan, the waiting period discourages unwarranted absences from work due to sickness. In a few cases, benefits are paid retroactively to the date of disability if the disability lasts for a predetermined period. However, it is generally felt that retroactive benefits cause employees to prolong their return to work in order to receive benefits for the full period of their disability.

Once an employee begins receiving benefit payments under a short-term disability contract, the benefits continue until the end of the benefit period specified in the contract, if the employee remains disabled for that long. Although short-term contracts may provide benefits up to 2 years (with long-term contracts providing benefits for periods over 2 years), benefits rarely continue for more than a year. In fact, the majority of short-term contracts stipulate that benefits are paid for either 13 or 26 weeks, with the latter period being most prevalent. Short-term plans are often described in terms of their waiting period and their duration of benefits. For example, a "1-8-26" plan pays benefits for a maximum of 26 weeks beginning with the first day of disability

in the case of an accident and with the eighth day of disability in the case of sickness.

In a few cases, the maximum period of benefits applies to a specified duration of time (such as any consecutive 12 months) regardless of the number of separate disabilities. However, in most plans, both the maximum benefit period and the waiting period apply to each separate disability. Moreover, successive periods of disability caused by the same accident or the same or related sickness are generally considered to be a single disability unless they are separated by a period (normally 2 weeks) of continuous resumption of active employment. This provision prevents an employee from briefly returning to work in order to obtain a second maximum period of benefits for the same disability.

Although reducing short-term disability income benefits for older employees may be justifiable on a cost basis, few plans have done so.

Long-Term Plans. Although waiting periods in long-term disability income plans may be as short as 30 days or as long as a year or more, most plans use periods of 3 to 6 months, with 6 months most common. The length of the waiting period often corresponds to the length of time benefits are paid under a firm's short-term disability income plan or sick-leave plan. Unlike short-term plans, the waiting periods for sicknesses and accidents are the same.

Long-term disability income benefits may be paid for as short a period as 2 years or as long as the lifetime of the disabled employee. In a few cases, the length of the benefit period may differ, depending on whether the disability was a result of an accident or a sickness. Benefits are commonly reduced for older employees, and several different approaches are acceptable under the Age Discrimination in Employment Act. In a few cases, benefits are paid until age 70 for any disability that occurred before that age. For disabilities occurring at age 70 or later, benefits are paid for a reduced duration. A more common approach is to use a graded benefit period and give benefits to age 65 for employees who are disabled before a specified age. Employees disabled after the specified age get benefits for a limited duration, as shown in Table 6-6.

Table 6-6
Duration of Long-Term Disability Income Benefits

Age at Commencement of Disability	Benefits Duration
59 and younger	To age 65
60–64	5 years
65–69	To age 70
70–74	1 year
75 and older	6 months

A similar approach uses a sliding level of benefit durations after a certain age. For example, a plan may provide that employees disabled prior to age 60

will receive benefits until age 65. The plan might then use the schedule shown in Table 6-7 for employees who are disabled at age 60 or older.

Table 6-7
Duration of Long-Term Disability Income Benefits

Age at Commencement of Disability	Benefit Duration (in Years)
60	5
61	4
62	3½
63	3
64	2½
65	2
66	2
67	1
68	1
69	1

As do short-term disability income plans, long-term plans typically provide for successive disabilities. The majority of contracts stipulate that successive periods of disability that are separated by less than some period (usually varying from 3 to 6 months) of continuous, active full-time employment are considered a single disability, unless the subsequent disability (1) arises from an unrelated cause and (2) begins after the employee has returned to work.

Coordination with Other Benefits

To minimize the possibility that an employee will receive total benefits higher than his or her predisability earnings, disability income plans commonly stipulate that benefits be coordinated with other sources of disability income. The effect of this coordination (often referred to as integration) is to reduce (either totally or partially) the benefits payable under the disability income contract to the extent that certain other benefits are available. In general, the insurance laws or regulations of most states allow policies to have such reductions because of benefits from social insurance programs and group insurance or retirement plans provided by the employer. Reductions because of benefits from individual disability income contracts are not usually allowed unless the policies were purchased by the employer. Employers and employees often resent the fact that disability income benefits that they have "paid for" may be reduced. However, such reductions are considered in determining the rates charged for disability income insurance. In effect, the employer is purchasing a

contract that is only a supplement to these other available sources of disability income rather than being penalized because these resources are available.

For various reasons, including the limited duration of benefits and the desire for simplified operating procedures, coordination with other benefits is less common for short-term plans than in long-term plans. If a short-term plan covers only nonoccupational disabilities, there is no need for coordination with workers' compensation benefits; also, unless benefits are provided for disabilities lasting longer than 5 months, there is no need to coordinate benefits with Social Security. In general, benefits under short-term plans are coordinated with the following:

- workers' compensation benefits, if the plan covers occupational disabilities
- temporary disability laws, if they are applicable
- Social Security benefits, if the maximum benefit period is longer than 5 months

Some insurance companies sell long-term disability income coverage without any provision for coordination with other disability income benefits; however, the availability and potential magnitude of other benefits is an underwriting factor in determining the maximum amount of coverage that is written. Usually, long-term disability income benefits are coordinated with benefits provided under the following:

- Social Security
- workers' compensation laws
- temporary disability laws
- other insurance plans for which the employer makes a contribution or payroll deduction
- pension plans for which the employer has made a contribution or payroll deduction to the extent that the employee elects to receive retirement benefits because of disability
- sick-leave plans
- earnings from employment, either with the employer or from other sources

A few insurers also coordinate group long-term coverage with individual disability income policies.

The coordination with Social Security may be based solely on the benefit a disabled worker receives for himself or herself (referred to as the employee's primary insurance amount). It may also be based on the employee's total family benefit if the employee has eligible dependents.

Two basic approaches to Social Security coordination of disability income benefits are used: a full-coordination approach and a dual-percentage approach. Under the *full-coordination approach*, long-term disability income benefits are reduced to the extent that any benefits subject to coordination are received.

Example:

Theresa earns \$2,500 per month and is entitled to a disability income benefit of 60 percent, or \$1,500 per month. In addition, she is entitled to a disability benefit of \$900 under Social Security, as well as additional family benefits of \$450 (a total of \$1,350). If her long-term disability income benefit plan provides for coordination with total family benefits, she will receive \$1,500 (\$1,350 from Social Security and the remaining \$150 from the long-term plan). However, if full coordination is provided only with respect to the primary insurance amount (in other words, the \$450 of family benefits is not considered), she will receive \$1,950 (\$1,350 from Social Security and \$600 from the long-term disability plan).

Under the *dual-percentage approach*, two percentages are used. The first is applicable to benefits that are provided under the long-term plan when there are no other benefits subject to coordination. A second and higher percentage is applicable to total benefits payable from the long-term plan and other sources subject to coordination.

Example:

Assume Theresa's disability income plan provides benefits equal to 60 percent of earnings in the absence of other benefits subject to coordination. If there are benefits subject to coordination, benefits under the insured plan are reduced to the extent that the sum of the benefits under the long-term disability plan and the benefits subject to coordination exceed 70 percent. Using these percentages and the previous example, 70 percent of earnings is \$1,750. Because the long-term disability benefit and all the Social Security benefits total \$2,850, the long-term disability benefit is reduced by \$1,100 if the plan provides for coordination with total family benefits. Therefore, she will receive a total benefit of \$1,750 (\$1,350 from Social Security and \$400 from the long-term plan).

Coordination with other benefits has the potential to totally eliminate a long-term disability benefit. To prevent this from happening, many plans provide (and some states require) that a minimum benefit, such as \$50 or \$100 per month, be paid. Most plans also contain a provision freezing the

amount of any reduction because of Social Security at the initial level that was established when the claim began. Without such a provision, the intended effect of increases in Social Security benefits would be erased by equivalent reductions in other disability income benefits provided to the employee. This is seen by some regulators as contrary to public policy and thus a reason for requiring insured plans to contain a freeze on the amount of the reduction.

Example:

Herb is entitled to receive \$2,000 per month in disability income benefits under a long-term plan that contains a provision for full coordination with Social Security. If he initially receives \$800 from the long-term plan and \$1,200 from Social Security, the \$800 continues to be paid under a provision that freezes this amount even if Social Security benefits are increased. If a 5 percent increase is later granted in Social Security benefits, he will receive a total benefit of \$2,060.

As a general rule, both the insured and the insurer are better off if the insured is able to collect Social Security benefits for a disability. The insured has an increased overall benefit, and the insurer has a substantially lower claim to pay. Consequently, insurers are often willing to assist claimants by helping them with the filing of Social Security claims and the appealing of decisions denying claims.

Supplemental Benefits**buy-up plan**

It is becoming increasingly common to find group long-term disability income plans that provide employees with a base of employer-paid benefits and that allow each covered employee to purchase additional coverage at his or her own expense. For example, a plan may provide basic benefits of 50 percent of earnings and an option for an employee to increase this amount to 60, $66\frac{2}{3}$, or 70 percent of earnings. Such a supplemental or *buy-up plan* is becoming more popular because employers feel the need to control the costs of benefits by shifting a greater burden of the cost to employees.

Some plans are also designed to "carve out" benefits for certain employees, frequently key executives. For example, an employer might design one plan to cover most of its employees, but it might cover top executives with another group plan that provides enhanced benefits in the form of a larger percentage of earnings and a more liberal definition of disability. Another variation of a carve-out plan would provide the executives with a lower benefit percentage than other employees receive, but it could provide supplemental benefits in the form of individual disability income policies. In addition to more favorable policy provisions, a carve-out plan might offer better rate guarantees and an overall higher benefit than a group plan could offer. Furthermore, the portability

of the individual policy might be attractive to executives, although it might not necessarily appeal to the employer. In addition, individual policies might be available on a guaranteed-issue basis if the group of executives is large enough.

Catastrophic Benefits Rider

catastrophic benefits rider A few disability insurers that also sell long-term care insurance have recently started to make available additional benefits in the form of a *catastrophic benefits rider* if the insured suffers a severe disability that includes cognitive impairment or the inability to perform two or more of six activities of daily living. These are the same criteria that trigger benefits in long-term care policies.

The employer can typically purchase benefits that range from an additional 10 to 40 percent of earnings as long as total disability benefits do not exceed a specified limit that may be as high as 100 percent of earnings. The length of time the catastrophic benefits are paid is also selected by the employer and can vary from one year to the duration of the regular disability benefits provided by the policy. In addition, an employer may have the option of adding a flat monthly benefit that is payable if an employee's spouse suffers a cognitive impairment or is unable to perform two or more activities of daily living.

Other Contract Provisions

Many provisions in group disability income contracts are similar to those in group life insurance contracts and are not discussed further in this chapter. These provisions pertain to incontestability, a grace period, the entire contract, and the payment of premiums. The provisions that are discussed either are unique to group disability income benefit contracts or differ in certain respects from similar provisions found in group life insurance contracts.

Claims

The provisions concerning claims under both short-term and long-term disability income contracts are essentially the same. The insurance company must be notified within a relatively short period—20 or 30 days (or as soon as is reasonably possible)—after the disability for which benefits are being claimed begins. A claim form must then be filed with the insurance company, usually within 90 days after the commencement of the disability or after the end of the week, month, or other time period for which benefits are payable. The claim form normally consists of three statements; one by the employee concerning the disability, another by the attending physician, and a third by the employer indicating the date and reason that active employment ceased. Provisions also require periodic reports from the attending physician or permit the insurance company to request such reports at reasonable intervals. The insurance company also has the right to have the employee examined by a

physician of its own choice (and at its own expense) at reasonable intervals during the duration of the claim.

Payment of Benefits

The insurance company is not obligated to make benefit payments until a proof of loss has been filed. Although benefits are usually payable to the employee, a facility-of-payment provision is included to allow payments to a guardian if the employee is physically, mentally, or otherwise incapable of giving a valid release for any payment received. Benefits may be assigned to another party if such an assignment is permissible under state law and the insurance contract.

Rehabilitation

rehabilitation provision

As an incentive to encourage disabled employees to return to active employment as soon as possible, but perhaps at a lower-paying job, most insurance companies include a rehabilitation provision in their long-term disability income contracts. This provision permits the employee to enter a trial work period (sometimes referred to as a return-to-work program) of 1 or 2 years in rehabilitative employment. During this time, disability benefits continue but are reduced by some percentage (varying from 50 to 80 percent) of the earnings from rehabilitative employment. For example, with a 50 percent reduction, an employee who is otherwise entitled to a disability benefit of \$1,500 per month will have this benefit reduced by only \$600 if he or she can earn \$1,200 in the new job. If the trial work period indicates that the employee is unable to perform the rehabilitative employment, the original long-term benefits continue and the employee is not required to satisfy a new waiting period.

Often, there are no other provisions in long-term disability income contracts that require the insurance company to aid in the rehabilitation of disabled employees. Insurance companies, however, sometimes provide benefits for rehabilitation when it is felt that the cost of these benefits is offset by shortening an employee's disability period. These benefits may be in the form of physical therapy, job training, adaptive aids to enable a disabled person to perform job functions, or even the financing of a business venture.

In the past, the decision to seek rehabilitation was left to the disabled person. A number of insurers now require the person to undertake rehabilitation or have benefits reduced or stopped.

The rehabilitation of disabled workers is continuing to grow in importance among insurance companies. In fact, the rehabilitative services provided are often used as a selling feature for a company's product. More and more companies are taking a proactive role in managing disability claims by employing more skilled professionals and by intervening earlier in the claims process. In addition to providing rehabilitation benefits, insurance companies are monitoring claims data more closely so that they can better advise employers of areas where action can be taken to reduce the number of future claims.

**integrated disability
management**

Integrated Disability Management. Because early intervention is a key to getting disabled employees back to work sooner, more and more employers are turning to *integrated disability management*. These employers use the same organization to manage the rehabilitation of disabled employees under all their disability programs—short-term, long-term, and workers’ compensation. The organization may be the insurance company that provides insurance coverage to the employer or a firm that specializes in disability management. This approach is commonly referred to as integrated disability management, and it applies to both insured and self-funded benefits.

Integrated disability management has several advantages to both the employer and the employees. There is a single centralized claims-reporting system that is easier to understand and less expensive than duplicate programs for each type of coverage. There are consistent treatment protocols for all disabilities, no matter where or when they occurred, and it is easier to measure and track outcomes of return-to-work programs. In addition, there is a lower incidence of fraudulent claims from employees trying to collect under disability plans and workers’ compensation at the same time.

Termination

For the most part, the provisions in disability income contracts concerning either the termination of the master contract or an employee’s coverage are the same as those found in group life insurance. However, there is one notable exception: A conversion privilege is rarely included, based on the theory that the termination of employment also terminates an employee’s income and thus the need for disability income protection. If a conversion privilege is available, an extra charge is made for the coverage.

One other situation should be mentioned. When an employee meets the definition of total disability under a disability income contract, the employee is considered to have terminated employment by reason of ceasing to be an active, full-time employee. Without some provision to the contrary, an employee who resumes work is then required to resatisfy any eligibility requirements, including a new probationary period. However, most group disability income contracts allow the employer to consider disabled employees as not having terminated employment for insurance purposes. The employer may continue coverage as long as it is done on a nondiscriminatory basis and as long as the required premiums are paid. In short-term contracts, coverage is generally continued by the payment of premiums on the same basis as for active employees. However, it is common for long-term contracts to contain a waiver-of-premium provision. This waiver normally begins at the time benefit payments start, not at the beginning of the waiting period.

The only practical effect of continuing coverage on a disabled employee is to guarantee that the employee will again be eligible for disability income benefits after he or she has returned to active employment. The continuation of coverage (or termination of coverage) has no effect on the future disability

income benefits to an employee who is currently disabled and therefore entitled to receive benefits.

Additional Benefits

Long-term disability income contracts occasionally provided several types of additional benefits. The most common are a cost-of-living adjustment, a pension supplement, and a survivor's benefit.

cost-of-living adjustment (COLA)

Some disability income plans have a *cost-of-living adjustment (COLA)* so that inflation does not erode the purchasing power of disability income benefits being received. Under the typical COLA formula, benefits increase annually along with changes in the consumer price index.

pension supplement

Many firms make provisions in their pension plan for treating disabled employees as if they were still working and accruing pension benefits. Such a *pension supplement* requires the employer to make contributions to the pension plan on behalf of disabled employees, usually from the employer's current revenues. However, some disability income contracts stipulate that the contributions to fund a disabled employee's accruing pension benefits will be paid from the disability income contract.

Some retirement plans also provide disability income benefits by allowing disabled employees to begin receiving retirement benefits when they are totally and permanently disabled. It is common, however, to limit these early retirement benefits to employees who have satisfied some minimum period of service or who have reached some minimum age. However, the feeling among employee benefit consultants seems to be that it is preferable to have separate retirement and disability income plans.

Some long-term contracts provide a benefit to survivors in the form of continued payments after the death of a disabled employee. In effect, the disability income payments continue, possibly at a reduced amount, for periods ranging up to 24 months, with 3 to 6 months being most common. Payments are generally made only to eligible survivors, who commonly are the spouse and unmarried children under age 21.

Other less common types of additional benefits may also be found. Examples include child-care payments for disabled employees who can work on a part-time basis, spousal disability benefits payable to the employee, benefits to pay premiums for medical expense coverage, and benefits for worksite modification.

FEDERAL TAX TREATMENT

As with group life insurance, employer contributions for an employee's disability income insurance are fully deductible to the employer as an ordinary and necessary business expense if the employee's overall compensation is reasonable. Sick-leave payments are similarly tax deductible. Contributions by

an individual employee are considered payments for personal disability income insurance and are not tax deductible.

Income Tax Liability of Employees

In contrast to group life insurance, for which employer contributions may result in some taxable income to an employee, employer contributions for disability income insurance generally result in no taxable income to an employee. However, the payment of benefits under an insured plan or sick-leave plan may or may not result in the receipt of taxable income. To make this determination, it is necessary to look at whether the plan is fully contributory, noncontributory, or partially contributory.

Fully Contributory Plan

Under a fully contributory plan, the entire cost is paid by employee contributions and benefits are received free of income taxation.

Noncontributory Plan

The tax situation for an employee will vary with a noncontributory plan, depending on how an employer designs a disability income plan. Almost all plans follow the usual design described below. However, a few plans are now designed so that an employee can receive benefits on a tax-free basis.

The Usual Design. Under a typical noncontributory plan, the employer pays the entire cost and benefits are included in an employee's gross income. However, the Internal Revenue Code provides a tax credit to persons who are permanently and totally disabled. A tax credit is better than a tax deduction in that it is subtracted from an individual's federal income tax liability rather than deducted from gross income to determine taxable income. For purposes of this tax credit, the IRS uses the Social Security definition of disability; that is, an employee must be unable to engage in any kind of gainful work because of a medically determinable physical condition that has lasted or is expected to last at least 12 months or to result in death.

The maximum credit is \$750 for a single person, \$1,125 for a married person filing jointly, and \$562.50 for a married person filing separately. The credit cannot exceed the taxable disability benefit actually received. The maximum credit is reduced if a single individual has an adjusted gross income (including the disability benefit) over \$7,500, if a married person filing jointly has an adjusted gross income over \$10,000, or if a married person filing separately has an adjusted gross income over \$5,000. The reduction is equal to 7 1/2 percent of any income over the limit. In addition, the credit is reduced by 15 percent of any tax-free income received as a pension, an annuity, or a disability benefit from certain government programs, including benefits from Social Security. Because disability income plans are usually coordinated

with Social Security, the tax credit available to most individuals who receive disability benefits from employer plans is substantially reduced or may be eliminated altogether.

The Tax-Free Design. A 2004 IRS Revenue Ruling allows an employer to design a disability income plan so that an employee can receive tax-free benefits from a noncontributory plan. In order to receive these benefits, however, the employee must elect to have the employer-paid premium for his or her coverage reported as taxable income. Such an election, which applies separately to each employee covered under a plan, must be made prior to the beginning of a plan year and is irrevocable during that period. The election must also apply to the full cost of the employer-provided coverage.

Few plans have incorporated such an election. It creates administrative burdens for the employer, and most employees prefer to minimize their income tax burden on a current basis. If this option is available, an employee should discuss its implications with a tax advisor before making such an election.

Partially Contributory Plan

Under a partially contributory plan, benefits attributable to employee contributions are received free of income taxation. Benefits attributable to employer contributions are includible in gross income, but employees are eligible for the tax credit described previously.

The portion of the benefits attributable to employer contributions (and thus subject to income taxation) is based on the ratio of the employer's contributions to the total employer-employee contributions for an employee who has been under the plan for some period. For example, if the employer paid 75 percent of the cost of the plan, 75 percent of the benefits would be considered attributable to employer contributions and 25 percent to employee contributions. The time period used to calculate this percentage varies, depending upon the type of disability income plan and the length of time that the plan has been in existence. Under group insurance policies, the time period used is the 3 policy years ending prior to the beginning of the calendar year in which the employee is disabled. If coverage has been in effect for a shorter time, IRS regulations specify the appropriate period that should be used. Similar provisions pertain to contributory sick-leave plans. There is one major exception, however, that stipulates when the period should be based on calendar years rather than policy years. If benefits are provided under individual disability income insurance policies, the proportion is determined on the basis of the premiums paid for the current policy year.

Tax Withholding and Social Security Taxes

Benefits paid directly to an employee by an employer under a sick-leave plan are treated like any other wages for purposes of tax withholding. Disability income benefits paid by a third party (for instance, an insurance company

or a trust) are subject to the withholding tax rules and regulations only if the employee requests that taxes be withheld. In both cases, benefits that are attributable to employer contributions are subject to Social Security and Medicare taxes. However, taxes are payable only during the last calendar month in which the employee worked and during the 6 months that follow.

STATE TAX TREATMENT

For income tax purposes, some states consider an individual's taxable income to be the figure shown on the individual's federal income tax return, and those states treat disability income and sick-leave benefits as the federal government does. Although considerable variations exist in other states, disability income and sick-leave benefits are generally treated more favorably than under the federal tax laws and are often totally exempt from state income taxation.

CHAPTER REVIEW

Key Terms and Concepts

disability income insurance	exclusion
short-term disability (STD) income plans	preexisting-conditions provision
long-term disability (LTD) income insurance	waiting (elimination) period
sick-leave plan	buy-up plan
paid time off (PTO) program	catastrophic benefits rider
partial disability	rehabilitation provision
own-occupation definition of disability	integrated disability management
dual (split) definition of disability	cost-of-living adjustment (COLA)
	pension supplement

Review Questions

Review questions are based on the learning objectives in this chapter. For example, a [6-3] at the end of a questions means that the question is based on learning objective 6-3. If there are multiple objectives, they are all listed.

- 6-1. Why does long-term disability have a more severe financial impact on a family than does death? [6-1]
- 6-2. Why is it important to coordinate insured group disability income plans with other sources of disability income benefits? [6-1]
- 6-3.
 - a. What are the most common eligibility requirements found in sick-leave plans? [6-2]
 - b. What variations are sometimes found in these requirements? [6-2]

- 6-4. Describe the approaches used in determining the duration of benefits under sick-leave plans. [6-3]
- 6-5. Why are long-term disability income plans less likely to cover all employees than short-term disability income plans? [6-3]
- 6-6. Compare insured short-term and long-term disability income contracts with respect to each of the following:
 - a. length of probationary periods [6-3]
 - b. the definition of disability [6-3]
 - c. coverage for partial disabilities [6-3]
 - d. coverage for nonoccupational disabilities [6-3]
- 6-7. Identify the exclusions commonly found
 - a. in both short-term and long-term disability income contracts [6-3]
 - b. in long-term disability income contracts only [6-3]
- 6-8. What is the rationale for providing disability benefits that are less than an employee's earnings prior to disability? [6-3]
- 6-9. Compare insured short-term and long-term disability income contracts with respect to the following benefit provisions:
 - a. waiting (elimination) period [6-3]
 - b. duration of benefits [6-3]
- 6-10. Compare insured short-term and long-term disability income contracts with respect to the following benefit provisions:
 - a. the extent to which benefits are usually reduced for older employees [6-3]
 - b. the extent to which benefits are usually coordinated with other disability income benefits [6-3]
- 6-11. Lindsay Grant, who earns \$1,600 per month, is covered under a group long-term disability income plan that provides benefits equal to 60 percent of predisability earnings. If disabled, she will also receive Social Security disability benefits of \$780—\$520 as her primary insurance amount and an additional \$260 as a family benefit. If the group plan contains a provision reducing benefits to the extent that the long-term disability income benefit and the primary insurance amount exceed 75 percent of earnings, how much will Lindsay receive from each source if she is disabled? [6-3]
- 6-12.
 - a. What is the nature of supplemental or buy-up disability income plans? [6-3]
 - b. Why might an employer carve out disability income benefits for employees such as key executives? [6-3]
- 6-13. What provisions are contained in disability income contracts that enable the insurer to verify whether a disability continues to exist? [6-3]
- 6-14. Describe the rehabilitation provision often found in long-term disability income contracts. [6-3]

-
- 6-15. a. What is the rationale for and role of insurance companies in providing rehabilitation benefits to disabled employees? [6-3]
b. What are the advantages of an integrated disability management program? [6-3]
- 6-16. Explain how long-term disability income contracts are sometimes modified to provide
a. inflation protection [6-3]
b. a pension supplement [6-3]
c. survivor benefits [6-3]
- 6-17. Under the federal income tax laws, to what extent are employer contributions for disability income insurance
a. deductible to the employer [6-4]
b. taxable as income to an employee [6-4]
- 6-18. Sam Jones has been totally and permanently disabled for the past 2 years and receives a monthly disability benefit of \$1,600, consisting of \$700 from Social Security and \$900 from the long-term disability income plan of Sam's former employer. The plan was contributory, and Sam was required to pay one-third of the cost of his coverage. Other than the disability benefits, Sam and his wife expect to have an adjusted gross income of \$12,000 this year from Mrs. Jones's part-time work and interest on their savings.
a. What portion of Sam's disability benefit is includible in his gross income for federal income tax purposes? [6-4]
b. What is Sam's tax credit this year for his disability income if he and his wife file jointly? [6-4]