Testimony of Lou Mazawey
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Managing Disability Risks in an Environment of Individual Responsibility
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I appreciate the invitation to present to you today. The focus of my testimony is on the retirement income gap created when an employee becomes disabled for an extended period, and more specifically, the solutions that already exist – subject to regulatory action – to address that major risk.

I commend the Council for taking on this issue to raise awareness of its importance – much in the way the Agencies are already seeking to facilitate lifetime income solutions in defined contributions plans. Ms. Rappaport's recent article on this topic in the International Foundation's Benefits Magazine (Nov. 2011) does an excellent job of explaining the many different facets of the disability risk problem.

I have practiced law in the employee benefits area for over 35 years. A major focus of my practice has been representing insurance companies, benefit consultants and plan sponsors in designing benefit products to meet the evolving needs of employers and participants.

Since the early 90s, I have advised clients on various approaches to address the risk that a person's pension contributions will stop if he or she becomes disabled for an extended period. The objective was to provide a source of continued retirement contributions as was often done by defined benefit plans that offered a "qualified disability benefit." Most of the defined contribution ("DC") solutions involved the proverbial "square peg in a round hole." For example, one approach involved the purchase of extra LTD income replacement coverage by an employer where the proceeds would be placed in an annuity or an IRA or a trust for the benefit of the employee to accumulate as a future retirement supplement. These approaches – not

widely used – created lots of tax and ERISA compliance issues that were difficult to solve – not to mention added administrative costs.

Several clients, however, did develop creative approaches to the dilemma that could be used by plan sponsors generally.

One successful approach utilizes a group LTD policy held as an asset of the 401(k) or other DC plan. The amount of coverage purchased was pegged to the amount of contributions going into the participant's account as of the end of the last plan year or most recent coverage period. This approach had the advantages of

- lower group premiums and expenses,
- use of the existing trust and participant accounts, and
- flexible funding design (it could be employee-funded, employer-funded, or both, could be structured as an investment option or a match, etc.)

My colleague, Richard Shea, explains how one large multinational corporation successfully used this approach in its 401(k) plan.

In late 1999, the IRS issued a private letter ruling (LTR 200031060) that spelled out the favorable tax treatment of this design, including

- no imputed income to the participant on the premium payment, and
- treatment of the amounts paid to the plan like other investment earnings, and
- straightforward treatment of distributions.

A second successful approach was designed by the National Telecommunications Cooperative Association ("NTCA"), a trade association that we have represented for over 25 years. NTCA's approach utilizes the association's VEBA (Sec. 501(c)(9) trust) to function as the insurer, but otherwise works much like the group LTD approach. Specifically,

- the employer could opt to pay an actuarially determined premium for disability "waiver" coverage, and
- in the event of the participant's disability, the VEBA would pay into the participant's account (in the 401(a) plan) the amounts necessary to continue the contribution stream for that participant for the period of disability.

We were hopeful that both approaches would be widely used to expand the ability of DC plan participants to protect against the retirement risk of disability. However, in 2007, an unexpected regulatory hurdle arose. Treasury and the IRS published a proposed regulation which they intended would put to rest plan designs that sought to use qualified plans to provide tax-free retiree health benefits except as expressly permitted under the Code, such as under section 401(h). 72 Fed. Reg. 46421 (Aug. 20, 2007). Because disability coverage has the same tax code underpinnings as medical benefits – i.e., "accident and health" coverage – it inadvertently (we think) impacted the disability area, too.

Among other things, the proposed rules would generate imputed income on the current premium and effectively treat any disability proceeds as if they were contributed to the plan by the disabled participant – subject to the various IRC Code contribution limits. Accordingly, the proposal has frozen the market for any new arrangements of this type for nearly five years.

Richard Shea and I have submitted various comments to Treasury recommending the regulations adopt the original treatment in the letter rulings. We also testified at the IRS hearing and had some follow-up meetings, and are hopeful of a favorable outcome. We hope the Council will also recommend that Treasury not disrupt these creative and beneficial disability protection arrangements.

We also think it is important for the Council to urge the Department to educate plan sponsors and workers about (1) the broader risks of disability, (2) the adverse impact on their standard of living and, of course, retirement savings, and (3) the importance of providing adequate LTD coverage so that participants won't need to prematurely tap their 401(k) accounts to help them meet their daily income needs.

Thank you very much for your attention and this opportunity to testify. I would be happy to answer questions.