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ERISA Advisory Council
United States Department of Labor
Hearing on

MANAGING DISABILITY RISKS IN AN ENVIRONMENT OF INDIVIDUAL RESPONSIBILITY

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Introduction

I commend the ERISA Advisory Council for addressing in today's hearing an important and often overlooked problem—the adverse impact of disability on retirement security. I appreciate the Council's invitation to testify on this topic. My testimony will focus on options for providing protection against loss of retirement savings in defined contribution plans on account of disability. Specifically, I want to emphasize that both ERISA and the Internal Revenue Code define "qualified disability benefits" to cover both defined contribution and defined benefit plans and to encourage both types of plans to provide disability benefits that replace retirement benefits employees would otherwise lose through disability.

The Disability Savings Gap

Prolonged disability can be economically devastating to an employee's retirement savings. Long-term disability benefits can replace the employee's current income, but generally do not make up for the employee's lost retirement savings during disability. The inability to save during an extended disability can permanently undermine an employee's retirement savings. For example, an employee who is disabled at age 50 and does not return to work until age 55 loses five years of retirement savings that may be impossible to make up over the remainder of his or her working career. *See* K. Hube, *Securing a Nest Egg*, Wall Street Journal (Mar. 22, 2008). Those lost savings can easily make the difference between a retirement that is secure and one that is filled with privation and financial insecurity. *See generally* A. Rappaport, *Linked: Disability Risk and Retirement Security*, Benefits Magazine (Nov. 2011).

Congress has long recognized the importance of protecting retirement savings against disability. For this reason, ERISA permits retirement plans to provide a "qualified disability benefit" to disabled employees—that is, a benefit at normal retirement age that equals the benefit the employee would have earned had he or she not become disabled. *See* ERISA § 3(22); IRC § 411(a)(9); *see also* Treas. Reg. § 1.411(a)-7(c)(3); T.D. 8360, 56 Fed. Reg. 47,524, 47,531 (Sept. 19, 1991) (Preamble).

Defined benefit plans often provide qualified disability benefits by continuing pension accruals during long-term disability. However, defined contribution plans are supplanting defined benefit plans as employees' primary retirement savings vehicle, and few defined contribution plans offer disability benefits. As a result, fewer and fewer employees are protected against a disability savings gap.

Qualified Disability Benefits in Defined Contribution Plans

Fortunately, the statute does not preclude defined contribution plans from offering qualified disability benefits. *See* ERISA § 3(22) (defining "qualified disability benefit" for both defined benefit and defined contribution plans); IRC § 411(a)(9) (same). In concept, qualified disability benefits in a defined contribution plan simply replace the contributions that would have been credited to the disabled employee's account had he or she not become disabled.

Actual Replacement Contributions. One way to replace the contributions an employee loses during disability is for the employer (or the employee) to make contributions to the plan and to allocate these replacement contributions to the disabled employee's account. However, among other complications, the Internal Revenue Code limits such contributions to only the most severely disabled employees. *See* IRC § 415(c)(3)(C)(i). Thus, many employees who qualify for benefits under an employer's long-term disability plan and, in fact, are unable to continue working for the employer, are ineligible for actual replacement contributions under the Internal Revenue Code.

Insured Replacement Benefits. An alternative approach for replacing contributions lost during disability is to purchase disability insurance coverage in a defined contribution plan. Under this approach, the plan enters into a group disability insurance policy under which each employee is permitted to apply a portion of his or her defined contribution account to pay premiums for coverage under the policy. If a covered employee becomes disabled, the policy makes payments to the plan during the employee's disability equal to the contributions that would have been made had the employee not become disabled. These payments are credited to the disabled employee's account, invested just like other assets in the account, and eventually distributed from the plan, together with other amounts credited to the employee's account. Unlike actual replacement contributions which are limited to only the most severely disabled employees, insured replacement benefits are available to any employee covered under the policy who meets the policy's definition of disability.

It might be instructive to review an example of an insured benefit replacement program that an employer has actually put in place. To provide its employees with a way to guard against the gap in retirement savings that can result from an extended disability, the employer amended its defined contribution plan to add a Disability Protection Program. The program permits each employee to elect to apply a portion of his or her account balance under the plan to pay insurance premiums for disability protection coverage. Unlike conventional disability insurance, this coverage does not provide current income to employees while they are disabled. Rather, if a covered employee becomes disabled, the coverage makes payments to the employee's defined contribution plan account equal to the amounts that would have been credited to the account had the employee not become disabled—including nonelective, elective, and matching contributions. To reduce premiums costs, employees can elect less than full replacement of their current contributions.

The definition of disability under the program is the same as under the employer's long-term disability plan. As a result, the definition is substantially less restrictive than the definition that applies under the Internal Revenue Code to actual replacement contributions. This decision reflects, not just the employer's desire to keep the program in sync with its long-term disability plan, but a judgment that the actual replacement contribution approach in the Internal Revenue Code fails to protect many disabled employees who do not meet its strict definition of disability.

Thousands of employees have enrolled in the Disability Protection Program since its inception. A small number of these employees have become disabled and are currently receiving benefits under the program.

Tax Treatment of Qualified Disability Benefits in Defined Contribution Plans

As noted above, the ability to make actual replacement contributions is limited under the Internal Revenue Code to only the most severely disabled employees. As a result, employers that wish to provide more comprehensive disability savings gap protection to their employees are unlikely to be satisfied with this approach.

From a tax perspective, the alternative approach of providing an insured replacement benefit raises two related questions: (1) how the premiums for the insurance coverage should be treated when they are debited from the employee's account, and (2) how the insurance policy proceeds should be treated when they are credited to the employee's account. The IRS had answered both questions in private letter rulings.[1] These rulings hold that the policy is a plan investment and that any policy benefits credited to the employee's account are a return on that investment. In other words, the policies are in the nature of an investment designed to provide retirement benefits. Accordingly, premium payments are not distributions subject to taxation when they are debited from the employee's account. Nor are policy proceeds taxed when they are credited to the employee's account. Rather, policy proceeds are taxed to the employee when they are distributed from the plan — just like any other taxable amounts the employee receives from the plan.

In 2007, Treasury and IRS issued proposed regulations that cast doubt on the tax treatment previously outlined in the Service's private letter rulings. *See* 72 Fed. Reg. 46421 (Aug. 20, 2007). These regulations generally would provide that (1) payments of health or accident insurance premiums from an employee's account are treated as taxable distributions to the employee, and (2) insurance proceeds credited to the employee's account are treated as immediately distributed to the employee and re-contributed to the employee's account, subject to all the rules governing contributions to qualified plans. If the proposed regulations applied to insured replacement benefit programs, the qualified plan rules would block re-contribution of the insurance proceeds in many cases and defeat the purpose of preserving disabled employees' retirement savings. Even in cases where re-contribution were not blocked, many believe that the proposed regulations would replace a sensible and legally sound approach developed by the IRS

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[1] *See* PLR 200235043 (June 6, 2002); PLR 200031060 (Aug. 26, 2000).

in its prior private letter rulings with an approach that would impose unsustainable administrative burdens and tax qualification risks on plans that include such programs.

In response to comments submitted on the proposed regulations, Treasury and IRS indicated that the proposed regulations were not targeted at insured replacement benefit programs for disabled employees, and that both agencies were willing to work with plan sponsors to develop alternative rules and/or safe harbors for such programs. However, it was unclear whether the agencies would stand by the tax treatment previously outlined in the Service's private letter rulings.

Nearly five years have passed since the proposed regulations were issued, and no action has been taken to withdraw, modify, or finalize them. Their presence has brought adoption of insured replacement benefit programs for disabled employees to a standstill.

Recently Treasury and IRS announced that they intend to finalize the proposed regulations by the end of 2012. Treasury officials have indicated privately that insured replacement benefit programs for disabled employees appear to be consistent with Treasury's overall policy objective to make defined contribution plans more comprehensive retirement programs. Plan sponsors believe that the best and most sensible way to implement Treasury's policy objective is to adopt final regulations that incorporate the tax treatment previously outlined by the IRS in its private letter rulings.

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That concludes my prepared testimony. I would be pleased to answer any questions you may have.