Brown & Brown

EMPLOYEE BENEFITS

Employer-Sponsored Disability Benefits

General Overview

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Employers often choose to sponsor or maintain disability benefits that provide income protection for employees unable to perform the regular duties of their full-time occupation and experience a loss of earnings due to a non-occupational (off-job) illness or injury. Occupational (on-the-job) injuries or illnesses are generally covered by workers' compensation insurance, which most employers are required to carry for the benefit of their employees under state law. Workers' compensation insurance is generally the only recourse for employees with job-related disabilities/injuries unless the non-occupational disability plan includes benefits that supplement workers' compensation coverage.

Employer-sponsored disability benefits will vary in the dollar amount paid, providing either full or partial wage replacement or salary continuation payments to disabled employees. As a matter of plan design, employers may provide the benefits through:

1) purchasing group disability insurance
2) offering employees the opportunity to purchase individual disability insurance
3) self-insuring the benefit through short-term wage continuation with direct payments from the employer's general assets
4) some combination of the above three approaches

The two primary types of disability coverage employers provide to their employees are short-term disability insurance (STD) and long-term disability insurance (LTD).

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Short-Term Disability

The primary difference between STD and LTD insurance is the length of time the employee will receive the benefit. As the name suggests, STD coverage is intended to only pay benefits/replace income for a shorter duration, typically three months to one year following a benefit waiting period (also referred to as an elimination period) in which no benefits are paid. The benefit amount will vary by plan, but STD plans often provide a greater percentage of income replacement than LTD plans during the coverage period. For example, an STD plan may replace 70% of an employee's pre-disability income versus 50% of the employee's pre-disability income under an LTD plan.

Long-Term Disability

LTD benefits will begin after the STD benefit has been exhausted and will typically continue for a period during which the employee is disabled, up to between two and ten years, or until the employee reaches age 65 or reaches Social Security Normal Retirement Age, depending on the plan. The elimination period (i.e., benefit waiting period) under an LTD plan is generally longer than for STD plans, lasting around 90 days. LTD benefits are primarily suited for situations in which the employee is injured and will be out of work for a longer period or even permanently.

The remainder of this overview identifies and discusses some compliance issues related to disability benefits.

State Disability Coverage Mandates

Several states, including California, Hawaii, New Jersey, New York, and Rhode Island, as well as Puerto Rico, require covered employers to offer short-term or temporary disability coverage either as part of a state-sponsored disability program or through short-term/temporary disability coverage (either fully insured or self-insured) provided by a covered employer to its employees. Like other STD plans, state-mandated disability programs provide wage replacement to employees unable to work for a specified reason. In addition to the definition of covered employer and employee varying under certain state laws, the elimination period and benefit amount also typically vary by state. Some states permit covered employers to offer disability insurance through an approved private plan insured by an insurance company or an approved self-insured short-term/temporary disability arrangement to satisfy their obligation under state law to provide employees with disability coverage as an alternative to electing to comply via a state-run program.

ERISA*

Under ERISA §3(1), the term "employee welfare benefit plan" specifically includes any plan, fund or program established or maintained by an employer to the extent that it is established or maintained to provide benefits to employees (or former employees) in the event of disability. As a benefit specifically listed under ERISA, disability plans will generally be subject to ERISA (and its plan document, amendments, Summary Plan Description (SPD), Summary of Material Modifications (SMM), Form 5500 annual return/report, and claims procedure requirements) unless an exemption applies.

**Employee Retirement Income Security Act of 1974.*

Disability Plans Exempt from ERISA:

- **Payroll Practice Exemption –** Under a Department of Labor (DOL) safe harbor, certain employer-provided benefits (including disability benefits) that technically fit within the definition of an ERISA employee welfare benefit plan could be exempt from ERISA's requirements. In general, for the safe harbor to apply, the following conditions must be met:
  - » *Unfunded* – The plan must be unfunded to satisfy the safe harbor requirements. To be unfunded, the benefit must be paid out of the employer's general assets and be funded solely by the employer (i.e., employees do not make any contributions). Using a separate account (including a TPA account) that separates contributions from the employer's general assets to pay benefits can result in creating a funded benefit plan, in which case the program will fall outside of the DOL safe harbor, making the plan subject to ERISA. Furthermore, if the benefits are paid through insurance (i.e., through a fully insured plan), the program will be subject to ERISA unless another exception applies.
  - » *"Normal Compensation"* – An unfunded income replacement arrangement may only replace up to the employee's ordinary pre-disability income to fall within the payroll practice safe harbor. A plan that pays more than normal compensation will fall outside the DOL safe harbor and be subject to ERISA.
  - » *Employer's Treatment of Program* – Under certain circumstances, courts have determined that an employer's treatment of an STD plan as an ERISA plan coupled with other evidence (i.e., minimal funding of the plan and describing the plan as an ERISA plan in the SPD) was enough to determine that the plan was subject to ERISA. Employers intending to avoid ERISA compliance obligations by taking advantage of the payroll practice safe harbor should consider reviewing how the STD program is addressed in relevant documentation (i.e., SPDs, benefits books, benefit guides and other plan-related materials).
  - » *Former Employees* – A disability plan that pays benefits to former employees may not satisfy the payroll practice safe harbor. According to the DOL, a payroll practice is intended to pay employees absent from work and not allow former employees to receive disability benefits. Employers who plan on utilizing the DOL safe harbor should review their disability program to determine whether the benefits payment ends upon employment termination.

- **Voluntary Plan Safe Harbor –** In some cases, the disability coverage by an employer might be exempt from ERISA under the voluntary plan safe harbor. The voluntary plan safe harbor applies if the following conditions are satisfied:
  - » The employer makes no contributions;
  - » Participation in the program is entirely voluntary for employees;
  - » The sole functions of the employer with respect to the program are, *without endorsing* the program, to permit the insurer to publicize the program to employees, collect premiums through payroll deductions, and remit the premiums to the insurer; and
  - » The employer receives no consideration in the form of cash or otherwise in connection with the program other than reasonable compensation, excluding any profit, for administrative services rendered in connection with payroll deductions.

  Factors that suggest endorsement of a disability plan has occurred include allowing use of the cafeteria plan (i.e., pre-tax contributions); selection or negotiation with the insurer; endorsing the plan or associating the plan with an employer's ERISA plan(s) (including voluntary plan in ERISA materials or using the employer's name in the plan name); recommending the plan to employees; asserting that ERISA applies; performing administrative functions (other than remitting premiums); and assisting employees with claims. **Due to these potential issues, employers should seek out a formal legal opinion from qualified legal counsel regarding whether the employer has endorsed the program.**

- **Exemption for Disability Plans Maintained to Comply with State Disability Insurance Law –** Under ERISA §4(b)(3), plans maintained to comply with applicable state disability insurance laws are exempt from ERISA. However, the program will fall outside of the exemption and thus be subject to ERISA if:
  - » The disability plan offers ERISA benefits in addition to those required by state law or
  - » If the employer exercises an option to opt out of the state program (i.e., an employer chooses to provide a separate disability plan outside of a state program).

Plan Documentation Issues:

When a disability plan is subject to ERISA, the plan sponsor must determine whether the material/documentation provided by the insurer or third party administrator satisfies ERISA's plan document and SPD requirements. The documentation provided by insurers often lacks the required provisions under ERISA, as they are typically not drafted for ERISA compliance, so a plan sponsor may need to consider drafting separate documents (i.e., wrap documents) to satisfy ERISA's documentation requirements.

If the disability program is exempt from ERISA based on one of the exemptions described above, there is no requirement to maintain the program under a written document or to distribute an SPD related to the disability plan. Nevertheless, some employers include non-ERISA benefits in their wrap plan documentation. Such employers should consider how bundling ERISA and non-ERISA benefits can impact the exempt status of a benefit. The general rule is that bundling ERISA benefits with non-ERISA benefits will not necessarily affect the ERISA status of the underlying benefit. However, the impact on the exempt status of the benefit will depend on the exemption on which the employer is relying and how the benefit is addressed in the wrap documentation. Employers should work with qualified legal counsel to determine how the inclusion of the disability program in the wrap documentation impacts its ERISA status.

***Consolidated Omnibus Budget Reconciliation Act.*

COBRA**

COBRA generally applies to plans maintained by an employer that provide medical care to participants or beneficiaries. Because many LTD and STD plans are designed to provide only income replacement and not medical care, they will not be considered group health plans subject to COBRA. Plan sponsors should carefully examine what benefits are offered under the disability coverage to ensure that no medical care is provided as a part of the benefit. Furthermore, LTD insurers frequently bundle an Employee Assistance Plan (EAP) with the disability policy as a value-added benefit. If the EAP provides coverage for treatment of a mental health condition or a substance use disorder, it is a group health plan and is subject to COBRA.

The other COBRA-related issue that can arise is whether employees taking a disability leave (i.e., employees potentially eligible for benefits under the STD or LTD plan) must be offered COBRA under any group health plan benefit(s) in which they are enrolled. As a practical matter, some group health plans will allow an employee to remain eligible for health coverage for a prescribed period while an employee is on disability leave. However, depending on the terms of the employer's group health plan(s), individuals who are out of work and receiving STD/LTD benefits may experience a COBRA qualifying event (e.g., a reduction in hours causing a loss of eligibility) during a period of disability. If there is a loss of eligibility, an employer is generally required to offer COBRA continuation coverage to any qualified beneficiaries (employees, spouses or dependents covered by the employer's health plan) enrolled in coverage under a group health plan(s) (i.e., medical/dental/vision coverage) prior to the loss of eligibility.

Employers will also need to consider the impact of other laws, such as FMLA and protected state leave when determining whether health coverage can be terminated during a disability benefit period.

Section 125 Cafeteria Plan Funding

Short- and long-term disability plans are considered qualified benefits eligible for pre-tax funding under a Section 125 cafeteria plan. Note, however, that allowing employees to pay for disability coverage on a pre-tax basis will impact the taxation of any benefits received, as discussed in the next section.

Taxation of Disability Benefits

The taxability of the disability benefit will generally depend on how the premiums for coverage are paid during the year of the disabling event[1].

- *Pre-Tax* – If premiums for the disability benefit are paid entirely with pre-tax dollars (by the employer and/or employee), the benefits received when the employee becomes disabled are taxable.
- *Post-Tax* – If premiums for the disability benefit are paid entirely with post-tax dollars (by the employer via imputed income to the employee and/or with premiums paid by an employee with post-tax dollars), then the benefits received when the employee becomes disabled are not taxable (i.e., are not included in the employee's taxable income).
  - Example 1 – Employer-Paid Imputed or Gross-Up: When an employer pays 100% of the disability premiums and reports the amount on the employee's Form W-2 as taxable income, the premiums will be considered paid on a post-tax basis, and any payments received by an employee/former employee during the time of their disability are not included in the employee's taxable income.
  - Example 2 – Employee-Paid Post-Tax: When an employee's only option is to pay premiums for disability coverage on an after-tax basis or the employee makes an irrevocable annual election under the employer's cafeteria plan to pay premiums for disability coverage on an after-tax basis and subsequently becomes disabled, wage replacement/salary continuation payments made to a covered individual are generally non-taxable.
- *Combination Pre-Tax and Post-Tax* – If premiums are paid with a combination of pre-tax and post-tax dollars, then the taxable portion of the disability benefits are determined using a three-year look-back method. Under the look-back rule, the ratio is calculated by dividing the taxable portion of the premiums (employer-paid imputed/gross-up and employee paid post-tax) by the total premiums paid by the employer and employee over a three-year period.

  Plan sponsors should communicate to employees the tax consequences of paying for disability benefits on a pre-tax basis. Due to the potentially significant taxation of disability benefit payments to an employee, employers may want to consider offering employees the option to pay their disability premiums on a post-tax basis.

[1] *Rev. Rul. 2004-55.*

Affordable Care Act (ACA) Hours of Service

Applicable large employers (i.e., those with 50 or more full-time/full-time equivalent employees during the prior year) must offer affordable and minimum-value medical coverage to their full-time employees to avoid an Employer Shared Responsibility Payment (ESRP). Under the ESRP provisions, an employee is considered full-time if they average at least 30 hours of service per week or at least 130 hours per month. An hour of service consists of:

- "Each hour for which an employee is paid, or entitled to payment, for the performance of duties for the employer, and
- Each hour for which an employee is paid or entitled to payment by the employer for a period of time during which no duties are performed due to vacation, holiday, illness, incapacity (including disability), layoff, jury duty, military duty or leave of absence."[2]

According to IRS guidance, if an individual remains employed but is not performing duties and is receiving taxable payments under an STD or LTD policy, they will be treated as earning hours of service unless the employer did not contribute directly or indirectly to the benefit.[3] Once the employee terminates employment, hours are not credited even if they receive a taxable disability benefit.

Examples:

- If an employee paid LTD or STD premiums on a pre-tax basis (resulting in taxable disability benefits), the premiums are treated as paid indirectly by the employer, and any hours in which they remain employed and receive disability benefits will be included in the calculation of an employee's hours of service per week/per month for purposes of determining full-time status under the ACA's ESRP provisions.
- If an employee paid disability premiums with post-tax dollars, then the disability benefit period would not count towards their hours of service per week/per month.

Family and Medical Leave Act (FMLA)

Employers must understand the interaction between STD/LTD and the FMLA. While disability benefits are often provided simultaneously with FMLA leave, there are differences between the two programs.

First, STD and LTD benefits are a type of insurance that provides income protection (as a paid benefit) to individuals who experience a loss of earnings due to a disability. In contrast, FMLA is a law that provides job/benefit protection when the employee is unable to work. Job-protected FMLA leave is usually unpaid (except states that have enacted paid family/medical leave laws).

Second, the eligibility requirements and conditions for taking FMLA leave and for receiving disability benefits can be different. For example, while FMLA requires 12 months of employment before being eligible for FMLA leave, depending on the policy, employees may be eligible for STD/LTD coverage and benefits after a short eligibility waiting period. In addition, STD/LTD benefits generally apply to injury/illness of the employee, while FMLA can be taken due to serious medical conditions of both the employee and their family members, as well as for bonding with a newborn or newly adopted child.

[2] *Identifying Full-time Employees* *https://www.irs.gov/affordable-care-act/employers/identifying-full-time-employees.*
[3] *IRS Notice 2015-87, 2015-52 I.R.B. 889, Q/A-14.*

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