Executive Disability Insurance

As employers look to improve their benefit offerings to attract and retain key talent, one often overlooked benefit is disability income protection insurance. A loss of income due to a disability can be financially devastating, especially when you consider that an executive's future earning potential may be their most valuable asset.

Therefore, it is vitally important that those responsible for benefits and compensation decisions raise the awareness of how employer-sponsored supplemental income protection plans can be designed to help close a gap in coverage for highly compensated employees.

The income replacement gap

All employees benefit from the protection afforded by Group Long-Term Disability (LTD) insurance, but high-earning executives can face a meaningful gap in protection if they rely solely on their group LTD plan to protect their earnings. Most of these plans are designed to protect base earnings up to a maximum of $200,000 or $300,000 per year, and when fully paid by the employer these benefits are taxable upon receipt. Unprotected bonus income, taxable group LTD benefits and contract definitions that may be too restrictive can make a difficult situation much worse if an executive is disabled.

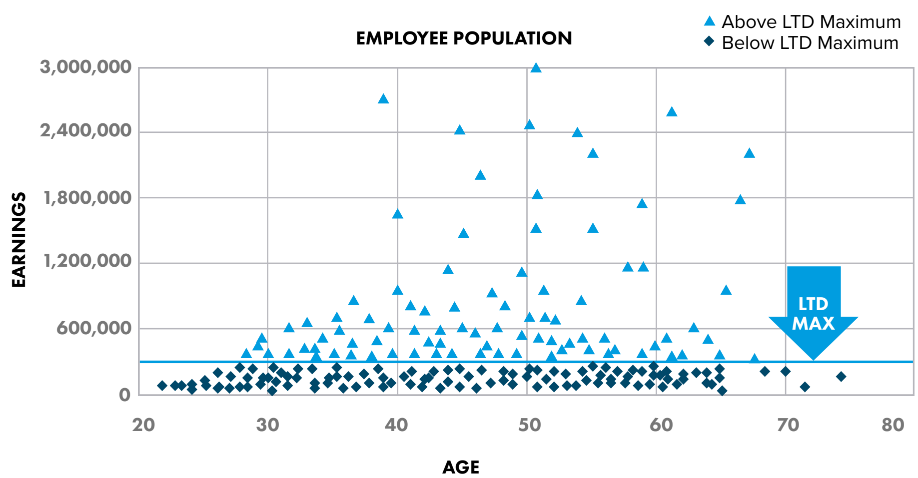
Figure 1 shows just how dramatic the benefit inequity can be for the highly compensated employees in this hypothetical example.

Figure 1: The Coverage Gap Based on Earnings

The Case: The Group LTD plan protects 60% of employee salary up to a maximum benefit of $15,000 per month.

The Gap: Earnings above $300,000 per year are not protected by the Group LTD program.

The Concern: If a high earning employee was to have a disability, it could be very difficult to maintain their financial responsibilities and could have a dramatic impact on their future earnings and retirement goals.



As a result of these issues, an appropriate goal would be to design a comprehensive LTD strategy aimed at income restoration for highly compensated employees, where coverage for all employees is at the same percentage of income rather than having a lower percentage of income covered for highly compensated employees.

Bridging the gap—A three-tiered approach to restoration

An employer's group LTD coverage is a good starting point to restore coverage to highly-compensated executives so that the percent of earnings covered is equal to the percent covered for all other employees. Additional coverage can then be layered on top of the group coverage using individual disability insurance (IDI), and if income is high enough, an optional third layer of coverage from Lloyd's of London.

Layer 1-Group LTD coverage

Group LTD is a good foundation because it is:

- Inexpensive—An employer has access to a quality insurance plan offering a sufficient level of coverage for most employees with a nicely discounted premium that is possible because of the negotiating clout a large group of employees offers an entity.
- Guaranteed issue—Often, guaranteed issue is available where an individual just has to answer a couple of questions confirming that they work.
- Unisex pricing—This is a major advantage as coverage sold to a female on the open market will typically be 30% more expensive than coverage for a male.

Layer 2-IDI

Group LTD can be supplemented with an individual policy to add more protection for a highly compensated employee. Unlike group coverage, IDI is purchased for specific individuals and has the versatility to replace higher amounts of income; replace commissions and bonuses; offer portability of coverage; and because of individual underwriting, can offer better benefits—although at higher premiums.

If an employer sponsors an IDI plan, there may be discounted pricing and little-to-no underwriting. While the insurer may also have participation requirements, these can sometimes be negotiated. When individual policies are purchased through an employer on a group basis, guaranteed issue is often available. This is the most cost effective and efficient way to obtain an IDI policy, and the objective is to start with as much guaranteed issue coverage as possible.

As an alternative to an employer-sponsored plan, the executive could purchase coverage on the open market, but these policies can be expensive, costing the full retail price and subjecting the executive to full medical underwriting which can be stringent. One expert DI source found that 66% of IDI applicants on the open market were either declined, rated, or had an exclusion.

Whichever option is used, IDI offers the benefit of portability should the executive leave the current employer. As a reminder, group LTD coverage is not generally portable.

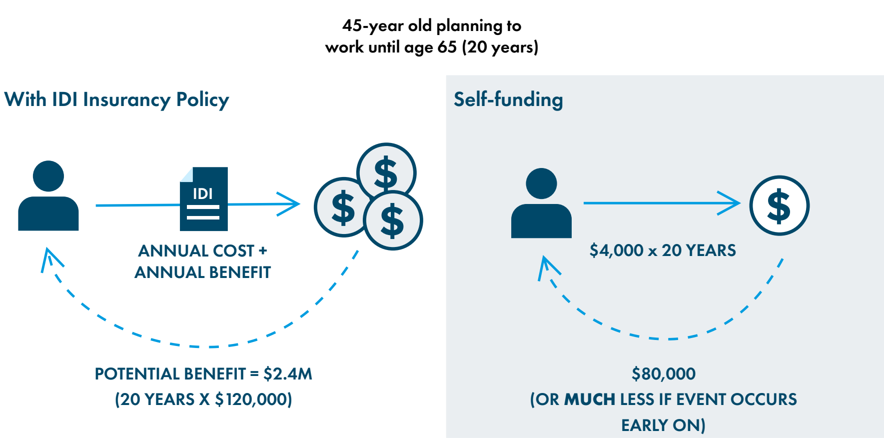
Layer 3-Lloyd's of London

The third piece in this comprehensive LTD strategy can make it possible to ensure monthly replacement of income remains at 60%-65% of income even for those with extraordinarily high incomes. In working with Lloyd's of London, coverage levels as high as $50,000 to $100,000 or more can be obtained. In some instances, it has been possible to buy as much as $250,000 a month in coverage on a guaranteed issue basis. Annual premiums can fall in the $40,000-$50,000 range for such coverage, which may be worth the investment if a highly-paid executive is earning $5 million to $10 million a year.

What is the value of income restoration?

The economic value of IDI insurance coverage becomes clear when you look at two income continuation choices in the hypothetical illustration in Figure 2.

Figure 2: Hypothethical IDI Insurance Costs vs. Self-Funding



Annual Cost: $4,000 fixed premium x 20 years = $80,000 (cost)
Annual Benefit: $10,000 X 12 = $120,000 (benefit)
Potential Benefit: 20 Years X $120,000 = $2.4M

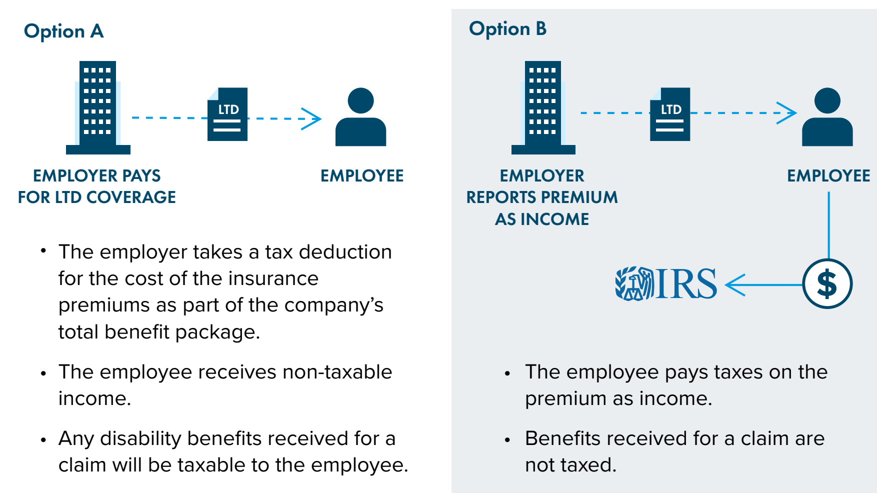
Make the LTD benefit work

Once an organization commits to the strategy of using **income restoration** to enhance the LTD benefits for high earners, it needs to manage both taxes and costs to ensure success.

Manage taxes

Tax treatment of LTD policies depends on how the employee benefits program is structured. If the LTD plan premiums are paid by the employer and there is no recognition of this premium as income to the individual, the benefits received from the plan will be taxable to the employee at the time of a claim. If the individual pays the premium OR if the amount of premium paid for an individual is added to that individual's income, the benefits will likely be tax-free as illustrated in Figure 3.

Figure 3: Tax Treatment of Individual LTD Policies



Some employers offer a "tax choice" plan that lets highly compensated employees choose the payment method that best suits their tax situation. Although attractive for employees, it can make the LTD plan more complex and costly for the employer to administer.

In most cases, the employer pays the premium, takes a tax deduction and the individual receives the LTD benefit without cost. In this approach, a claim will create a tax liability for the executive. So, even if an individual is at the $200,000 cap level and receives the full benefit, there are still federal and state income taxes that come due if they go out on claim. Therefore, a 60% income replacement plan after taxes, is not 60% coverage.

Additional Considerations

LTD insurance, and the important role it plays in protecting an employee's income, is not always top of mind with employees. Unless employees understand the value of this benefit, an opportunity to ensure income continuation may be lost. Effective communication is vital to assure that they understand the value of, and participate in, this important benefit.

It's also important to remember that, while the business may be able to finance the delivery of these benefits in ways that significantly reduce their cost and/or tax impact, it will still need to plan for the ongoing communication, administration, and maintenance of the plan.

Fairness

Organizations, their senior managements and boards of directors are increasingly called upon to focus on issues such as diversity, equity, and inclusion (DEI) and environmental, social, and governance issues (ESG). Therefore, it's particularly important that an employer's LTD insurance plan reflect this growing public awareness. An employer also needs to clearly communicate that its LTD program is designed to ensure that all employees are treated equitably.

Take the next step now...

Your M Financial professional is in the financial wellness business, trying to help your organization provide its executives and employees with core benefits, including a comprehensive LTD insurance program, that they might not be paying enough attention to.

- If you don't have an LTD program in place, consider equitably adding this important benefit along with an effective way to communicate its value.
- If there is an existing LTD program, evaluate whether all employees are treated equally, and whether restoration is needed so that the same percentage of income replacement is available and applied equally across all employees if a long-term disability occurs.

Your M Financial professional has the experience to provide a thorough analysis of how the right LTD program will benefit your organization and your employees. Please contact them for more detailed information on this and other business planning and preservation solutions.

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CONTRIBUTOR:

Randall Peck
rpeck@peckfinancial.com
M Member Firm Principal

David Richter

M Member Firm Principal