8 PITFALLS
Of Employer Disability Insurance
by Mitch Nelson, DIA, CLTC
CAREER MOBILITY

Employer coverage lacks true portability. This means if a client changes employers, explores entrepreneurial opportunities, or loses their job, they also lose their employer disability insurance.

In some situations, coverage may be extended to the end of the month after terminating employment, but the coverage typically stops immediately upon leaving the employer.

It's unlikely, but a client may be provided an opportunity to convert their coverage. Be aware that this conversion will look completely different from the original employer insurance. These conversion policies are not individual insurance policies, instead, the conversion is to a trust product designed for severely ill participants, which comes with higher premiums and more restrictive qualifications for benefits.

INSIDER TIP

An individual disability insurance policy will follow your client wherever their career aspirations take them.
REVERSE DISCRIMINATION

High-income earners often run into reverse discrimination with monthly benefit caps, which decreases their expected percentage of income replacement. This is not the only area where their high-income works against them; there is a lesser known form of reverse discrimination within employer certificates.

The more education, training, and experience that high-income earners possess, the easier it is for the employer's insurer to determine alternative work the client is able to perform under the Any Occupation definition of benefit qualification.

Many employer plans have limited time periods when the Own Occupation of a client is considered for benefit payment. Once this time period has passed and Own Occupation changes to Any Occupation for the benefit criteria, your clients education, training, and experience can actually work against them to deny benefits because they have the skills to perform more occupations.

INSIDER TIP

An individual disability insurance policy will cover more of your client’s income, and an Own Occupation definition of disability can be chosen to better protect them.
QUALITY CONTROL

Employer coverage is controlled by the employer, and its availability and design depends on their insurance budget. Many employers are facing increased costs of medical insurance, making it more difficult to provide robust disability benefits. In response, many employer policies have been reduced to the bare necessities of coverage and this trend is expected to continue.

The employer can change or cancel their group coverage at any time without approval or the offer of alternative options for employees. This instability makes group coverage a risky income protection strategy.

INSIDER TIP

Clients can customize their individual disability insurance policy to their goals and needs. As long as premiums are paid, the contract cannot be altered or cancelled.
PRE-EXISTING CONDITIONS LOOPTHOLE

Unlike with major medical insurance, pre-existing medical conditions are still prominent within employer disability coverage.

Many people confuse employer disability insurance for guaranteed issue because no medical underwriting is required to join. However, employer disability plans will protect against new employees utilizing benefits for prior or on-going medical conditions by including a waiting period. This period often includes medical conditions, medications taken, and consultations that have occurred three to six months prior to becoming eligible for the employer coverage. This pre-existing condition period then extends for the next 12 to 24 months of continuous coverage under the employer plan.

This is risky for older clients who change employers and believe they are covered for pre-existing conditions because no medical underwriting was required. The client will not know if their pre-existing condition(s) will impact their benefits until they request benefits during a claim.

INSIDER TIP

It is important to purchase individual disability insurance as early as possible prior to the development of poor health. Individual policies can also include guaranteed insurability features that can protect the client even after they develop poor health.
TRANSITIONAL QUALIFICATIONS

Employer disability insurance is designed to cover a wide variety of employees. In order to provide competitive pricing to the employer and minimal risk to the insurance company, the vast majority (up to 75%) of employers shorten their Own Occupation definition of disability in their group coverage to 24 or 36 months. Once that period passes, the definition of disability transitions to a more restrictive Any Occupation qualification of benefits.

This often happens for all employees, including executives and the highly compensated. This may appear to be adequate for many entry-level positions, but when consulting clients with specialty training, advanced education, or years of experience, this can be very troublesome in determining the assumption of benefit payments beyond the Own Occupation period.

This transition of qualifications can place a moving target on benefit assumptions and leave a client unexpectedly without benefits if they undergo this transitional evaluation and are able to perform the material and substantial duties of any occupation.

INSIDER TIP

Individual disability can extend the own occupation definition for the entire benefits period and add a valuable backup plan against the shortfall of employer disability insurance.
VARIABLE INCOME INEFFICACIES

Employer coverage is often designed to provide a base-level of protection for a large employee population. Because premiums are calculated using covered payroll, many employers will limit the type of income eligible for monthly benefit replacement because of premium budgets. This typically involves base salary coverage only. Unfortunately, this is often not where the inefficiency stops.

Many employer disability plans will also reduce monthly benefits for any bonus or commission income received while benefits are paid.

This means variable income sources are not part of the percentage replacement calculation, but are used to lower expected benefits during actual claim payments. To say this is inefficient is an understatement.

INSIDER TIP

Individual disability insurance will extend coverage for most sources of variable earned income when setting the monthly benefit within the policy.
TAXATION PENALTIES

Many employer disability benefits are provided and paid for by the employer, which means any benefits received will be considered taxable income.

Tax-free benefits can be achieved if the employer requires them to pay premiums through payroll deductions or grossing up their W-2 at year-end for the cost of disability insurance. This is before reductions and other income offsets are calculated to reduce actual benefit payments.

On the surface, low-cost premiums and tax-free benefits appear like a great strategy. However, this assumption of tax-free benefits is tied to inferior contractual qualification requirements which may not be attained past the Own Occupation period over an extended disability. These tax-free benefits also reduce what the client may customize in their individual disability policy at no fault of their own.

INSIDER TIP

Because a client pays the premiums on their individual disability insurance coverage, they receive benefits tax-free.
LIMITATIONS, REDUCTIONS, AND OFFSETS

This overlooked section within most employer disability insurance requires the review of certificate booklets and cannot be reviewed using a summary page.

Some benefit payment limitations can cap benefit periods at 12 or 24 months over the lifetime of the employee. These limitations include (but are not limited to) the following: mental health, substance abuse, chronic fatigue, environmental allergies, musculoskeletal and connective tissue disorders, and self-reported conditions.

Reductions and offsets include (but are not limited to) the following: sick pay, annual or personal leave pay, severance pay or other salary continuation, work earnings, workers compensation benefits, social security disability benefits, state disability benefits, association or other employer disability benefits, unemployment compensation, retirement plan disability benefits, and no-fault auto settlements. Because of these reductions and offsets, the monthly benefit maximum is not always what it appears.

INSIDER TIP

Individual disability insurance often does not limit benefits for mental health or substance abuse related disabilities. Some limits may be added or required per certain occupation types.
**CONCLUSION**

Employer disability insurance is a valuable employee benefit, and without it, many clients and their families would find themselves without income protection. However, it has also led to a form of planning complacency within the financial advice industry. This default planning is led by an over-simplification of the effectiveness of employer coverage in addressing perceived risks clients face as they progress through their inconsistent, and somewhat unpredictable, career paths.

The ultimate asset a client has is their human capital. Most savings and retirement strategies require a consistent income generated from this human capital to succeed. The one risk a client cannot diversify is their personal health; they must deal with the cards they have been dealt, and bad things do happen to good people. The consequences are real and a serious approach to the subject will strengthen the trust of the advisor-client relationship.

Individual disability insurance is a powerful strategic financial planning tool when properly constructed within a well-designed comprehensive financial plan.