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View From McDermott: Protecting Defined Contribution Plan Retirement Savings During Disability

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As employers have moved away from traditional defined benefit plans toward defined contribution plans as the primary retirement savings vehicle for their employees, much has been written about the risks of shifting the retirement savings burden from the employer to the employee. One widely-recognized consequence of this shift in retirement savings methods is that many employees are not contributing enough of their income, or earning high enough returns on their investments, to provide sufficient funds to meet their retirement needs through defined contribution plans. Many plan sponsors have responded to this concern by adding features to their defined contribution plans, such as automatic enrollment, automatic annual increases of employee deferral percentages and increased matching contributions, in order to encourage employees to save more for retirement.

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Another consequence of this shift to defined contribution plans that has received less attention is that employees who suffer long-term disability are left without the retirement safety net that often has been provided under defined benefit plans. Employees typically lose the ability to continue making contributions to a defined contribution plan upon becoming disabled and often rely on their retirement savings under a defined contribution plan to meet their current income needs. While the Internal Revenue Code (the Code) and the regulations thereunder provide a framework for incorporating long-term disability benefits into defined contribution plans, these benefits have yet to become widely adopted by plan sponsors, perhaps partially due to inconsistent guidance from the Internal Revenue Service (the IRS) and uncertainly on the part of plan sponsors regarding how such benefits can be implemented in practice. However, as employers continue to limit, and in some cases terminate, defined benefit plans, it will become more pressing to turn these theoretical frameworks into workable solutions to provide an important benefit for disabled employees.

Long-Term Disability Under Defined Benefit Plans

Traditional defined benefit plans, which provide benefits to employees upon retirement that are typically funded solely by employer contributions and often calculate those benefits using a formula based on an employee's compensation and length of service, have historically provided several features to protect employees' retirement savings in the event of long-term disability. First, many defined benefit plans provide continued service crediting for participants receiving long-term disability benefits. This means that, although the participant is no longer actively working or receiving compensation for services from the employer, the participant continues to be credited with hours or years of service that are used to calculate the participant's pension benefit. Second, many defined benefit plans allow participants to commence all or a portion of their plan benefit

upon qualifying for long-term disability and often subsidize the early commencement of this benefit so that it does not reduce the pension benefits payable to the participant upon reaching normal retirement age.

Historical Long-Term Disability Under Defined Contribution Plans

Defined contribution plans, which are based on employee and/or employer contributions held in individual accounts, generally do not provide a method of continuing contributions during periods of long-term disability or permit early commencement without risk of depleting the participant's account. Because contributions under a defined contribution plan are based on participants' compensation from the employer, once a participant ceases active employment and is no longer receiving compensation from the employer, there is no basis for continuing contributions to the plan. In addition, when a defined contribution plan participant withdraws funds from his or her account prior to qualifying for early or normal retirement, the withdrawal is typically subject to a 10% penalty, and any amounts withdrawn reduce the amount available at upon reaching retirement age because there is a limited amount of funds held in the individual's account. The combination of not being able to accumulate savings during disability and depleting future retirement savings upon early withdrawal can have a devastating effect on retirement savings for a participant who has a long-term disability.

Providing Greater Disability Benefits Under Defined Contribution Plans

While the individual account structure of defined contribution plans does not lend itself to providing early access to accumulated savings without reducing the funds available at retirement, this structure can be consistent with an ongoing savings opportunity during long-term disability. As described below, there are currently several options for integrating continued savings during long-term disability into defined contribution plans, though limited IRS guidance and employer and provider experience with these approaches continue to present challenges to plan sponsors.

Insured Long-Term Disability Investment Option The option that has received the most attention from the benefits community is insuring a participant's future plan contributions in the event of long-term disability through a policy offered as an investment option under the plan. Under this approach, participants may elect to have a portion of their plan contributions be used to pay premiums for long-term disability coverage, which is provided by an insurance company or voluntary employee benefits association (VEBA). If a participant who elects this coverage becomes disabled, the insurance company or VEBA provides contributions directly to the plan on the participant's behalf in an amount equal to what the participant (and, depending on the policy, the employer) contributed prior to becoming disabled.

The IRS published Private Letter Ruling 200031060 in 2000 and Private Letter Ruling 200235043 in 2002 (the PLRs) approving this arrangement (as long as certain requirements were met) and providing that (1) the premiums paid through the defined contribution plan would not be taxable to the participant at the time of payment (i.e., pre-tax contributions and employer matching or profit-sharing contributions used to pay premiums could remain tax deferred), and (2) payments from the policy to the participant's defined contribution plan account in the event of a long-term disability would not be taxable to the participant until the participant withdrew such funds from the plan. The PLRs concluded that payment of premiums under the insurance policies constituted incidental accident or health insurance under Treasury Regulation Section 1.401-1(b)(1)(ii) rather than a distribution under Code Section 402(a), and that the payments made to the plan by the policy are treated as investment earnings of the account, and thus not taxed until distributed from the plan pursuant to Code Section 402(a). Approval of these arrangements is contingent on (1) insurance payments not exceeding a reasonable expectation (which may take into account reasonably expected future salary increases) of the annual contributions that would have been made to the plan on the participant's behalf for the period of disability within that year, reduced by any other contributions for the period of disability within that year, and (2) insurance payments being reduced by any contributions paid by the employer on behalf of the disabled participant. Code Section 402(g) limits do not apply to continuation contributions made by LTD policy because contributions are treated as an investment return by the participant's account.

However, proposed regulations issued by the Department of the Treasury (the Department) in 2007 (the Proposed Regulations) suggested that the IRS was backtracking on its approval of these arrangements. The Proposed Regulations, which applied to accident or health insurance premiums paid through a qualified retirement plan, stated that (1) such premiums would be taxable to the participant at the time they were paid to the insurance company or VEBA, and (2) payments from the policy or VEBA to the plan would be taxable to the participant at the time payment was made (rather than delayed until distributed to the participant). In introductory language, the Department noted that it was considering whether there should be exceptions to the general rule, including in the case of disability coverage. This led the benefits community to conclude that, absent further guidance, the favorable tax treatment described in the PLRs would likely no longer apply to long-term disability investment options under defined contribution plans. The Department provided this long-awaited guidance in 2014 (the 2014 Regulations), when it finalized the accident and health insurance premium regulations and explicitly carved out amounts used to pay premiums for disability insurance to replace retirement plan contributions. The final regulations also clarified that premiums for long-term disability 401(k) replacement benefits must be paid using contributions to the plan, and that the payment of premiums outside of the plan (e.g., directly by the employer), would result in adverse tax consequences. The 2014 Regulations resolved the concern of plan sponsors, insurance providers, and benefits practitioners that providing in-plan long-term disability insurance would lead to adverse tax consequences for participants, and opened the door to implementation of this feature in defined contribution plans.

One limitation of this arrangement is that it requires participants to take the affirmative step of electing the

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policy as an investment option. This is in contrast to continued service crediting during long-term disability under defined benefit plans, which is automatically applied to all eligible participants. Participants may be hesitant to direct contributions away from investments they will be able to withdraw from in the future and, instead, elect an insurance policy they will use only in the event of long-term disability, which many may perceive to be an unlikely occurrence. In addition, for employers terminating their defined benefit plans and seeking an immediate replacement for those benefits under their defined contribution plans, they may find that insurers are unwilling to provide this benefit to employees who are already disabled at the time the policy is added as an investment option. Thus, it would help employees going forward, but may lead to a gap in benefits available to participants who are already disabled.

Continued Employer Contributions Another approach to providing ongoing benefits under a defined contribution plan to participants on long-term disability is to structure the plan to continue any employer contributions provided prior to disability. There are two ways this type of benefit could be incorporated into defined contribution plans, although, as described below, both have complicating factors that employers would need to address.

1. Continuation Contributions Based on Pre-Disability Compensation. Section 415(c)(3)(C) of the Internal Revenue Code provides that an employer can continue to provide nonforfeitable employer contributions to a disabled participant based on the compensation the participant would have received for the year if the participant was paid at the rate of compensation paid immediately before becoming permanently and totally disabled. However, this is only permitted for participants who are totally and permanently disabled, which Code Section 22(e)(3) defines as an individual who is ''unable to engage in *any* substantial gainful activity'' (emphasis added). This standard is different from the one typically used to determine eligibility for benefits under employer-sponsored long-term disability plans, which is typically an inability to continue in the individual's specific occupation prior to the disability. As a result, some participants may be considered disabled and receiving benefits from the company's long-term disability plan, but nevertheless are ineligible for continuation contributions under the defined contribution plan because their disability does not meet the ''total and permanent'' standard.

In addition, continuation contributions to highly compensated employees present additional challenges. The contributions permitted pursuant to Code Section 415(c)(3)(C) may be made to highly compensated employees only if the contributions are made on behalf of *all* participants who are totally and permanently disabled. This may require employers to provide the benefit to participants who previously became totally and permanently disabled as opposed to implementing the contributions on a prospective basis to active employees if the employer desires to make the benefit available to highly compensated employees in the future.

Nondiscrimination testing presents another potentially complicating factor, as it is not clear how testing will be passed in the absence of ongoing employer compensation to the disabled employee. Continuation contributions would be tested under Code Section 401(m) as matching contributions through the end of the plan year following the year they were first made to the participant, and thereafter tested under Code Section 401(a)(4) as non-elective, non-matching employer contributions. However, because Code Section 401(a)(4) regulations do not permit a defined contribution plan to use imputed income for testing purposes, and the general nondiscrimination test may be difficult to pass based on actual compensation, it may not be feasible to offer these contributions to highly compensated employees. These issues would not apply to a collectively bargained plan not subject to nondiscrimination testing; however, sponsors of non-collectively bargained plans would have to work closely with their plan service providers to ensure the contributions pass nondiscrimination testing.

2. Continuation Contributions Based on Long-Term Disability Plan Payments. A similar arrangement to providing continuing contributions based on pre-disability compensation, as described above, is to provide employer contributions based on payments a participant is receiving under the employer's long-term disability plan. To provide this benefit, an employer would need to revise the plan's definition of compensation for purposes of the non-elective employer contribution to include imputed income based on payments received under the employer's long-term disability plan. While this is theoretically permissible, the IRS has not yet published guidance describing how this would work in practice. Of particular concern to sponsors of plans that must conduct nondiscrimination testing (i.e., plans other than those that are comprised solely of collectively bargained employees) is whether such an arrangement would prevent the plan from passing nondiscrimination testing.

Next Steps

While ongoing disability contributions under defined contribution plans have not yet been widely adopted, the general shift away from defined benefit plans toward defined contribution plans makes it likely that plan sponsors will seek to incorporate these benefits into their defined contribution plans in the future in order to address this gap in employees' retirement savings. Additional guidance from the Department regarding how these benefits should be structured and, in particular, how they will be treated for testing purposes, is needed to encourage more widespread adoption. In the meantime, plan sponsors will need to work closely with legal counsel and other providers to evaluate the feasibility of incorporating long-term disability features into their defined contribution plans.