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Employer-Sponsored Tax Advantaged Disability Plan

Information Kit: *Educational Materials*

This Kit Contains:

Educational Materials

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Summary of Important Information Employers Should Know About Short- and Long-Term Disability Plans

The purpose of this Assurant Employee Benefits Employer-Sponsored Disability Plan Information Kit (the "Kit") is to make important general information available to employers about issues they should consider in the design and maintenance of their short- and long-term disability programs. The Kit is not designed to be a comprehensive treatment of the legal rules applicable to these benefit arrangements. Employers are advised to seek advice from their own counsel or advisors with respect to legal, tax or other issues discussed in this Kit.

The Kit is made available to employers for an informational service only. This Kit is not, and should not be deemed to be, in any way made available as an inducement to establish or maintain a business relationship with Assurant Employee Benefits.

BACKGROUND AND SUMMARY OF IMPORTANT INFORMATION:

More than half (56%) of U.S. adults say they would be unable to pay their bills or meet expenses if they become disabled and could not work for a year or longer.[1] Furthermore, an illness or accident will keep 1 in 5 workers out of work for at least a year during their working careers.[2] Many employers provide disability benefits to their employees, through private insurers, as a means of income protection. The disability plans are designed to replace a portion of the employee's income if he or she becomes disabled. A common question for employers and their employees is whether disability benefits received from a *Disability Plan*[3] are taxable when received. The short answer is: if the disability premium is paid with employee *After-Tax Dollars*[4], then all or a portion of the disability benefit may be received *tax free*. Receiving disability benefits tax free is an important benefit for employees because disability programs are typically designed to provide a benefit that represents only a percentage of the employee's compensation. While the benefits are already a percentage of total compensation, receiving them tax-free eliminates a further reduction in the benefit amount.

However, there are certain Disability Plan design choices that employers may make in establishing and maintaining a Disability Plan that will ensure that the desired tax free status of the disability benefit is achieved.

In general, if the employer designates its Disability Plan as a "2004-55 Arrangement," and an employee irrevocably elects to have the Disability Plan premium paid for with After-Tax Dollars, then the disability benefits will be received tax free. In contrast, if an employer does not designate its Disability Plan as a 2004-55 Arrangement but simply chooses to "gross-up" the employee's compensation to reflect the value of the premium, certain rules, including a three-year look back rule, may cause all or part of the disability benefit received to be taxed, even though the Disability Plan premium was paid for with After-Tax Dollars.

While a full summary of the laws governing Disability Plans (including the U.S. Internal Revenue Code ("Code") and the Employee Retirement Income Security Act ("ERISA")) is beyond the scope of this Kit, we note that ERISA-governed Disability Plans must—among many other requirements—be maintained in accordance with a *plan document* and the terms of the plan must be clearly and concisely summarized for Disability Plan participants in a *summary plan description* ("SPD").

The primary focus of this Kit is to answer some key questions with respect to the designation and maintenance of a 2004-55 Arrangement , and to contrast 2004-55 Arrangements with so-called "gross-up arrangements." The information is provided in what we hope are easy to read FAQs.

[1] National Association of Insurance Commissioners, 2007
[2] U.S. Census Bureau, December 1997
[3] In this Kit the term "Disability Plan" includes both long- and short-term group disability plans.
[4] In this Kit the term "After-Tax Dollars" refers to employee compensation which is taxable and subject to withholding.

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Frequently Asked Questions (FAQs) On Important Issues Related to the Establishment of Disability Plans

In general, under federal law, when Disability Plan premiums are *paid*[1] solely by the employee's employer on behalf of the employee, disability benefits received by an employee from the Disability Plan are taxable income to the employee. When Disability Plan premiums are *paid* with employee After-Tax Dollars, all or part of the disability benefits received by an employee from the Disability Plan may or may not be taxable income, depending on whether the Disability Plan has been designated as a 2004-55 Arrangement or is a so-called "gross-up arrangement." The following FAQs provide, through questions and answers, information about some of the design and other issues related to the designation of a Disability Plan as a 2004-55 Arrangement.

General Questions:

Q1. *What is a Revenue Ruling 2004-55 Arrangement?*

A1. A Revenue Ruling 2004-55 Arrangement ("2004-55 Arrangement") is a designation by a sponsoring employer to indicate its intent to have its Disability Plan meet the requirements of Revenue Ruling 2004-55. A Disability Plan properly designated as a Revenue Ruling 2004-55 Arrangement permits employees to irrevocably elect, prior to the beginning of a plan year, to have their Disability Plan premiums paid with After-Tax Dollars to ensure that Disability Plan benefits will be received tax free.

Q2. *What is a gross-up arrangement?*

A2. A "gross-up arrangement" refers to a Disability Plan for which the Revenue Ruling 2004-55 designation has not been made. (This could also be referred to as a "non-2004-55 Arrangement.") A "gross-up arrangement" can be utilized by a Disability Plan, but the tax free treatment of the Disability Plan benefits may not be ensured because the Disability Plan has not been designated as a 2004-55 Arrangement.

Q3. *What is the difference between a 2004-55 Arrangement and a gross-up arrangement?*

A3. The key difference between a 2004-55 Arrangement and a "gross-up arrangement" is the certainty of the tax treatment of the disability benefits received from a 2004-55 Arrangement. If a Disability Plan has been properly designated as a 2004-55 Arrangement, and the premium for the Disability Plan is paid solely with After-Tax Dollars, the disability benefits under that Disability Plan will always be received tax free. In contrast, if the Disability Plan is not designated as a 2004-55 Arrangement and is thus a "gross-up arrangement," the tax treatment of the benefits received will be uncertain as they may be subject to the so-called three year rule (See Q&A 13 discussed below), which means that the taxability of the benefit received under that Disability Plan may not be ensured.

Another key difference between a 2004-55 Arrangement and a "gross up" Arrangement is that a 2004-55 Arrangement offers employees a choice. For both Arrangements, it is the employer's sole decision to implement the Arrangement, but only under a 2004-55 Arrangement do the employees have a choice. That choice is to continue to have the employer pay 100% of the premium, or for the employee to "pay" the premium on an after-tax basis.

[1]With respect to premium payments, this means that the employer has paid the premium on the employee's behalf and the amount of the premium is not included in the employee's income.

Q4. *What does the term "gross-up" mean?*

A4. The term "gross-up" is used to describe a payroll action performed by an employer to add income to the employee's wages to reflect all or part of the amount of the Disability Plan premium paid, so that the premium will be paid with After-Tax Dollars. That is, the employer "grosses up" the employee's taxable wages by the amount of Disability Plan premium paid by the employer on the employee's behalf, and thus the premium is paid with After-Tax Dollars (even though the employee has not paid "out-of-pocket" for the coverage). The amount of the "gross up" is considered taxable wages, and is subject to federal, state, and local (if applicable) income and employment taxes and applicable withholding.

Q5. *Can an employer who has made a 2004-55 designation use a gross-up method to pay the disability premium with After-Tax Dollars?*

A5. Yes. Premiums may be handled on a gross-up basis under a 2004-55 Arrangement or a gross-up arrangement. The certainty of the tax treatment of the Disability Plan benefits received is the main advantage of a 2004-55 Arrangement.

Q6. *What types of groups are eligible for a 2004-55 Arrangement?*

A6. While any employer group may sponsor a Disability Plan, a 2004-55 Arrangement may be implemented only by an employer which designates for future plan years its Disability Plan as a 2004-55 Arrangement. In addition, for the plan year prior to the year for which the designation is made, the Disability Plan premiums must be paid entirely by the employer either through direct payments by the employer (not using employee After-Tax Dollars) or with pre-tax employee dollars under the employer's Section 125 plan. After the designation is effective, the premium must be paid either by the employee (with After-Tax Dollars) or by the employer so that the premium is not paid with employee After-Tax Dollars, <u>but not by both</u>. There is no requirement that 100% of the employees must elect to pay the disability premium with After-Tax Dollars. Employees must be given the right prior to the beginning of a plan year to irrevocably elect to have the employer continue to pay the premium or to pay the premium paid with taxable or After-Tax Dollars.

Q7. *What period of time constitutes a "plan year" for a Disability Plan?*

A7. A plan year is the twelve-month period designated by the employer sponsoring the Disability Plan to constitute that Disability Plan's plan year. There are no specific rules for what period must be used for a plan year; employers are free to designate any twelve-month period. However, once designated, the twelve-month period must be maintained on a consistent basis—it cannot be changed from year to year. Some employers find that designating a Disability Plan's plan year to coincide with the group health plan sponsored by the employer simplifies administration. Others find that maintaining the plan year on a calendar year plan year basis works best for them. All ERISA plans must specify a twelve-month period as their plan year and clearly state the plan year period in their Summary Plan Description.

Q8. *Can an employer that has historically operated its Disability Plan on one twelve-month period as its plan year simply amend the Disability Plan to use a new plan year during its current plan year to permit it to make the 2004-55 Arrangement designation earlier than it otherwise could?*

A8. This question can be illustrated and answered using an example. Assume "ABC Company" sponsors a Disability Plan and has historically operated with a January 1 – December 31 plan year. ABC Company has never designated its Disability Plan as a 2004-55 Arrangement. Solely to permit it to amend the Disability Plan to designate it as a 2004-55 Arrangement (and to meet the requirement discussed in Q&A 6 that the designation be made prior to the beginning of a plan year), may the employer in March 2010 amend its Disability Plan to create a "short plan year" for the period January 1, 2010 thru March 31, 2010, with a new full plan year to begin on April 1, 2010, and then further amend the Disability Plan in March 2010 to designate the Disability Plan as a 2004-55 Arrangement commencing with the new plan year that starts on April 1, 2010?

No, it is unlikely that the employer would be permitted to do that. Instructive guidance from the Internal Revenue Service ("IRS") suggests that an employer may implement a short plan year only to serve bona fide business purpose *and not simply to achieve a desired tax result*. The IRS would likely disallow the plan year amendment and find that the 2004-55 Arrangement designation was not effective until a plan year beginning on or after January 1, 2011.

Q9. *If employees pay 100% of the premium for Disability Plan coverage on a pre-tax basis under a Section 125 plan, can the employer now designate its Disability Plan as a 2004-55 Arrangement?*

A9. Yes. Premium paid on a pre-tax basis under a Section 125 plan is considered employer-paid so that the Disability Plan is eligible for 2004-55 Arrangement designation. Once the 2004-55 Arrangement designation is made, the Disability Plan will be considered a new plan by the Internal Revenue Service.

Q10. *Who actually benefits from designating a Disability Plan as a 2004-55 Arrangement?*

A10. In a Disability Plan designated as a 2004-55 Arrangement, the employee may be assured of the tax treatment of the Disability Plan benefit received. If the employee effectively makes the irrevocable election under the Disability Plan designated as a 2004-55 Arrangement to pay the premium with After-Tax Dollars, then as of the beginning of the plan year for which that election is made, he or she can be certain that any Disability Plan benefits received are tax free. In addition to the employee relations benefit derived by ensuring the consistent tax treatment of the Disability Plan benefits received, the employer is pleased because it can provide an extra benefit (the certainty of the tax free treatment of the benefit) at limited cost. Your Assurant Employee Benefits sales representative can provide additional information regarding other plan design alternatives which may provide additional cost savings.

Q11. *Are there any limitations as to the employees who may benefit from the designation of a Disability Plan as a 2004-55 Arrangement?*

A11. Subject to the requirements described in Q&A 6, any employer may designate a Disability Plan as a 2004-55 Arrangement. A Disability Plan designated as a 2004-55 Arrangement will typically benefit all *employees*. However, capital or equity partners of a partnership, more than 2% owners of a subchapter S-Corporation, members of a limited liability company treated as a partnership and sole proprietors (collectively "Owners") will not see any benefit from this designation because they are not *employees* for federal tax purposes. Owners are deemed to have paid the Disability Plan premium on an After-Tax basis and thus any Disability Plan benefits will be received tax free.

Q12. *If the Disability Plan is maintained as a "gross-up arrangement" and the employer grosses up the amount of the premium that it pays on an employee's behalf, will all Disability Plan benefits be received tax free?*

A12. Not necessarily. Tax treatment of the benefits received will be determined based on the *"three-year rule"* (see Q&A 13 below) which creates uncertainty as to the tax treatment of any Disability Benefit received if the employee becomes disabled during the first three years that the gross-up arrangement is in effect.

Q13. *What is the "three-year rule" and how does it work?*

A13. The "three-year rule" is imposed by federal tax regulations to determine what portion of Disability Plan benefits received will be subject to taxes and what portion will be received tax free. The three-year rule may apply if the Disability Plan has not been designated as a 2004-55 Arrangement. The three-year rule requires a "look back" to the three policy years prior to the calendar year in which the disability occurs to determine what portion, if any, of the disability benefit will be taxable. To determine what is taxable using the three-year rule, first you must determine the total employer-paid premium and the total premium paid. The percentage of disability benefit taxable equals the percentage of employer-paid premium during that three-year period. That percentage will apply to all disability benefits received during that period of disability.

For example, an employer begins to add the cost of premium to an employee's gross income as of January 1, 2010 under a Disability Plan that has not been designated as a 2004-55 Arrangement. The employer paid 100% of the premium for the five-year period prior to 2010. A covered employee becomes disabled on February 1, 2010. The disability benefits received by that employee will be 100% taxable because during the entire look-back period (2007, 2008, and 2009) the employer paid 100% of the premium. However, if the disability onset is February 1, 2011, only 66.67% of the disability benefits are taxable (look back to 2008, 2009 and 2010), if disability onset is February 1, 2012, 33.3% is taxable (look back to 2009, 2010, 2011). It is not until a disability occurring on and after January 1, 2013, that the disability benefits are received tax free.

The three-year rule does not apply to benefits received under Disability Plan that has made a 2004-55 Arrangement.

Q14. *Does the "three-year rule" apply if the company changes carriers?*

A14. The operation of the "three-year rule" would not be disrupted or prolonged by an employer's change from one insurance carrier to another. Changing from one insurance carrier to another does not result in the creation of a new Disability Plan; it is just a change in the insurer who is providing the benefits under the Disability Plan.

Q15. *Can a 2004-55 Arrangement be implemented for the partners of a partnership?*

A15. Yes. Unlike a Code section 125 "cafeteria plan" which prohibits participation by the business Owners described in Q&A 11, there are no restrictions on participation by Owners in a Disability Plan designated as a 2004-55 Arrangement. However, those Owners don't really see any tax benefit to participating in a Disability Plan designated as a 2004-55 Arrangement since their premium is always deemed paid by them with After-Tax Dollars. See Q&A 11 above.

Q16. *Can a portion of the premium for the Disability Plan be paid by both the employer and the employee under a 2004-55 Arrangement?*

A16. No. In a 2004-55 Arrangement, the entire cost of the Disability Plan premium must be paid by either the employer or the employee. The disability benefits will be received tax free only if the premium is paid with After-Tax Dollars. How the premium is paid with After-Tax Dollars is determined by the employer and applies to all employees who elect to pay premium with After-Tax Dollars; that is, the employer can decide to add the cost of the premium to taxable wages (will appear on w-2) or deduct the cost of the premium from an employee's taxable compensation as an after-tax payroll deduction. (won't appear on w-2)

Q17. *Does a 2004-55 Arrangement or a gross-up arrangement apply to both long-term disability ("LTD") and short-term disability ("STD") Plans?*

A17. Yes, a 2004-55 Arrangement or gross-up arrangement applies to both LTD plans and STD plans.

Q18. *Does the use of a 2004-55 Arrangement mean the employer does not have to maintain a Summary Plan Description or other documentation?*

A18. No, a "2004-55 Arrangement" is simply a designation by the employer that ensures the tax treatment of Disability Plan benefits received. Employers must continue to follow the requirements, including the Summary Plan Description requirements, of all applicable laws, including ERISA, with respect to their Disability Plan. In addition, the Disability Plan document and the Summary Plan Description should be amended to reflect the funding arrangement of that plan prior to the beginning of the plan year for which the 2004-55 Arrangement designation is made. Samples of suggested Disability Plan and Summary Plan Description amendments are included in this Kit. These amendments should be reviewed with the employer's employee benefits counsel to determine if they are appropriate for use with an employer's Disability Plan.

Employer Administration Questions:

Q19. *What steps are required for an employer to designate a Disability Plan as a 2004-55 Arrangement?*

A19. The employer should designate its Disability Plan to be a 2004-55 Arrangement by amending its Summary Plan Description and its plan document to reflect the designation. The amendments and designation must be completed prior to the beginning of the plan year in which the change is to become effective. (See Q&A's 6 and 18 above.) Sample amendments designating a Disability Plan as a 2004-55 Arrangement are included with this Kit.

Of course, an amendment to the Disability Plan's Summary Plan Description requires the employer to provide either an amended Summary Plan Description or a "summary of material modification" to all employees participating in the Disability Plan on a timely basis.

The employer should also discuss the implementation of a 2004-55 Arrangement with its payroll department or payroll provider. Additional administrative and payroll practices may have to be revised to reflect the correct treatment of the premium payment as chosen by the employer.

Q20. *What steps are required in order to designate a Disability Plan as a "gross-up arrangement"?*

A20. There are no documentation requirements. Use of a "gross-up arrangement" is assumed if employers do not designate a Disability Plan as a 2004-55 Arrangement.

The employer should discuss the gross-up arrangement with its payroll department or payroll provider so that premium is properly reflected in taxable wages and on Form W-2.

Q21. *When do employees have to enroll in a 2004-55 Arrangement?*

A21. Active employees must elect to participate in a 2004-55 Arrangement <u>prior to</u> the beginning of the plan year. This election is typically made during the employer's annual enrollment period. (Q&A 7 provides additional information about the plan year.) New employees may enroll upon hire.

Q22. *How do employees enroll in a 2004-55 Arrangement?*

A22. Employees must make a valid, irrevocable written 2004-55 election <u>prior to</u> the beginning of each plan year. That election is an "all or nothing" decision because the election must apply to the entire cost of the premium. The employer may choose to treat the irrevocable election so that, once made, it will continue in place for all subsequent plan years until changed by the employee prior to a subsequent plan year. If the employer so chooses, the plan document and summary plan description must reflect this employer choice.

Q23. *If the Disability Plan is part of the employer's Section 125 plan, and the employee has a "Change of Status" event under the Section 125 plan, can the employee change his or her irrevocable election with respect to the tax treatment of the premium payment for the 2004-55 Arrangement?*

A23. No. The Section 125 Change of Status rules do not apply to these irrevocable elections. Regardless of the occurrence of a Change of Status event, the 2004-55 election, once made, cannot be changed until a valid, irrevocable written election is made for the next plan year.

Q24. *Are there any special requirements if the employer has never had a Disability Plan?*

A24. No. The new Disability Plan document and Summary Plan Description must clearly state that it is intended to be a 2004-55 Arrangement.

Q25. *How does the employer set up deductions? How does the employer know how much to gross-up?*

A25. Regardless of whether the employer chooses to fund by adding the cost of the employee's premium to the employee's taxable wages, or have the employee pay premium on an after-tax deduction basis, the employer must coordinate with its payroll department or payroll provider.

The amount that should be added to an employee's taxable wages or deducted as an After-Tax payroll deduction is the Disability Plan premium for each employee as can be found on the employer's premium billing statement or on Assurant Employee Benefits' Online Advantage website at www.assurantemployeebenefits.com. See your Assurant Employee Benefits sales representative for more information about accessing Assurant Employee Benefits' Online Advantage.

Q26. *Does the employer have to pay payroll taxes and withhold taxes on any premium added to the employee's taxable wages?*

A26. Yes, the additional income is subject to all applicable taxes and withholding.

Q27. *Are there any rules as to when the employer must add premium to taxable wages and withhold income taxes and payroll taxes?*

A27. There are no special rules that are applicable solely to Disability Plans, but employers must follow the applicable payroll tax and withholding reporting rules. In general, employers may elect to treat the cost of the premium grossed-up as paid on a per pay-period, quarterly, or calendar year basis. Any required withholding must occur in that same period and the withheld taxes must be deposited for that same period. (See IRS Publication 15.)

Q28. *Can the employer deduct any premium added to employees' taxable wages as a business expense?*

A28. In general, under federal tax laws, employers may deduct premium paid on behalf of employees which has been added to taxable wages as long as the total compensation paid is reasonable.

Q29. *Can the treatment of an employee's premium payment to a Disability Plan have an impact on an employer's 401(k) or other employee benefit plans?*

A29. Possibly. Compensation is always specifically defined in an employer sponsored qualified plan, like a 401(k) plan. Employers should always review the definition of compensation used in its retirement plans and other employee benefit plans to determine whether the manner in which the employee's premium is paid for a Disability Plan will impact those plans.

Q 30. *If the employer chooses to designate its Disability Plan as a 2004-55 Arrangement, will the employer's group disability insurance policy or certificates of insurance for participating employees include language referring to the 2004-55 Arrangement?*

A30. No. Neither the group disability insurance policy nor the certificates of coverage provided by Assurant Employee Benefits will include any language referencing the 2004-55 Arrangement. The designation of a Disability Plan as a 2004-55 Arrangement is solely the result of the employer's decision as to how the premiums due under the policy should be funded. That funding decision does not change any of the benefits or the provisions of the group disability insurance policy or the certificates of coverage.

If the employer indicates that Assurant Employee Benefits should provide SPD language as part of the certificate of coverage and Assurant Employee Benefits is aware that the employer has designated a 2004-55 Arrangement, the contribution section of that SPD will show that the employer has funded the premium for the coverage. The reason is that for purposes of ERISA, the employer has funded the premium by including the premiums in the employees' taxable wages, deducted the premium from after-tax pay, or has paid 100% of the premium not using employee After-Tax Dollars.

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Side-by-Side Comparison

	Revenue Ruling 2004-55 Arrangement	Gross-Up Arrangement
Background/Purpose:	• Stability in tax treatment of disability benefits • Depending on employee's election, disability benefits received may be tax free	• Uncertain tax treatment of disability benefits • All or a portion of any disability benefits received may be taxable, depending on the onset date of disability
Qualifying Disability Plans:	Any disability plan where the Employer pays 100% of the premium	Any disability plan.
Applicability of the Three Year Rule:	Does not apply	May apply for a period of time
Implementation:	• Employer amends its disability plan documents • Employee makes a written election <u>prior</u> to the beginning of the disability plan year • Employee election gives employees two options: Employer continues to pay 100% of the premium or Employee pays premium with after-tax dollars • Election, once made, is irrevocable. Cannot change until next plan year. Section 125 change event rules do not apply. • For Employees who elect to pay premium with after-tax dollars, Employer decides how premium should be funded, either by adding the cost of premium to taxable wages or after-tax payroll deductions • If Employer adds the cost of premium to taxable wages, Employer can add cost of premium on a per payroll period basis, quarterly or in the last pay period of the calendar year	Employer adds the cost of the premium to Employee's taxable wages and reports those premiums in Box 1, Form W-2 Employer can add cost of premium on a per payroll period basis, quarterly or in the last pay period of the calendar year
Administration:	If the Employer chooses to add the premium to electing Employees' taxable wages, total taxable wages are subject to income tax withholding (federal, state, local if applicable) and employment taxes (Social Security, Medicare, FUTA, SUTA)	Additional taxable wages subject to income tax withholding (federal, state, local if applicable) and employment taxes (Social Security, Medicare, FUTA, SUTA)
Other Concerns:	If premium is added to taxable wages, potentially impacts other employer-sponsored pension, retirement, 401(k) plans and any other plans that have benefits tied to compensation (such as group term life insurance)	Potentially impacts compensation under other employer-sponsored pension, retirement, 401(k) plans and any other plans that have benefits tied to compensation (such as group term life insurance)

	Revenue Ruling 2004-55 Arrangement	Gross-Up Arrangement
Taxability of Disability Benefit:	Beginning with the plan year implemented and thereafter, those employees who elect to have the premium paid with after-tax dollars, any disability benefits received, are not taxable.	All or a portion of any disability benefit received will be taxable depending on the onset date of disability. Three-year rule *determines the portion of the benefit that is taxable income.
Proof at Claim:	Assurant Employee Benefits will rely upon the Employer representations on the claim form and any additional information received from Employer. Cannot rely on information provided by Employee.	Assurant Employee Benefits will rely upon the Employer representations on the claim form and any additional information received from Employer. Cannot rely on information provided by Employee.

*The three year rule may apply if no 2004-55 designation has been made. The three year rule looks back to the three policy years prior to the calendar year in which the disability occurs to determine what portion, if any, of the disability benefit will be taxable. The first step is to determine the total Employer-paid premium during that three-year period and the total premium paid for that same period. The percentage of Employer-paid premium to total premium for that three-year period is the percentage of the disability benefit that is taxable. That percentage will apply to all disability benefits received during that period of disability.

For example, an employer begins to add the cost of premium to an employee's gross income as of January 1, 2010 and does not make a 2004-55 designation. The employer paid 100% of the premium for five years prior to 2010. A covered employee becomes disabled on February 1, 2010. The disability benefits received by that employee will be 100% taxable because the look-back period is 2007, 2008, and 2009 and during that entire time period, the employer paid 100% of the premium. However, if the disability onset is February 1, 2011, only 66.67% of the disability benefits are taxable (look back to 2008, 2009 and 2010), or if disability onset is February 1, 2012, 33.3% is taxable (look back to 2009, 2010, 2011). It is not until a disability occurring on and after January 1, 2013, that the disability benefits are received tax free.

IRS Revenue Ruling 2004-55

Create Tax Certainty

On June 9, 2004, the IRS issued Revenue Ruling 2004-55, clarifying the three year rule. It states when an employer who previously paid 100 percent of the premium on a disability plan (STD or LTD) amends its disability plan to permit its employees to irrevocably elect, (prior to the beginning of each plan year), to either pay the entire premium with after-tax dollars or to continue having the employer pay the entire premium, that amendment constitutes a new plan and the three year-rule does not apply. In the event of disability, those employees who paid the premium with after-tax dollars (for the plan year in which the onset of disability occurs), their disability benefits are received tax-free. For those employees who elect to have the employer continue to pay the premium, any benefits received are taxable. Under the ruling, the election can only be made once a year and must be made prior to the beginning of the plan year. Once made, it cannot be changed until the next plan year.

The employer can handle the employee's after-tax payment of premium either by an after-tax payroll deduction or adding the cost of the premium in the employee's taxable wages as reported in Box 1, Form W-2. This latter method is referred to as "grossing up" the employee's taxable wages.

This ruling only addresses those situations where the employer pays 100% of the premium (so that the benefits are taxable) and thereafter the plan is amended in the manner described in the revenue ruling. If both the employer and employee pay a portion of the total premium, this ruling does not apply.

If an employer chooses to take advantage of this ruling, the employer will need to revise its disability plan document (outside of the group insurance policy) and Summary Plan Description to reflect that the election is irrevocable and set out the mechanics of the election process.

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Frequently Asked Questions -
2004-55 Arrangements: Premium on a gross-up basis

1. What is "grossing-up?"

"Grossing-up" is a term that means that the employer increases the taxable wages of its employees to include the premium for each employee's disability coverage. Under a 2004-55 Arrangement, the employer grosses-up the taxable wages for those employees who irrevocably elect to pay disability premiums with after-tax dollars. The employer (not the electing employee) determines as part of its 2004-55 Arrangement design whether the disability premium will be grossed- up or whether the disability premium is paid with after-tax payroll deductions. If only part of the premium is grossed up, the arrangement is not a 2004-55 Arrangement.

The amount of the "gross-up" is considered taxable wages and is subject to federal, state, and local (if applicable) income taxes, and Social Security, Medicare taxes, and any federal and state unemployment taxes (FUTA and SUTA). The employer is responsible for withholding any applicable federal, state, and local income taxes, and the employee portion of Social Security and Medicare taxes from the grossed-up amount, plus paying the employer portion of Social Security and Medicare taxes, and any federal and state unemployment taxes (FUTA and SUTA). Employers can elect to either add the gross-up amount to the taxable wages on a per pay-period or quarterly basis and withhold and pay any taxes due at that time, or add the total gross-up amount in the last pay-period of the calendar year and withhold and pay any taxes due then.

2. How is the gross-up (employer-paid premium) reported on the W-2 form?

The total premium cost is added to other taxable wages and reported in Box 1 on the employee's Form W-2. In addition, the grossed-up amount is included in the wages subject to Social Security and Medicare taxes.

3. What is the effect to the claimant?

Any disability benefits received by the claimant are tax-free.

Frequently Asked Questions - 2004-55 Arrangements: Premium on a gross-up basis
continues on the next page.

4. What is the effect to the employer?

When the employer grosses-up the cost of the disability premium, the employer is able to deduct the cost of the premium as part of the total wages paid to the employee (to the extent that the employee's total compensation is reasonable). In contrast, if the employees pay the premium with after-tax payroll deductions, the employer is not able to deduct the cost of the premium, but only the actual compensation paid to the employee (assuming the compensation is not grossed-up for the cost of the premium).

Get More Net Benefit for Your Premium Dollar

*While the average premium paid by the employer for the 60% plan through a 2004-55 arrangement is as much as 20% less than the standard employer-paid 66.67% plan, it may also result in higher net benefits paid to the employee in the event of disability!

Sample Illustration
Standard 66.67% plan vs. 60%

For illustrative purposes we will make the following assumptions:

Current Plan:

- Disability premium is 100% employer-paid (Non-contributory)
- 66 2/3% to $5,000/month

Proposed Plan:

- Employer makes a 2004-55 designation and includes the cost of premium in employees' taxable wages
- Disability premium is 100% considered employee-paid for tax purposes
- 60% to $5,000/month

Consider three examples:

Example 1

Employee making $36,000/year
Current plan details:
66 2/3% of $3,000/mo. =
$2,000 taxed @ 13% effective tax rate ->
net $1,740 benefit

Proposed plan details:
60% of $3,000/mo. =
$1,800 not taxable
Increase of $60
per month

Example 2

Employee making **$60,000/year**
Current plan details:
66 2/3% of $5,000/mo. =
$3,333 taxed @ 16% effective tax rate ->
net $2,800 benefit

Proposed plan details:
60% of $5,000/mo. =
$3,000 not taxable
Increase of $200
per month

Examples continue on the next page.

Example 3

Employee making **$100,000/year**
Current plan details:
66 2/3% of $8,333/mo. =
$5,000 (max bft) taxed @ 20% eff. tax rate ->
net $4,000 benefit

Proposed plan details:
60% of $8,333/mo. =
$5,000 not taxable
Increase of $1,000
per month

*Note: Actual results will vary depending on the actual plan design and claimant's actual tax situation. Examples assume disability benefits are the only source of taxable income, and the effective tax rate is based on single filing status, 1 exemption, standard deduction, tax rates based on the 2009 federal tax rate schedules and 5.5% state and local rate. Numbers are rounded to nearest dollar.

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Get More Net Benefit for Your Premium Dollar

*While the average premium paid by the employer for the 50% plan through a 2004-55 arrangement is as much as 25% less than the standard employer-paid 60% plan; it may also result in higher net benefits paid to the employee in the event of disability!

Sample Illustration
Standard 60% plan vs. 50%

For illustrative purposes we will make the following assumptions:

Current Plan:

- Disability premium is 100% employer-paid (Non-contributory)
- 60% to $5,000/month

Proposed Plan:

- Employer makes a 2004-55 designation and includes the cost of premium in employees' taxable wages
- Disability premium is 100% considered employee-paid for tax purposes
- 50% to $5,000/month

Consider three examples:

Example 1

Employee making **$36,000/year**
Current plan details:
60% of $3,000/mo. =
$1,800 taxed @ 13% effective tax rate ->
net $1,566 benefit

Proposed plan details:
50% of $3,000/mo. =
$1,500 not taxable
decrease of $66
per month

Example 2

Employee making **$60,000/year**
Current plan details:
60% of $5,000/mo. =
$3,000 taxed @ 16% effective tax rate ->
net $2,520 benefit

Proposed plan details:
50% of $5,000/mo. =
$2,500 not taxable
decrease of $20
per month

Examples continue on the next page.

Example 3

Employee making **$100,000/year**

Current plan details:

60% of $8,333/mo. =
$5,000 (max bft) taxed @ 20% eff. tax rate ->
net $4,000 benefit

Proposed plan details:

50% of $8,333/mo. =
$4,167 not taxable
increase of $167
per month

*Note: Actual results will vary depending on the actual plan design and claimant's actual tax situation. Examples assume disability benefits are the only source of taxable income, and the effective tax rate is based on single filing status, 1 exemption, standard deduction, tax rates based on the 2009 federal tax rate schedules and 5.5% state and local rate. Numbers are rounded to nearest dollar.

Four Years to 'Tax-Free' Disability Benefits

The following illustration demonstrates how the three-year look-back rule applies to eventually achieve tax-free benefits.

Sample Illustration
Gross-up Arrangement without RR-2004-55

For illustrative purposes we will make the following assumptions:

Original Plan (5 years prior to 2010):

- Disability premium is 100% employer-paid
- 60% to $5,000/month

Plan the Employer Implements Jan. 1, 2010:

- Employer includes cost of premium in employee's taxable wages ("grosses-up" wages)
- Employer does not make a 2004-55 designation
- Disability premium is considered 100% employee-paid for tax purposes

The chart on the next page details how the net monthly benefit, taxable benefit amount, and three-year look-back period varies depending on the onset date of disability.

That chart illustrates that if an employer wants to achieve tax certainty for its employees immediately, a gross-up arrangement does not deliver this result until the 4th year.

In contrast, if a qualifying employer designates its disability plan as a 2004-55 Arrangement, the employer can deliver tax certainty immediately for its employees. This Kit includes examples which illustrate the impact when tax certainty is immediately achieved.

Example continues on the next page.

<u>Meet Mary:</u>
Wages: $36,000/year
Disability Plan Coverage since 2006
Plan Details:
60% of $3,000/mo. =
$1,800 monthly benefit

The chart below details how the net monthly benefit, taxable benefit amount, and three-year look-back period varies depending on her date of disability onset.

Onset Year	1st Year: 2010	2nd Year: 2011	3rd Year: 2012	4th Year: 2013
Taxable Amount	100%	66.67%	33%	0%
Net Monthly Benefit*	$1,566	$1,644	$1,722	$1,800
Three-year Look-back Period	2009 2008 2007	2010 2009 2008	2011 2010 2009	2012 2011 2010

*Assumes 13% effective tax rate

Note: Actual results will vary depending on the actual plan design and claimant's actual tax situation. Examples assume disability benefits are the only source of taxable income. The effective tax rate is based on single filing status, one exemption, standard deduction, tax rates are based on the 2009 federal tax rate schedules and 5.5% state and local tax rates. Numbers are rounded to the nearest dollar.

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