

Commonwealth Sense

Volume 2, Issue 5

The Importance of Parity When Designing an Employee Benefits Program

By Rick Applegate, CFP®, ChFC®, CLU®, AIFA®, President and CEO, First Commonwealth Financial Advisors
Michael Bartolini, Vice President and Product Manager, Employee Benefits, First Commonwealth Insurance Agency

It's your money. It's your life. It's your time.

One size fits all" is not necessarily the right assumption to be made when it comes to speaking with closely held business owners about his or her company's employee benefit programs. There are some occasions when that business owner may be interested in providing more to a certain group of employees than what a single benefit formula may allow, especially if the owner is among those select executives.

Take disability income insurance benefits as an example. Many employers provide the employees with a benefit formula for income replacement that may be similar to the following scenario: after 90 days of disability, the plan will pay 60% of the individual's base salary, subject to a monthly maximum benefit of \$5,000 to age 65. Sounds reasonable enough, doesn't it?

However, consider the salary ranges that may be involved. If the company's top executives earn up to \$100,000, the \$5,000 a month maximum benefit may be adequate. But if they make more than that, they are actually insured for a lower percentage than 60%. Say an executive's salary is \$150,000. Then the \$5,000 a month replaces only 40% of their gross salary during disability, not the 60% the plan suggests.

Another point to consider is who is paying the premiums. If the employer pays the premium, the benefit is a taxable event to the disabled employee which further reduces the

benefit received. In the example above, let's assume the \$60,000 of disability benefits is federally taxed at 15%. The income is reduced another \$9,000 so the net income is \$51,000. The executive who earned \$150,000 is now receiving 34% of his gross salary. That amount probably won't make ends meet during a particularly tough time, such as disability leave.

Here are some suggestions to help solve the problem for this executive. First of all, we might suggest that the disability plan be split into classes of employees. Class I might be classified as "Executives and Management" and Class II as "All Other Employees." The insurance carrier is informed that the premiums paid by the company for Class I employees will be reported as income to the executives. These employees in Class I will pay ordinary income tax rates on the premium which is much better than being taxed on the benefits if ever received, and the disability income benefit is now tax free when paid.

The next step might be to increase the Class I benefit from \$5,000 to something higher. A \$7,500 monthly benefit would be more of a 60% income replacement for the executive making \$150,000. We might also change the definition of income from "Base Salary" to "Base Salary, Bonus and Commissions" if those additional sources of income are a large part of the executive's compensation that are otherwise overlooked.

First Commonwealth Advisors might also question the business owner about the set up of a "Qualified Sick Plan" in their corporate minutes. Often we find such closely held business owners expect to continue their salaries if they were disabled because they own the company. In the absence of a Qualified Sick Pay Plan, the benefits paid to this business owner may be viewed by the IRS as dividend distributions to the shareholder, rather than as ordinary income. Making the distinction between the executive as an employee with an employment agreement versus a business owner at the time of a disability can avoid double taxation applied to a dividend distribution.

The careful consideration to the design of a company benefit plan to meet the needs of all company employees, especially the business owner, will go a long way to establishing credibility and professional competence.

Whether you own or operate a large or small business, you should sit down for a consultation with one of First Commonwealth's experienced professionals. You can reach them toll-free at 1-855-ASK-4-FCA or visit us on the web at ask4fca.com.



1-855-ASK-4-FCA
www.ask4fca.com

With Wealth Teams in PITTSBURGH • DUBOIS • GREENSBURG • INDIANA • WEXFORD

First Commonwealth Advisors is a registered trademark of First Commonwealth Bank for investment management, trust and fiduciary services and for investment advisory services provided by First Commonwealth Financial Advisors, a registered investment advisory affiliate. Securities, insurance products and certain other advisory services are offered through Essex National Securities, Inc., member FINRA/SIPC and an SEC registered investment advisor, which is not affiliated with this financial institution. Certain insurance products are offered through First Commonwealth Insurance Agency, a licensed insurance affiliate.

NOT Guaranteed by the Bank

NOT FDIC Insured

NOT A Deposit

NOT Insured by any Federal Government Agency

May Lose Value including Loss of Principal