GUEST COLUMN | GARY F. TERRY

The cost of bonuses

IF YOU'RE EXPECTING a raise in salary, don't be surprised if you get handed a bonus check instead as more and more companies are moving toward giving performance-based bonuses instead of handing out pay raises, according to a "2014 Salary Increase Survey" by Aon Hewitt, a human resources and consulting-services firm based in Lincolnshire, Ill.

Spending on variable pay among U.S. employers reached a record-high level of 12.7 percent of payroll in 2014 – the highest in the 38 years that Aon Hewitt has conducted these studies. At the same time, salary increases for U.S. workers accounted for just 2.9 percent, reflecting a continued focus among companies on controlling fixed costs by offering more attractive bonus opportunities to both current and prospective employees.

In many ways, employees' guard is often down as they view the salary and bonus figures as one big, very attractive annual compensation. Buoyed by the promise of a hefty payday they carve out for themselves a certain lifestyle, befitting their annual income.

Perhaps they have even tapered it to still be viable should they suffer a disability, with the belief that their company's disability income plan provides them with 60 percent of their annual compensation. That is the perception they hold. Unfortunately, in the world of disability benefits, perception is definitely not reality, and they may very well be in for a rude awakening.

Most companies offer 60 percent income replacement, to a maximum of $20,000 per month of benefit, up to a maximum of $400,000 per year. But the disturbing fact is that for many companies, its Group Disability Coverage only provides 60 percent of base salary, with no bonus income protected. So in reality, an employee has significantly less coverage than they think because they are receiving only 60 percent of their base salary, not their total income (including bonuses).

We know of a large Boston software firm that has two-thirds of their 450 employees' salaries tied into a bonus plan. So if a vice president makes $400,000 per year, which includes a base salary of $250,000 and a bonus of $150,000, comes down with a serious illness, then it's his or her belief the monthly disability will be $20,000 per month. But think of that employee's surprise when a monthly check shows up in the amount of $12,500 ($250,000 x 60 percent, divided by 12). It's as if the bonus never existed. Fortunately, there are supplemental disability insurance products in place to solve the problem, and they can either be firm paid or voluntary. In the case of law firms, consulting firms and investment firms, there are other issues to face. In these types of businesses, it's not uncommon for partners to earn $1 million to $3 million a year, with most benefits already structured as tax free.

Here's another scenario. John is a partner in a very large investment firm, earning $1.2 million a year. He goes out on disability indefinitely. He has $35,000 per month of coverage (Group LTD $25,000 and supplemental coverage of $10,000). This means his original pre-disability, after-tax take home pay of $780,000 is now $420,000 ($35,000 per month). Being disabled, he must now live on 46 percent less monthly income.

Attractive bonuses can often be the carrot dangled by employers to fill their work needs. But before signing on the dotted line, potential employees need to review their bonus programs to determine what the financial ramifications will be should they go out on an extended disability.

And for the employer, who is looking to retain good employees, it is important to be educated in the limitations of their current disability programs, and be aware of the supplemental products and strategies available to fill the gaps. ■

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