



INSURING INCOME AGAINST INABILITY TO WORK

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Important Notice

This report is intended to serve as a basis for further discussion with your other professional advisors. Although great effort has been taken to provide accurate numbers and explanations, the information in this report should not be relied upon for preparing tax returns or making investment decisions.

Assumed rates of return are not in any way to be taken as guaranteed projections of actual returns from any recommended investment opportunity. The actual application of some of these concepts may be the practice of law and is the proper responsibility of your attorney.

The Individual Need for Disability Insurance

Many people believe that their biggest asset is their home. For most of us, our biggest asset is the ability to work and earn an income. Not being able to work – due to a job loss or a disability having taken away the ability to work – is often financially devastating.

Everyone who works for a living is very familiar with what can happen if they are fired. On the other hand, the possibility of becoming seriously disabled is a risk few seem to think much about. How likely is it that you will become disabled? According to one study, 30% of all Americans between the ages of 35 and 65 suffered a disability lasting at least 90 days.¹ The risk of disability is real. The question is, “What to do about it?”

Don't Count on Social Security

A few individuals do manage to qualify for disability benefits from Social Security. However, the Social Security definition of “disability” is so strict that over 60% of initial claims are rejected.² Obviously, something else beyond Social Security is needed.

Group Disability Insurance

Many employers will provide – or make available – disability insurance on a group basis. However, even those who are covered by a group policy can still be at substantial risk. Employer-sponsored disability policies seldom provide you with more than 60 % of your monthly salary. Many policies set a monthly maximum benefit that may be far less than what some people earn. Income taxes can also be an issue; if the employer is paying the full cost of the coverage, disability benefits are fully taxable.³

Individual Disability Income Insurance

For many, the real solution to the disability problem is individual disability income insurance. Although individual policies may cost you more, as long as you pay the premiums the benefits are not taxable. Plus, an individual policy allows you to tailor its terms to fit your own needs. Factors to consider when shopping for an individual disability policy include:

- **Company strength:** You need to know if the company is financially sound.
- **Definition of disability:** Look for a policy that defines disability in the broadest terms possible. Some policies will permit you to work in a different occupation and still collect disability benefits.
- **Elimination period:** How long must you wait before disability payments begin?
- **Benefit period:** How long will you need coverage? Both short-term and long-term disability benefits are available.
- **Inflation protection:** Try to find a policy that adjusts benefits for inflation.

¹ Based upon the 1985 Commissioners' Individual Disability Table.

² General Accounting Office, Social Security Administration: More Effort Needed to Assess Consistency of Disability Decisions (Washington, D.C.: GPO, 2004), 7.

³ This discussion concerns federal income tax law only. State or local law may vary.

The Impact of Disability

While most Americans insure their lives and physical possessions such as their homes, cars, etc., many overlook the need to protect their most valuable asset – the ability to earn an income.

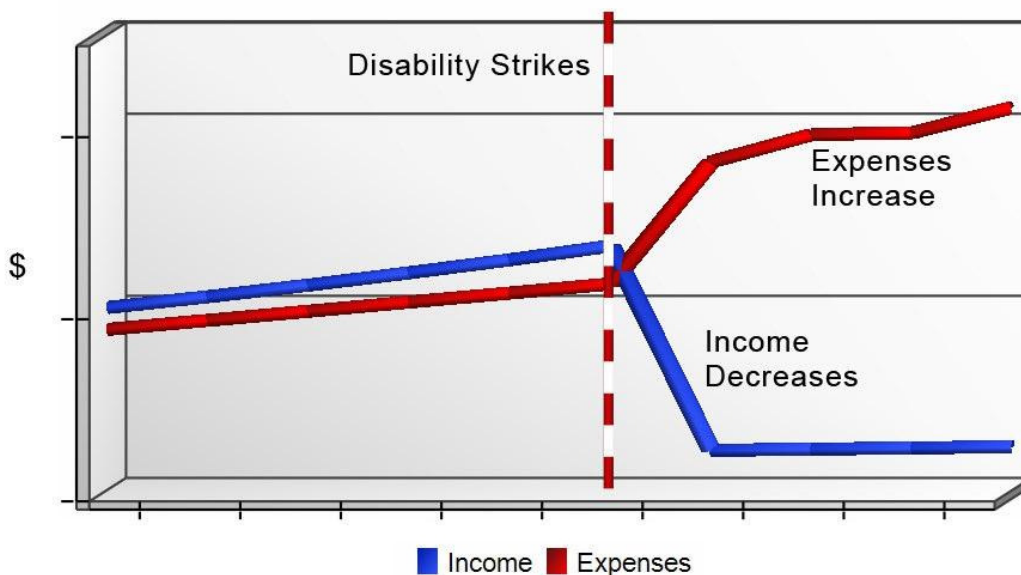
How likely is it that someone will become disabled? The table below, developed using data collected by the federal government, shows the number of working-age Americans who have a disability that affects their daily lives.

Individuals with Disabilities by Age¹

Age Range	No Disability	With a Disability
5-15 Years	94%	6%
16-20 Years	93%	7%
21-64 Years	87%	13%
65-74 Years	70%	30%
75 Years and over	47%	53%

Income Down, Expenses Up

The graph below illustrates the problem typically faced by an individual who becomes disabled for an extended period of time – income decreases while expenses increase.

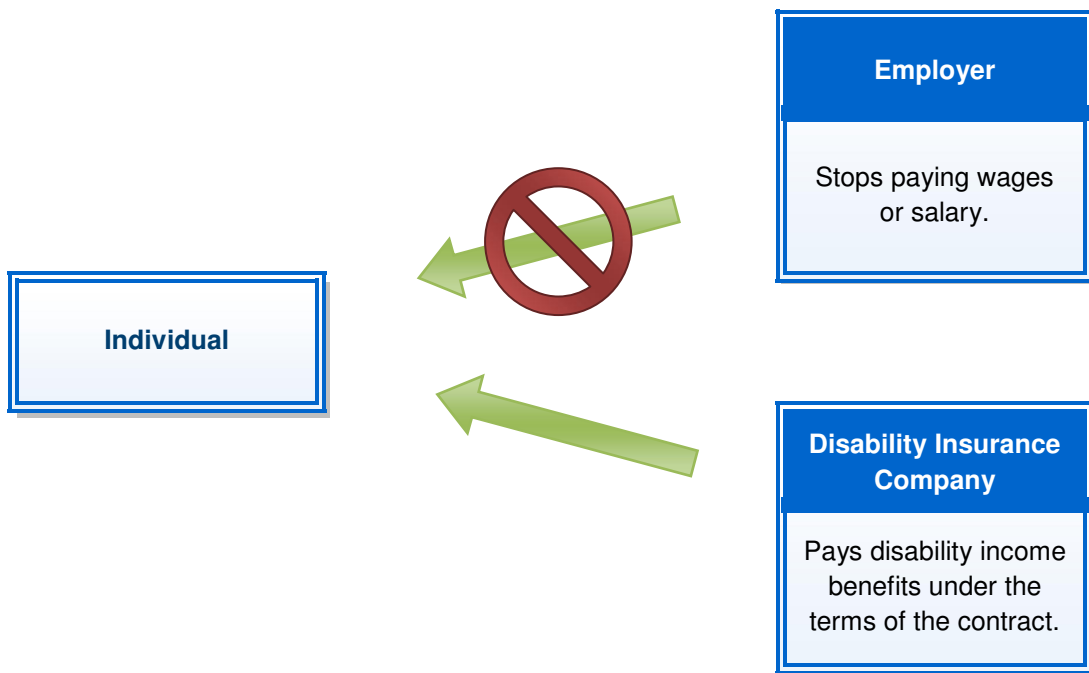


¹ Source: U.S. Census Bureau, 2005-2007 American Community Survey, 3-year estimates. Table B18002, sex by age by disability status for the civilian noninstitutionalized population 5 years and over, male and female.

How Individual Disability Income Insurance Works



DISABILITY OCCURS



Individual Disability Income Insurance

One approach to the problem of providing income during an extended period of disability is to purchase individual disability income insurance.



What to Look for in a Disability Insurance Policy

- **Definition of disability:** Are education, experience, and past earnings taken into account in determining whether the insured is qualified to resume work? Many policies provide for an initial “own occupation”¹ definition of disability, for a specified period of time, after which a different definition of disability applies.
- **Partial or residual benefits:** Partial or residual disability benefits may be paid in some policies when the impairment allows the insured to perform only a portion of his or her duties. This provision may also pay benefits in the event the disability reduces the insured’s income by a certain amount (e.g. 20% or more) from pre-disability levels.
- **Cost of living adjustment:** Is there a cost of living adjustment (COLA) which would increase benefit payments after a disability occurs?
- **Cancelability and renewability of policy:** Except for nonpayment of premiums, is the policy noncancelable or guaranteed renewable? Noncancelable generally means that the insurance company cannot cancel the policy, change the policy provisions or increase policy premiums after issue, as long as premiums are paid on a timely basis. Guaranteed renewable is similar, but allows the insurance company to increase the premium.
- **Waiting and elimination period:** Is the waiting or “elimination” period proper for the insured’s circumstances? Commonly available periods may include 30, 60, 90, 180 and 360 days. Naturally, the longer the elimination period one selects, the lower his or her premium payments will be. However, a person’s needs, cash reserves and income sources should be the deciding factors in selecting a proper elimination/waiting period.
- **Benefit period:** What benefit period should be selected? Since a long-term medical disability can be financially devastating, one should elect a long-term benefit where possible. Some companies offer lifetime benefit periods, but periods as short as 24 months to 60 months are also available.

¹ “Own occupation” generally means the insured’s current occupation. The own occupation definition of disability may not be available for all occupations or professions.

Individual Disability Income Insurance

Types of Disability Contracts

Several other specialized disability contracts are available to the businessperson:

- **Business overhead expense:** Covers expenses such as staff salaries, rent, telephone, utilities, malpractice insurance, and other expenses necessary to keep a business open.
- **Key person disability:** Reimburses the business for the loss of a key employee and allows funding of temporary replacement or training of a successor.
- **Disability buyout:** Provides income to fund a buy-sell agreement triggered by the total disability of a shareholder/business owner. Payouts may come in the form of a lump sum, monthly installments, or a combination of the two.

Caution: Highly-compensated employees should be aware of payment caps in many group long-term disability policies. While some programs will provide disability income payments at 60% or 66% of salary, many have a relatively low dollar limitation, such as \$3,000 per month.

The Business Need for Disability Insurance

Self-motivated individuals frequently play a crucial role in the success of a business. This is particularly true of small businesses in which one or two talented people possess highly specialized skills or knowledge that other employees do not have. If such a “key” person were to suffer a long-term disability, not only would the individual face substantial financial risk, but the very survival of the company could be in jeopardy.

Although sole-proprietorships and partnerships are generally the most vulnerable, corporations, particularly corporations built around one or two individuals, are also at significant risk. However the business is organized, when you consider the likelihood that you or one of your key employees may become disabled, there is a clear need to protect both your personal income and the financial well-being of the company.

Options to Consider

There is no single strategy or type of policy to protect your business from the risks posed by a key employee’s disability. Like a puzzle, a number of pieces are needed to complete the picture:

- **Adequate cash reserves:** Liquid funds can cover a short-term disability.
- **Key employee disability insurance:** Pays income to a disabled key employee. If the employer pays any portion of the premium, then a proportionate amount of the benefit is taxable income to the employee. If the employer pays the entire premium, the entire benefit is taxable.
- **Business overhead expense insurance:** This type of insurance covers normal operating expenses such as employee salaries, equipment leases, utilities, rent, advertising, maintenance, etc.
- **Qualified sick pay plan:** The federal tax code prohibits a business owner from paying himself (or herself) a salary while disabled, and then deducting the payments as an allowable business expense. A formal, written qualified sick pay plan (also known as a salary continuation plan), established in advance, can provide for funding the disability benefits as well as maximizing the tax benefits.
- **Disability buy-out:** In the event that you or another owner of the business suffers a permanent disability, disability insurance can be used to fund a buy-sell agreement.

Seek Professional Guidance

The guidance of knowledgeable tax and insurance professionals is essential in preparing for the potential impact of disability on a business.

Sources of Disability Insurance

Disability insurance is designed to replace a portion of the income you can lose if you are too sick or injured to work. There are two main sources of disability insurance: private disability insurance programs and government-sponsored disability insurance programs.

Private Disability Insurance Programs

There are two primary sources of private disability insurance:

The individual purchases the policy directly from an insurance company. The terms and benefits of the policy can vary widely.

Group plans are typically purchased through your employer and generally offer a low-cost alternative to individual coverage. The terms and coverage will vary.

Government-Sponsored Disability Insurance Programs

At the federal level, there are two primary programs offering disability insurance. Both are administered by the Social Security Administration.

Social Security Disability Insurance (SSDI) pays benefits to qualified individuals under the age of 65 regardless of current income. Benefits are based upon your Social Security earnings history.

Social Security Supplemental Security Income (SSI) pays benefits to qualified individuals who are either over 65, blind or disabled, and with limited income. Benefits are not related to the individual's record of Social Security earnings.

The Department of Defense and Veterans Administration offer military service members and veterans disability compensation for service-related health problems. In addition, federal employees covered under the Federal Employees Retirement System (FERS) are eligible for benefits if they have at least 18 months of service, and are unable to perform their job because of injury or disease.

All states and the District of Columbia have workers' compensation laws that provide disability compensation to employed individuals who get sick, become injured, or who are killed on the job. Although most workers are covered, states laws vary dramatically as to who is excluded and to the amount of benefits paid.

A Word of Caution

Neither of the above programs offered through Social Security covers partial disability and both have a strict definition of what it means to be disabled. In fact, over 60% of initial claims for Social Security disability benefits are denied.¹

¹ General Accounting Office, Social Security Administration: More Effort Needed to Assess Consistency of Disability Decisions (Washington, D.C.: GPO, 2004), 7.

Taxation of Disability Insurance Premiums and Benefits

Personally-Owned Policies

Premiums for a non-medical benefit such as disability insurance are not deductible when purchased by an individual. See IRC Sec. 213(d)(1).

The benefits from a personally owned disability insurance policy are exempt from income taxation. See IRC Sec. 104(a)(3). State disability compensation is nontaxable if the benefits paid are in the nature of workmen's compensation. However, unemployment compensation from federal and state programs is fully includable in gross income.¹

Business-Owned Policies

If the premium is paid by the employer for its employee, the results are different.

- The premium is deductible by the employer whether the insurance is a group policy or individual policies, so long as the benefits are payable to the employees or their beneficiaries. See Reg. Sec. 1.162-10(a).
- The amount paid by the employer for disability insurance premiums is not taxable to the employee. See IRC Sec. 106, Reg. Sec. 1.106-1 and Reg. Sec. 1.79-3(f)(3).
- When a benefit is collected, it is fully includable in gross income of the employee. If the employee paid part of the premium, that portion of the benefit will be tax-free.² See Reg. Sec. 1.105-1(c).
- If the policy pays for accidental death, the proceeds are generally tax-exempt to the beneficiary under IRC Secs. 106 and 101(a). (Policies issued after 12/31/84 must meet the statutory definition of life insurance under IRC Sec. 7702.)

Key Person Disability Insurance

If the policy is payable to the business to protect it from the loss of services of a key employee, the premium is not tax deductible. See IRC Sec. 265(a)(1), and Rev. Rul. 66-262 and 1966-2 CB 105.

On the other hand, benefits collected by the company are received income tax free. See IRC Sec. 104(a)(3) and Rev. Rul. 66-262.

¹ Based on federal law. State law may vary.

² In Revenue Ruling 2004-55, IRB 2004-26, 6/9/04, the IRS reviewed an employer-sponsored disability plan in which an employee could choose to have the employer-paid premium included in current wages, thus treating the premiums as having been made by the employee on an after-tax basis. Any disability benefits received under this arrangement would be excluded from the employee's gross income.