

# The Individual Need for Disability Insurance

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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 familiar with what can happen if they lose their job. On the other hand, the possibility of a serious disability is a risk few seem to consider. How likely is it that you will become seriously disabled? According to one study, 30% of all Americans between the ages of 35 and 65 suffered a disability lasting at least 90 days.<sup>1</sup> The risk 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, in 2011, only 35.2% of initial claims for Social Security disability benefits were accepted.<sup>2</sup> 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 replace more than 60% of your monthly salary. Further, many policies have 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, and not including it in the employee's income, disability benefits are fully taxable. If an employee pays for disability insurance with after-tax dollars, the benefits are received free of income tax.<sup>3</sup>

## Individual Disability Income Insurance

If group coverage is not available, the solution may be individual disability income insurance. Although individual policies can cost more, as long as you pay the premiums with after-tax dollars, the benefits are not taxable. Plus, an individual policy allows you to tailor its terms to fit your own needs. When shopping for an individual disability policy, consider the following:

- **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.

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<sup>1</sup> Based upon the 1985 Commissioners' Individual Disability Table.

<sup>2</sup> Annual Statistical Report on the Social Security Disability Insurance Program, 2012, November 2013. Table 60, Medical decisions at the initial adjudicative level, by year of application and program, all decisions.

<sup>3</sup> The discussion here 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.

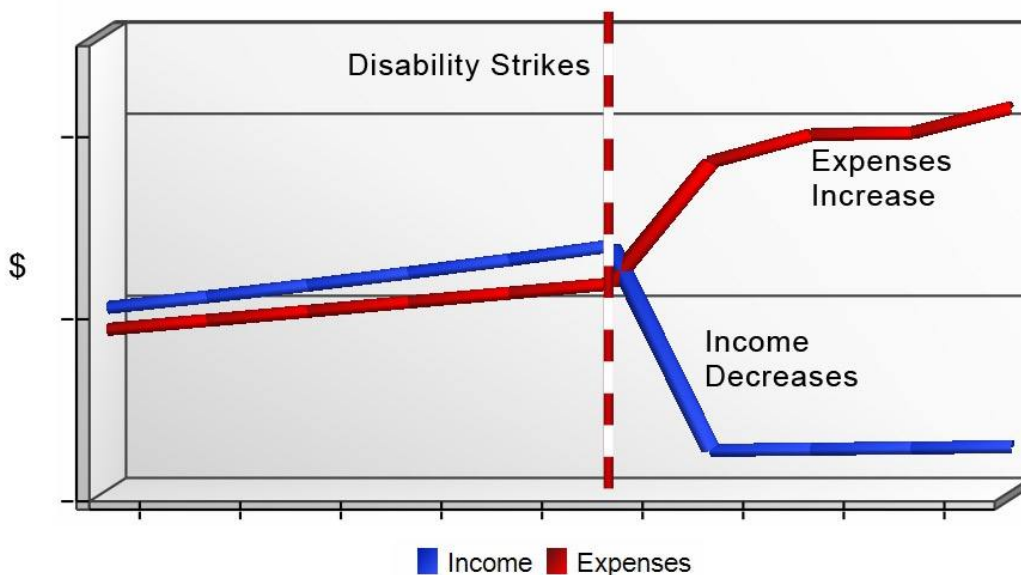
How likely is it that someone will become disabled? The table below, developed using data collected by the federal government, shows the number of working-age Americans who have a disability that affects their daily lives.

Individuals with Disabilities by Age<sup>1</sup>

Age Range	No Disability	With a Disability
5-17 Years	95%	5%
18-34 Years	95%	5%
35-64 Years	87%	13%
65-74 Years	74%	26%
75 Years and over	49%	51%

## 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.



<sup>1</sup> Source: U.S. Census Bureau, 2009-2011 American Community Survey, 3-year estimates. Table B18101, sex by age by disability status for the civilian noninstitutionalized population 5 years and over, male and female.

# Odds of Disability

Insurance claims studies indicate that the odds of becoming disabled for 90 days or longer are much greater than dying during one's working years. Studies also suggest that, as the number of business owners or key employees increases, so do the odds that one of them will suffer a long-term disability.

**Probability of at Least One Long-Term Disability Prior to Age 65**

Age	Number of People in the Age Group					
	1	2	3	4	5	6
25	58%	82%	92%	97%	99%	99%
30	54%	79%	90%	96%	98%	99%
35	50%	75%	88%	94%	97%	98%
40	45%	70%	84%	91%	95%	97%
45	40%	64%	78%	87%	92%	95%
50	33%	55%	70%	80%	86%	91%
55	25%	43%	57%	68%	76%	82%

**Note:** Based on the 1985 Commissioners Individual Disability Table, most recent available.

## Determining Odds of Disability Among People of Different Ages

Use the following table and worksheet to determine the risk of a long-term disability among your business owners or key employees.

Value	Age						
	25	30	35	40	45	50	55
Value	.42	.46	.50	.55	.60	.67	.75

**Step 1:** For each owner or key employee you wish to include in your analysis, choose the value from the table above that corresponds to the age closest to the actual age of the owner or key employee, and include the value in the space below.

**Step 2:** Multiply all of the values by each other to arrive at a single value.

$$\underline{\hspace{2cm}} \times \underline{\hspace{2cm}} \times \underline{\hspace{2cm}} \times \underline{\hspace{2cm}} \times \underline{\hspace{2cm}} = \underline{\hspace{2cm}}$$

**Step 3:** Multiply the single value by 100 to convert it to a percent.

$$100 \times \underline{\hspace{2cm}} = \underline{\hspace{2cm}} \%$$

**Step 4:** Subtract the single value from 100% to determine the odds of long-term disability for any one of the groups of owners or key employees in your company.

$$100\% - \underline{\hspace{2cm}} = \underline{\hspace{2cm}} \%$$

**Note:** You can perform this analysis for any number of owners or key employees, not just the five shown in this worksheet.

# Sources of Disability Insurance

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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, in 2011, only 35.2% of initial claims for Social Security disability benefits were accepted.<sup>1</sup>

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<sup>1</sup> Annual Statistical Report on the Social Security Disability Insurance Program, 2012, November 2013. Table 60, Medical decisions at the initial adjudicative level, by year of application and program, all decisions.

# The Business Need for Disability Insurance

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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.