Course Objective

This course was created to teach advisors (CPAs, EAs, accountants, attorneys, financial planners and insurance advisors) about a topic that is very important to many of our high-income clients, e.g. disability insurance.

Many high-income clients have disability insurance, but many do not. This course material was created to give readers the basics of how disability policies work, where they can be of benefit to particular clients, and how, through some specific types of disability insurance policies, an advisor can rise above the local competition selling disability insurance.

Disability Insurance (DI)

What You Need To Know Before Giving Advice to Clients

Introduction

Many advisors do not deal with the issue of disability insurance for their clients. Usually that is left up to a local life insurance agent. While many of the advisors who will be taking this course are insurance licensed, many will not be. The material to follow will explain in detail the basics of designing a disability policy for a client and why all advisors should be dealing with the topic as a value added service for their clients.

While many advisors see disability insurance as "boring" and something that is tough to distinguish from one advisor to another, through this material readers will learn several non-traditional ways to help clients.

When reading this material, keep in mind the following comments you might hear or questions you may be asked by your clients when discussing whether they should have disability insurance.

1) In order for me to be disabled, I would have to be brain dead; and, therefore, I do not need to buy disability insurance.

This is a typical response a professional (lawyer, CPA, accountant) will give to an advisor when discussing disability insurance. What the client needs to think about is if he/she would be able to work after something as simple as a car crash that left the client with a head trauma and migraine headaches.

2) If I get disabled, my family and friends will be there to support me.

This comment comes from someone who is very naive and certainly has never gone through a divorce. Many times when a client becomes disabled for a protracted period of time, their spouse will not be able to handle the stress and decides to exit the marriage stage right.

3) Even if I work in a job that makes me susceptible to disability, "it won't happen to me;" and, therefore, I do not want to pay the premiums.

The American public insures their homes against fire, floods, and earthquakes; but many will not insure the loss of their livelihood with disability insurance. Would a client change his mind if he/she knew the fact that one in three will miss work for 90 days or longer prior to reaching age 65 due to a serious illness or accident? The problem with the American public is that they are not properly educated on risks and, therefore, are not conditioned to think that disability could be a real live problem for them.

4) I do not think I can afford it right now.

This is the classic response from most clients. Simply ask if he/she could afford to take a six-month vacation without pay? If the answer is "no", then the client is not in a financial position to sustain a short-term disability.

One thing is certain in our client's lives…..change

We, as advisors, are here to protect clients., To do that, we must be as prepared as possible by educating ourselves and our clients on the issue of disability insurance.

It can easily be said that, "Americans are materialistic," and most definitely fear the loss of their possessions. They naturally, therefore, feel the need to insure these possessions without hesitation. Most of us would agree that our homes cannot go uninsured for fear of loss by fire, flood, hurricanes, and even earthquakes. Truth be told, only 1 in 1,200 homes actually burn down. Depending where you live, you already know what risks you face and what it costs to insure against these losses.

If, on the other hand, your get your clients to take one minute to compare the following examples and think about the actual risk, they might feel differently about the order of importance and need.

Let us assume a physician is 40 years of age and has an annual income of $300,000. For argument's sake, let's keep that income level until age 65. The earning potential to age 65 would then be 25 years x $300,000 = $7,500,000.

Also, let us assume the same physician lives in a NEW $500,000 home. The homeowner's insurance the physician pays each year, covers the loss and possible replacement of this home. The premiums, as we all know, might increase in any given year and or might just be cancelled (especially if you live in a coastal state like Florida). Still, in today's market place, we are lucky to be able to get this type of coverage at all. A typical homeowner's premium for a $500,000 house would be $3,000 per year, and the policy would have a $2,500 deductible. This insurance is not cheap, but clients do not even blink when paying the premiums.

Now let's look at insuring the physician's ability to earn income, or insuring the goose instead of the golden egg.

Disability is 16 times more likely than Death to cause Foreclosure
(Source: Society of Actuaries DTS)

Probability of Having a Loss

Home	1 in 88
Automobiles	1 in 70
Disability	1 in 8

If you consider the odds of having a loss and the amount of the loss, there is only one true loss that, if left uninsured, cannot be recaptured, rebuilt, or replaced. That is the physician's loss of income.

Here is an example of what the same 40-year old physician **should** insure.

90 Day Elimination Period
$10,000 Per Month after 90 Days
Benefits Payable To Age 65
Insures: "Medical Specialty"
Provides: Total and Residual Benefits
Annual Premium: $4,259 per year
Potential Benefits: $3,210,000

This above quoted disability policy, unlike homeowner's insurance, major medical insurance, and Long Term Care insurance is Non-Cancelable. The premiums are also Guaranteed to be Level To Age 65. Once a client buys it, he/she owns it as issued and no changes can be made by the insurance company. This is not like Group Disability that can be changed, cancelled, or modified.

The simple truth is most clients never consider a short-term disability. No one ever said you have to be totally disabled forever for disability to be a good deal. Just look at the math. If a client's benefits are $10,000 per month and the client was disabled for 12 months, that's $120,000 the client would receive from the disability policy. If the client calculates what he/she is going to pay in premiums to the insurance company to Age 65, it would total $106,475. That amount is not even as much as the short-term disability illustrated, and is hundreds of thousands less than would be paid if a client becomes permanently disabled.

Let's assume the ridiculous. A client's home burns down, and they do not have homeowner's insurance. If we use the client's income potential to Age 65 of $7,500,000, I am sure a banker would still lend the client enough money to rebuild the home.

On the other hand, if the client were to become disabled, all bets are off. There is no future income to rely on; no credit, only debt. The house, the boat, and the cars could be lost in a heartbeat. The client would no longer have a need for homeowner's and auto insurance because they will not be able to afford either.

Many of our clients work extremely hard to provide for their families. The years of education, training, and practicing should provide them with an ability to earn a good income. It is rather amazing to think that they can actually guarantee their income when disabled with a disability policy. How many clients would purchase Non-Cancelable and Guaranteed Premium Major Medical, Homeowner's, Long Term Care, or Automobile insurance? Probably all of them. As important as all these types of coverage may be, none is equal to the very source itself that pays for each, i.e. your client's ability to produce income.

While this introduction is much longer than a standard introduction to a continuing education module, the mindset of clients and advisors who believe disability insurance is not necessary **make** it necessary to include an almost lecture-like introduction explaining why disability insurance **is** so important.

Overview

If you are an advisor who sells disability insurance (hereinafter DI), you are probably aware of all the changes that have been taking place in the DI market place. The policies available today are drastically different from those available a few years ago. Although the DI policies have changed (and not in favor of the client), if advisors research and work with the right companies, they can find quality companies with appropriate policies at reasonable prices.

Important Statistics

According to a recent study, most people estimate they have only a 16% chance of becoming disabled during their working years[1] - in spite of the following startling facts[2]:

-If you are under age 35, chances are one in three that you will be disabled for at least six months during the course of your career.

-Men have a 43% chance of becoming seriously disabled during their working years.

-Women have a 54% chance.

-At age 42, it is four times more likely that you will become seriously disabled than die during your working years.

1. Gallup survey, conducted for UNUM Corporation (508 respondents, aged 30 to 65), reported by Best's Review.
2. "Why Disability" booklet, published by National Underwriter.

Duration of Disability

The following chart gives clients a good reason to purchase disability insurance. While not everyone will incur a long-term disability at some point in their working life, once disabled, it is usually a lengthy endeavor. The question for your clients is: Can they afford to be without income for as long as the average times listed below?

Average Duration of a Long Term Disability at Various Ages

(Disabilities lasting 90 days or more)

Age at Beginning of Disability	Duration
25	2 years, 2 months
30	2 years, 8 months
35	3 years, 1 months
40	3 years, 6 months
45	3 years, 11 months

50	4 years, 2 months
55	4 years, 5 months

Source: 1985 Commissioners' Disability Individual Table A

Disability vs. Death

Almost all of our clients, at one point in their working lives, will have purchased some type of life insurance policy. Clients buy life insurance because it is engrained in our minds that, if we die, we need to provide for family members; and, therefore, we insure against death. Approximately 95% of all term life policies never pay, but yet clients have no problem purchasing a $1,000,000+ life insurance policy.

The chart below is a very interesting one to show your clients to wake them up to the reality that insuring against a disability is just as, or more important than, insuring against death.

Probability of Disability vs. Death

Age	Ratio
30	2.31 to 1
35	2.21 to 1
40	1.95 to 1
45	1.69 to 1
50	1.53 to 1
55	1.33 to 1

Source: 1985 Commissioners' Disability Individual Table A and 1980 CSO Mortality Table

What is the Likelihood of Disability

As illustrated above, a client under the age of 40 is two times more likely to have a disability than die. This chart refutes the comment that clients typically make, i.e. "it won't happen to me." The odds of encountering a long-term disability (one lasting more than 90 days before age 65) are shown below, along with average duration.

Likelihood of Disability Before Age 65 at Different Ages

Your Age	Likelihood of long term disability	Ratio
30	1 in 3	32 months
40	3 in 10	42 months
50	5 in 22	50 months
60	1 in 10	54 months

Source: 1985 Commissioners' Disability Individual Table A

Types of DI Policies

These are the basic types of DI policies that are available:

-**Individual** disability insurance policies for most occupations.

-**Group** disability insurance for employers of all sizes.

-**High-risk** disability insurance for dangerous occupations.

-**Special-Risk** disability insurance for impaired health.

-**Business overhead expense** coverage for small business owners or partners.

-**Disability buyout** coverage for partners.

How Policies are Offered

DI can be purchased on an individual or group basis. Group insurance is usually provided by an employer or purchased individually from a sponsoring medical association. **Although initially low in cost, group policies have several limitations**. They can be cancelled (by the association or insurance company), rates increase as you get older, and premiums are subject to adjustments based on the claims' experience of the group. In addition, group and association contracts often contain restrictive definitions of disability as well as less generous contract provisions.

As a general statement, group policies many times are not worth the premiums paid. Most of the clients using group policies are those who cannot purchase affordable individual policies. Therefore, with the limiting language of the contract, the lower premiums are typically not worth paying.

Most insurance companies used to issue DI coverage equal to approximately 60% of earned income. Unfortunately, due to adverse claims' experience, insurance companies have decreased the amount of individual coverage available to physicians regardless of their earnings. The most common maximum monthly benefit is now $10,000 (although many non-surgical physicians can purchase up to $15,000 if they can financially qualify). Some companies now will sell an extra $5,000 in coverage to a client to bring them up to $15,000 a month if the first $10,000 is with a different carrier. Additionally, some insurance companies might allow clients to purchase up to a total of $15,000 when combined with group disability coverage that is already owned.

Group vs. Individual Disability

Because so many insurance agents are pitching group disability coverage, it seems prudent to compare group coverage to individual coverage. Many clients believe that they have sufficient disability coverage because of a group policy when in reality the group policy is nowhere near as good for the client as an individual policy.

Group disability coverage is typically the easiest coverage for a client to obtain. It is offered through various sources: Societies and Associations, and may even be available to clients and their employees within a company.

Seldom do clients read their individual or group disability contracts. In most cases, clients enroll by simply completing the application and mailing in the forms. The "brochure" looked okay and the prices seemed more than reasonable. There were no hassles of underwriting and, overall, there was no fuss involved in purchasing the group policy.

What didn't the client know?

Group coverage usually issues a CERTIFICATE of coverage, not a policy. There is one MASTER CONTRACT, and the client is issued a certificate number. This type of coverage can be cancelled, modified, and changed. The clauses, premiums, and benefits can ALL be changed at any time by the insurer. Does this happen? Unfortunately, the answer is **YES**.

What is the difference in an Individual disability policy?

Quality Individual disability coverage is issued to the client. The application is underwritten based on personal information. Once accepted, the POLICY is Non-Cancelable and Guaranteed Renewable. The premiums are guaranteed to be level, usually to age 65. The clauses cannot be changed or modified in any way. No restrictions can be added. The benefits cannot be reduced.

What is bought remains as issued until age 65.

What should clients know about Group and Association Coverage?

When a client enrolls in Group Association coverage, the words ENDORSED and ENDORSEMENT are generally used not only to entice the client, but also to assure the client that, if it's good enough for the Association, it should be good enough for the client.

What didn't your client know?

Association or Group coverage is just an offering to the MEMBERS of that Association. Remember, it is still insurance; and it must be profitable for the insurance company in order to be maintained. Thus, the Master Contracts are controlled by the insurer. This allows for future changes in clauses, reduction of benefits, modifications, more restrictive definitions, and even cancellation.

Physicians targeted by disability companies and association brochures touting "Medical Specialty" coverage are everywhere now. Your client is likely to read something such as: "The plan will pay benefits to you when you are unable to perform the duties of your medical specialty for the first 2 years of a covered disability". "Thereafter, you will receive benefits if you are unable to perform the duties of any occupation for which you are reasonably suited by education, training, or experience."

That's not what the client thought he/she was getting (which is typically own occupation). Caveat Emptor.

Individual policies differ in their definitions of "Medical Specialty" coverage, and some carriers will even write the physician a medical specialty coverage letter. This guarantees that, if the physician is unable to perform the material and substantial duties of the regular occupation (medical specialty), they are deemed to be totally disabled for the full benefit period. Even if the physician can work at another occupation, full benefits will be paid.

What else should a client know?

Quality coverage is underwritten on an individual basis. If accepted, the benefits, exclusions, and limitations are known once the policy is issued.

In other words, clients know where they stand when buying the policy. If the client had back problems and the insurer excluded that condition from coverage, the client knows that no benefits will be paid for back problems.

It should also be noted that after two years these policies are incontestable. That means that, after two years, if a client disclosed all the information required on the application and the medical history was disclosed, a claim cannot be contested; "pre-existing" is no longer a factor, as the insurer, during underwriting, "knew of" the client's past medical history.

What has happened in the past can surely happen in the future.

With the quality insurers re-entering the individual disability marketplace, more and more clients are becoming aware of the "shortcomings" and "pitfalls" of Group and Association coverage. Typically, many clients who remain with Group and Association coverage are those who have become uninsurable, and ineligible for individual coverage.

When only the difficult to insure stay in association programs, it creates a situation of adverse selection. An association or group that is over weighted with uninsurables is more likely to experience claims. Claims are losses and will result in changes to the group policies. In light of this, many group carriers are left with options that are not very favorable to the client. They must increase the premiums, change the Master Contracts, or CANCEL the groups completely.

What about the premiums?

Once purchased, the premiums for a quality individual disability policy remain level to AGE 65.

Group/Association premiums will typically increase with age. In addition, the premiums are usually not guaranteed and can be increased at anytime. Although a client might see a schedule of premiums and benefits, either can usually be changed with adverse claims experience of the group.

What should a client do?

First, I'd suggest that a client actually take a few minutes and read over the group or association contract or certificate. If you are helping the client obtain disability insurance, it is important for you to understand the group policy as well and to point out to the client the pitfalls of using such a policy. A client might only get one chance to make the right decision.

The Cost of Disability Insurance

Premiums are based on many factors including age, sex, smoker status, health history, monthly benefit, riders added to the policy, and the occupational classification the insurance company assigns to your client.

The younger you are when the purchase is made, the lower the cost of the insurance. Therefore, you should advise clients to purchase a policy as early as possible in their career so as to lock in lower premium rates.

The occupational classifications assigned by the insurance company specifically for physician clients will have a significant impact on the total premium rates as well as the policy provisions made available. Generally, if a physician performs invasive procedures, he/she will be placed in the "surgical" category; the definition of disability will not only be more restrictive, the premiums charged will be higher as compared to a non-invasive, non-surgical physician.

Can Disability Coverage be Implemented in a Discriminatory Manner?

Yes. Disability can only be deducted in any meaningful way in a C-Corporation. If a client (owner of a company) has a C-Corporation and would like to purchase and deduct a personal insurance policy, this is allowable under the current laws.

What nondiscrimination requirements apply to employer provided health benefits? "Insured Plans": Other than the rules concerning discrimination based on health status under HIPAA '96 (which apply generally to both insured and uninsured plans), a plan that provides health benefits through an accident and health insurance policy **need not** meet the nondiscrimination requirements of IRC Section 105(h). An accident or health insurance policy may be an individual or a group policy issued by a licensed insurance company, or "an arrangement in the nature of a prepaid health care plan" regulated under federal or state law (e.g., an HMO)

What to Look for in a Disability Policy

Renewability Provision

The renewability provision is one of the key features of an individual disability income insurance policy. This provision defines your rights when it comes to keeping your disability policy in force. In general, a disability policy can be Guaranteed Renewable *only* or *both* Non-Cancelable and Guaranteed Renewable.

Guaranteed Renewable

If a policy is Guaranteed Renewable *only*, the insurance company cannot cancel or change any provisions of the policy as long as you continue to pay your premiums (up to age 65). This is true even if there is a change in circumstances that would make the client a greater risk.

A Guaranteed Renewable policy, however, does not guarantee that the premium will remain the same. The company still reserves the right to raise premiums for all policies in a given class. So, even though premium increases must be justified by statistics and approved by state regulators, the owner of a policy which is only guaranteed renewable doesn't really know how high his or her premiums might go.

Non-Cancelable and Guaranteed Renewable

If a policy is *both* Non-Cancelable and Guaranteed Renewable, the insurance company cannot cancel, change any provisions, or increase the premiums for the life of the policy (up to age 65); therefore, a policy that is *both* Non-Cancelable and Guaranteed Renewable is preferable as it provides you with an added level of security.

Definition of Total Disability

Arguably, the definition of disability is the most important aspect of a disability policy. As a surgeon, you must pay careful attention to the definition of disability found in your policy as it will ultimately determine how any claim you make for benefits will be judged. There are three definitions of “disability” commonly found in the insurance industry, with significant differences between them.

“Own Occupation”

“Own Occupation” (also known as “true” or “pure” Own Occupation) is clearly the definition of choice for surgeons as it is the most liberal definition of total disability available. This type of disability policy pays benefits if you **“are not able to perform the material and substantial duties of your occupation**.” Therefore, you would collect full disability benefits if you could no longer perform surgery, even if you decided to work in another occupation or medical specialty earning the same or more income than you did as a surgeon. Ideally, you want to purchase a policy with the longest “Own Occupation” period available.

As a side note, Own Occupation policies refer to an occupation at the time of disability NOT at the time of purchase.

Modified “Own Occupation”

This type of disability policy has become the most prevalent in the industry today and, typically, pays benefits if you are **“unable to perform the substantial and material duties of your occupation <u>and you are not working.</u>”** Although benefits are still contingent upon your ability to perform surgery, this definition will not allow you to continue receiving full disability benefits if you are working in another occupation or medical specialty.

"Any Occupation"

This definition is the most restrictive of the three described and is commonly found in group or association policies. Under this definition, you are eligible to receive benefits only if you are found to be **"unable to work in any occupation which you are reasonably suited to by your education, training, or experience."** Unfortunately, it is the insurance company that makes this determination and surgeons, being as educated and well trained as they are, will find it extremely difficult to collect benefits from this type of policy.

Hybrid Definitions

Many policies offered to physicians today might incorporate an "Own Occupation" with a Modified "Own Occupation" definition. Here, the policy would contain a true "Own Occupation" definition for a limited time period (typically one, two, or five years) and then convert to the more restrictive Modified "Own Occupation" definition described above.

Although the hybrid definition is not as liberal as a policy with a true "Own Occupation" definition for the entire benefit period, after five years of receiving benefits (in the same claim), it is the insured's decision to continue collecting disability benefits or to return to work in another occupation or specialty.

Merely being able to work in another occupation or specialty would not affect your disability benefits. You would actually have to engage in another occupation to have your benefits reduced or eliminated.

Elimination Period

It is vitally important for advisors to communicate to their clients what the elimination period is in their policy. The elimination period in an individual disability insurance policy is a waiting period during which the client will receive NO benefits. In most disability policies, the client will have a choice as to how long they would like the elimination period to be. A typical range is from 30 days to one year. As you might imagine, the longer the waiting period the less expensive the policy.

For example, a client in a car crash and in the hospital for 60 days would not receive any disability benefits if the policy had a 90 day elimination period.

A question that frequently comes up is what would happen with the elimination period if the client had another disability shortly thereafter? Would the client have to start the elimination period all over from day one or could the client tack on the days already disabled? Not surprisingly, the answer depends on the policy language. Some disability polices require the client to start counting days from the beginning and some allow the client to tack on days from the previous disability period. If a policy allows the client to tack days, usually the window of opportunity to tack is limited to 12 months.

Again, it is important for any advisor to know the elimination period on a client's policy. I would also suggest that an advisor create a checklist and have the client initial each part of the policy where there is potential liability.

Waiver of Premium

A waiver of premium provision to a disability policy relieves the client from having to make premium payments after for 90 days of continuous disability (or the length of the elimination period, if shorter).

The best disability insurance policies continue to waive the premium during the 90 days following a recovery from disability. This allows you additional time to get adjusted before assuming the full burden of your pre-disability financial commitments.

Capital Sum Benefit

Some individual *disability insurance* policies pay a lump sum benefit for certain specified losses, e.g., the sight of one eye with no possibility of recovery or a hand or foot is severed through or above the wrist or ankle. This benefit (12 times the monthly benefit) is paid **in addition** to any other benefit that you may qualify for under the policy.

Rehabilitation Benefit

To help a disabled insured return to work in his or her own occupation, most disability insurance policies offer a rehabilitation benefit. This benefit will pay some of the expenses incurred when the insured enrolls in an approved rehabilitation program. The amount of the benefit is paid **in addition** to any other benefit the insured may qualify for under the policy.

Disability Insurance Exclusions and Limitations

Every company excludes certain causes of disability from disability insurance coverage. These exclusions are stated in the policy. A universal exclusion is the "pre-existing condition:" an ailment that had manifested itself before the policy was purchased but which was not disclosed on the application. Other common exclusions are disabilities resulting from acts of war, commission of a crime, or suspension of a professional license. Some policies limit benefits (typically to 24 months) for mental/nervous or substance abuse disorders.

Optional Riders

Residual Disability Rider

Unless your policy contains a Residual Disability Rider, you may have to be totally disabled to collect any benefits. While an "Own Occupation" policy protects your ability to perform surgery, it may not sufficiently protect your income level.

There are many disabilities that might allow you to continue working in your occupation on a limited basis while suffering a loss of income. Adding a Residual Disability Rider to your policy would allow you to continue receiving benefits proportionate to your loss of income if you returned to your practice on a part-time basis.

Furthermore, with policies such as Modified "Own Occupation" or "Any Occupation," this Rider might allow you to continue receiving benefits if you decided to work in another occupation or if the insurance company determined that you could work in another "reasonable" occupation with reduced earnings.

Generally, to qualify for Residual Disability benefits, you must experience an income loss of 20% or more compared to your pre-disability earnings. Additionally, if your loss of earnings were equal to or greater than 75% or 80%, depending upon rider provisions, then 100% of your monthly disability benefit would be paid.

Cost Of Living Adjustment (COLA) Rider

A COLA Rider is designed to help your benefits keep pace with inflation after your disability has lasted for 12 months. This adjustment can be a flat percentage or tied to the Consumer Price Index. Ideally, you want a COLA that is adjusted annually on a compound interest basis with no "cap" on the monthly benefit. Although important, if cutting the cost of coverage is an issue, this might be the first optional rider to consider excluding from your policy.

Future Increase Option Rider

This rider is a must for young physicians. It offers the ability to increase your disability coverage, regardless of your future health, as your income rises. It is important to know when you can increase your coverage as well as by what increments on any given option date.

If your client is in the later years of practice, make sure they are not paying for this rider after the maximum age. The insurance companies offer this rider but then have an age where it is no longer available (the companies still let you pay for the rider, which is a complete waste of money).

Tax Deductible

DI is 100% deductible for employees and owners in a C-Corporation and only deductible for non-owners in S-Corporations (unless the owners are less than 2% shareholders). In addition, many companies that provide group coverage write off the insurance premiums. This tax deduction would cause the benefits to be taxed when received by the individual employee. This means a client in the 40% tax bracket could lose as much as 40% of benefits at the time when they will need it most. Therefore, I do not recommend that advisors have their clients write off their traditional disability premiums.

When are Disability Income Benefits Taxable?

Premium Paid By	Benefits Paid to	Policy owner	Tax Treatment	
			Premiums	Benefits
Individual (Including a sole proprietor)	Individual	Individual	Nondeductible (IRC Sec. 213 & 262)	
Employer (Key person coverage or business reducing term)	Employer	Employer	Nondeductible (IRC Sec. 265)	Tax-Free (IRC Sec. 104)
Employer (under a Qualified Sick Pay Plan (QSPP)	Employee (Including C-corp. owners)	Employee	Deductible by employer (ICR Sec. 162). Employer-paid premium excluded from employee's taxable income (IRC Sec. 106)	Reported as Income (IRC Sec. 105)
Partnership, S-corporation (under a QSPP)	Partner, S-corp. owner	Partner, S-corp. owner	Deductible by partnership or S-corp. Included in partner's or S-corp. owner's personal taxable income (Rev. Ruling 91-26)	Tax-Free (Rev. Ruling 91-26)
Employee (under an Executive Bonus Plan)	Employee	Employee	Bonus paid to cover premium by employer is deductible. Bonus is included in employee's taxable income (IRC Sec. 162)	Tax-Free (IRC Sec. 104)

Overhead Expense

Premium Paid by	Benefits Paid to	Policy owner	Tax Treatment	
			Premiums	Benefits
Business or Owner	Business or Owner	Business or Owner	Tax Deductible Revenue Ruling 55-265	*Reportable as Income, Revenue Ruling 55-265

Disability Buy Out

Premium Paid by	Benefits Paid to	Policy owner	Tax Treatments	
			Premiums	Benefits
Partnership of Corporation (under Entity Purchase Agreement)	Partnership or Corporation	Partnership or Corporation	Nondeductible IRC Sec. 265	Tax-free* IRC Sec.104
Partnership or Corporation (under a Cross Purchase Agreement)	Insured's Partner or Fellow Shareholder	Insured's Partner or Fellow Shareholder		

*Benefits are paid to reimburse amounts paid to purchase disabled owner's business interest.

Caution

We know that many high income small business owners want to buck the system and figure out ways to do things in a more tax favorable manner (even if to do so is questionable in the eyes of the IRS).

One sales pitch you need to watch out for is when an insurance agent tells you or your clients to "write off" the premiums after the year of coverage is almost over.

Let's take an example.

Dr. Smith, who despises paying his disability premium, ran into an insurance advisor who told him how to write off his disability premium and still receive the benefits income tax free. Dr. Smith, who is always looking to put one over on the IRS, is all ears.

The insurance agent advises Dr. Smith to pay his disability premium on January 1 each year with a personal check (as if he is not writing it off). Then on December 31st of the same year when it is clear that he is not disabled, Dr. Smith has his medical practice reimburse him as a deductible expense for his January 1 premium. Then on January 1 the next day, Dr. Smith would again cut a check to the disability carrier out of his own personal account.

The theory behind this is simple. If Dr. Smith gets disabled during the year, he can look the IRS in the face and say he cut a personal check for coverage on January 1 and was not intending to deduct it from his taxes. If the coverage was paid for with a personal check, the IRS should not question things and should allow the client to take the benefit income tax free.

This is a road you and your clients do not want to go down. While it might be likely the IRS will never find out what was done; if they do, they will surely tax the disability benefits. If the disability benefits are taxed, the client is going to be in a terrible situation due to the fact that the taxed benefit will not be sufficient to cover expenses.

The bottom line is that you do not want to have your clients playing this game due to the potential severe consequences.

Non-Standard Risks

Our society gaining weight by the minute and with the number of new diabetics skyrocketing due to our poor eating habits, it is becoming more common to have clients who are not able to qualify for "standard" healthy disability insurance rates.

In addition to having clients who are not healthy, you might run across a client in a high-risk occupation that makes the client more prone to disability claims. When you have such a client, the primary insurance carriers will decline the business.

What do you do for a client who is turned down by the primary insurance carriers? You must take the client to the substandard market to buy DI coverage.

In the substandard market, the client is offered a "graded" disability insurance policy which provides coverage for the client but at a much higher premium.

Here is how a graded policy works;

-Benefits paid for a covered disability within the first 12 months of owning the policy are paid at 33%.

-Benefits paid for a covered disability within months 12 to 24 of owning the policy are paid at 66%.

-Benefits paid for a covered disability after 24 months of owning the policy are paid at 100%.

While graded policies are not what the client is looking for, it is nice to be able to provide a solution to any client that walks in the door (even if they are not healthy).

Sidestep the $10,000 (or even $15,000) Maximum Monthly Benefit Level

The most common way to increase a client's disability benefit is through a Future Increase Option Rider. The only problem with this option is that the client might be subject to the rules that applied at the time the policy was purchased. Another possibility might be to have a client supplement an individual policy with a group disability policy.

Disability Insurance Protection for Retirement Plan Contributions

If I gave a seminar for clients on DI and said with a straight face I knew an insurance company that sells to clients an additional $40,000 a year over and above any other DI a client owns, would that interest the clients? It should (especially the physician clients who cannot seem to buy enough DI). How can I show a client how to purchase an additional $40,000 a year benefit when they have been told for years they cannot purchase more than $15,000 a month in benefits?

The answer is very simple; DI carriers will sell clients protection against the cost of funding their retirement plans (401(k), Profit Sharing, Keogh, SEP, 403(b), and even some non-qualified deferred compensation plans). Therefore, if a client normally pays $40,000 a year to fund a retirement plan, the disability carrier will pick up that cost with **retirement plan** DI.

The most effective approach uses an individual DI policy that pays benefits into a trust set up specifically for the benefit of the insured client. If a disability occurs, monthly benefits from the policy are paid directly into the trust. The trustee, with input from the disabled client, then invests the monies received into mutual funds, annuities, or individual securities until the insured (the trust beneficiary) reaches age 65. At that point, the trust's assets are distributed to the individual to provide supplemental income for retirement.

Policy benefits and trust earnings are subject to the normal rules that govern the taxation of trusts and individual disability income insurance. Trust earnings are generally taxable to the insured as the beneficiary of the trust. As mentioned previously, DI policy benefits are either taxable or tax free depending on who paid the premiums.

Would Pension Protection Insurance Interest your Clients?

If you simply ask your clients the following question, you'll be surprised at the level of interest.

> If you get disabled, who is going to make a contribution to your pension plan? If you become totally disabled, how much money are you going to have in a retirement account when you reach age 65?

The answers the client should give are: 1) no one is going to make a contribution to my qualified plan if I get disabled, and 2) I will have no money in a private pension plan when I reach age 65. These answers leave clients in a situation where they are forced to consider that, if they do not have the proper type of disability insurance, when they reach 65 they may have to live on disability income from the government as their sole source of income.

> **<u>Example</u>**:
>
> Dr. Smith, age 40, with an annual income of $250,000 a year. Assume he traditionally funds his 401(k)/Profit Sharing Plan with $4,000 per year. Now assume that Dr. Smith purchased retirement plan DI protection insurance with the maximum benefit of $40,000 a year.
>
> If Dr. Smith became totally disabled at age 40, the insurance company would fund $40,000 a year into a trust account, where the money would grow and could be used at retirement. If Dr. Smith

stayed disabled, his total cumulative benefit at age 65 would be $993,720.

If, in addition to this, he purchased a cost of living adjustment (COLA) with a 6% inflation rider, his total cumulative benefit at age 65 would be $2,205,396.

What did the insurance cost? With the COLA rider, the annual premium would be $2,385; and without the COLA rider, the annual premium would be $1,883. This premium may be deducted from the practice (although the benefits like other retirement benefits would be taxable when received).

Should clients deduct pension protection disability coverage premiums?

While I typically do not recommend deducting traditional individual DI policy premiums, a client should **seriously consider** deducting pension protection insurance premiums. Why? Because, during a long period of permanent disability, it is likely the client will be in a very low tax bracket in retirement (and, therefore, the benefit, while taxable, will be hurt less due to the low tax bracket).

Whether to deduct these premiums is a decision the client should make with the help of an informed advisor.

Conclusion on Pension Protection Disability Insurance

Clients looking for more benefits should strongly consider purchasing retirement plan protection DI. Many insurance advisors do not even know this type of disability insurance exists; and, therefore, those who understand it can demonstrate to clients their superior knowledge on the subject matter.

Supplemental Disability Benefits

Almost every physician I have talked with regarding disability insurance says the same thing, “I cannot get more than $10,000-$15,000 of monthly disability coverage; and, typically, the insurance company limits the “own occupation” coverage to a maximum of $10,000 a month.” Surgeons especially worry about something happening to them that would preclude them from earning a living. Thus, almost all surgeons look to purchase disability insurance, and most opt for “own occupation” disability insurance.

With a supplemental disability program, clients can pay premiums through the corporation as a deduction to fund significant amounts of surplus or secondary disability coverage.

Business deductions

High income clients around the country complain they are paying far too much in income taxes each year and that there are no solutions besides funding a pension plan. Funding a supplemental disability program is a nice solution that allows for sizable deductions through the corporation that will reduce the income tax liability of key owner(s) of the corporation while at the same time providing significant supplemental disability benefits for the client.

Discriminatory plan

Disability payments by corporations are not governed by ERISA; and, therefore, there is no requirement to include staff members and no IRS reporting is required. Therefore, a corporation can choose who is going to be covered under the supplemental disability program. One owner in a corporation of 30 owners could implement a supplemental disability plan on his/her behalf without cost or involvement of the other owners or staff.

Looking at the numbers

The money contributed to a supplemental DI program is typically invested in the market via a very conservative portfolio of mutual funds, stocks, or bonds The following example is for a 40-year old who pays a supplemental premium of $100,000 a year into DI program for ten years. It also assumes that growth of 8% per year and a favorable claims history.

	Cost each year	Amount going towards insurance reserves	Reserve Account value at age 60 (assuming no claims)
Supp. Insurance	$100,000	$94,000	$2,578,627

Conclusion

The previous material is a cursory overview of a supplemental disability program. A separate education module will be introduced on this topic that advisors who have an interest can take for continuing education. However, the previous material should give readers enough information to determine if the topic might be worth looking into further for clients who would like to be able to deduct premiums for supplemental insurance coverage when there is a refund available with a good claims' history.

Business Overhead Expense (BOE)
Help Clients Protect Their Business As Well As Themselves

Most clients do not carry Business Overhead Expense insurance (BOE) because they have a difficult time seeing the value and are hesitant to buy a product they do not understand or do not think they will need.

If you have clients (especially physicians) who are owners in small businesses, the owners are typically individually responsible for their share of the office expenses each month. For example, if the client is a four-doctor orthopedic clinic, each physician pays 25% of the expenses each month and the remaining amount made by each individual physician is their pre-tax take-home pay.

When a client says that he/she has no interest in BOE insurance (mainly because they are too frugal/cheap), ask the following questions.

-How long would your business survive if you couldn't work?

-How would you pay salaries to your employees?

-How would your doors remain open?

What would happen in the medical practice if one of the four physicians became disabled? Are the other three partners going to immediately pay 1/3rd of the monthly expenses instead of 1/4th? No, typically the disabled physician is still going to be on the hook for 1/4th of the monthly expenses of the practice. If the disability is long term, he/she will have to either quit the practice or take out a loan to pay the share of expenses until the disability ends.

A BOE policy provides reimbursement for the expenses of operating the practice if one or more of the partners are sick or hurt and cannot work. These expenses may include:

-Employee salaries

-Employment taxes

-Employee benefit costs

-Rental payments for property and equipment

-Utilities

-Accounting and legal fees

-Business insurance expenses (including malpractice insurance)

-Interest on business debts

-Property taxes

-General office supplies

-Principal and interest payments of mortgaged business property

-And more…

The bottom line is that business partners are going to expect the disabled client to pay a fair share of the office overhead. This expense could be quite large and will come out of the disabled client's pocket one way or another. An employee owner's salary would not be covered by BOE insurance.

Tax Deductible

Premium payments for BOE insurance are **tax deductible** as a reasonable and necessary business expense. As such, benefits received during disability while taxable upon receipt are used to pay practice related expenses that are tax deductible. The net tax result is a "wash."

If you have clients who complain that they cannot get enough disability, then you should present to those clients the idea of buying PBOE as a tax-deductible expense. The client will be pleasantly surprised with your knowledge about disability insurance and the choice to buy BOE should be a simple one.

Summary

Purchasing a high-quality DI policy has never been easy. Unfortunately, the individual DI market place has become even more complicated. The policies available today vary greatly in terms of definitions, maximum benefit limits and premium rates.

It is more important than ever that you and your clients take the time to compare the contract provisions of the policies being considered and understand how and why they differ. It is vitally important to be known as an advisor who knows the different policies and the few ways to provide clients with maximum benefits (like adding retirement plan protection) at the lowest possible price.

If you have not called your clients in the last two years to review their disability policies, you owe it to them and to yourself to do so. The chances are that you'll be able to either help them add more DI coverage or save on their current premiums.

Conclusion on Disability Insurance

As stated in the beginning of this material, most advisors do not deal with disability insurance in their consulting practice. The topic seems to be left to disability insurance specialists.

As you have read, there are many ways advisors can differentiate themselves from even the disability insurance specialist. Most advisors selling disability insurance are not aware of the various products in the marketplace which can be helpful to clients. It can be stated with confidence that few advisors know anything about supplemental disability programs.

Whether readers choose to start selling disability insurance in their practices is one decision. But whether you choose to sell disability or not, knowing the material covered in this chapter will put you ahead of nearly every other advisor you run up against, which will put you in a position to be the team leader when working on a comprehensive financial and estate plan for a client.

