SHAW AMERICAN
FINANCIAL CORPORATION

DISABILITY INCOME INSURANCE

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Prepared for:

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The Concept

- Disability income insurance pays an income to an insured who meets the policy's definition of disability.
- The amount of disability income is never as much as the insured person could be earning at work. Instead, each payment represents a percentage of the insured's income.
- Different insurance companies offer policies that may pay from 40% to 70% of the disabled person's income. A common percentage is 66⅔%.

Definitions

- Disability income policies define the exact conditions that constitute a disability that will trigger payments. There can be substantial differences in how disability is defined, so it's critical to read the definition carefully.
- Most disability income policies use a two-step definition of disability similar to this:

  1. Total disability is defined as the insured's inability to perform the duties of his or her own occupation for a specified period of time.

  2. At the end of the period, total disability is redefined as the inability to perform the duties of any gainful occupation for which the insured is reasonably suited by education, training or experience.
- **Example:** Amanda is an obstetrics nurse. There is a two-step definition in her disability policy, and the specified period is two years. Amanda suffers a disability and is unable to continue practicing for two years, so she's considered totally disabled during this time. After two years, Amanda is still unable to resume working, although she is able to teach at a local nursing school. At this point, Amanda is no longer considered totally disabled.

Other Payments

- Following a total disability, an insured may recover enough to be considered only partially disabled—usually defined as the insured's inability to perform one or more important duties of his or her occupation. Some policies provide a reduced benefit (commonly called a residual benefit) for a partial disability.
- A residual benefit is usually payable when an insured is able to return to work but unable to earn at a level at least equal to that earned before the total disability.

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- A policy with a residual benefit specifies that if earnings are reduced by at least a certain percentage of pre-disability earnings—usually 20% to 25%—a residual benefit is paid.
- **Example:** Amanda earned $10,000 per month as a nurse before her disability. After her total disability ends, she's able to earn just $6,000 a month teaching at the nursing school—40% less than her previous earnings. If her policy includes a partial disability benefit, she qualifies for the reduced benefit because her income is reduced by more than 25%, assuming that is the percentage stipulated in the policy.

  The amount of the residual benefit is determined by multiplying the percentage of income lost by the regular monthly total disability benefit. If Amanda's total disability benefit was $7,000 and her income is now reduced by 40%, her residual benefit will be 40% x $7,000 or $2,800.
- Some policies provide a minimum guaranteed benefit during the first 6 or 12 months of residual disability. Typically, such a policy will pay 50% of the total disability benefit during this period.

Waiting Periods

- Before disability income benefits are paid, the insured generally must be totally disabled beyond a certain waiting or elimination period.
- During this period, the insurance company pays no benefit. If the disability continues beyond this period, disability income payments begin.
- Insurers offer a range of elimination periods. The most common are 30, 60, 90 and 120 days. Periods of 180 days and one year might also be available.
- The shorter the elimination period, the more the policy costs since the insurance company becomes obligated sooner.
- With a longer elimination period, there's a greater chance the insured will recover before— or soon after —payments begin, so the premium is less.

Benefit Period

- The period during which the insured receives disability income payments is known as the benefit period.

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- Several options may be available. Common benefit periods are one year, two years, five years, to the insured's age 65, and lifetime.
- The longer the benefit period, the more costly the policy.

The Tax Picture

- Different tax treatment applies according to whether someone purchases a disability income policy directly from an agent, or the person pays the premiums on a policy offered through an employer arrangement, or the employer pays the premium.
- When the insured individual pays the premiums, they're not tax deductible by the individual. However, the individual can receive any disability benefits free of federal income tax.
- When an employer pays premiums under a qualifying arrangement, the premiums are excluded from the employee's taxable income, but they are tax deductible by the employer. The insured employee pays federal income taxes on any benefits received.
- When employer and employee share in the premium payments, the portion of any benefits paid for by the employee is received tax-free, but the portion paid by the employer must be reported as income by the employee in the year it is received. The employer's contribution is tax deductible by the employer and is excluded from the employee's taxable income.

The Bottom Line

Insurance tables readily demonstrate that the risk of becoming disabled at younger ages is far greater than the risk of dying. For example, the risk of disability is nearly three times greater for a 27-year-old than the risk of death. This illustrates how important it can be to insure the ability to earn an income during an employee's working years.

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SUMMARY

What Is Disability Income Insurance?

Disability income insurance provides an income to an insured who becomes totally disabled and unable to work. The amount is always a specified percentage—always less than 100%—of the insured person's income when the disability occurs.

How Is Disability Defined?

The policy includes a precise definition of what constitutes a total disability that will qualify for benefit payments. Most policies have a two-step definition of total disability.

Initially, disability is defined as the insured's inability to perform the duties of his or her own occupation for a specified period of time. If the insured is still unable to return to work after the specified period ends, total disability is redefined as the inability to perform the duties of any gainful occupation for which the insured is reasonably suited by education, training or experience. Because policies can differ significantly, it's important to read and understand the definition in each policy.

Some policies pay a residual benefit if the insured is able to return to work but can no longer earn income at the pre-disability level. The formula for determining the amount of the residual benefit is specified in the policy.

When Do Payments Begin?

Disability policies have a waiting or elimination period that starts when the insured becomes disabled and extends for a specified length of time, typically from 30 to 120 days or longer. During this period, no benefits are paid. If the insured is still totally disabled at the end of the period, payments begin. This feature helps control the cost of the policy, with a longer waiting period generating smaller premiums and a shorter period generating larger premiums.

The length of the benefit period during which income payments will be made also affects the premium. Insurers commonly offer periods of one, two and five years, to age 65, or for life. The longer the period, the greater the premium.

Depending on who pays the premiums for a disability income policy, benefits paid might be received by the insured wholly or partly free of federal income tax.

Why Is Disability Income Insurance Important?

Most wage earners will need a source of ongoing income during their working years if they aren't able to work. A disability income policy provides that income. A disability that isn't covered by insurance can wreck an individual's or family's efforts to create a retirement income or to build and conserve an estate.

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