

Disability Insurance

Disability income insurance is a broad and complex topic. This section will introduce you to some of its basic principles. You will learn about the conditions under which a person can qualify for disability benefits, the specifics of individual and group disability underwriting, and the benefits that are available through the Social Security and Workers Compensation programs. With disability insurance, the key is to understand what injuries qualify for benefits, how much the payments will be, and how long they will last.

TERMS TO KNOW

Benefit period — a period of time during which benefits are paid under the policy

Earned income — salary, wages, or commissions; but not income from investments, unemployment benefits, and similar sources of income

Overinsurance — insurance that exceeds in amount the actual value of the person or property insured or insurance in a greater amount than the insured can afford

Social Security Disability Insured Status — fully insured or currently insured, depending on the number of coverage credits earned

Tax deductible — a qualified expense that may reduce the amount of income subject to taxation

Taxable — subject to taxation

Total disability — inability of the insured to perform any occupation for which he or she is reasonably suited by reason of education, training or experience

A. Qualifying For Disability Benefits

One major risk that individuals face in their lifetime is the possibility that they will become totally disabled and be unable to perform work duties for a period of time. Recent statistics show that there is a 30% chance of a 25-year-old being disabled for more than 90 days prior to age 65. It is far less likely that the same 25-year-old will suffer a premature death prior to age 65.

For most people who are unable to go to work, employment income would terminate after a brief period of time. Consequently, most people would be forced to turn to personal savings to pay normal living expenses such as food, rent and utilities. A question to ask is how long a person can survive without any income.

Disability income insurance is designed to replace lost income in the event of this contingency, and is a vital component of a comprehensive insurance program. It may be purchased individually or through an employer on a group basis.

Disability income benefits are limited to a percentage of earned income. The insurer wants a claimant to have a financial incentive to return to work. A person becomes eligible for regular disability benefits when they meet the insurance

company's definition of disability due to either a sickness or an injury. This definition of disability does vary from company to company. It is important for the applicant and the producer to be fully aware of this important benefit trigger.

1. Inability to Perform Duties

To pay benefits, a disability income policy will require for the insured to not be able to perform the duties of his or her occupation. The benefits will also depend on the definition of disability chosen for the policy.

Own Occupation

An *own occupation* policy will provide benefits when the insured is unable to perform any duties of their own occupation because of sickness or accident.

This definition is usually limited to the first 24 months after a loss. It allows insureds (claimants) to receive benefits if, because of disablement, they cannot perform the duties of their normal occupation even though they might be able to earn income from a different occupation. After 24 months, if the insured is still unable to perform the duties of their own occupation, the definition of disability narrows to mean the inability to perform **any occupation** for which the insured is reasonably suited by education, training, or experience. This is a dramatic reduction in the insurer's liability because it is very likely that claimants can find something they can do for financial gain. The "own occ" definition is generally used for highly trained, skilled occupations such as surgeons, trial attorneys, etc.

Any Occupation

A policy that has an "any occupation" provision will only provide benefits when the insured is unable to perform any of the duties of the occupation for which they are suited by reason of education, training, or experience. "Own occupation" is the more liberal definition and therefore provides a better benefit for the insured.

Although some companies still utilize the two-tier approach by combining both definitions in a single disability income policy, from an underwriting standpoint, it is much easier for an insurance company to justify the "any occupation" definition when agreeing to issue a policy.

Know This! Considering a disabled insured is able to perform some duties of the occupation, coverage under the "any occupation" policy is more likely to be denied than under the "own occupation" policy.

2. Presumptive Disability

Presumptive Disability is a provision that is found in most disability income policies which specifies the conditions that will automatically qualify the insured for full disability benefits. Some disability policies provide a benefit when people simply meet certain qualifications, regardless of their ability to work. The presumptive disability benefit provides a benefit for dismemberment (the loss of use of any two limbs), total and permanent blindness, or loss of speech or hearing. Some policies require actual severance of limbs rather than loss of use.

3. Requirement to Be under Physician Care

Most disability income policies require that the insured be under the care of a physician and possibly confined to the house in order to receive benefits.

B. Disability Income Insurance Features

Educational Objective:

IV.A.5. For disability income insurance, be able to identify:

- a. The need for coverage
- b. Definitions of partial and total disability, and eligibility requirements
- c. The difference between occupational and nonoccupational coverage
- d. Reasons for insurer limitations on coverage amounts
- e. Purposes of and needs for long-term disability vs. short-term disability policies

1. Types of Disability and Related Terms

Total disability is defined differently under some disability income policies. Some policies use a relatively strict definition such as the **any occupation** definition, similar to Social Security. This definition of total disability requires the insured to be unable to perform any occupation for which the insured is reasonably suited by reason of education, training or experience. Other insurers have adopted a more liberal definition that defines total disability as the "inability to perform the duties of one's **own occupation**." As would be expected, the more liberal "own occupation" definition of disability makes it easier to qualify for disability benefits.

Partial disability is often defined as the inability to perform one or more of the regular duties of one's own occupation or the inability to work on a full-time basis, which results in a decrease in the individual's income. The purpose of the partial disability benefit is to cover a partial loss of income when the insured is disabled to the point of being able to report to work, but not being able to perform all of the regular duties of the job. The **partial disability benefit** is typically 50% of the total disability benefit, and is limited to a certain period of time, as noted in the policy.

The benefits paid on a partial disability policy are paid in a flat amount, or a residual amount.

Know This! Partial disability covers a partial loss of income for disabled insureds who are unable to perform some, but not all, of their regular job duties.

Residual disability is the type of disability income policy that provides benefits for loss of income when a person returns to work after a total disability, but is still not able to work as long or at the same level he/she worked before becoming disabled. Many companies have replaced partial disability with residual disability.

Residual disability will help pay for loss of earnings. If the person can only work part-time or at a lesser paying position, residual disability will make up the difference between their present earnings and what they were **earning prior** to disability.

Know This! Residual disability is calculated as a percentage, determined by current earnings and earnings prior to disablement.

Recurrent Disability is generally expressed in a policy provision that specifies the period of time (usually within 3-6 months), during which the recurrence of an injury or illness will be considered as a continuation of a prior period of disability. The significance of this feature is that recurrence of a disabling condition will not be considered to be a new period of disability so that the insured is not subjected to another elimination period.

Elimination period is a waiting period that is imposed on the insured from the onset of disability until benefit payments commence. It is a *deductible measured in days, instead of dollars*. The purpose of the elimination period is to eliminate coverage for short-term disabilities in which the insured will be able to return to work in a relatively short period of time. The elimination periods found in most policies range from 30 days to 180 days. Just as a higher deductible amount results in lower premiums for medical expense insurance, a longer elimination period translates into a lower premium for disability income insurance. An important consideration in selecting the elimination period is that payments are made in arrears. Therefore, if the insured selects a 90-day elimination period, the insured will be eligible for benefits on the 91st day, but payments will not begin until the 121st day. The insured must determine how long he or she can go without benefit payments following disability in selecting the duration of the elimination period.

Know This! The elimination period is a "time" deductible, designed to eliminate coverage for short-term disabilities, and reduce the filing of excessive claims.

Probationary period is another type of waiting period that is imposed under some disability income policies. It does not replace the elimination period, but is in addition to it. The probationary period is a waiting period, often 10 to 30 days, from the policy issue date during which benefits will not be paid for illness-related disabilities. The probationary period applies to only sickness, not accidents or injury. The purpose for the probationary period is to reduce the chances of adverse selection against the insurer. This helps the insurer guard against those individuals who would purchase a disability income policy shortly after developing a disease or other health condition that warrants immediate attention.

Know This! Probationary periods apply to sickness, not accidents or injury.

Injury is defined using either the accidental bodily injury definition, or the accidental means definition. *Accidental bodily injury* means the damage to the body is unexpected and unintended. *Accidental means* indicates that the cause of the accident must be unexpected and unintended. A policy that uses the accidental bodily injury definition will provide broader coverage than a policy that uses the accidental means definition.

Sickness or illness is defined as either a sickness or disease contracted after the policy has been in force at least 30 days; or a sickness or disease that first manifests itself after the policy is in force.

Benefit Limitations—The amount of monthly benefit that is payable under most disability income policies is based on a percentage of the insured's past earnings. The benefit limits are the maximum benefits the insurer is willing to accept for an individual risk. It is common to find policies that limit benefits to roughly 66% of the insured's average earning for the period of two years immediately preceding disability.

Rarely will an insurer write a disability income policy that will reimburse the individual for 100% of lost income. The reason that insurers don't pay benefits that are equal to the insured's prior earnings is to reduce the chance of malingering on the part of the insured. If an insurer were to pay an insured benefits that were as much or more than the insured earned, the individual would have no incentive to return to work as quickly as possible. Paying the insured an amount that is less than their prior earnings creates an incentive for the insured to return to work after a disability, as opposed to collecting benefits even after the insured is capable of returning to work.

Most insurers will adjust benefits in accordance with any amounts that the insured may be receiving from Social Security or Workers Compensation. If the insured is receiving benefits from these programs, the insurer will decrease the amount of benefit that is paid under the policy so that the insured will not be able to profit from the disability.

Generally, disability income policies do not cover losses arising from war, military service, intentionally self-inflicted injuries, overseas residence, or injuries suffered while committing or attempting to commit a felony.

2. Occupational and Nonoccupational Coverage

Health insurance, including disability insurance, can be written on an **occupational** or a **nonoccupational** basis. *Occupational* coverage provides benefits for illness, injury or disability resulting from accidents or sicknesses that occur *on or off* the job. *Nonoccupational* coverage, on the other hand, only covers claims that result from accidents or sicknesses occurring *off* the job. While many individual health policies are written on an occupational or nonoccupational basis, most group plans are nonoccupational only. It is assumed that accidents or injuries occurring on the job will be covered by Workers Compensation coverage.

Know This! Policies written on an occupational basis cover accidents or sicknesses that occur on or off the job. When written on a nonoccupational basis, policies cover claims that result solely from accidents or sicknesses occurring off the job.

3. Insurer Limitations on Coverage Amounts

Benefit Limitations—The amount of monthly benefit that is payable under most disability income policies is based on a percentage of the insured's past earnings. The benefit limits are the maximum benefits the insurer is willing to accept for an

individual risk. It is common to find policies that limit benefits to roughly 66% of the insured's average earning for the period of two years immediately preceding disability.

Rarely will an insurer write a disability income policy that will reimburse the individual for 100% of lost income. The reason that insurers don't pay benefits that are equal to the insured's prior earnings is to reduce the chance of malingering on the part of the insured. If an insurer were to pay an insured benefits that were as much or more than the insured earned, the individual would have no incentive to return to work as quickly as possible. Paying the insured an amount that is less than their prior earnings creates an incentive for the insured to return to work after a disability, as opposed to collecting benefits even after the insured is capable of returning to work.

Most insurers will adjust benefits in accordance with any amounts that the insured may be receiving from Social Security or Workers Compensation. If the insured is receiving benefits from these programs, the insurer will decrease the amount of benefit that is paid under the policy so that the insured will not be able to profit from the disability.

4. Eligibility and/or Rating Factors

Educational Objective:

IV.A.7. Be able to identify how and why each of the following applies to eligibility and/or rating factors to influence rating structures: *age, gender, job classification, avocation, health (past and present).*

Age

When applying for disability income insurance, the applicant's age is an important rating factor. As people get older, their chance of mortality (death) increases. Also, as people age, their likelihood of having accidents or becoming ill also increases. However, they do not recover from an accident or illness as fast as younger people. For these reasons, the premium rates typically increase as a person ages.

Gender

A person's gender influences his or her eligibility and rating factor. Men, statistically, have a shorter life expectancy than women, so they are a higher mortality risk. On the other hand, women tend to have more health problems as they mature, which makes them a higher health risk.

Income Requirement and "Elimination Period"

Insurers use two methods to determine the amount of benefits payable under their disability income policies:

1. Determine benefits using a percentage of the insured's predisability income, and take into account other sources of disability income; or

2. A flat-amount approach as to the amount of disability income that will be paid in the event of total disability of the insured.

There are many factors that are underwriting considerations when determining the amount of disability income that may be offered to an applicant based upon other factors that may create a moral hazard.

Example:

Suppose that Bob and Jim each earn \$100,000 per year and both apply for disability income. Bob owns his own home and has no mortgage. He also has \$500,000 invested in CDs at the bank.

Jim is buying a home and has mortgage payments of \$1,500 per month and, in addition, has to make payments on his car and is repaying student loans made while he was in college.

If Bob becomes disabled, with the amount of disability income and the interest income from the CDs, he might not be as anxious to return to work as Jim would be, simply because of the difference in their financial obligations. This may cause an underwriter to be reluctant to write as much benefit for Bob as he would write for Jim.

Elimination Period is a waiting period that is imposed on the insured from the onset of disability until benefit payments commence. It is a *deductible measured in days, instead of dollars*.

Job Classification

In disability income policies, the **insured's occupation** is a critical underwriting factor. The more hazardous the applicant's occupation, the higher the premium the insurance company will charge. Professionals like attorneys and doctors pay the lowest premiums and get the superior definitions of disability. More hazardous occupations, like construction workers, pay higher premiums and receive poorer definitions of disability because of a greater risk of disability.

Avocation

Avocation is defined as a person's hobbies or personal interests. It is important for an insurer to take these into consideration. Dangerous or high-risk avocations increase the probability of loss occurring. Also, dangerous hobbies increase the possibility that a loss will be severe. To determine a person's avocations, the insurer will have an applicant fill out a questionnaire to obtain information regarding hobbies and personal interests.

Health (Past and Present)

Finally, insurers will evaluate a person's past and present physical condition in determining eligibility and rating factor. Obviously a person in good health is less likely to become ill or have an accidental injury. A person's height and weight are taken into consideration while determining a person's overall health. The reason for this is that statistics show that people who exceed the weight proportion

recommended for a certain height by more than 20% have higher incidences of heart disease, cancer, diabetes, and respiratory problems.

5. Effect of Taxes on Participants and Sponsors

Educational Objective:

IV.A.8. Be able to identify the income tax liabilities on premiums and benefits for the participants and sponsors of group and individual policies.

Premium payments on personally owned disability income policies are **nondeductible** by the individual. However, disability **income benefits** are received **income tax free** by the individual.

Individual

An **individual disability income** policy is applied for and paid for by the individual rather than through the employer as for group disability income. Individual Disability Income premiums are paid with after-tax dollars, and benefits are not income taxable.

In **medical expense** insurance policies, unreimbursed medical expenses paid for the insured, the insured's spouse and dependents may be claimed as deductions if the expenses exceed a certain percentage of the insured's adjusted gross income. The law permits **deductions for unreimbursed expenses in excess of 7.5%** of the adjusted gross income (AGI).

This provision only applies if the insured itemizes these deductions on his/her tax return.

Group

Disability income benefits are taxed on the basis of who pays the premium. If an employer pays half of the cost of the insurance, half of the benefit is taxable as income to the employee. If a person's employer is making payments toward the premium, in whole or in part, the benefit will be taxable for income purposes in the same percentage, because the employer will be granted a tax deduction for the employee benefit. The same applies for an individual disability income contract: if the employer pays any part of the premium directly, that same percentage of benefit when compared to total premium would be taxable as income.

In general, if someone claims a tax deduction, someone else will pay tax on the benefit. Disability income premiums are not tax deductible to individuals. The IRS treatment of insurance premiums by individuals is generally understood to mean with the use of "after-tax" dollars. It is similar in theory to "nonqualified" annuities where the percentage of "imputed" income (interest) is always taxable. In disability income, if the income results from someone else's tax deduction, the recipient owes the taxes back.

Premiums paid by the employer for disability income insurance for its employees are **deductible** as a business expense and are **not considered taxable** income to the employee.

Benefits received by an employee that are attributable to employer contributions are fully **taxable** to the employee as income.

When the employer and employee share in disability insurance premium contributions, the employee's contribution is not deductible; however, benefits received by the employee that are attributable to the employee's portion of the contribution are not taxable as income. The taxation of income received by the employee would depend on the type of a group plan:

- **Noncontributory** – The employer pays the entire cost of the disability insurance premium, so the income benefits are included in the employee's gross income and taxed as ordinary income.
- **Fully contributory** – The employee pays the entire cost of the disability insurance premium, so the income benefits are received income tax free by the employee.
- **Partially contributory** – The cost of disability insurance is paid partially by the employer and partially by the employee. The portion paid by the employee is received income tax free and the portion paid by the employer is included in the employee's gross income and taxed as ordinary income.

For example, if an employee contributes 40% of the premium and receives a benefit of \$1,000, only \$600 (60% = employer contribution) of the benefit payment will be taxed to the employee as income, while \$400 (40% = employee contribution) will be received tax free.

Know This! Disability insurance premiums are deductible as business expense; benefits are taxable income for employee.

Short-term disability (STD) group plans usually have a benefit period of less than 2 years. It is common in this type of disability income plans to place a maximum dollar amount on the benefit that will be provided regardless of earnings, and to have an elimination period (except for disability resulting from accidents).

Long-term disability (LTD) group plans usually pay benefits for 2 years or longer.

Group **long-term disability** plans are often reserved for management employees. The elimination period will usually coincide with the benefit period of the short-term disability plan. The benefit period may be to age 65. Lower-wage employees are usually limited to 66 and 2/3 % of monthly wage, while higher-wage employees are limited to 50% of monthly wage.

It is not uncommon for an employer to provide **short-term disability** benefits for all of the company's employees. The elimination period could be as short as 0 days and the benefit period not longer than 2 years, but the benefit period could be 6 months or 1 year.

Short-term disability and **long-term disability** insurance policies serve the same purpose — provide income replacement while an insured is disabled. The difference between the two is when coverage begins and how long it lasts. **Short-term disability** insurance is intended to cover the insured immediately after a serious illness or injury, and **long-term disability** insurance is intended to maintain

income replacement if the disability lasts for a long period of time — years, or even to retirement, depending on the plan.

Short-term and long-term disability insurance policies are designed to work together. If an insured has both a short-term and a long-term disability policies in place, short-term disability will pay benefits during the waiting period before the long-term disability coverage begins, at which point the insured will transition from one policy to the next to receive benefits. For that reason, it makes sense to have both policies to help ensure that an unexpected disability will not adversely affect the insured's financial situation for months or years.

There are a few additional factors to consider when choosing disability insurance and deciding on whether to buy either one or both, such as cost of coverage and an insured's ability to self-insure. If someone does not have an emergency savings fund that could cover living expenses for a few months if they are unable to work, then short-term disability insurance would provide the essential financial protection, even if only for a short period of time. In general, short-term disability insurance is best if offered by the insured's employer either for free or at a low cost. Private short-term disability insurance may be just as expensive as long-term disability insurance despite having a shorter coverage period.

Even if a person has significant emergency savings available, but is concerned with how a long-term disability could impact their financial wellbeing and retirement plans, the person may choose to buy long-term disability insurance to the protection they are looking for. Private long-term disability coverage can be a better choice than buying coverage through an employer because it is cheaper in the long run, and the insureds can take it with them when changing jobs.

6. Provisions or Riders

Educational Objective:

IV.A.9. Be able to identify each of the following provisions / riders for disability insurance: *maximum and minimum benefits; notice of claim; automatic increase provision; beneficiary; own occupation; cost of living rider; benefit period; social insurance supplement benefit rider; benefit integration; residual disability; rehabilitation; recurring disability; transplant benefit; and standard exclusions and limitations.*

Maximum and Minimum Benefits

Disability income insurance policies, like other types of policies, have minimum and maximum benefit amounts. Usually, the benefits are \$50-\$100 as a minimum and as high as \$10,000 as a maximum. Benefits for disability income may not exceed 50-70% of gross earned income.

Benefit Period

Benefit period refers to the length of time over which the monthly disability benefit payments will last for each disability after the elimination period has been satisfied. Most policies offer benefit periods of 1 year, 2 years, 5 years, and to age

65. Some plans offer lifetime benefits. The longer the benefit period, the higher the premium will be.

Notice of Claim

Under a disability income policy, the insured must notify the insurer within 20 days or as soon as reasonably possible of the onset of a disability. If the disability is ongoing and benefits are required for two or more years, the insurer has the right to examine the insured, at its expense, as often as reasonable to verify his/her continuing disability.

Automatic Increase Provision

The **automatic increase provision** increases an insured's monthly benefits each year for about 5 years. Generally, it gives an insured about a 25% increase in coverage. The insured's premiums will go up each year under this provision because the insured is purchasing more disability coverage. The reason for choosing this rider is that the insured's coverage will increase automatically with inflation.

Beneficiary

Contracts for disability income policies must have a beneficiary designation because they offer accidental death and dismemberment benefits. Since AD&D pays both life and health benefits, a beneficiary designation provision is required.

Cost of Living Rider

The purchasing power of disability benefits can be eroded by inflation. The cost of living adjustment (COLA) rider will help protect against inflation. Under this rider the insured's monthly benefit will be increased automatically, once claim payments have begun. Generally, the first increase would be at the end of one year to be followed by annual increases for as long as the insured remains on the claim. Some of these riders provide for compound interest adjustments while others provide simple interest adjustments.

Social Insurance Riders Coordination with Social Security Benefits

In order to avoid overinsurance, the insurance companies have several options to work with Social Security benefits.

Additional Monthly Benefit Rider

Some insurance companies offer the **Additional Monthly Benefit** rider for approximately the same amount as what the Social Security would pay. The benefit only is provided for one year. It is then anticipated that Social Security benefits would commence at the end of one year.

Social Insurance Supplement Benefit Rider

The insurance company may offer a **Social Insurance Supplement rider** (note: this is a rider, and not a separate plan), which will pay a benefit in the approximate

amount that Social Security would pay, but if Social Security does in fact pay, the Social Insurance Supplement benefit is reduced dollar for dollar by the Social Security benefit payment.

Social Insurance Supplement (SIS) riders are used to supplement or replace benefits that might be payable under Social Security Disability. These provide for the payment of income benefits generally in 3 different situations:

1. When the insured is eligible for Social Security benefits but before the benefits begin (There is a usually a 5-month waiting period for Social Security benefits, with the payment of benefits beginning on the 6th month);
2. If the insured has been denied coverage under Social Security (Roughly 75% of the people who apply for Social Security benefits are denied coverage because of their rigid definition of "total disability"); or
3. When the amount payable under Social Security is less than the amount payable under the rider. (In this case, only the difference will be paid.)

These riders can also be used to replace or supplement benefits payable under other social insurance programs, such as Workers Compensation.

Benefit Integration

The **integration of benefits provision** is designed to prevent duplication of benefits or "overinsurance." Thus, when an insured with an individual disability contract is disabled, the insurer will reduce its benefits by an amount equal to the insured's other disability payments.

Residual

A **residual rider**, when attached to a disability income policy, provides benefits for loss of income following disability, rather than the inability to perform the duties of an occupation. This is an important coverage for a professional whose disability causes a business interruption that results in a loss of clients, even though recovery from the disability is complete.

Rehabilitation

If the insured has been totally disabled, it is possible that rehabilitation will be necessary to help get the insured back to work, either in their old occupation or in another occupation. The rehabilitation benefit will cover a portion of the cost for the insured to enroll in a formal retraining program that will help the insured to return to work. This benefit usually offers a specified sum (several times of the monthly indemnity) to cover costs not paid by other insurance.

Recurring Disability

A disability that results from the same cause is known as a **recurring disability**. If the insured has been back at work for a certain amount of time, the recurring disability will be considered a new disability. This exposes the insured to new elimination period. If the insured has not been back to work for the specified amount of time, the recurring disability will be considered a continuation of the original.

Transplants

Donating a body organ will be covered under a disability income policy if the transplants are being performed in life-threatening situations.

Social Insurance Supplement and Social Security Riders

Social Insurance Supplement (SIS) or Social Security Riders are used to supplement or replace benefits that might be payable under Social Security Disability. These provide for the payment of income benefits generally in three different situations:

- When the insured is eligible for Social Security benefits but before the benefits begin (usually there is a 5-month waiting period for Social Security benefits);
- If the insured has been denied coverage under Social Security (roughly 75% of the people who apply for Social Security benefits are denied coverage because of their rigid definition of total disability); or
- When the amount payable under Social Security is less than the amount payable under the rider (in this case only the difference will be paid).

These riders can also be used to replace or supplement benefits payable under other social insurance programs, such as Workers Compensation.

Educational Objectives:

IV.A.6. Be able to identify the uses of disability income insurance:

- a. Individual disability income policy;
- b. Business overhead expense policy;
- c. Business disability buyout policy;
- d. Group disability income policy;
- e. Key-employee and partner policies.

C. Group Disability Income

Group plans differ from individual plans in a variety of ways. Listed below are the most common differences between group and individual disability plans:

- *Group plans* usually specify the benefits based on a percentage of the worker's income, while *individual policies* usually specify a flat amount.
- *Short-term group plans* usually provide maximum benefit periods of 13 to 52 weeks (with 26 weeks being the most common), with weekly benefits of 50% to 100% of the individual's income. *Individual short-term plans* have maximum benefit periods of 6 months to 2 years. Short-term plans are not renewable.
- *Group long-term plans* provide maximum benefit periods of more than 2 years, with monthly benefits usually limited to 60% of the individual's income.
- *Group disability plans* also have minimum participation requirements. Usually, the employee must have worked for 30 to 90 days before becoming eligible for coverage.
- *Group plans* usually make benefits supplemental to any benefits received under workers compensation.
- Some *group disability plans* limit coverage to only nonoccupational disabilities.

Know This! Group disability plan benefits are based on a percentage of the worker's income; individual policies specify a flat amount.

There are two major ways for seeking health and/or disability coverage through group insurance, as opposed to individual plans:

1. Most people obtain their health/disability insurance as an employee benefit. The economics of the group approach makes coverage cheaper than individually underwritten coverage because the coverage is underwritten for the group. Also, reduced rates are possible because of the lower potential for adverse selection; and
2. Employer-paid premiums are deductible as a business expense. The amount of the premiums is not taxable as income to the employee. This means that the employee would have to receive more than the amount of premium paid by the employer as additional compensation to purchase the same level of benefits in an individual policy.

There are, however, disadvantages to group insurance. The trend in recent years has moved away from the traditional fee-for-service plans and has now moved toward several types of plans that involve a more direct relationship between the provider and insurer. These plans include HMOs, PPOs, and point-of-service plans. These types of plans are referred to as "managed care" and contain cost containment provisions that may leave subscribers with few optional or individual choices for medical care.

Another disadvantage to insureds under a self-insured plan is that if the plan ceases, there is no right of conversion to an individual policy.

The following are **disadvantages** of self-insurance:

- It can leave the organization exposed to catastrophic loss. (This disadvantage can be eliminated if the self-insurer purchases reinsurance or stop-loss coverage.);
- There may be greater variations of costs from year to year than projected. (This could cause the loss of tax deductions for the losses that occur in years when there are no profits from which to deduct the losses.); and
- Self-insurance can create adverse employee and public relations. (The organization makes the determination as to which loss is covered or rejected, as opposed to having an insurance company make the determination.)

D. Business Disability Insurance

Just as an individual purchases disability income insurance to protect his/her ability to earn a living, a business purchases **business disability insurance** on its key employees to protect it from loss when the employee becomes disabled.

1. Key Employee (Partner) Disability

Key person disability is purchased by the employer on the life of a key employee. The key person's economic value to the business is determined in terms of the potential loss of business income which could occur as well as the expense of hiring and training a replacement for the key person. **The contract is owned by the business, the premium is paid by the business, and the business is the beneficiary.** The person is the insured, and the business must have the key person's consent to be insured in writing.

Know This! In key person disability insurance, the business is the contract owner, premium payor, and the beneficiary.

2. Business Overhead Expense Policy

Business overhead expense (BOE) insurance is a unique type of policy that is sold to small business owners who must continue to meet overhead expenses, such as rent, utilities, employee salaries, installment purchases, or leased equipment, following a disability. The business overhead expense policy reimburses the business owner for the actual overhead expenses that are incurred while the business owner is totally disabled. This policy does not reimburse the business owner for their salary, compensation, or other form of income that is lost as a result of disability. There is usually an elimination period of 15 to 30 days and benefit payments are usually limited to one or two years. The benefits are usually limited to covered expenses incurred or the maximum monthly benefit stated in the policy. The premiums paid for BOE insurance are tax deductible to the business as a business expense. However, the benefits received are taxable to the business as received.

3. Disability Buy-sell Policy

A **buy-sell agreement** is a legal agreement prepared by an attorney. The buy-sell agreement specifies how the business will pass between owners when one of the owners dies or becomes disabled. It is common for the business to purchase insurance to provide the cash to accomplish the buyout when the owner either dies or becomes disabled. The policies that fund buy-sell agreements generally have an extremely long elimination period, possibly one or two years. Generally, these policies funding buy-sell agreements also provide a large lump-sum benefit to buy out the business rather than monthly benefits.

E. Social Security Disability

Social Security, also referred to as **Old Age Survivors Disability Insurance** — OASDI, is a federal program enacted in 1935, which is designed to provide protection for eligible workers and their dependents against financial loss due to old age, disability, or death. With a few exceptions, almost all individuals are covered by Social Security. In some respects, Social Security plays a role of federal life and health insurance, which is important to consider when determining an individual's needs for life insurance.

1. Qualifications for Disability Benefits

Social Security uses the Quarter of Coverage (QC) system to determine whether an individual is qualified for Social Security benefits. The type and amount of benefits are determined by the amount of **credits** or **QCs** a worker has earned. Anyone working in jobs covered by Social Security or operating their own business may earn up to a maximum of 4 credits for each year of work.

The term **fully insured** refers to someone who has earned **40 quarters** of coverage (the equivalent of 10 years of work), and is therefore entitled to receive Social Security retirement, premium-free Medicare Part A, and survivor benefits. If an individual is entitled to premium-free Medicare Part A, they are automatically eligible for Medicare Part B, but must pay a monthly premium.

An individual can attain a **currently insured** status (or partially insured), and by that qualify for certain benefits if he or she has earned **6 credits** (or quarters of coverage) during the 13-quarter period *ending with the quarter in which the insured:*

- Dies;
- Becomes entitled to disability insurance benefits; or
- Becomes entitled to old-age insurance benefits.

For younger workers, the number of quarters required to qualify for the benefits differs by age according to a table established by Social Security.

2. Definition of Disability

Assuming that one qualifies for Social Security disability benefits by being *fully insured* or *partially insured*, one must then meet Social Security's definition of disability. **Disability**, under Social Security, is defined as the inability to engage in any substantially gainful activity by reason of a medically determinable physical or mental impairment that has lasted or is expected to last 12 months or result in an early death. **This definition is not as liberal as most definitions of disability found in policies marketed through insurance companies.**

3. Waiting Period

The waiting, or elimination period for Social Security disability benefits is **5 months**. Benefits begin at the beginning of the 6th month and are not retroactive to the beginning of the disability.

4. Disability Income Benefits

The amount of Social Security disability benefits is based upon the worker's **Primary Insurance Amount (PIA)**, which is calculated from their Average Indexed Monthly Earnings over their highest 35 years. The lowest 5 years of income may be deleted from calculation.

Social Security disability benefits will continue for 3 months when a person returns to work making more than \$1,050 per month. This is an incentive to get people back to work.

F. Chapter Recap

This chapter explained the key concepts and major types of disability income insurance, including group individual, group, and business disability policies. Let's recap the key features for each category:

DISABILITY INCOME

Disability Income Insurance

- Replaces lost income in the event of disability
- Insured must be unable to perform occupational duties
- *Presumptive disability* – specifies condition that qualify insured for full disability benefits

- *Recurrent disability* – specifies period of time during which the recurrence of an injury or illness will be considered a continuation of a prior disability
- *Elimination period* – waiting period that lasts from the onset of disability until benefit payments start
- *Probationary period* – period after the policy starts during which benefits won't be paid for illness-related disabilities
- *Benefit period* – length of time monthly disability benefit payments last
- *Benefit limitations* – maximum benefits an insurer is willing to accept for an individual risk; based on percentage of insured's past earnings
- *Social Insurance Supplement (SIS) or Social Security Riders* – supplement or replace benefits payable under Social Security Disability

Business Overhead Expense Policy

Reimburses small business owners for overhead expenses incurred while the business owner is totally disabled

Business Disability Buyout Policy

Specifies who will purchase a business partner's interest in case of disability

Key Person Disability

- Covers the potential loss of business income and the expense of hiring and training a replacement for a key person
- Business owns the contract, pays the premium, and is the beneficiary

Group Disability

- Short-term disability (STD) - benefit period no longer than 2 years
- Long-term disability (LTD):
 - Elimination period may last as long as the benefit period for STD
 - Benefit period may last until age 65
 - Usually reserved for management employees

SOCIAL SECURITY BENEFITS

Basics

- OASDI - Old Age, Survivors, and Disability Insurance
- Provides disability income benefits
- Individual must meet proper insured status, definition of disability, and waiting period requirements

Qualifying for Disability Benefits

- Fully insured: 40 quarters of coverage (equivalent of 10 years of work)
- Currently insured: 6 credits during the 13-quarter period
- 5-month waiting period
- Benefits based on PIA

WORKERS COMPENSATION

Eligibility and Benefits

- Must work in an occupation covered by workers compensation
- Benefits paid in response to work-related injuries
- Fault or negligence is not a factor in payable benefits
- Provides medical, income, death, and rehabilitation benefits