

# The CPA Journal



## Disability Insurance Planning for Professionals

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DECEMBER 2007 - Doctors, lawyers, and other professional clients of CPAs often pay attention to their family's life insurance needs, but concerns about becoming disabled usually go unaddressed. Statistically, however, a professional is far more likely to suffer a severe disability that damages the ability to work, rather than die prematurely. While some people have the financial resources to fund a disability on their own, most need disability income insurance to cover the risk. Good planning on the part of a CPA can result in peace of mind and financial security—the perfect gift for one's family and other loved ones.

Disability insurance planning has changed dramatically over the last decade. Professionals and their financial advisors have demanded more flexibility when structuring disability policies. The insurance industry has responded by offering myriad options. Now more than ever, CPAs can help clients protect their most valuable asset—the ability to earn an income. This is one area where what applies to all professionals also applies to CPAs themselves and to their businesses.

### How Policies Are Offered

Disability insurance can be purchased on an individual or group basis. Group insurance is usually provided by an employer or purchased individually through a sponsoring professional association. Although initially low in cost, and a reasonable alternative for some professionals, such group policies do not provide the customized benefits that can be achieved through quality individual policies.

Group policies can be canceled (by the sponsoring association or the insurance company), rates increase with age, and premiums are subject to adjustments based on the claims experience of the group. In addition, group and association contracts often contain more restrictive definitions of disability as well as less generous contract provisions when compared to well-structured individual policies. On the other hand, they are initially far less expensive than individual policies.

Most insurance companies will issue disability insurance coverage equal to approximately 60% of earned income. Certain occupations, however, are provided with “special limits.” The limits permit new professionals to purchase benefits in excess of what their current earnings would normally allow. The most common maximum monthly benefit available to professionals is \$15,000. However, some companies, depending on occupation, may allow a professional to purchase up to \$20,000 in coverage combined with group long-term disability (LTD) insurance provided by the professional's employer.

### Cost of Disability Insurance

Premium rates are based on factors such as the insured's age, gender, monthly benefit, optional riders, and the occupational classification that the insurance company assigns to each profession. As a general rule, the younger the policy owner, the lower the cost. Professionals should purchase a policy as early in one's career as possible to lock in lower premium rates.

Although women are better risks for life insurance, this does not hold for disability insurance. Rates for

females are substantially higher, and their policies can cost 50% to 75% more than policies for men. Unisex rates may be available by taking advantage of a “multilife” discount. This arrangement typically requires that three or more policies be purchased by individuals employed at the same law firm, medical practice, or other professional firm. While this strategy allows females to save as much as 50% on the cost of their policies, males’ rates may actually increase. One must consider any potential savings against the overall makeup of the individuals to be insured.

The occupational classification assigned to a profession or medical specialty by the insurance company will significantly impact premium rates, as well as the policy provisions made available to the insured. The classifications are generally based on the insurer’s claims experience. Professionals such as CPAs and attorneys generally qualify for the highest occupational classification, and therefore pay the lowest premium. On the other hand, physicians qualify for a lower classification and therefore pay higher premiums.

### **What to Look for in a Disability Policy**

***Renewability provision.*** The renewability provision is a key feature of an individual disability income insurance policy. The provision defines an insured’s rights when it comes to keeping the disability policy in force. In general, a disability policy can be guaranteed renewable only, or both noncancellable 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 the insured continues to pay premiums. In the event of poor claims experience, however, the insurance company does reserve the right to increase premiums, with state approval, for an entire class of policies.

***Noncancellable and guaranteed renewable.*** If a policy is both noncancellable and guaranteed renewable, the insurance company cannot cancel, change provisions, or increase the premiums for the life of the policy. Such a policy is preferable because it provides insureds with an added level of security.

Arguably, the definition of total disability is the most important aspect of a disability policy. Professionals must pay careful attention to the definition of disability found in their policies because it ultimately determines how any claim for benefits will be judged. There are three definitions of “disability” commonly found in the insurance industry, with significant differences between them.

“Own-occupation” (also known as “true” or “pure” own-occupation) is the most liberal definition of total disability available. It pays benefits if one is “not able to perform the material and substantial duties of [one’s] occupation.” An insured would collect full disability benefits if he could no longer work in his occupation, even if he decided to transition into another occupation, earning the same or more income prior to disability.

Modified “own-occupation” has become the most prevalent type of disability policy in the insurance industry and typically pays benefits if an insured is “unable to perform the substantial and material duties of your occupation *and not working*” (emphasis added). Although benefits are still contingent upon the insured’s ability to work in an occupation, this definition will not allow an insured to continue receiving full disability benefits if working in another occupation.

“Any occupation” is the most restrictive definition of the three and is often found in group or association policies. Under this definition, an insured is eligible to receive benefits only if found to be

“unable to work in any occupation which you are reasonably suited to by your education, training or experience.” Unfortunately, this determination is made by the insurance company, and professionals—being generally well-educated and well-trained—will find it very difficult to collect benefits under this type of policy.

***Residual disability rider.*** Unless a policy contains a residual disability rider, insureds may have to be totally disabled to collect any benefits. While an “own-occupation” policy protects an insured’s ability to work in his occupation, it may not sufficiently protect the insured’s income level. Many disabilities might allow someone to continue working in his occupation, albeit on a limited basis while suffering a loss of income. Adding a residual disability rider to the policy would allow a disabled person to continue receiving benefits proportionate to the loss of income if he returned to his occupation on a part-time basis.

Furthermore, with policies such as modified “own-occupation” or “any occupation,” a residual disability rider might allow an insured to continue receiving benefits if working in another occupation, or if the insurance company determined that the insured could work in another “reasonable” occupation with reduced earnings. Generally, to qualify for residual disability benefits, one must experience an income loss of 20% or more (as compared to pre-disability earnings). Additionally, if the loss of earnings is greater than 75% or 80%, then, depending upon the rider’s provisions, 100% of the monthly disability benefit might be paid.

### **Recovery Benefits**

Self-employed professionals and service providers whose incomes are based solely on the number of clients or patients that they see must understand how recovery benefits work. While some policies have an unlimited recovery benefit built into the residual disability rider, others make the recovery benefit available as a separate rider.

Consider the example of a small-firm lawyer whose income is based solely on the business generated and number of documents prepared. She had been totally disabled for one year and after a full recovery she has returned to the firm. Her physician has stated that she can perform all of her job duties and work the same number of hours as before.

The clients that had depended on the lawyer for legal advice and document preparation have gone elsewhere. Additionally, referral sources with whom she had built relationships had no choice but to refer clients elsewhere. Obviously, it would be very difficult to take the business away from the practitioner or firm that had been providing these services during another lawyer’s disability.

As a result, rebuilding a practice and income level might take years. Without a recovery benefit, she would no longer qualify to collect any benefits at all. With an unlimited recovery benefit, however, the lawyer would continue to receive benefits until her income reached 81% or more of her pre-disability income. For a self-employed individual this can mean the difference between surviving financially or not.

***Cost of living adjustment (COLA) rider.*** A COLA rider is designed to help an insured’s benefits keep pace with inflation after a disability has lasted for 12 months. The adjustment can be a flat percentage, or tied to the consumer price index (CPI). Ideally an insured wants a COLA that is adjusted annually on a compound-interest basis with a “catch-up” feature and no cap on the monthly benefit. This rider is important, but if reducing the cost of coverage is an issue, professionals should consider excluding it from a policy because it is expensive and would be a significant benefit only when a disability lasts

several years. Because one cannot predict or choose the length of a disability, excluding this provision might also be risky.

***Future increase option rider.*** This rider is important for young professionals. It offers the ability to increase an insured's disability coverage, regardless of future health, as income rises. It is important to know when coverage can be increased, as well as by what increments, on any given option date. Some companies may allow an insured to use the entire option in one year as long as the insured's current income warrants the increase; others, however, may limit the amount that can be purchased based upon the original monthly benefit in place when the policy was purchased.

***Tax implications.*** According to IRC section 104(a)(3), personal disability insurance benefits are received free of income tax, provided premiums are paid with post-tax dollars. If an employer provides coverage and takes a tax deduction for the premiums paid on the insured employee's behalf, however, the benefits are taxable when received. This means that an employee could lose as much as half of the benefits when they are most needed. A better alternative would be for the employee to forego the tax deduction, or for the employer to give the employee an annual bonus equal to the policy's premium. The employee will owe taxes on the bonus, but the employer will retain its tax deduction, and the insured employee's benefits remain untaxed.

***Catastrophic disability rider.*** This relatively new rider, also called a CAT rider, was introduced by many insurance companies to pay additional benefits if an insured is unable to perform two or more activities of daily living (ADL) without human standby assistance, or if the insured suffers a cognitive impairment or an irrevocable disability. The ADLs are bathing, dressing, eating, transferring, toileting, and continence. This same definition of disability is found in a long-term care insurance policy. The CAT rider works well when the insured has already reached the maximum benefit level in traditional insurance policies and is still looking for relatively inexpensive ways to supplement coverage.

Take the example of a young professional who loses both legs in a car accident. He would meet the definition of disability because he would be unable to perform the material and substantial duties of his occupation or is considered presumptively disabled. However, he does not require a physician or other skilled healthcare provider to take care of him—he simply needs help performing ADLs. As a result, this would not be covered by health insurance. The additional benefits of a CAT rider would pay for the cost of the caregiver and preserve the value of the insured's disability benefits to meet monthly expenses. Generally, this rider can provide up to \$8,000 month in benefits, not to exceed 100% of the insured's prior monthly income, in addition to the monthly disability benefits under the policy.

***Sidestepping the \$15,000 maximum monthly benefit.*** Someone who has an old policy with a future purchase option rider might be subject to the rules that applied at the time the policy was purchased. In such a case, the insured might be able to purchase coverage in excess of \$15,000 per month. Other possibilities might be to supplement an existing individual policy with a group disability policy or to purchase additional disability policies that protect the insured's retirement plan contributions, overhead expenses, or ownership interest in a practice.

## **Group Long-Term Disability Insurance**

An individual whose employer makes group LTD insurance available, or who is changing employers, may have the opportunity to supplement individual disability insurance coverage. Once purchased, an individual policy would not be affected by subsequently enrolling in a group LTD plan. If, however, an individual policy is not already at its maximum benefit level, this strategy might prohibit the insured from increasing an individual policy further.

## **Disability Insurance Protection for Retirement Plan Contributions**

Group and individually owned disability insurance plans traditionally are designed only to replace a portion of the insured's current income, not to replace monthly contributions into company or individual defined-contribution (DC) retirement plans. Nevertheless, a few disability insurers have developed programs designed specifically to replace lost retirement savings.

The most effective approach uses an individual disability insurance policy that pays benefits into a trust set up specifically for the insured's benefit. If a disability occurs, monthly benefits are paid directly into the trust. The trustee, with input from the disabled individual, then invests the money in mutual funds 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 noted above, disability insurance policy benefits may be taxable or tax-free, depending on who paid the premiums.

## **Protecting Professional Practices and the Professionals**

***Disability overhead expense insurance.*** A professional in public practice, responsible for some or all of the monthly expenses required to keep an office open, should consider purchasing a business overhead expense (BOE) policy in addition to a personal disability policy. A BOE policy provides reimbursement for the expenses of operating a practice if one of the practice owners is sick or hurt and cannot work. These expenses may include staff salaries, rent or mortgage payments, utility bills, professional liability insurance premiums, and other fixed costs normal to the operation of a professional practice. In addition, some policies may even provide benefits for disabled professionals to hire a temporary replacement to fill in during a disability. This way, the practice's expenses are covered until the disabled partner returns to the practice or until the disabled partner's share in the practice can be sold. Premium payments for BOE insurance are tax-deductible as a reasonable and necessary business expense (Revenue Ruling 55-264, 1955-1 C.B. 11). Benefits received during disability, while taxable upon receipt, are used to pay practice-related expenses, which are tax-deductible. As such, the net tax result is a wash.

***Disability buyout insurance.*** Partners in a firm will also want to consider a policy known as disability buyout (DBO) insurance, which is designed to help provide funds toward the purchase of a disabled partner's ownership interest if, due to a lengthy disability, the individual is no longer capable of being a productive member of the practice.

Due to the specific skills each individual brings to a practice, attorneys often recommend a buy-sell agreement that details what is to occur upon the death, disability, or retirement of each partner/owner. Having a proper buy-sell agreement in place before disability occurs can avoid the hard feelings and the conflicts of interest that often result from a partner's disability. The agreement should set forth the purchase price to be paid or should provide a formula for determining the price. Perhaps most important, the agreement must have a mechanism for providing the funds needed to make the purchase.

Furthermore, in conjunction with a disabled partner's individual disability income insurance and BOE insurance, a DBO policy will allow the business to continue to generate an income for the healthy partners, while a disabled partner is supported by the benefits from an individual disability policy. Any continuing share of business expenses is reimbursed by the disabled partner's BOE policy until the

buyout is in effect. Premiums paid for DBO policies are never tax-deductible, whether paid by corporations, partnerships, or individuals. The benefits, therefore, would not be subject to tax.

### **Planning Options**

Purchasing high-quality disability insurance has never been easy. Although the additional options available today create more flexibility, they also mean that the individual disability insurance marketplace has become even more complicated for professionals. Policies vary greatly in terms of the quality of the insurer, definitions offered, maximum benefit limits, and premium rates. It is more important than ever for professionals to take the time to compare the contractual provisions of the policies under consideration and to understand how and why they differ. The best approach for a CPA is to employ the services of a professional insurance agent or financial planner who specializes in working with CPAs and CPA firms. Such an individual will be familiar with which companies' policies are best-suited to the needs of a particular firm's professionals.

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