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White Paper

*Disability Income Insurance*

[www.selectportfolio.com](http://www.selectportfolio.com) • Toll Free 800.445.9822 • Tel 949.975.7900 • Fax 949.900.8181

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# Disability Income Insurance

## What is disability income insurance?

Disability income insurance is insurance that pays benefits when you are unable to earn a living because you are sick or injured. Like all insurance, disability income insurance is designed to protect you against financial disaster. Most disability policies pay you a benefit that replaces part of your earned income (usually 50 percent to 70 percent) when you can't work.

**Example(s):** Lola, Lorraine, and Leslie were friends who never expected to become disabled. One day, however, Lola broke her leg in a car accident and wasn't able to work as a dance instructor for five months. Because she didn't have disability insurance, she fell behind on her mortgage payments, and the bank threatened to foreclose on her house. A few days later, Lorraine became ill and couldn't work for weeks. With no disability insurance, she was forced to rely on her family for support. Fortunately, Leslie was prepared. She had purchased a disability insurance policy. When she suffered a stress-related heart attack, her disability benefits allowed her to pay her expenses while she recovered.

## Who needs disability insurance?

### The odds are ... you do

Your chances of being disabled for longer than three months are much greater than your chances of dying prematurely. One reason for this is that medicine has made treatable many illnesses and injuries that formerly would have killed you. Although this is good news, it increases your need to protect your income with disability insurance.

### Working individuals

What would happen if you suffered an injury or an illness and couldn't work for days, months, or even years? If you're single, you may have no other means of support. If you're married, you may be able to rely on your spouse for income, but you probably also have many financial obligations, such as supporting your children and paying your mortgage. Could your spouse really support both of you? In addition, remember that you don't have to be working in a hazardous position to need disability insurance; accidents happen not only on the job but also at home, and illness can strike anyone. Everyone who works and earns a living should consider purchasing disability income insurance.

**Example(s):** Bob worked as an accountant, a relatively nonhazardous occupation. However, on Christmas Day, he broke both wrists when he slipped and fell on a patch of ice. Since his injury was not work-related, he was not eligible to receive workers' compensation insurance. In addition, he was not covered by an individual or group disability policy. His wife was working

full-time as a seamstress but was not able to support Bob and their children on her salary alone. Within a few weeks, they were in financial trouble.

**Caution:** If you work part-time, work in a hazardous occupation, or are self-employed, you may have a hard time buying a private disability policy. If you can purchase one, it will likely be expensive. You may have to rely on your group employer or association issued disability policies. (See Questions & Answers.)

## Nonworking individuals

If you don't work because you took an early retirement, or you live off your investments, you may still need disability income insurance. Although your income may remain constant after you get sick or hurt, your expenses may rise dramatically. You may need round-the-clock medical care or part-time help, and you may need special equipment. In addition, you may need to pay high medical insurance deductibles. If you don't have enough income or savings to meet those needs, you may financially burden your family. Many policies may not pay benefits, however, unless a disability results in a loss of income.

**Caution:** You may find it difficult or impossible to buy an individual disability policy that will pay benefits if you don't work because disability income insurance is designed to replace the income you lose as a result of not being able to work and maintain your current lifestyle. In addition, in the eyes of the insurance company, you have no financial reason to get better; after all, your income stream from investments won't change. Your only option may be to buy an association policy (if available) or to buy a policy before you retire (unless disability benefits end at retirement). Even if a disability income policy is available to you, you should read it carefully to determine whether it will pay benefits to an individual who is not working at the time the disability occurs.

## Business owners and employers

If you own a business, disability insurance can protect you in several ways. First, you can purchase an individual disability policy that will protect your own income. Second, you can purchase key person insurance designed to protect you from the impact that losing an important employee will have on your business. Third, you can purchase insurance to fund a salary continuation program that will help you reduce your income taxes while protecting key employees at the same time. Fourth, you can purchase business overhead expense insurance to ensure that if you get sick, your business will stay healthy. Finally, you can purchase a disability insurance policy that will enable you to buy your partner's business interest in the event that he or she becomes disabled. See Disability Insurance: Business Applications for more information.

## Types of disability insurance

In general, disability insurance can be split into two types: private insurance (individual or group policies purchased from an insurance company) and government insurance (social insurance provided through state or federal governments).

### Private disability insurance

Private disability insurance refers to disability insurance that you purchase through an insurance company. Many types of private disability insurance exist, including individual policies, group policies, group association policies, specialized group policies, and riders attached to life insurance policies. Depending on the type of policy chosen, private disability policies usually offer more comprehensive benefits to insured individuals than social insurance. Individually owned policies may offer the most coverage, followed by group policies offered by an employer or association.

### Government disability insurance

Workers' compensation and Social Security are two well-known government disability insurance programs. In addition, some states, including California, Hawaii, New Jersey, New York, and Rhode Island, along with Puerto Rico, have mandatory disability insurance programs that provide disability benefits to resident employees. If you are a civil service worker, a military service member, or other federal, state, or local government employee, there are many disability programs set up to benefit you. In general, however, government disability insurance programs are designed to provide limited benefits under restrictive terms, and you should not rely upon them (as many people do) as your main source of income if you are disabled. For more information on this topic, see Government-Sponsored Disability Income Insurance Programs.

## How does disability income insurance work?

### You become disabled

What does being disabled mean? If you've ever seen an apparently healthy man or woman park in a handicapped spot at the mall, you know that a person can be disabled without using a wheelchair or showing any outward signs of illness. Any disease or injury that is severe enough can cause disability. For insurance purposes, being disabled means having a mental or physical condition that impairs (either permanently or temporarily) your ability to work. In general, to be considered disabled enough to receive insurance benefits, your condition must be medically certifiable, expected to last for a certain period of time, and (depending on the policy or type of insurance) impair your ability to do your own job, any other job, or both.

**Example(s):** Elise is an architect. She develops muscle spasms and is no longer able to write, draw, or use a computer. As a result, her insurance company covers her disability because her

physician reports that she is unable to perform any duties of her occupation for at least six months while she undergoes therapy.

**Caution:** Government disability insurance definitions may be much more restrictive than private insurance definitions of disability. For example, to receive benefits under workers' compensation, your sickness or injury must be work-related. When reviewing what coverage you may be entitled to if you become disabled, pay close attention to how the insurance policy or source defines disability.

## You apply for benefits, then wait

Once you become disabled and apply for benefits, you have to wait for a certain amount of time after the onset of your disability before you receive them. If you are applying for benefits under a private insurance policy, this amount of time (called the elimination period) ranges from 30 to 720 days, although the most common period is 90 days. If you are applying for benefits under a type of social insurance, your waiting period may be over six months (for Social Security). After you satisfy the elimination period, you will begin receiving a monthly disability benefit that usually replaces 50 to 70 percent of your earned income.

## You receive benefits, but not usually forever

You can purchase private disability insurance policies that guarantee lifetime coverage, but they are very expensive. Most people buy either short-term policies (benefits are paid for up to two years) or long-term policies that pay benefits up for a few years or up until age 65. In fact, many injuries or illnesses do not disable you permanently; you may be able to go back to work full-time after a rehabilitation period or return to work part-time. Most private and social insurance programs encourage you to go back to work either by paying you partial or full benefits while you try to work or by continually reevaluating your disability. In addition, they usually pay for any training or rehabilitation you might need to help you get back to work.

**Example(s):** Clark is seriously hurt. He begins receiving Social Security disability benefits five months after his accident. One year later, he wants to go back to work, but isn't sure he can make a living as a carpenter anymore. According to work incentives established by the Social Security Administration, Clark is able to go back to work for a nine-month trial period without losing any of his benefits. At the end of that period, Clark found that he could resume his career as a carpenter, and his disability benefits ended.

## Strengths of disability income insurance

### Can protect a disabled person from financial ruin

Typically, people buy property and casualty insurance to protect their possessions (houses, cars, and furniture) and life insurance to provide income for their survivors. However, many people don't think

about protecting their income with disability insurance. But how well could you live without your income? Disability is an unpredictable event, and if you become disabled, your ability to make a living will be restricted, at least for the short-term. Although you may have enough money in the bank to meet your short-term needs, what would happen if you were unable to work for months, or even years? The real value of disability insurance lies in its ability to protect you over the long haul.

## Individual policies can be tailored to meet individual needs

Although government disability insurance programs are generally inflexible because they are designed to meet the needs of the masses, private individual policies can be tailored to meet your needs.

**Example(s):** Mr. Mason has adequate savings to meet his income needs for six months in the event he becomes disabled, so he buys a disability insurance policy with a 180-day elimination period that will pay him benefits for two years. However, his next-door neighbor Mr. Dixon wants his disability benefits to begin sooner and last longer, so he buys a policy with a 30-day elimination period that will pay him benefits until he is age 65, if necessary.

## Tradeoffs of disability insurance

### Individual policies can be expensive

Ask anyone why he or she doesn't own an individual disability income insurance policy, and you're likely to hear this answer: "Because it's expensive!" Although you pay for government insurance through your taxes and your employer may pick up part of the cost of a group disability policy, quality individual disability policies cost a lot more money. You can try to lower the cost of an individual policy by reducing the benefit period, increasing the elimination period, or getting rid of features that you originally wanted. However, if you do this, you may end up with a policy that doesn't meet your needs. For more information on purchasing individual disability insurance, see Ten Ways to Lower the Cost of Disability Income Insurance.

### Disability claims can be hard to evaluate

If you get in a car accident, your insurance company will want a copy of the police report as proof of damage, and you'll receive a check in a few days or weeks. If you die, your insurance company will ask your beneficiary for a copy of your death certificate, and your claim likely will be paid quickly. If you become disabled, however, not only will you have to prove that you actually got hurt or got sick, but you'll have to prove that your injury or illness is expected to outlast your elimination period. This means that your disability will have to be certified by a physician, and you'll have to wait (sometimes for months) before you receive any money from the insurance company. In addition, while some claims are easy to evaluate, some are more difficult, especially mental illness claims.

## Disability insurance is complex

Both private and government disability insurance are complex because the needs of humans are complex. In addition, injury or illness is unpredictable. As a result, governments and insurance companies have designed insurance programs with many restrictions and--in the case of individual disability insurance, at least--many options. When you purchase a disability policy, you may have to spend a lot of time evaluating your future needs and weighing what coverage you can afford to buy against what coverage you'd like to have. Then, you'll have to compare individual policies and determine what coverage you are already entitled to through your employer or through the government. For more information on this subject, see [Evaluating Disability Income Insurance Policies](#).

## Questions & Answers

### **If you begin receiving Social Security disability benefits, why do you receive a reduced benefit from your individual disability income insurance policy?**

Disability insurance is designed to protect your earned income, not to pay you extra income in the event you become disabled. Because insurance companies know that you may (but often do not) collect other disability benefits, they usually give you the option of buying a rider (in your case, a Social Security offset rider) to your policy that will pay extra benefits to you before benefits begin or if Social Security denies your claim. However, if you do receive Social Security benefits, your policy benefit will be reduced proportionately.

### **If you are self-employed or work part-time, why is it difficult to purchase disability income insurance?**

If you are self-employed, you may have a hard time buying a disability income insurance policy if you haven't been working very long or if you have inconsistent earnings. This makes your risk of disability--and the amount of income you need to replace--difficult to determine, and you may pose a higher risk to the insurance company as a result. However, once you've been established for two to three years and can show earnings over a certain amount (usually \$12,000 per year at the minimum), you should be able to qualify for disability insurance. If you work part-time, you may find it difficult to buy a policy because many insurance companies require that you work more than a certain number of hours to qualify for disability insurance, as well as earn more than a certain amount annually. For more information on disability insurance underwriting, see [Surviving the Underwriting Process when Buying Disability Income Insurance](#).

# How Disability Income Insurance Contracts Define Disability

## What is it?

When you purchase disability insurance, you should pay close attention as to how the policy defines disability. Not only will the disability definition determine, in part, how much the policy will cost, but it will also determine how you can qualify for disability benefits. In general, to be considered disabled, you must be unable to work and earn income; however, many policies narrow down this definition quite a bit. They may specify whether you must try working in another occupation if you can't do your own job, or they may pay benefits if you can do some but not all of the duties of your own occupation. Other policies aren't concerned with occupation at all; they consider you to be disabled when, because of illness or injury, you experience a loss of earnings.

## Total disability coverage

Disability policies that pay benefits according to an occupational definition of disability are called total disability policies. You qualify for benefits under these policies if you are totally unable to work and earn income. Several types of total disability coverage exist: own occupation coverage, any occupation coverage, split definition coverage, and presumptive disability coverage.

## Own occupation coverage

In general (see note below), an own occupation policy defines disability as the inability to perform the usual and customary duties of one's own occupation. This is a liberal definition of disability, because even if you can work in another occupation, you will still receive disability benefits. Because it is relatively easy to qualify for benefits under this definition of disability, insurance companies are limiting the availability of own occupation coverage, either by making it extremely expensive or by restricting coverage to individuals that are unlikely to file a claim.

**Example(s):** Cynthia was an artist who purchased own occupation disability coverage. When she developed carpal tunnel syndrome in her right hand (the one she used to sketch with), she began receiving disability benefits because she was unable to perform the duties of her own occupation. Even though she went to work selling real estate a few months after she began receiving benefits, her ability to work in another occupation did not affect her eligibility for disability benefits, and she continued to receive them for another year.

**Tip:** The terminology used to define disability will vary from policy to policy.

## Any occupation coverage

An any occupation policy defines disability as the inability to perform the duties of any occupation. This definition of disability is strict; to receive benefits according to this definition, you have to be unable to work in any gainful occupation, not just your own. Occasionally, however, the wording is modified to take into consideration your earnings level, education, training, and experience.

**Example(s):** Audra bought an insurance policy that defined disability as the inability to perform the duties of any occupation for which she was reasonably suited by reason of her education, training, or experience. A few weeks later, she suffered a heart attack and was unable to continue practicing law. Because she loved to teach, she began teaching at a local college. However, she no longer continued to receive disability benefits.

## Split definition coverage

Many disability policies incorporate both an own occupation definition of disability and an any occupation definition. You purchase a policy that provides own occupation coverage for a limited period of time, then after this period ends, you must meet the any occupation definition of disability in order to continue receiving benefits. This is sometimes known as short-term own occupation coverage.

**Example(s):** Stephen bought an insurance policy that used a split definition of disability to determine when benefits would be paid. When he was hurt in a car accident and was unable to go back to his teaching job, he found a telemarketing job and continued to receive disability benefits. Two years later, when the own occupation disability coverage period ended, Steve's disability benefits ended because he was able to work as a telemarketer and didn't meet the stricter any occupation definition of disability that now covered him.

## Presumptive total disability coverage

No matter how your insurance company defines total disability, most companies automatically consider certain catastrophic ailments to be totally disabling. If you are disabled by one of these ailments, you won't have to meet the conditions normally required in order to be considered totally disabled. In addition, not only will you receive immediate benefits, but you will continue to receive benefits even if you are able to return to work. These ailments (which may be caused by injury or illness) are the loss of sight in both eyes, of hearing in both ears, of speech, of the use of both hands, of the use of both feet, and of use of one hand and one foot.

## Residual disability coverage

Traditional total disability policies pay benefits in the event that you are totally disabled and can no longer work. However, a newer type of policy called a residual disability or income replacement policy pays benefits according to how much income you have lost due to disability. These policies pay benefits even if you are not totally disabled and can work part-time. Your benefit will be based on the

percentage of income you earn working part-time in relation to what you used to earn working full-time. In general, to qualify for benefits, your earnings have to be at least 20 percent less than your pre-disability earnings. Residual disability is often long-term coverage, especially if your policy requires a period of total disability first.

**Example(s):** Craig suffered anxiety attacks and was unable to work as a full-time stockbroker. However, he was able to go back to work part-time. Under the terms of his residual disability contract, he was able to receive partial disability benefits because he was earning only 40 percent of his average earnings in the 12-month period that immediately preceded his disability.

**Tip:** Some confusion surrounds residual disability coverage. In the past, it was primarily available as a rider to a total disability policy, and you were required to be totally disabled before you were eligible for residual disability benefits. Today, however, you can also purchase residual disability coverage as a stand-alone policy, and you can receive disability benefits even if you never suffer a total disability. Some policies combine both types of coverage in the base policy or offer one as base coverage and the other as add-on coverage.

## Partial disability coverage

Partial disability coverage is usually offered as an optional rider to a total disability policy, although it may be included in base coverage. It is similar to, but not the same as, residual disability coverage. Both types of coverage provide benefits to you if you return to work after a period of total disability and pay benefits if you can perform some but not all of the duties of your occupation. However, unlike residual disability, a partial disability definition does not consider loss of income. Rather, you will be paid an amount equal to 50 percent (occasionally less) of the benefit that you would earn if you were totally disabled. In addition, the benefit period is much shorter than that for residual disability (a few months or a year at most).

**Example(s):** Alan bought a total disability insurance policy and purchased an optional rider that paid partial disability benefits. He suffered a disabling injury and for 18 months was unable to work at all. During this period, he received a monthly benefit of \$1,000. Finally, he recovered enough to go back to work part-time, and he began to receive a reduced benefit of \$500. He continued to receive this benefit until he fully recovered.

## What types of disabilities does the policy cover?

Disability insurance contracts further limit disability definitions by narrowing down types of coverage. Most policies offer coverage for both injuries and illnesses and pay benefits no matter where you were disabled. Some policies, however, offer accident-only protection and don't cover work-related injuries or illnesses, because work-related disabilities are covered by workers' compensation. For more information on this subject, see Workers' Compensation.

## Injury

Most disability policies define injury as accidental bodily injury. The term accidental, however, doesn't necessarily mean that an accident caused the injury. It may simply mean that the injury was not sustained intentionally or while the insured was doing something that would knowingly cause the injury. You can buy a disability policy that only covers accidental injuries and not sickness.

## Sickness

Sickness is defined in disability policies as illness or disease that manifests itself while the policy is in force. This definition covers mental illness as well as physical illness. Knowledge is key here; you may have a preexisting condition, but you might not know it, or a medical exam might not reveal it. Most disability policies cover both sickness and accidental injury; policies that cover only illness are not widely available.

If you are interested in an insurance product that offers specific protection against major illnesses, consider critical illness insurance. This type of health insurance policy pays benefits when you are diagnosed with one of many serious illnesses, such as a heart attack, a stroke, and cancer. It can be purchased as a separate policy or as a rider to an existing policy.

## Occupational

Injury or sickness can either be occupational or nonoccupational. An occupational injury or sickness is caused by one's job and is related to that job. To be eligible for benefits under this definition, your injury or sickness must be work-related. These types of disability are covered under workers' compensation, so sometimes they are excluded from group disability insurance contracts. Individual disability insurance contracts may pay you benefits, but these benefits may be offset according to the terms of a social insurance rider.

## Nonoccupational

A nonoccupational injury or sickness is unrelated to one's job and occurs away from one's place of business. Nonoccupational coverage is much more liberal than occupational coverage and often implies 24-hour benefits. This means that if you get injured, either away from home or on the job, your disability insurance will pay benefits.

## Disclosures

This material does not constitute the rendering of investment, legal, tax or insurance advice or services. It is intended for informational use only and is not a substitute for investment, legal, tax, and insurance advice.

State, national and international laws vary, as do individual circumstances; so always consult a qualified investment advisor, attorney, CPA, or insurance agent on all investment, legal, tax, or insurance matters.

The effectiveness of any of the strategies described will depend on your individual situation and on a number of other factors. After reviewing your personal situation, we may recommend that you not use any strategy in this document but instead consider various other strategies available through our practice.

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