



COMBINED INSURANCE COMPANY OF AMERICA

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A CLOSE LOOK AT DISABILITY INCOME INSURANCE

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CONTINUING EDUCATION ON THE WEB
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WHAT IS DISABILITY INCOME INSURANCE?

The Insurance Dictionary defines disability income insurance in the following manner:

“A form of health insurance that provides periodic payments under certain conditions when the insured is unable to work as the result of illness, disease or injury.”

In Loma’s Principles of Life and Health Insurance, the term Disability Income is described in the following manner:

“Disability income coverage provides a specified income benefit when an insured person becomes unable to work because of an illness or an accidental injury.”

While the terminology is different, essentially the definition of disability income insurance is the same.

Disability Income Insurance simply put, is income replacement protection in the event of an income loss when disabled as the result of an accident or sickness.

To carry this definition one step further, disability income insurance is income replacement protection against the loss of earned income while disabled.

Earned Income is income from active employment such as gross salary, wages, net income of self-employed individuals, in essence earned income is any form of income generated through employment.

In some situations, unearned income if substantial and if it continues after disability, may be taken into consideration by the insurer. Unearned income includes rental income, investment and pension income, as well as income from a trust.

The term Disability Income Insurance can also be referred to as Income Protection, Income Replacement, Loss of Time Insurance, Loss of Income, or a wage Loss Replacement program.

PURPOSE OF DISABILITY INCOME INSURANCE

Our ability to work and earn an income is one of the most important assets we have during our income-generating years (normally between the ages of 18 to 65). Unfortunately, our chances of being disabled during our working career are substantial.

Statistics show that prior to age 65, the chances of being disabled for three months or more are significant.

What are your chances of becoming disabled for a period of more than 90 days before you reach the age of 65? The following table shows your chances of being disabled more than 90 days, and the average duration of your disability if it does indeed exceed 90 days.

IT COULD HAPPEN TO YOU!

Your Age	Chances of Being Disabled (past 90 days)	Average Duration of Disability (past 90 days)
25	58%	1.2 years
30	54%	2.5 years
35	50%	2.8 years
40	45%	3.1 years
45	40%	3.2 years
50	30%	3.1 years
55	25%	2.6 years
60	14%	1.6 years

Source: Commissioner's IDA Morbidity and Commissioner's SO Mortality Tables, Society of Actuaries.

POINTS TO CONSIDER:

What would happen to you if unable to work as the result of an accident or sickness?

From the above chart, what are your chances of being disabled for 90 days or more prior to age 65?

Based on the above chart, on average, what length of time would you be disabled?

How long could your current standard of living be maintained?

Could you meet mortgage or rent payments?

What about all your other fixed monthly expenses?

TYPES OF INDIVIDUAL DISABILITY CONTRACTS

There are three basic types of individual disability accident and sickness contracts sold by insurance companies. A complete understanding of the characteristics of each contract is a necessity. These contracts are identified as:

- **Cancellable (also known as Commercial)**
- **Guaranteed Renewable**
- **Non-Cancellable and Guaranteed Renewable**

THE CANCELLABLE CONTRACT

The insurer reserves the right to make changes to both the premiums paid by classification and the coverage purchased by the insured from one premium due date to the next. If the insurer's claims exposure is high in relationship to premiums collected, the insurer might:

- Cancel the policy
- Increase the premium
- Add restrictive conditions (riders)

Because of the lack of guarantees found in cancellable contracts, premiums initially are very low.

THE GUARANTEED RENEWABLE CONTRACT

This type of contract offers the insured better protection and coverage because the insurer is legally obligated to:

- Maintain the coverage as outlined in the policy; and
- Has to renew the contract annually.

The contract is guaranteed to be renewed to a specified age, generally age 65, but it could be earlier or later.

However, the insurer does reserve the right to change the premium amount, for example, if the claims paid exceed their reserves.

If this occurs, the insurer will modify the premium for an entire class of insured and not just for those individuals who file numerous claims.

Examples of a class of insured are everyone who bought the policy in the province of Ontario (by province) or by occupation, all professional engineers who bought the policy. However, recognize the insurer can increase the premium in any number of ways by classification.

The term **classification** is very broad in nature and as mentioned can be referred to a particular occupational group.

Of importance a grouping, which is not discriminatory in nature, may be used by an insurance company as a classification when considering a rate adjustment. Examples of categories could be groups based on the year the policy was issued, groups that purchased a Return of Premium rider on groups with a common elimination period or benefit period.

A Similarity Between Cancellable and Guaranteed Renewable Policy

While a Guaranteed Renewable contract provides better coverage (i.e. it can't be cancelled by the insurer, nor can the insurer add restrictive conditions), the commonality these two contracts have is that if premiums are increased, the rate increase is by classification.

THE NON-CANCELLABLE GUARANTEED RENEWABLE CONTRACT (NON-CAN)

This contract offers the best degree of protection to the insured. With a contract of this type the insurer cannot

- Increase the premium
- Cancel the policy
- Change the coverage
- Add restrictive conditions (riders)

In the absence of fraud or misrepresentation of facts, the insurer is legally obligated to live up to all the terms and conditions of the contract. The insured's only obligation is to pay the premiums by a specified time.

These contracts generally provide protection to age 65 and because the insurer cannot make any changes once the policy is issued, Non-Cancellable contracts require stringent underwriting by the insurer. Premiums charged for Non-Cancellable policies are more expensive than cancellable or guaranteed renewable contracts because they offer the best protection.

The Parties To A Disability Income Contract

It should be understood that when a Disability Income contract is purchased, the insured is purchasing a policy to provide ongoing benefits in the event the person insured becomes totally disabled.

Unlike life insurance, there is no need to name beneficiary. The only time that a beneficiary designation is required is when an Accidental Death and Dismemberment rider is added to the basic contract or if a Return of Premium at Death provision is a feature included in the contract.

In essence, a Disability Income policy is generally a contract between the following parties:

- The insured – the owner of the contract.
- The person insured – the person whose information the contract is based on.
- The insurer – the insurance company.

In most instances, the insured and person insured are the same person. However, there are situations where the insured and person insured are different parties. An example would be a corporation taking out a Disability Income contract on a key person.

In this scenario:

- The insured would be the corporation.
- The person insured would be the key person
- The insurer is the insurance company issuing the contract.

DEFINITIONS OF TOTAL DISABILITY

How the term “**Total Disability**” is defined in an individual disability contract is one of the most important features of the contract. It determines whether or not the insured will receive benefits when the person insured is disabled as the result of an accident or sickness. In common use today are the following definitions of “**Total Disability**”.

Any Occupation

Any Occupation is an extremely stringent definition of total disability. If the person insured is unable to engage in any occupation for which one is reasonably fitted by education, training or experience, the insurer will pay the benefit.

The problem is that strict adherence to the definition could result in very few individuals qualifying for disability income benefits.

Regular Occupation

This definition specifies that if the person insured is unable to perform the important duties of one’s regular occupation and is not gainfully employed in another occupation, the insurer will pay the stated benefit.

Own Occupation

This definition states that if the person is unable to perform the important duties of one’s regular occupation, the insurer will pay the stated monthly benefit. The monthly benefit will continue to be paid even if the person insured is working in another occupation.

The own occupation definition is not offered to all occupations, only to preferred risks such as lawyers, accountants and white-collar workers at the management level.

Note the distinction between regular and own occupation. The definition of total disability is the same, however working in another occupation will result in the termination of benefits, if the definition of disability is regular occupation, while benefits will continue with the own occupation definition of total disability.

Both any and regular occupation definition of disability are frequently found in the same policy.

The following is an example of this:

“Totally Disabled” or “Total Disability” means the inability to perform the substantial and material duties of the insured’s occupation. After the Insured has been totally disabled 24 months, “Totally Disabled” or “Total Disability” means the inability to perform any job for which he or she is qualified by reason of training, education or experience.

Regarding the payment of premiums, logically the better the definition of total disability, the higher the premium.

Accordingly, premiums increase in the following manner:

- **Any occupation** Costs the least because the definition of total disability could result in no benefit being paid.
- **Regular occupation** Costs more because if unable to perform the important duties of one’s regular occupation, benefits will be paid. However, if working in another occupation, depending on the policy the benefits will be reduced or no benefits will be paid at all.
- **Own occupation** The most expensive. The definition of total disability is identical to regular occupation, however if working in another occupation, benefits will still be paid.

Most individual contracts issued today provide a regular occupation definition of disability for the first two years of disability, reverting to any occupation after two years.

EXAMPLE

Dr. Jeff Levine, a dentist, was involved in a horrible car accident resulting in the loss of both his arms. He can no longer practice dentistry.

Because Jeff’s injury prevents him from performing the important duties of his regular occupation, the insurer will pay the benefits for the first two years on claim.

After two years however, the insurer has the ability to stop the benefit payments as the definition has reverted from regular occupation to any.

If Jeff had an own occupation definition of disability included in his policy, benefits would continue for the life of the contract, regardless of whether Jeff was working or not.

DISABILITY BENEFIT PERIODS

A disability income policy will stipulate the maximum benefit period, that is, the maximum period of time over which payments will be made during a period of disability.

It is important to distinguish between benefit periods pertaining to individual Accident and Sickness coverage and group A&S coverage.

For purposes of individual coverage, a short term disability income policy is traditionally defined as a policy that provides a benefit period of under two years whereas a long term disability income policy provides a benefit period of more than two years, often until age 65.

In group insurance however, a short term disability income benefit is usually paid for a matter of weeks such as 13, 26, 37 or 52. Group Insurance benefits will be discussed in a later module.

THE IMPORTANCE OF OCCUPATIONS WHEN SELLING A DISABILITY INCOME POLICY

What a person does for a living is critical when applying for a disability income policy. Occupational activities can have an impact on the premiums charged, the type of policy available and the length of benefit period an insurer is prepared to offer. Of major importance, the higher the occupational classification (4A) the lower the premium. Stated another way, an Accountant (4A) is going to pay far less for identical coverage than a Class A, a plumber. In addition, the insurer generally will offer a longer benefit period to the better risks such as 4A, 3A than to a poorer risk Class A.

We include an example of how occupational classification are determined by an insurer.

Class 4A

This class includes most professionals and certain executive occupations requiring significant education, training and experience, such as chartered accountants, dentists, lawyers, engineers, and corporate executive (white-collar in major decision-making capacity).

This class of individual provides the insurer with less risk than any other category; consequently the premium paid for coverage is much less than a lower category. In addition, benefit periods are much more attractive.

Class 3A

This class includes professionals, management individuals, and most white-collar workers in non-hazardous occupations who work full-time in an office and who might do some travelling. Generally not at the ownership level as most 4A's are. Examples include programmer, teacher, secretary, bookkeeper, or librarian.

Class 2A

This class involves occupational activities without danger, however involving more physical activity than those found in the 4A and 3A category. Examples include salesperson, registered nurse, and locksmith.

Class A

This class involves individuals who are involved in light manual labour, skilled or unskilled in areas that involve little danger. Examples include an electrician, plumber, baker, or stationary engineer.

Class B

This class includes individuals who participate in moderate to heavy manual labour involving a high risk of accidents. Examples include ambulance drivers, landscaper, bricklayer, crane operator, and unarmed security guards.

The length of benefit periods offered varies depending on the occupation of the person insured. For example, the chances of a bricklayer being permanently disabled due to an accident are much greater than for an accountant.

For this reason, an insurance company would be reluctant to offer a bricklayer age 25 a benefit period to age 65, whereas a benefit period "to age 65" for an accountant may be offered.

ELIMINATION PERIOD **ALSO REFERRED TO AS WAITING PERIOD**

To help reduce the premium cost to the insured and make the coverage more affordable, disability income policies are sold with an elimination or waiting period.

The elimination period is the period of time that must elapse before the person insured is eligible to receive benefits under their disability income contract. In essence, it is a period of “self-insurance”.

Depending on the insured’s specific needs, the elimination period may vary from 15, 30, 60, 90, 120, 365 days and even longer.

The longer the elimination period, the lower the premium, and the shorter the elimination period, the higher the premium.

Major differences exist within the insurance companies concerning the actual definition of the elimination period. For example, one contract might stipulate the elimination period will be the number of consecutive days of total disability while another might allow the accumulation of total disability over a specific period of time.

The following are actual definitions of the elimination period found in various disability contracts.

“Elimination Period” means the number of consecutive days the Insured must be totally disabled before benefits begin.

“Elimination Period” is the minimum number of days of disability which must elapse during a Period of Disability before any benefits are payable. Non-consecutive Periods of Disability, which result from the same, or a related cause, and which are separated by 12 months or less, will be accumulated and deemed continuous for purposes of the elimination period.

COMMON METHODS TO ESTABLISH AMOUNT OF DISABILITY **INCOME BENEFITS**

Every insurer has limits as to the amount of disability insurance they are prepared to issue based on the applicant’s

- Earned income from employment
- Amount of disability insurance already purchased

Unlike life insurance, where the amount of coverage which can be purchased is unlimited (subject to underwriting approval), when applying for a disability income policy, the risk to be insured is loss of income from employment, consequently, insurers impose a maximum limit on the amount of disability income an applicant can purchase; an amount less than earned income so there is an incentive for the applicant to return to work as soon as possible.

All insurers provide agents with what are known as Issue and Participation Limits. These are tables, which provide specific guidelines as to the maximum amount of disability coverage the insurer is prepared to offer.

Issue and Participation limits are for the most part, based on the individual's earned income and generally range from 60% to 75% (to prevent over insurance), but the percentage amount can be higher if the benefits applied for are taxable to the individual at the time of disability.

Simply stated, in order to sell a disability income policy, the agent must know what the person's earned income is in order to determine the maximum amount of disability insurance available.

In addition, before selling a policy, the agent has to take into account what amount of disability income the individual has already purchased.

Specifically, the agent has to find out the following:

- Amount of individual disability income coverage currently owned.
- Amount of short term/long term group disability income coverage currently held.
- Whether any individual disability income coverage has been added to an existing life insurance policy.

Once these factors have been determined, then and only then can the agent sell an individual the appropriate amount of coverage, as set by the insurer.

From the foregoing, it should be evident that the definition of earned income is extremely important in the determination of disability coverage the insurer is prepared to offer.

If employed, earned income is salary or wages earned before the payment of income tax, in other words, the employee's gross income. In addition, bonuses if paid on a regular basis and taxable benefits are also taken into account.

If an individual is on commission, earned income is gross commissions less business expenses, in other words net income, prior to the payment of income tax.

If operating as a sole proprietorship, earned income is net business income (i.e. gross earning minus business expenses).

In the case of a partnership, earned income is net income multiplied by the partner's percentage income.

Other factors which can impact the amount of disability income an insurer is prepared to offer include the following:

- Age
- Sex
- Health
- Lifestyle
- Unearned income
- Occupation
- Family history
- Hobbies
- Pre-existing conditions

INSURABLE EARNINGS – THE UNDERWRITER’S APPROACH

Earned Income

For many disability income insurance applicants “earned income” is the amount of salary they receive from an employer. For those who are not employees, however, but are sole proprietors or major shareholders in a closely-held corporation, the determination of earned income is more involved. A sole proprietor or major shareholder may receive a salary from the business while in fact he or she is responsible for the net revenues earned by the business.

Example

Shirley pays herself a salary of \$30,000 a year from her interior design business. Over the last five years the business has generated annual gross revenues of \$250,000 and net revenues after expenses of \$200,000. In considering her earned income, an insurer will look at the net revenues of the business and not the “salary” that she takes from the business. It is the business revenues that are in jeopardy if Shirley becomes disabled and the disability plan should address the replacement of net revenues as much as possible based on the insurance company’s issue limits for Shirley’s occupation class and other coverage features, such as elimination period and benefit period.

In addition, the underwriter might take into consideration bonuses received over a period of time (i.e. the last 3 years). As bonuses are not guaranteed, the insurer generally uses an average of the bonus over this period, instead of the specific sum paid in the last bonus period.

Unearned Income

If an applicant for disability income insurance has a source of income that will continue whether or not he or she is disabled the insurer will consider that resource when considering the level of coverage it is prepared to offer.

Example

Roberto is an investment consultant who earns \$100,000 a year from his consulting business. He has also established a personal investment portfolio that generates dividend and income payments of \$25,000 per year. If the insurer was prepared to issue Roberto a disability income policy with a monthly benefit of \$6,000 based on his earned income, it may reduce the benefit to perhaps \$4,500, given the level of investment income he is receiving.

Other Insurance Plans

An applicant for disability income insurance may also have existing disability income insurance in force. The insurer will also take that coverage into consideration.

Example

If Roberto, introduced in the previous example, has an individual policy or group disability insurance in effect, the insurer will consider it. Roberto declares on his application for disability income insurance that he is covered for \$1,500 of monthly income under a group insurance plan with his employer. The insurer will most likely reduce the amount of coverage it is prepared to offer, to perhaps \$3,000 per month.

Government Insurance Plans

Continuing the premise that an individual should not have access to a higher level of income while disabled, than the income he or she is receiving prior to disability, the disability insurer will also factor in the government benefit plans under which the applicant is insured. The applicant may be entitled to short-term disability benefits under Employment Insurance as well as more comprehensive benefits under the provincial Worker's Compensation plan.

Example

Samantha works as an editor for a publishing company. She earns \$50,000 per year. She contributes to EI. But has access to no other type of disability insurance coverage. She has applied for an individual disability insurance policy. The insurer is prepared to issue \$2,500 of monthly benefit coverage, based on her earned income, but is also considering the fact that she is entitled to a short-term disability benefit under EI.

The insurer may offer her a policy with a monthly benefit of \$2,500 with a 120 day elimination period to offset the EI benefit, or it may offer a reduced benefit for the first few weeks of disability, increasing to the full benefit of \$2,500 after the EI disability benefit has been exhausted.

Example

Dora resides in British Columbia and works for Computers to Order, assembling personal computers. Dora earns \$40,000 a year. She is covered under the provincial Workers' Compensation plan. If Dora were to suffer a work related disability, she will be entitled to benefits that may approach 90% of her salary and those benefits may continue for a long time, depending on the severity of her disability. Dora has no other group or individual coverage in force on her life. She has asked her insurance agent if there is any coverage available to protect her if she suffers a disability away from the workplace. Her agent informs her that an insurer will offer her "non-occupational" coverage that provides benefits if she were to suffer an illness or injury away from the job. Dora applies to the insurer for individual disability income insurance and the insurer offers "non-occupational" coverage of \$2,000.

Insurance companies typically set the amount of disability income coverage as a percentage of the applicant's monthly earned income. If the plan is designed to pay any benefits on a tax-free basis, the coverage available will be based on a percentage of the applicant's monthly after-tax income. If the plan is designed in such a way that benefits are taxable, then the coverage will be based on the applicant's before-tax monthly income.

The insurer must be satisfied during the underwriting process that the coverage to be issued fairly indemnifies the applicant for the loss of earned income during a period of disability without providing as much or more in monthly benefits than the applicant is able to earn before disability.

In addition to an applicant's level of earned income, an insurance company will consider other financial factors that might have a bearing on the applicant's financial status.

The insurer may consider the applicant's other source of income such as investment or rental income as well as income from a trust that will not cease when the applicant becomes disabled. Again the applicant should not be better off financially after suffering a disability taking into consideration both earned and unearned income. The insurer may reduce the amount of disability income benefit it is prepared to issue because of the applicant's level of unearned income. A large net worth may have the same effect on the insurer's offer of coverage as well. Assets can be organized to provide an income stream that is not diminished as a result of the applicant's disability.

The insurer will also consider the amount of disability coverage that the applicant has in force and reduce the amount of coverage it is prepared to issue.

KEY TERMS

Issue and Participation Limits

All insurers have tables, which provide agents with the maximum amount of coverage that can be sold on the person insured's earned income.

Statutory Condition Number Four – Relation of Earnings to Insurance

Statutory Conditions will be discussed later in this course. However, this statutory condition is relevant to the topic.

In essence, it states that prior to selling an individual disability policy, the amount of coverage already owned personally, provided through group insurance coverage, or added to a life insurance contract must be taken into account.

Example

Harold Regan's earned income per month is \$7000. Currently, Harold owns a disability income policy that will pay him \$2000 per month after an elimination period of 30 days.

He also has another policy that will pay \$500 per month following an elimination period of 30 days. This was added to a life insurance policy many years ago.

He has indicated to his agent that he wishes to purchase additional insurance. The agent's first step is to go to the Issue and Participation Limits of the insurance company. The maximum amount of disability insurance that can be sold is 65% of his earned income. If the agent sells more than that amount, Harold is deemed to be over-insured and the possibility exists that if disabled, he might try to stay on claim as long as possible.

Maximum amount which can be sold is 65% of \$7000 = \$4550.

However, the agent has to relate to Harold's earned income the amount of coverage already owned – Statutory Condition #4.

As Harold already owns \$2500 of disability coverage, the maximum amount that can be sold is \$4550 - \$2500 or \$2050.

PROVISIONS INCLUDED IN AN INDIVIDUAL DISABILITY CONTRACT

WAIVER OF PREMIUM

A provision included in most disability income policies, which exempts the insured from the payment of premiums after being totally disabled for a stated period of time such as 90 days, 120 days, or six months.

Some insurance companies however provide that no premium payments are required as soon as the disabled individual is eligible to receive benefits while other contracts stipulate the payment of premiums for a stated period such as 60 or 90 days, at which time it is fairly common to refund the premiums that were paid during the stated period (Called Refund of Premium).

The following is an example of a Waiver of Premium provision found in an actual disability contract.

Waiver Of Premium

If the Insured is totally disabled for more than 90 consecutive days, the insurer will:

- (1) Waive the payment of premium for the first 90 days of total disability by refunding, if necessary, premium for the 90-day period.
- (2) Following the 90-day period, waive the payment of premium during the continuance of total disability until the end of the maximum benefit period.

It should be clearly understood that Waiver of Premium is built into the premium costs of a Disability Income Policy.

When purchasing a Life Insurance Policy waiver of premium can be added to the policy as an optional benefit rider.

PRESUMPTIVE DISABILITY

Presumptive Disability is a feature found in most individual disability contracts that states that total disability will be presumed if, due to sickness or an accident, the person insured sustains the complete and irrecoverable loss of:

- Eyesight
- Hearing
- Speech
- The use of both hands or both feet
- The use of two limbs (one hand and one foot)

If any of the above occurs, benefits available are payable without regard to the ability to work. In other words, if the insured can continue to work in any occupation, benefits will continue to be paid. Further, the continuous care of a physician is not a requirement in order to receive benefits.

The following is an example of the Presumptive Disability provision found in an actual disability contract.

Presumptive Disability

Presumptive Disability means the complete and irrecoverable loss of any of the following due to either sickness or injury.

1. The loss of speech.
2. The loss of hearing of both ears.
3. The loss of sight of both eyes.
4. The loss of use of both hands or both feet.
5. The loss of use of one hand and one foot.

If you are Presumptively Disabled you will be considered to be Totally Disabled regardless of your Earned Income or activity in any occupation, and even if you no longer require the regular care and attendance of a Doctor.

RECURRENT CLAUSE

This clause addresses an issue that occurs frequently, namely the person insured returning to work, followed by a recurrence of the disability.

Under this provision, a disability that reoccurs within a stated period of time, such as 6 or 9 months is considered to be a continuation of the original claim and a new elimination period would not have to be satisfied.

Being a continuation of the original claim, the benefit period would end in accordance with the original claim. For example, if an individual had purchased a policy with a 5 year benefit period, went back to work after having received 4 years of benefits, and suffered a recurrence after 2 months back on the job, then the maximum benefit entitlement would be for 1 year.

The importance of the recurrent clause is to ensure that the person insured is not penalized if he/she returns to work and becomes disabled again during the recurrence period. Without this provision, the person insured might be reluctant to return to work.

SUPPLEMENTAL BENEFITS

These are additional options that can be added to an Income Replacement policy to provide the insured with a greater degree of protection and benefits.

Also called “Optional Benefits” or “Riders”, these include:

- Future Insurability
- Cost Of Living Adjustment (Cola)
- First Day Hospitalization Coverage
- Lifetime Extension
- Accidental Death And Dismemberment
- Premium Refund
- Partial Disability
- Own Occupation Definition
- Residual Disability Benefits

A clear understanding of these riders and their use and application are of prime importance.

FUTURE INSURABILITY

An optional benefit, which guarantees the insured the right to increase his or her disability insurance coverage at, stated times in the future regardless of health or occupation. In order to take advantage of the option however, the insured must have sufficient income to justify the increase.

For example, Nelson Brady purchased a disability income policy five years ago when he was age 25. At the time of purchase, Nelson’s earned income was \$2000 per month, and he owned no disability income protection. He purchased the maximum amount of coverage permitted by the insurer, \$1200 per month (60% of his earned income). A future insurability rider was added to his contract.

Three years later, Nelson can exercise a future insurability option. His income has increased by \$1000 from the time of purchase and the rider allows him to purchase an additional \$600 per month regardless of his health or occupation.

Future insurability is offered to younger individuals and is generally not available to applicants over 50.

COST OF LIVING ADJUSTMENT (COLA)

An optional benefit that is designed to increase disability income benefits when the person insured has been on claim for a stated period of time such as six months or one year.

Each year, payments are increased by a stated percentage amount or an amount equivalent to the increase in the Consumer Price Index (CPI).

For example, one contract might indicate a maximum increase in benefits of 5% annually while another might have no maximums.

An increase in the cost of living could have a profound effect on a disabled person. If the cost of living were to increase at a rate of 6% over the next 10 years in order to maintain income requirements, a \$2000 per month disability income benefit would have to increase to \$3582 per month.

Recognize that most Canadians when disabled are living on a fixed monthly income and an increase in the cost of living could result in financial hardships.

A cost of living rider can reduce these financial problems.

FIRST DAY HOSPITALIZATION COVERAGE

Pays sickness or accident benefits from the first day of disability while confined to hospital.

With this rider the insured might receive a daily benefit of \$100, \$200, \$300 or more per day while hospitalized for a specified period of time. This benefit is not as popular as it once was due to the fact that hospital stays are much shorter than they were in the past.

LIFETIME EXTENSION

This rider provides that disability benefits will continue beyond the termination date of the contract, usually age 65, provided the disability occurs before that date. The benefit could be payable for life, provided the insured remains totally disabled.

Lifetime extension is not offered to all occupations, it is only offered to the best risks such as professionals and white-collar workers. In addition, in order to secure the rider, the benefit period of the individual policy should be "to age 65". This rider cannot be added to a policy with a benefit period of for example, two, five or ten years. The benefit period must be "to age 65".

ACCIDENTAL DEATH AND DISMEMBERMENT

Generally offered as a rider, an Accidental Death and Dismemberment benefit pays a lump sum specified amount if the insured dies, suffers irrecoverable loss of sight, or loses two limbs as the result of an accident. A lesser amount is payable for the loss of one eye, arm, leg, hand or foot.

The following is an example of an Accidental Death and Dismemberment Benefit:

ACCIDENTAL DEATH AND DISMEMBERMENT BENEFIT	
<p>We agree to pay you, the Insured named in the schedule or your beneficiary, subject to the following terms and conditions, the amount shown in the schedule of benefits for loss resulting from an accidental bodily injury which occurs while the policy is in force. The loss must occur within 365 days of the accident causing the injury and must result directly and solely from an accidental bodily injury.</p>	
Death	The Principal Sum
Dismemberment of Both Hands	The Principal Sum
Dismemberment of Both Feet	The Principal Sum
Loss of Sight of Both Eyes	The Principal Sum
Dismemberment of One Hand and One Foot	The Principal Sum
Dismemberment of One Hand and Sight of One Eye	The Principal Sum
Dismemberment of One Foot and Sight of One Eye	The Principal Sum
Dismemberment of One Hand or One Foot	One-Half the Principal Sum
Loss of Sight of One Eye	One-Half the Principal Sum
<p>Dismemberment means complete severance of the hands at or above the wrist or of the feet at or above the ankle. Loss of sight means the entire and irrecoverable loss of eyesight beyond remedy by surgical means or otherwise.</p>	

PREMIUM REFUND

An option that provides a refund of premiums paid at predetermined dates, less any benefits, if paid over the stated period of time.

The following is an example of a premium refund rider found in a disability income contract.

Return of Premium Benefit
<p>If the return of premium option is chosen in the application, and in consideration of the additional premium paid for this benefit, the Company will: after the policy is continuously in force for 20 consecutive years, return the premium paid for the policy less any benefits paid over the 20 year period.</p> <p>After the initial return of premium a new return of premium benefit period will begin and subsequent periods will begin at the end of each 20 years.</p> <p>This option terminates at the end of the return of premium period after the insured reaches age 55.</p>

PARTIAL DISABILITY

Provides a short term benefit for approximately six months with the amount of benefit totalling up to 50% of the total disability benefit when the person insured returns to work and is unable to perform one or more of the important duties of his or her occupation; **or** they can perform all the important duties of their occupation, but only on a part-time basis.

OWN OCCUPATION

This definition of disability is very rarely offered by insurers in a basic income replacement contract, rather it is offered as an optional benefit.

The definition states that if the insured is unable to perform the important duties of one's regular occupation, the insurer will pay the stated monthly benefit, and the monthly benefit will continue to be paid, even if the person insured is working in another occupation.

The own occupation definition of disability is only offered to specific occupations, mainly to professionals and white-collar workers. It is not offered to higher risk occupations such as electricians and construction workers.

RESIDUAL DISABILITY BENEFITS

An accident or a sickness does not necessarily result in the person insured being totally disabled. Because of this, most insurance companies provide what is known as a Residual Disability Benefit option. This provides the disabled person with partial benefits, based on their percentage loss of income.

In order to receive benefits under this option the insured must meet the following conditions:

- Be unable to perform one or more of the important duties of their occupation

Or

- Be able to perform all the important duties of his or her occupation, but not on a full-time basis.

And

- Have a reduction in their earned income of at least 20% or more.

If an individual's loss of income is over 75%, most insurance companies consider the individual totally disabled and will pay the full benefit.

Example

Harold, a plumber earning \$60,000 per year purchased a disability income policy providing coverage of \$3000 per month. He was involved in a serious snowmobile accident, the consequence being he can only work part-time resulting in an income loss of \$24,000 or 40%. When Harold bought the policy, he included a residual disability income rider with a zero day qualification period.

What amount of monthly income will Harold receive?

Loss of Income is $\$24,000 \div \$60,000 = 40\%$

Harold will receive 40% of \$3000 or \$1200.

If Harold's loss of income were 15%, what would he receive?

If Harold's income loss were 88%, what would he receive?

QUALIFICATION PERIOD

The only time that this term is relevant is when an individual has purchased a disability income policy that provides residual disability income benefits.

The qualification period is the period of time which could be 30, 60, or 90 days in which the insured has to be totally disabled in order to receive residual benefits.

While not the same as the elimination period, the qualification period and the elimination period could occur at the same time.

Today, most insurers' provide a zero day qualification period.

The relevance of the qualification period for residual benefits can be best illustrated by the following example:

Example

Gary Jordan suffers a heart attack and is off work for 26 days. He returns to work on a part-time basis for the next four months. Gary's policy has a 90-day elimination period and a residual benefit with a 30-day qualification period on his individual Income Replacement Policy.

In the above example, Gary would not qualify for residual benefits. In order to receive residual benefits, Gary would have to be totally disabled for a period of 30 days.

EXCLUSIONS AND LIMITATIONS

A provision found in an accident and sickness contract excluding certain risks, thereby limiting the scope of coverage.

The following, while not all inclusive, are examples where certain disabilities are generally excluded:

- Self-inflicted injuries
- Injuries or sicknesses resulting from military service, war, or acts of war
- Normal pregnancy
- Criminal acts
- Mental or nervous breakdown

Each individual policy will outline the specific exclusions, under a specific heading such as Exclusions or Exceptions.

Prior to a contract being issued by the insurer, many questions must be asked of the person insured by the agent, such as:

- Personal information
- Health information
- Hobbies, habits and morals
- Specific details concerning occupation
- Earned income

Based on the above information, additional exclusions could result. For example, if the person insured is engaged in high-risk sport activities, there might be an exclusion for that hazardous activity such as sky diving, bungee jumping, hand gliding, scuba diving, parachuting, etc.

Similarly, if the person insured recently had been off work for a week due to a lower back problem, a permanent exclusion might be added to the contract stating that a disability resulting from a lower back problem will result in benefits being excluded.

There are instances when a temporary exclusion might be attached to the contract. For example, a recent hernia operation might result in a temporary exclusion for a period of six or nine months from the issue date of the contract, or from date of full recovery.

When changes are made to the contract, generally a waiver agreement is added to the policy. This agreement exempts the specified condition or conditions from coverage, either for the length of the contract, or depending on the condition for a specified period of time (for example, three years) after which the condition is reviewed and the exclusion might be maintained or taken off the contract.

LIMITATIONS

Some individual policies might limit payment of benefits due to a pre-existing condition.

A pre-existing condition is a medical condition for which medical advice had been sought six months, one year, or two years (as specified in the contract) prior to applying for the disability contract and which recurs within a stated period of time, such as six months or one year from the policy issue date.

Some insurance companies in the underwriting process very rarely request an **Attending Physicians Statement** (APS).

Because of this, their disability contracts have a pre-existing and waiting period conditions limitation similar to the following:

‘Pre-existing Condition’ means a condition for which you received medical advice or treatment within 24 months preceding the issue date of the policy or showed symptoms within 12 months prior to the issue date that would have caused an ordinarily prudent person to seek medical advice or treatment. A pre-existing condition does not include any condition fully disclosed in the application for the policy.

‘Waiting Period Condition’ means a condition for which you received medical advice or treatment within 30 days after the issue date of the policy or if it showed symptoms within 30 days after issue date that would have caused an ordinarily prudent person to seek medical advice or treatment.

PRE-EXISTING AND WAITING PERIOD CONDITIONS LIMITATIONS

A loss caused by a pre-existing condition or waiting period condition is not covered unless the loss begins after 24 months from the policy issue date.

BUSINESS APPLICATION FOR DISABILITY INCOME INSURANCE

INTRODUCTION

In addition to fulfilling individual needs for replacement income to a person who is disabled and unable to earn an income for himself or herself, disability insurance policies can be valuable in fulfilling business needs. Special disability policies have been designed to deal with situations where:

- A key employee of a business becomes disabled;
- An owner of a business becomes permanently disabled and the ongoing expenses of running a business must be met during a period of disability;
- The shareholders of a corporation purchase the interest of a disabled shareholder under the provisions of a formal buy-sell agreement.

Each of these situations, and the types of disability insurance policy used to deal with them, will be discussed on the following pages.

Key Person (Employee) Disability Insurance

Introduction

Key person life insurance protects an employer from loss incurred as a result of the death of a key employee. Key employee insurance applies equally (if no more so) in cases where the key employee becomes disabled and unable to work for a period of time.

Definition Of A Key Employee

A key employee is a person whose service are integral to the success, prosperity, and possibly even survival of the business. The loss of a key employee to a disability would result, at a minimum, in significant economic loss to the employer.

Dual Purpose For Key Employee Insurance

Disability insurance on the life of a key employee might be initiated by the employer for one (or both) of the following purposes:

Salary Continuation For The Key Employee

Since it is reasonable to assume that the employer will suffer income losses or additional expenses during a period of disability of a key employee, it might be difficult for the employer to continue paying salary to a non-productive disabled key employee. Disability insurance coverage that is designed to simply replace the employee's salary would alleviate the cash flow burden on the employer while guaranteeing the continuation of salary to the disabled employee.

Compensation For The Employer

Continuing a salary to the disabled key employee might only be half the problem. What about the losses incurred by the employer as a consequence of the loss of the services of the disabled key employee? The employer might lose sales or productivity, which would in turn result in reduced profits. Money might have to be expended to hire and train a replacement employee for the duration of the disability. Or other employees might have to “pick up the slack” of the disabled employee’s duties, thereby impairing their own efficiency and value to the employer.

All of the above expenses might be provided for by the acquisition of a disability insurance policy on the life of the key employee, with benefits designed to replace the losses/expenses incurred by the employer during the period of disability.

The amount of insurance benefit, the elimination period and the benefit period would depend upon the details of each situation. The definition of disability would of course be own or regular occupation, since it precisely the loss of the key employee’s regular services that gives rise to a loss in the hands of the employer.

Structure Of The Arrangement

Key person arrangements are generally funded with individual insurance policies applied for, owned by and paid for by the employer. In the event of a claim, benefits are also paid directly to the employer.

If the policy is intended to provide a continuing income for the disabled key employee, the benefits are in turn paid to the employee by the employer, in the form of salary continuation.

If the policy is intended to compensate the employer for the loss of the services of the disabled key employee, the benefits are simply retained in the employer’s business account, to be used in whatever manner he or she deems to be most appropriate.

Taxation Of The Key Employee Disability Arrangements

Regardless of the purpose of the insurance coverage, employer-paid premiums for a key employee disability policy are not a deductible expense to the employer for income tax purposes.

Provided the plan benefits are paid directly to the employer, the payment of premiums by the employer for key person disability insurance does not constitute a taxable benefit to the insured employee.

On the other hand, any benefits paid to the employer under the policy are received free of tax.

If the plan benefits are retained by the employer, there remains no tax consequences for either the employer or the insured employee.

If the plan benefits are subsequently paid out to the insured employee, by way of salary continuation, the amount paid out becomes a deductible business expense for the employer and is treated as taxable income to the employee for the year of receipt.

A Key Employee Disability Funding Example

Raj Rupal is the sales manager for Techlite Enterprise, a company that specializes in the manufacture and distribution of office furniture components. Raj earns in excess of \$150,000 a year, on average, and accounts for over 40% of Techlite's sales (and therefore, 40% of its profits). Raj's success is not just tied to his client list – it stems from the personal relationship and trust that he has developed with each client.

Techlite realizes that Raj's worth to the company would be almost irreplaceable in the short term and has taken steps to protect itself (and Raj and his family) against the financial impact of his death or disability.

Techlite has taken out life insurance and two disability insurance policies on Raj life. The life insurance is designed to pay Techlite a lump-sum benefit of \$500,000 in the event of Raj's death, to compensate the company for any resulting lost profits and provide it with capital to hire, train and cultivate a replacement sales manager.

One of the disability policies provides for an initial disability benefit of \$8,750 a month for two years, with an elimination period of 30 days. This policy is intended to generate sufficient cash flow to allow Techlite to continue to paying Raj 70% of his current salary, in the event that he is disabled and unable to work at his own or regular occupation. After two years, the definition of disability under the policy changes to "any occupation to which the insured is reasonably suited by education, training and experience" and the benefit level drops to \$7,500 a month for a maximum of an additional three years.

The second disability policy taken out by Techlite provides for a benefit of \$15,000 a month to be paid to Techlite in the event that Raj is disabled and unable to perform the duties of his own regular occupation. The benefit is subject to a 90-day elimination period and is payable for two years (after two years, it is felt that Techlite would be forced to replace Raj permanently). The policy proceeds are intended to compensate Techlite for profits loss and/or additional expenses incurred as a result of Raj disability.

Disability Buy-Sell Agreements

Introduction

A disability buy-sell agreement is a contractual agreement between/among the owners of a business (or between the owner and a third party – usually an employee) providing for the orderly disposition of the business owner's business interest in the event that he or she should become permanently disabled and unable to fulfil his or her business duties and obligations.

The Purpose Of A Buy-Sell Agreement

The purpose of a disability buy-sell agreement is to guarantee that the needs of both the disabled owner and the “surviving” active business owners are addressed to the maximum benefit of all concerned.

Benefits To The Disabled Owner

A permanently disabled business owner faces two major dilemmas: generating income to replace earned income he or she was making prior to becoming disabled and the disposition of the business asset for a fair price. The latter might be quite difficult if the disabled business owner held a minority interest in the business – after all, how many people want to buy a minority business interest controlled by strangers (the majority owners)?

The buy-sell agreement can be structured to guarantee an income to the disabled business owner during the preliminary stages of his or her disability and to guarantee a fair sale of the business interest should the owner be permanently disabled.

Benefits To The “Surviving” Owners

The problems for the “surviving” active business partners of the disabled business owner? How to generate the cash flow needed to continue paying a salary to a non-productive disabled business partner? How to avoid having the disabled business owner’s family exert an influence on the business?

A proper disability buyout agreement will allow the surviving active owners to retain full ownership of the business, while still meeting the needs of the disabled owner.

The Element Of Certainty

A properly drawn and funded buy-sell agreement cannot only provide the blueprint for resolving the problems and fulfilling the needs of all of the parties involved, it can be drafted and funded so as to provide certainty as to the financial outcome of the permanent disability of a business owner.

Aspects Of A Buy-Sell Agreement

An effective buy-sell agreement must provide for the basic “triggering events” that could lead to the withdrawal of one of the business owners from the business and must contain the basic elements that will guarantee the successful completion of the buy-sell in the event of the happening of one of the triggering events.

Triggering Events

Comprehensive buy-sell agreements between co-owners (or owners and prospective owners) of a business provide for the triggering (execution) of the arrangement in the event of any one of the following eventualities:

- The death of one of the business owners.
- The permanent disability of one of the business owners.
- The retirement of one of the business owners.

Four Fundamental Elements Of A Buy-Sell Agreement

Similar to buy-sell agreements triggered by the death of a business partner or shareholder, disability buyout agreements must contain four fundamental elements to be effective:

- Provisions for a guaranteed sale by the disabled owner of the business interest.
- Provisions for a guaranteed purchase of the disabled business owner's interest by the other parties to the agreement (usually business partners or co-shareholders).
- A pre-set guaranteed price (or method for determining the price) of the business interest at the time of purchase under the agreement; and,
- A method of guaranteeing the funding of the purchase.

Example

The buy-sell agreement between Larry and Moe guarantees that, in the event of Larry's permanent disability, Moe will be legally obliged to buy out Larry interest in their party store, at price to be determined by the firm of Curly and Shemp, professional business valuers. The funding for the buyout will come from a disability policy taken out on Larry's life at the time of execution of the buy-sell arrangement.

Characteristics Of A Disability Buy-Sell Arrangement

A disability buy-sell agreement is much more complex than an agreement that is triggered by the death of a business owner. In the latter case, one need only establish that the business owner is dead (usually fairly straight forward) and then decide who buys what for what price. A disability buy-sell agreement involves many more variables:

The Definition Of Disability

In theory, a disability buyout agreement could employ any of the standard disability definitions (own occupation, any occupation, etc.) or it could be adapted to a specialized definition of disability not common to any disability insurance policy.

However, given that it is the services that an owner (who is also usually an owner-operator) of a business performs for the business that makes him or her integral to the business, most disability buy-sell agreements employ an own or regular occupation definition of disability. That is to say, the owner is considered to be fully disabled if he or she is unable to perform his or regular duties to the business.

The Elimination Period

The amount of time that elapses between the onset of a disability to a business owner and the actual triggering of the buyout under the buy-sell agreement (the elimination period) is critical. Too short an elimination period and the buyout may be triggered against an owner who recovers and would have wished to retain his or her interest in the business. Too long an elimination period and the disabled owner may become too great a drain on the business, causing its failure. Typically, elimination periods of six to 24 months (or longer) are used.

The Type Of The Benefit

Disability buyouts can be effected either with a lump-sum payment or with a series of periodic payments. The lump-sum buyout is becoming the most popular, paralleling most buyouts triggered at the time of an owner's death. Lump-sum buyouts have been facilitated by an increase in the past few years of insurance companies offering policies that will pay a lump-sum benefit in the case of total and permanent disability (see below).

The Duration Of The Benefit

Lump-sum payments are, of course, a one-shot enterprise. Periodic payments are generally designed to be facilitated over a period that correlates to standard disability benefit periods, like five years or to the insured's age 65 (retirement age).

The Amount Of Benefit

The amount of the benefit paid out to a disabled owner under the buy-sell agreement will be a function of the value of the business interest and the type of payment involved. Typically, the value (price) set for a lump-sum disability buyout will be the same as the price under a death-time disability buyout: the fair market value of the business interest at the time that the buyout is triggered. In cases where the buyout is to be effected over time, the periodic payments are usually a function of the buyout price, adjusted for the time value of money.

Example

A typical disability agreement might have terms as follows: “In the event that Owner A shall be deemed to be disabled and unable to perform the duties of his regular occupation with ABC Co. for a period of 12 consecutive months, ABC Co. shall buy out A’s common shares of ABC Co. within 60 days of the end of the above-noted 12 months period of disability, for a lump-sum payment of \$1,000,000 (or for such amount as the business valutors of Curly and Shemp shall deem appropriate as the value of A’s common shares of ABC Co.).”

CHARACTERISTICS OF DISABILITY BUY-SELL FUNDING

Coordinating The Policy With The Agreement

One of the most important factors in structuring the disability insurance policy used to fund a disability buy-sell agreement is to ensure that the terms of the policy coordinate with the terms of the agreement. Otherwise, the business could find itself in a position where an owner is deemed to be “disabled” for purposes of the buyout, but not for purposes of the required funding (insurance).

With respect to the definition of disability used in the funding policy, it must be equal to, or more liberal than, the definition used in the agreement. Most buy-sell agreements define disability as “own or regular occupation.” If, for example, the policy used an “any occupation” definition of disability, an owner who could not perform his regular duties to the company (due to illness) but who could perform other, suitable work outside of the business, would be disabled for purposes of the agreement but not for purposes of the policy. The buyout would be triggered, but no funding would be available.

Ideally, of course, the amount of benefit provided under the funding policy should be at least equal to the buyout price, or the buyout will be under funded. This can be a problem in lump-sum buyouts, where the insurer may only cover 80% of the purchase price, leaving the other 20% unfunded.

If the buyout price is subject to escalation (due to increase in the value of the business), it is important that the funding policy carry a future purchase option, guaranteeing the right to add coverage in the future, and that the level of coverage be reviewed regularly.

Lastly, of course, the elimination period under the funding policy should never be longer than the elimination period under the agreement. Otherwise, the buyout could be triggered prior to the availability of funding; leaving a gap that would have to be funded personally by the purchasing business owners.

Ownership Of The Policy

Depending upon the nature of the buy-sell agreement, the funding policy will either be owned by the business itself (in the case of an entity buy-sell, where the business itself purchases the disabled owner's interest), or by the other business owner(s) (in a criss-cross or cross purchase buy-sell, where the other owner(s) purchase the interest of the disabled owner directly).

Beneficiary Of The Policy

The benefits paid from the funding disability policy should be paid directly to the owner(s) of the policy, who have the obligation to buy out the disabled owner's interest.

TAXATION OF DISABILITY BUY-SELL FUNDING

Deductibility Of Premium Payments

Regardless of who owns the funding policy and/or who pays the premiums on the policy (the business or the individual business owners), the premiums paid for the policy are not a deductible expense for the payer for income tax purposes.

Taxation Of Benefit Payments

Provided the policy benefits are paid either to the business itself or the policy owner, they are not treated as income at the time of receipt. (NOTE: Care should be taken if the business owns the insurance not to have the buyout payments made directly to the disabled owner. If the agreement is not carefully drafted, such payments could be construed to be taxable income to the recipient, rather than a capital transaction.)

Taxation Of The Buyout

Payments made from the business or co-owners to the disabled business owner as discharge of the purchaser's obligations under the buy-sell agreements are capital payments (not income) and will give rise to tax consequences to the recipient only if he or she incurs a capital gain on the sale of the business interest.

OFFICE OVERHEAD EXPENSE INSURANCE COVERAGE

Introduction

One of the prime dilemmas facing a disabled business owner is how to cover the ordinary expenses of the business during the period of disability, so that the business can continue in business and will still be there when the disabled owner is ready to return to work.

Most closely held business resolves this problem by taking out an office overhead expense disability insurance policy on the owner(s) of the business, so that the regular expenses of the business attributable to a disabled owner will be paid for by the insurance benefits during a period of disability.

Insured Persons

In order to qualify for coverage under an office overhead expense policy, a business owner must generally meet the following criteria:

- Be self-employed
- Own a minimum of 20% of the business
- Have a maximum of three to five employees
- Have operated the business for a minimum of six to twelve months, depending on the contract.

The Definition Of Disability

The definition of “total disability” used for most office overhead expense policies is “own or regular occupation.”

Benefits

Benefits are paid in the form of a reimbursement of actually expended qualifying expenses, to a maximum monthly limit (e.g., \$4,000 a month).

Elimination periods run from zero to 90 days and benefits are often paid retroactively to the first day of disability, once the elimination period has been satisfied.

Benefit periods typically run from 12 to 24 months (after two years of disability on the part of the owner, the business isn't likely to survive anyway).

Covered Expenses

Office overhead expenses policies cover most usual and necessary business expenses, including: employee's salaries, rent payments, mortgage payments, loan payments, lease payments, insurance premiums, utilities, property taxes, and maintenance services, to name but a few.

Excluded Expenses

Excluded from coverage are new capital expenditures, salary payments to the disabled insured, his or her replacement and his or her family members, salary increase to staff and expenditures not requiring disbursements by the insured (such as life insurance premiums waived during a period of disability).

Extended Benefits

Because most business expenses cannot be neatly compartmentalized, month by month, most office overhead expense policies provide for a carry forward of benefits or expense from one month to another, within the coverage limits of the policy.

Example

Monty is the sole shareholder of a closely held business that services cleaning contracts. He has an office overhead expense policy on his own life, providing for a maximum of \$4,000 a months, in the event of his total disability.

Monty fell on a wet floor at a job site recently and was off the job for six months. Benefits started after the first three months of disability.

In the first month of qualification for benefits, his company actually incurred \$4,500 of qualifying expenses. The policy reimbursed Monty for the first \$4,000 of expenses (the monthly policy maximum) and he was allowed to carry the unclaimed \$500 expenses to the next month.

In month two, the company incurred only \$3,200 of qualifying expenses. The first \$500 of policy benefits was used to compensate Monty for the \$500 of unclaimed expenses from the previous month. The \$3,200 of expenses actually incurred during the month was covered, too. The \$300 of possible benefits not claimed for the current month ($\$4,000 - \$500 - \$3,200 = \300) could be carried forward to be used in the next month, if they were needed.

Additionally, some office overhead expense policies permit the insured to carry unused benefit room beyond the benefit period, to be used against future qualifying expenses, so long as the insured remains disabled.

Example

Let us assume that Monty was disabled permanently, not just for six months. Normally, at the end of the 24-month benefit period under his policy, benefits would stop. However, let's further assume that, by the end of the benefit period, Monty had claimed only \$82,000 of the maximum \$96,000 (\$4,000/month x 24 months) of benefits that he was entitled to under the policy. If Monty's policy provides for extended benefits, he could claim the other \$14,000 of benefits in the future, so long as his business has qualifying expenses and he remains disabled.

Taxation Of Premiums And Benefits

The tax treatment of premiums and benefits associated with an office overhead expense policy is at odds with all other types of disability insurance:

- Premiums paid for an office overhead expense policy are a deductible expense by the business for income tax purpose.
- Benefits received by the business under an office overhead expense policy are reported by the recipient as taxable income.

The fact that the benefits are taxable is generally offset by the fact that the expenses that the benefits are used to pay (employee salaries, rent, utilities, etc.) are most often a deductible expense for the business, so the benefit/expenses are a "wash" for income tax purposes.

The Tax Treatment of Individual Disability Benefits

Generally speaking, taxpayers cannot deduct premiums that they pay for individually owned disability plans. Since the coverage is paid for with after-tax income, the general rule is that any benefits paid under the plan will be received free of tax.

On the other hand, if the policy is owned by the taxpayer, but the premiums are paid for by the taxpayer's employer.

- If the employer-paid premiums are reported as income to the employee, the employer may deduct them as a business expense and the employee must report them as income for the year in which they were paid. Any benefits received by the employee will be received free of tax.

Example

Millie works for the Maudlin Manufacturing Company, a small family business. Maudlin pays the \$800 annual premium on Millie's personally owned disability policy, as part of her employee benefit package. Mille reports the \$800 as a taxable income each year. Last year, Mille injured her hand in a press at work and was disabled for six months. Mille's policy had a three month elimination period and then paid her three month's worth of benefits, at \$2,000 a month. The \$6,000 in benefits that Mille received were not included in her taxable income for the year.

GOVERNMENT PLANS THAT PROVIDE DISABILITY INCOME

THE CANADA PENSION PLAN

- The Canada Pension Plan Act became law in April 1965 and the plan became operational effective January 1, 1966.
- The **primary** objective of the CPP is the provision of an earnings – related pensions for the maximum number of **working** Canadians, based on their mandatory contributions into the plan from age 18 to retirement.
- Unlike most private pension plans, the CPP is **portable**; contributions are compulsory if you work in Canada.
- Although the CPP was initiated by the Federal Government, the Act allowed any province to establish and administer its own plan. Only Quebec exercised that right, and for the most part, the provisions are similar.
- While the primary component of the CPP is retirement pensions, it provides benefits for:
 - (A) Disabled contributors and benefits for their dependent children.
 - (B) Survivor benefits (including a lump sum death benefit, a surviving spouse's benefit, and an orphan's benefit, for each dependent child).
- The core however, of the CPP is providing working Canadians with retirement income.

For purposes of this module however, we will look at the disability component of the CPP.

- In order to receive disability benefits under the CPP:
 - (a) You **must** have contributed to the CPP in at least 4 of the last 6 years.
 - (b) You must be under age 65.
 - (c) Most important, the definition of total disability is extremely **restrictive**. Your disability must be a physical and mental impairment that is **both** severe and prolonged.
- Severe means you are not able to pursue any gainful employment, and prolonged means that such disability is likely to be of an indefinite duration or is likely to result in death.

- If an individual qualifies for the disability component, they are entitled to a flat rate amount plus 75% of their calculated pension as if they were age 65.
- Currently the flat rate on a monthly basis is \$397.61.
- In 2006 the maximum monthly retirement pension at age 65 is \$844.58.

Flat Rate + **75% of estimated retirement pension**
 \$397.61 + 75% of \$844.58
 = \$1031.05 per month.

- As a matter of interest, most individuals who qualify for a disability pension do not receive the maximum benefit.
- The flat rate provides the disabled individual with a higher level of income than otherwise would be the case.

WORKER'S COMPENSATION PROGRAM

- Known by different names in different provinces, these programs provide benefits for worked related accidents or illnesses.
- Funding of the program is entirely by the employers at no cost to either the worker, and any benefits received by the employee are tax-free.
- The premiums (contributions) paid by the employer vary directly to the risks of the type of business operations.
- The premiums payable by all employers range from almost 30% of payroll for very high risk businesses to less than 1% in low risk operations.
- Compensation, to which the worker is entitled to by law, replaces his/her right of action so that he/she may not sue the employer for damages or injuries received during employment.
- Some provinces (Ontario being one) allow the owners and key executives to opt out of the plan.
- The decision as to the type or classification of disability is made by the Workers' Compensation Board, based on medical evidence and reports submitted.

- Compensation varies from province to province, however WCB provides injured employees with superior weekly income, as the following chart demonstrates.
- Compensation is payable after a waiting period of one to four days, depending on the province.
- Contribution made by employers are tax deductible to the company, however benefits paid to employee are **NOT TAXED**
- Workers Compensation benefits are very comprehensive. As well as the benefits for work related injury or industrial disease, it provides benefits for
 - a) Any necessary health care cost, and any necessary medical and vocational rehabilitation programs, if employee is injured on the job or has a work related disease.
 - b) Funeral expenses, a lump sum death benefit and monthly income to the surviving spouse or eligible dependants if a workplace injury or disease results in death.

WORKERS' COMPENSATION

DISABILITY BENEFITS – BY PROVINCE - 2006

Province	Maximum Insurable Earnings	Percent of Earnings Payable	Waiting Period	Employer Average Assessed Rate (per \$100)
British Columbia	\$62,400	90% of net income	None	\$1.975
Alberta	\$63,300	90% of net income	None	\$1.57
Saskatchewan	\$55,000	90% of net income	None	\$1.84
Manitoba	No Maximum	90% of net income	None	\$1.68
Ontario	\$69,400	85% of net income	None	\$2.26
Quebec	\$57,000	90% of net income	None	\$2.27
New Brunswick	\$51,900	85% of net income	3 Days	\$2.19
Nova Scotia	\$45,100	75% of net income	2 Days	\$2.65
Prince Edward Island	\$43,300	80% of net income	None	\$2.33
Newfoundland & Labrador	\$47,245	80% of net income	None	\$3.19

Notes:

In Manitoba – after 24 months on claim, benefit is reduced to 80% of net income.

In Nova Scotia – after 26 weeks on claim, benefit increased to 85% of net income.

In PEI – after 38 weeks on claim, benefit increased to 85% of net income.

EMPLOYMENT INSURANCE (EI)

Human Resources Development Canada (HRDC) is the federal agency, which administers Employment Insurance.

EI provides a short-term disability benefit to employed people who qualify.

It should be noted that self-employed individuals do not contribute to EI nor do they qualify for any of the benefits. Representatives with Combined Insurance do not qualify for any benefits from EI as they are self-employed individuals (e.g. independent contractors), nor do they make any contributions to Employment Insurance.

In order to receive disability income benefits, the disabled employee must have:

- Accumulated the regular hours of insurable employment and made the required contributions into EI. The number of hours varies from province to province and from location to location, based on the unemployment rate in that area.
- Be disabled as the result of an accident, sickness, or quarantine.
- Have a physician's statement or medical certificate proving disability.

If the disabled employee qualifies, their entitlement of benefits is limited to 55% of weekly insurable earnings to a stipulated maximum per week. For low-income earners this percentage can be increased based on weekly insurable earnings.

The benefit is paid for a short duration of time, 15 weeks, following a 2-week waiting period. In other words, from day 15 to 120.

In addition, it should be understood that any benefit received from Employment Insurance is taxable income for the year in which it was received.

Of major importance is the fact that EI is "second payor" if the disabled employee is receiving income from certain other sources while disabled. These sources include:

- Continuing employment income or commissions
- Workers' Compensation weekly income benefits due to an on-the-job accident or work-related illness.
- Group disability income benefits from a short-term disability plan.
- Canada Pension Plan Disability benefits.
- Pension Income.

It should be noted that EI is not “second payor” in respect of any personally owned disability income insurance policies owned by an individual.

EXAMPLE:

Employee earns \$600 per week and qualifies for EI Disability Income. ENTITLEMENT is a percentage of weekly insurable earnings to a maximum. Currently, the maximum is \$750 per week.

Because the employee’s income is less than maximum, entitlement would be
 $55\% \times \$600 = \330 per week.

To cite another example, suppose the employee earned \$1200 per week. Because the employee’s income is over the maximum, entitlement would be limited to

$$55\% \text{ of } \$750 = \$412.50$$

This is the maximum amount that any employee can receive regardless of whether their income is \$750 per week or \$2000 per week.

As mentioned above, EI is secondary payor when the disabled employee receives income from sources outlined above.

For example, if the employee was injured on the job and was eligible to receive Workers’ Compensation, effectively they would receive nothing from EI, as WCB would pay more than EI on a weekly basis.

CO-ORDINATION OF BENEFITS

Some individual contracts co-ordinate or integrate disability benefits from all sources such as government-sponsored plans, group insurance disability benefits and in some instances, existing individual policies. Accordingly, benefits received by the insured could be less than the amount stated in the contract.

Contracts that co-ordinate or integrate benefits obviously cost less than those that do not.

The following is an example of a disability income policy that includes a co-ordination of benefits provision:

INTEGRATION (CO-ORDINATION) OF MONTHLY BENEFITS

The monthly benefit under this policy will be reduced to the extent that the sum of:

- (1) the monthly benefit,
- (2) government benefits, and
- (3) disability benefits under other insurance policies.

exceeds 75% of the average monthly earnings of the Insured from his or her regular occupation for the twelve months immediately preceding the commencement of total disability.

The monthly benefit will not be reduced by any cost-of-living adjustment in government benefits, which occurs after the Insured first becomes entitled to government benefits.

If the monthly benefit payable is reduced under the integration of monthly benefits provision, the maximum benefit period will be increased. During the extended benefit period, the monthly benefit, subject to continued integration of monthly benefits, will be paid until the total of all benefits paid for the same continuous period of total disability equals the monthly benefit multiplied by the number of months in the maximum benefit period.

“Government benefits” means the following benefits the Insured is eligible to receive or any member of his or her family is eligible to receive as a dependent because of the Insured’s disability:

- (1) disability or retirement benefits provided by Canada or Quebec Pension Plans;
- (2) disability benefits under workers’ compensation, occupational disease or similar law;
- (3) disability benefits under any compulsory benefit or law, including any no-fault automobile insurance;
- (4) federal, provincial or municipal programs providing disability benefits, including employment insurance disability benefits.

If the Insured received a lump settlement from a government benefit, that portion of the settlement representing future benefits will be divided by the government benefits monthly benefit to arrive at the number of months paid. The benefit payable under this policy will then be reduced for the same number of months. No benefits will be reduced by any government benefit period on a retroactive basis.

When the Insured or his or her dependent is eligible for any government benefit, in addition to proof of disability, the insurer must receive:

- (1) Proof that the Insured has applied for the government benefit;
- (2) Written authorization for the insurer to receive information about the status of the application;
- (3) Notice whenever the application is approved or disapproved; and
- (4) If disapproved, proof that an appeal has been made.

DIRECT OFFSET OF GOVERNMENT BENEFITS

Most individual contracts also have a Direct Offset clause contained in the policy. With this method, benefits under the disability contract are offset dollar for dollar by benefits received from Workers Compensation and the Canada Pension Plan to the extent that the combination exceeds some stated maximum, such as 75% of prior average earnings.

The type of policy used for this approach is usually a non-cancellable contract.

TAX IMPLICATIONS OF INDIVIDUAL

DISABILITY INSURANCE POLICIES

The taxation of individually owned disability income insurance is similar to life insurance, namely any premium paid is paid with after-tax dollars. In other words, premiums paid individually are not deductible from income as an expense. As such, any benefits received are received tax-free.

A corporation can aid an employee in acquiring individual disability insurance by increasing the employee's salary or paying the premium. If the employer increases the employee's salary to pay the premium, the salary increase is a **taxable income**. If the employer pays the premium and tax deducts it, the amount of premium is paid is deemed to be a taxable benefit.

It should be clearly understood that the employer cannot tax deduct a premium on an individually held policy, for example a policy taken out on a "key person".

There is one exception to the rule, what is called a "Grouped Disability Policy".

“GROUPED” POLICIES

- These are personal individual contracts applied for and owned by the employer, with benefits payable to the employees.
- Generally, a “grouped” disability policy is set up by a resolution of the Board of Directors of the company. There must be two or more employees as well as two or more grouped disability policies issued. Premiums paid by the employer are tax deductible to the employer and are **NOT** considered a **Taxable Benefit** to the employee. Reference for this arrangement is “Information Bulletin IT 85-R2”.
- Disability benefits received are taxable to the employee and, because of this insurance companies allow benefits larger than their usual Issue and Participation Limits.
- If employer is not a corporation, the same result can be obtained by setting up what is known as a Health and Welfare Trust Agreement.

The following chart outlines the income tax treatment of various sources of individual disability income policies.

<u>Income Source</u>	<u>Contribution by Individual</u>	<u>Contribution by Employer</u>	<u>Benefits Received</u>
Individually owned policies	Not deductible	None	Not taxable
Owned by employer on an individual	None	Not deductible	Not taxable
“Grouped Arrangement” owned by employer on two or more employees as per IT-85-R2	None	Deductible	Taxable to employee

The following chart outlines the income tax treatment of various sources of government disability income programs paid directly to an individual.

<u>Income Source</u>	<u>Contribution by Individual</u>	<u>Contribution by Employer</u>	<u>Benefits Received</u>
Employment Insurance	Non-refundable tax credit of 15.5%	Deductible	Taxable
Canada Pension Plan	Non-refundable tax credit of 15.5%	Deductible	Taxable
Workers’ Compensation	None	Deductible	Not Taxable

TAXATION OF GROUP DISABILITY BENEFITS

The taxation of Disability insurance and Group Benefits are relatively clear cut.

GROUP BENEFITS

A Group Benefit package can be sold on a Non-contributory or a Contributory basis. In a Non-contributory plan, the insured (an employer, or a trade union for example) pays the entire premium.

There are two instances where tax considerations are relevant.

1. Any premium paid for group life insurance, including group life insurance on dependants, is deemed to be a taxable benefit to the employee and that amount has to be included by the employee when preparing their income tax return.

The insurer will provide the employee with the exact amount on their T-4 statement under the heading “taxable benefits”. The premiums paid for all of the other benefits (for example, extended health care, dental care, etc.) of the Group Benefit Package are not deemed to be a taxable benefit.

2. If the group plan provides disability income benefits to the employee, if and when the employee is disabled and receiving benefits, the disability income payments are considered as income, and the amount of disability income received that year is income that is taxable to the disabled employee. Any other benefits from the group plan are paid on a tax-free basis.

CONTRIBUTORY PLAN

If the employee is a member of a contributory plan, meaning the employee pays a portion of the premium, the group life premium could be deemed to be a taxable benefit and any disability income benefits received could be taxable as income.

From a practical point of view, this rarely happens because prior to the plan being implemented, the group representative and agent selling the plan would make sure that the employees’ portion of the premium be designated to pay for the group life insurance as well as disability income benefits short and/or long term.

As the employee is paying the premium for the group life amount and the premium comes from the employees’ after-tax dollars, no taxable benefit has been conferred. Similarly, the premium the employee pays for the short term/long term disability comes from the employee’s after-tax dollars, consequently any disability benefits received would be received tax-free.

INDIVIDUAL POLICIES

Any individual disability income or accident and sickness policy purchased by an individual comes from their after-tax dollars; consequently any benefit received is tax-free.

If however, an employer purchases individual policies on two or more employees, or a “Grouped” arrangement, or a “Health and Welfare Trust” is established, premiums paid by the employer are tax-deductible, and any disability income benefits received by the employee is taxable as income. In all other instances, there are no tax consequences.

OVERHEAD EXPENSE POLICIES

If a professional such as a doctor or lawyer, or an unincorporated business person buys a reimbursement policy (i.e. a policy to meet ongoing business expenses such as rent, employees’ salaries, utilities, etc.) the premiums paid for this type of policy are tax-deductible and as such, if disabled and reimbursed for these expenses, any amount received is taxable business income.

Other than the above, there are no additional tax consequences.

A FINAL WORD

The information contained in the Web based Module is for information and educational purposes. When dealing with prospects and clients, it is always important that they seek advice from an accountant or lawyer on complex matters.

SECURING CONTINUING EDUCATION CREDITS

You must answer the following questions and obtain a passing mark of at least 70%.

SAMPLE ISSUE AND PARTICIPATION LIMITS

NON-TAXABLE LIMITS

Disability insurance is intended to replace a portion of an individual's earned income, specifically to provide income required for daily living expenses.

Actual Net Earned Income		Monthly Non-taxable Benefit Limits
\$30,000 to \$32,999	..... .....	\$1,775
\$33,000 to \$35,999	..... .....	\$1,900
\$36,000 to \$37,999	..... .....	\$2,025
\$38,000 to \$39,999	..... .....	\$2,125
\$40,000 to \$43,999	..... .....	\$2,250
\$44,000 to \$47,999	..... .....	\$2,400
\$48,000 to \$51,999	..... .....	\$2,600
\$52,000 to \$55,999	..... .....	\$2,825
\$56,000 to \$59,999	..... .....	\$3,025
\$60,000 to \$64,999	..... .....	\$3,250
\$65,000 to \$69,999	..... .....	\$3,425
\$70,000 to \$74,999	..... .....	\$3,600
\$75,000 to \$79,999	..... .....	\$3,750
\$80,000 to \$89,999	..... .....	\$3,925
\$90,000 to \$99,999	..... .....	\$4,150
\$100,000 to \$109,999	..... .....	\$4,425