Disability Insurance 101

Overview

Without disability insurance, you are exposed to considerable financial risk if you become disabled and are unable to work. While it is more common to have life insurance than disability insurance, you are far more likely to become disabled than to die before reaching retirement age. Because the chances of losing earnings to disability are so high, we advise our clients to make sure they have coverage at least equal to 60% of their pre-tax income.

The goal is to insure your most valuable asset: your ability to earn an income.

Disability insurance is not overly complex, but there are some technical terms and nuances that are important to understand. Unlike car insurance, disability insurance is not readily available online. To secure coverage tailored to meet your individual situation, you'll need to work with a reputable agent.

Benefits should equal at least 60% of pre-tax income

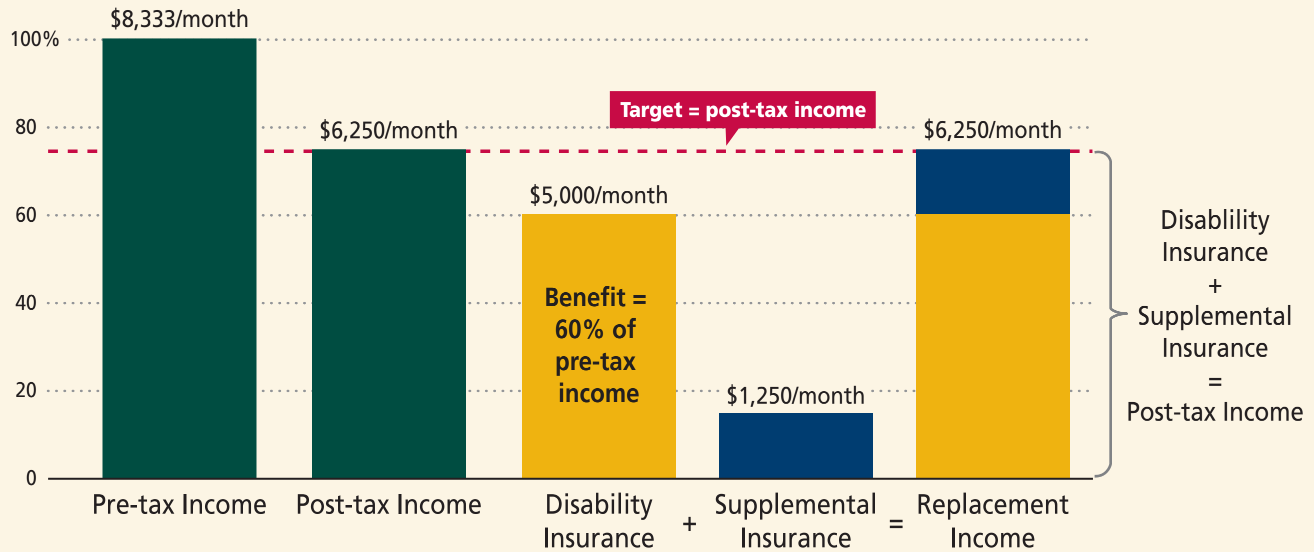
There are two disability benefits that combine to enable people to replicate their post-tax income: private disability insurance and supplemental sources, such as Social Security Disability Insurance.

1. **Private disability insurance.** Since you pay for private coverage with after-tax dollars, the benefits you receive are *not taxed*. With coverage equal to 60% of your pre-tax income, your monthly disability benefit will be close to your previous monthly income.

   For example, assume you earn a salary of $100,000 per year ($8,333/month) with a 25% income tax rate. Your net monthly pay would be $6,250 [$8,333 gross pay - $2,083 in taxes]. Your disability benefit, by comparison, would be $5,000 per month [$8,333 gross pay x 60%].

The following chart shows how the two benefits combine to replicate monthly post-tax income.

Disability Insurance Coverage Illustration
Assuming $100,000 annual pre-tax income and 25% tax rate



❷ **Supplemental sources.** The gap between your net pay and your disability benefit can be covered through supplemental sources, such as coverage available through an employer plan or SSDI. Typically, employer plans permit disability insurance to be purchased by the employee at favorable rates in addition to any benefit your employer may provide. The other major supplemental source of disability insurance is SSDI, and the average SSDI payment is about $1,250 per month.[1] Continuing with our example, SSDI would raise your monthly disability benefit to $6,250, equal to your prior monthly income.

Other important considerations

Typically, private coverage is available for income up to $400,000 per year ($20,000/month of disability benefit), although most providers allow you to "stack" coverage by adding a policy from another company. Larger coverage and/or lump sum benefits can be available in specialized circumstances.

60% maximum rationale

Insurance companies generally cap the disability benefit at 60% of your income to ensure you have an incentive to return to work.

Do I really need disability insurance?

According to the Social Security Administration, one out of every four 20-year-olds who enter the workforce will become disabled for a year or more before reaching retirement age.[2] Long-term disability insurance offers the peace of mind that comes with knowing your income will be secure even if you are unable to work for an extended period of time due to injury or illness.

If you do become disabled, statistics indicate there's a significant likelihood you will be unable to work for quite a while. For example, a 35-year-old person with a disability lasting 90 days or longer has a 38% chance of that disability lasting at least five years.[3] Moreover, the serious financial repercussions of disabilities are well-documented; historically, disabilities have caused many home foreclosures and bankruptcies.

What to know before buying a policy

There are six major factors to consider when evaluating a disability insurance policy.

❶ **Elimination period**

If you become disabled, your policy will not begin paying out benefits right away. You are expected to cover your own expenses during the "waiting period" or "elimination period," which is typically 90 days, though it varies by policy.

❷ **Occupation class (best to worst)**

One determinant of your policy premium is your occupation "class." When you apply for insurance, your occupation is matched with a class based on how risky your job is. The lowest-risk class includes architects and attorneys, while the highest-risk (insurable) class includes carpenters and mechanics.

❸ **Policy definitions ("own occupation" vs. "any occupation")**

One crucial policy definition to consider is "own occupation" coverage versus "any occupation" coverage. Under the former, if you become disabled and are no longer able to perform your chosen occupation, then you will be covered. Under "any occupation" coverage, you have to be unable to perform *any* occupation in order to receive benefits. Whenever possible, we advise you to protect your income more completely by selecting own occupation coverage.

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[1] *"The Importance of Disability Coverage in Uncertain Times," The Council for Disability Awareness.*

[2] *Johanna Maleh and Tiffany Bosley, "Disability and Death Probability Tables for Insured Workers Born in 1999," Social Security Administration, August 2019.*

[3] *"What's Your Personal Disability Quotient (PDQ)?," The Council for Disability Awareness.*

4 Benefit amount

This feature is straightforward: It is the amount your policy pays out each month if you become ill or injured. The higher the benefit amount, the more expensive the policy premium. We recommend maximizing your coverage at 60% of income, subject to the cap for high income earners.

5 Benefit length (or "benefit period")

The benefit period designates how long your monthly benefits will be paid out for a long-term disability. Periods may be as short as two years or as long as up to retirement age. While a five-year period might cover the length of many *long-term* disabilities, we suggest prioritizing peace of mind and covering your income through retirement.

6 Policy riders

There are a litany of policy options outside of the scope of this briefing, but one worth highlighting is the "future purchase option," which allows you to increase your coverage automatically when your salary increases without having to go through medical underwriting again.

How to obtain disability insurance

The best time to buy disability insurance is when you are young and healthy, as that is when it is easiest to obtain. However, it's never too late to get the coverage you need.

With the exception of auto insurance, the insurance industry has by and large resisted disintermediation by online services. In short, you still have to speak to an agent. And a good agent is essential to ensure you get exactly the right amount and type of coverage.

After you receive a quote, the insurance company will conduct an underwriting process by soliciting and evaluating information about your health before approving you for a policy. Once you are approved, most workers in low-risk occupations can expect to pay about 3% to 5% of their annual income for coverage.[4]

Other sources of coverage

Alternative sources of coverage are rarely sufficient on their own, and they should always be treated as supplemental/secondary rather than primary.

Employer-sponsored insurance

Many employers provide *short-term* disability coverage that typically pays out for a few months—sometimes up to a year. Some employers also provide *long-term* coverage through a group disability plan. However, be wary of low benefit limits. For example, many policies pay out a maximum of $3,000 per month, regardless of your income. Also, many of these policies offer only "*any* occupation" coverage, meaning that as long as you are capable of working in any occupation at all, you will not receive benefits.

Finally, some employers allow you to purchase your own additional coverage through your company at a preferred rate. This coverage is not automatically transferable if or when you change employers. However, there is often a conversion option that allows the departing employee to continue the policy individually (i.e., no longer under the auspices of the employer plan).

Odds of becoming disabled

Chances of becoming disabled for one year or more before retirement:

1 in 4

[4] *"How much does long-term disability insurance cost?," PolicyGenius.*

Social Security Disability Insurance

SSDI is difficult and time-consuming to obtain and will not pay out enough to replicate your standard of living. Over 65% of applicants for SSDI are rejected, and the average payout is only about $1,250 per month.[5]

State-level disability insurance

A handful of states offer disability insurance, but those benefits last one year at most. This is far less than the average length of a long-term disability claim, which is nearly three years.[6]

Worker's compensation

Worker's compensation covers only injuries that occur on the job, which affected less than 1% of American workers in 2018.[7]

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[5] *Annual Statistical Report on the Social Security Disability Insurance Program, 2018.*

[6] *"Overview" from The Council for Disability Awareness website.*

[7] *"The Importance of Disability Coverage in Uncertain Times," The Council for Disability Awareness.*

Important Legal Disclaimer: *We are not an insurance agency and are neither licensed nor qualified to render insurance recommendations or advice of any kind. Moreover, insurance is a specialty area that requires a subject matter expert to advise on the particulars of a given situation. The best course of action is to consult a qualified, licensed insurance expert in your state..*

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