How to Protect Your Income Against Disability

For most working Americans under about 50, their most valuable asset isn't a house or a retirement plan. It's the ability to continue working and earning a living. In fact, the younger you are, the more critical it is to protect this vital engine of wealth.

That's what disability insurance is for.

In a nutshell, disability insurance replaces your income in the event you should become sick or injured and unable to earn a living.

Many Americans get disability insurance as an employee benefit. The employer pays the premiums, and deducts the premiums against earnings as an employee benefit expense. Other Americans get disability insurance on their own, by going through an agent.

Disability policies are generally designed to replace about 60 percent of a workers' income. The idea: To give the worker enough of a cushion to keep paying the mortgage or rent and basic living expenses, while still giving the worker an incentive to recover quickly and get back on the job.

Benefits kick in after an 'exclusion' period, which can be anywhere from two weeks to a year. Some employers offer both short-term and long-term disability insurance plans, to ensure that workers and their families are not devastated even by the exclusion period. However, the longer the exclusionary period, the lower the premiums, all else being equal.

Definitions Matter

With life insurance, it's usually not hard to determine whether a benefit is payable: Either there is a death certificate or there isn't one. True missing persons cases are rare. Disability insurance policies, however, must operate in shades of gray, and judgment calls are routine. The precise language of the contract itself - and particularly the contractual definition of disability and when benefits will be payable - is paramount.

Own Occupation vs. Any Occupation

An own occupation policy pays a benefit if the disability prevents the insured from returning to work in his or her own occupation previous to the onset of the illness or injury that caused the disability. If a surgeon can't be a surgeon anymore, the policy is generally payable. An any occupation policy, on the other hand, pays a benefit only if the insured cannot work in any occupation to which the individual is suited by virtue of education and experience. If the surgeon cannot continue to work as a surgeon, for example, but can make a perfectly good college professor or medical school teacher, then the policy would not pay a benefit.

Own occupation policies are more expensive, though, than any occupation policies, all things being equal. However, it is common for a policy to have a hybrid definition - beginning as an "own occ" policy, as it is referred to in the industry, and switching to any occ after a couple of years. Most insurance professionals
recommend an own occupation policy to those who can afford it, though those with employer-paid plans may not have a choice in the matter.

**Taxation of Disability Insurance**

The way disability insurance is taxed depends mostly on who paid the premiums.

Premiums are not tax deductible to an individual. But if the individual paid the premiums, then disability insurance cash benefits are not generally taxable.

If the premiums were paid by the employer, however, benefits are taxable as income to the recipient.

**Available Riders**

Depending on your age, budget and overall situation, you might want to consider one or more of the following available riders, or endorsements. These are optional features, generally available for additional premium.

**Cost of Living Benefit.** This optional rider pegs benefits to the inflation rate. So your final benefits will increase as the cost of living increases.

**Future increase benefits.** Guarantees the right to buy additional disability insurance in the future, even if you are deemed uninsurable at that time. The new coverage you buy when you exercise your option under this rider is priced at your age at the time of purchase. For example, you may get the right to buy additional coverage upon getting married, having a child, or achieving specific ages. The contract will usually limit your future increase guarantee to half of the original coverage.

**Waiver of Premium.** If you do become disabled, the waiver of premium rider allows you to skip paying premiums on the policy. This is important, because if you do go on claim for a total disability, your income is already reduced by about 60 percent, in most cases. Continuing to pay a disability premium is going to be that much tougher if you have to keep it going while on claim, and while you may have additional medical expenses out of pocket at the same time.

**Lifetime Extension.** This rider guarantees that benefits will continue beyond age 65. Many policies cease paying benefits when the recipient is eligible for Social Security. With the lifetime extension rider, benefits for disabilities incurred before a certain age will remain payable beyond that point.

**Automatic Benefits Increase.** With this rider, the income benefits will increase automatically with any pay raises, regardless of the insured's medical condition at the time of the promotion or pay raise.

**Accidental Death and Dismemberment.** This option pays a specified cash benefit if you lose one or more limbs, or if you lose your eyesight. It may also pay an additional cash benefit if you are killed in an accident, rather than by illness.

**Return of Premium.** This rider returns any premiums you don't use back to you when you reach a specific age - typically age 65. If you use some benefits, the insurance company will deduct the benefits paid to you while disabled from the premium refund.