Disability Protection for Retirement Contributions

A Continuing Education Course for Life & Health Insurance Producers

Overview

◆ Planning for retirement: the current environment
◆ Retirement - the disability gap
◆ Traditional insured approaches
◆ New approaches - Group LTD
◆ New approaches - Individual DI
Retirement: The Disability Gap

What is it?

◆ The potentially huge gap that a serious disability can create in even the most carefully constructed retirement plan

Why should I know this?

◆ Few prospects are aware of the problem
◆ Few agents & brokers are aware of the problem
◆ Translation: Opportunity to...
  ● present your clients and prospects with a new idea
  ● complete their disability insurance protection program

Retirement Planning: The Current Environment

Our top financial concerns

<table>
<thead>
<tr>
<th>Financial Concerns</th>
<th>% Agree*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Enough money to live comfortably in retirement</td>
<td>70%</td>
</tr>
<tr>
<td>Health Insurance for self &amp; family</td>
<td>61%</td>
</tr>
<tr>
<td>Financial security for family if no longer able to work</td>
<td>60%</td>
</tr>
</tbody>
</table>

* Percent responding to survey as concerned or extremely concerned.

Source: JHA Disability Fact Book, 2001 (Survey by Roper Starch Worldwide, January 1999)
Retirement Planning: The Current Environment

- Confidence shaken - only 16% are “very confident” they have enough assets to meet retirement objectives*

- Lack of self-assurance due to:
  - negative stock market returns - 45%
  - “unexpected lifestyle changes” (including disability) - 54%

* Next Generation Retirement Planning Survey (Ernst & Young Actuarial - November 2002)

Other concerns

- Outliving retirement income
- Rising costs of medical care & prescription drugs
- Loss of assets if forced into a long term care facility
- Social Security crisis
- Company insolvencies/manipulation of pension plans (Enron, et al)
The U. S. Retirement Market

- $10.8 trillion in total assets (2001)*
  - IRAs 22%
  - Defined Contribution Plans 23%
  - Defined Benefit Plans 17%
  - Private Annuities (non-qualified) 11%
  - Government Defined Benefit Plans 27%

* Investment Company Institute, Washington, D. C

Retirement Planning: The Current Environment

What trends are you seeing?
**Growth of 401(k) Plans**

- Popularity of traditional fully employer-funded plans declining
- Assets in 401(k) plans grew 18% annually from 1990 - 2000*
- Now more than 275,000 401(k) plans in place**
- 42 million workers participated in 2000**

* Ron Panko, Best’s Review (May 2000)
** Investment Company Institute, Washington D.C.

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**Growth of Small Business Retirement Plans**

- Qualified plans for businesses <500 employees expected to grow by 45% from 2001-2006*
- Continued growth in...
  - qualified pension plans for high-income professionals & owners of small businesses
  - non-qualified retirement plans (deferred compensation)

** Cerulli & Associates (an investment industry research firm)**
Retirement: The Disability Gap

- If all goes according to plan, most of your clients can look forward to a financially secure retirement.
- But what happens if they become disabled along the way?

Retirement: The Disability Gap

- To complete even the best constructed retirement plan and assure an adequate retirement income….
- An individual must be able to work…
  - to make his or her own contributions
  - to assure continuing employer contributions
Retirement: The Disability Gap

- Contributions continue only as long one remains on the payroll
- If disabled, all employee & employer contributions will cease
- Qualified Plans will not make contributions if a “break in service”
  - i.e. if EE doesn’t work for more than 500 hours during the plan year
- Few people are aware of the terms of their retirement plan in this regard

Retirement – The Disability Problem

- Group plans and individual disability policies are intended to meet current income needs during disability...
- Normally not meant to replace lost retirement plan contributions
- Problem is compounded by the fact of income replacement ratios of most plans - up to only 60% of salary.
- What are the chances that during a disability there will be money available for long-term retirement savings?
Example...
Normal Retirement Savings

Individual age 45 works to age 65 and makes 20 annual payments of $10,000 to a defined contribution plan.

Assumes annual investment return of 8% compounded.

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Example...
Disability at age 50

Individual age 45 makes 5 annual payments of $10,000 to a defined contribution plan but is totally disabled at age 50.

Assumes annual investment return of 8% compounded.
What if disability isn’t permanent?

Even a shorter disability can mean dramatic loss of retirement plan value at age 65:

<table>
<thead>
<tr>
<th>Disabled for</th>
<th>Loss of Value at age 65*</th>
</tr>
</thead>
<tbody>
<tr>
<td>2 years</td>
<td>$61,094</td>
</tr>
<tr>
<td>5 years</td>
<td>$136,788</td>
</tr>
</tbody>
</table>

*Assumes disability occurs at age 50

Eliminating the disability gap: Traditional approaches

- Generally the problem has not been fully addressed in the traditional defined benefit plan
- Defined benefit plans for private & public employees may contain “disability retirement” provisions… but
- These are intended only to provide a modest level of disability benefits prior to normal retirement age
- Do not address the issues of
  - lost years of increasing income
  - lost opportunity for increasing contributions
Eliminating the disability gap: Traditional approaches

Small business market: Qualified or non-qualified retirement plans may be partially funded with life insurance or annuities...

Waiver of premium provisions

Problem:

- These are “split-funded” with other investments (e.g. mutual funds)
- “Waiver of premium” coverage not available for that portion of the contribution

Eliminating the disability gap: Traditional approaches

Graded lifetime benefit period

- Continues portion of monthly benefit past age 65
- Must remain disabled until 65 to collect
- Few companies still offer - used to be a standard optional feature of many individual DI contracts
Eliminating the disability gap: Traditional approaches

“Annuity” rider
- Portion of DI benefit (e.g. 10%) “deferred” - i.e. deposited into an annuity
- No longer available

Eliminating the disability gap: Traditional approaches

Including pension contributions as part of insurable income...
- available to self-employed professionals & business owners
- Example: MD maximizing pension contributions
  - total earned income: $300,000
  - pension contributions: $40,000
- MD may apply for disability income coverage for the entire $300,000, instead of $260,000
Eliminating the disability gap: Traditional approaches

*Including pension contributions as part of insurable income...*

**Problem:**

- Provides inadequate coverage

<table>
<thead>
<tr>
<th>Annual Income</th>
<th>Monthly Income</th>
<th>Monthly Benefit</th>
</tr>
</thead>
<tbody>
<tr>
<td>$300,000</td>
<td>$25,000</td>
<td>$10,700</td>
</tr>
<tr>
<td>$260,000</td>
<td>$21,670</td>
<td>$9,900</td>
</tr>
</tbody>
</table>

- $40,000 pension contribution is insured at only 24% replacement ratio

Eliminating the disability gap: New approaches

- The goal: to replace 100% of retirement contributions, while continuing to provide adequate benefit to cover current living expenses.
- We’ll consider plans using:
  - Group LTD
  - Individual DI policy
- Only a few insurers offer this type of coverage
- Few agents and brokers are aware of the retirement-disability problem
Group LTD: The 401(k) Approach

- Disability benefit for group LTD participants who participate in employer’s 401(k) plan
- Coverage for employee contributions and employer matching contributions
- Disability benefit is payable:
  - directly to the plan
  - to the employer for deposit into the plan
  - to a deferred annuity
- Benefit amount based on a percentage of salary
- Typically 6-month or 12-month elimination period

Group LTD: The 401(k) Approach

**Funding**

- Employer-paid… cost of coverage is deductible, and not taxable to the plan participant.
- Under IRS Section 106 governing employer-paid accident & health (qualified sick pay) plans
- Has not caught on in light of increasing employee benefit costs
Group LTD: The 401(k) Approach

**Funding**

- Employee-paid on a voluntary basis… participants in employer’s retirement plan
- 401(k) plan participant allocates a portion of salary deferral contribution to the purchase of the group disability benefit… as any other plan “investment option”
- Employee pays for coverage on a pre-tax basis
- The plan purchases the coverage and owns it
- Benefits paid directly into the 401(k) plan

**Benefits**

- Employee is not taxed on disability benefits paid to the retirement plan
- Disability benefits are invested into the plan, according to participant’s investment allocation choices, and become 401(k) plan assets
- All 401(k) plan assets grow on a tax-deferred basis
- Plan distributions of amounts of benefits paid and earnings on them are subject to the normal rules surrounding 401(k) plans
Group LTD: The 401(k) Approach

IRS Private Letter Rulings*

- Based on very specific circumstances of the insurers that requested the rulings, the IRS ruled favorably on a number of technical issues, indicating the viability of the Group LTD approach

Note: Private Letter Rulings are useful indicators of the IRS's approach, but are directed only to the taxpayers who request them. Strictly speaking, they may not be used as legal precedent.

Group LTD: The 401(k) Approach

IRS Private Letter Rulings

- Other technical points...
  - The disability coverage is subject to "incidental benefit limits" - i.e. the cost of life and/or disability insurance in a plan must not exceed 25% of total contributions on behalf of a participant
  - Amounts received by the 401(k) plan may not be withdrawn prior to normal retirement age, while the policy (or rider) is paying benefits into the plan
Group LTD: The 401(k) Approach

Advantages

◆ Inexpensive coverage
◆ Easy to obtain & pay for the coverage
  • guaranteed issue, little paperwork
  • payroll deduction, part of 401(k) contribution

Disadvantages

◆ Few carriers currently offer it
  • limited by 401(k) administrative software
◆ Not suitable for typical small business defined contribution plans
Individual DI with Trust

- Individual DI policy issued to cover retirement plan contributions
- Insured is the policy owner
- Benefits irrevocably assigned to a trust set up solely for this purpose
- Upon disability, benefits paid directly to the trust
- Trust assets are invested for the insured’s benefit, at his or her direction
- Trust corpus is distributed at age 65/67

Individual DI with Trust

- May cover 100% of total retirement plan contributions - both employee and employer contributions
- Coverage is issued in addition to normal disability benefits... i.e. above normal issue and participation limits
- If individual is “over-insured” for DI, amount available under a retirement protection program may be offset
- Coverage may be employer-pay or individual-pay
Individual Policy Parameters

- Coverage is issued on companies’ standard policy form(s), structured to fit the retirement protection program

- Typical policy parameters:
  - Total disability only (no partial or residual benefits)
  - Long elimination periods: 6 or 12 months
  - Benefit periods: 5 years, to age 65, to age 67

- Limited choice of riders:
  - COLA
  - Future Increase Option

Retirement Protection Rider

- Coverage may also be issued as a rider, attached to a base policy providing normal DI benefits

- Issue parameters:
  - Total disability only – modified own occupation
  - Long elimination periods: e.g. 6 or 12 months
  - Benefit periods: 5 years, to age 65, to age 67
Underwriting Criteria

- Generally subject to normal medical and financial standards
- Current disability policy owners may qualify for simplified underwriting
- Coverage qualifies for multi-life guaranteed issue programs

Structuring the Policy

- Benefit amount issued based on current level of retirement plan contributions
- Generally the plan must have been in existence and funded for at least one year
- Current maximum issue amounts:
  - Under age 50: up to $3,670 per month (accommodates 2006 maximum DC limit of $44,000)
  - Age 50+: $4,090 (additional catch-up limit of $5,000)
- Higher amounts may be considered - especially useful for non-qualified plans
- Minimum issue amount: $500 per month (for multi-life cases: $200 per month)
Eligible Retirement Plans

- Profit sharing plans, money purchase plans
- Employee Stock Ownership plans (ESOP)
- 401(k) 457, and 403(b) plans
- SEPs & SIMPLE plans
- Keogh plans
- IRA and Roth IRA accounts
- Non-Qualified Deferred Compensation Arrangements (case-by-case basis)

Non-Eligible Retirement Plans

- Defined Benefit plans
- Deferred Stock Option Plans
- Federal Employees/Civil Service Retirement Systems
- State Employees/Teachers Retirement Systems
- SERPS (Supplemental Employee Retirement plans)
- Any portion of a plan funded with life insurance or annuities that include a “waiver of premium” provision is not eligible
  - contributions directed into other investment vehicles may be eligible
Setting up the Policy & the Trust

**Required documentation**

- Authorization to establish trust
- Irrevocable assignment of right to receive benefits
  - assigns policy benefits to the trust
  - necessary to prevent risk of over-insurance
- Authorization for Exchange of Information
  - permits exchange of basic client info between insurer and trustee
- Must be signed and submitted with the application

**Declaration of Trust**

- The key document that sets up the trust
- Sent by trustee to the insured at time of claim
- Insurers do not allow producer to deliver - avoids “unauthorized practice of law”
- Trust is not activated or funded until time of claim
- Sample Declaration of Trust should be provided to the applicant
Trust Investments

- Mutual funds
- Annuities
- Individual securities

Tax Issues – Trust Earnings

- Policy benefits either taxable or non-taxable
  - employee pays: benefits non-taxable
  - employer pays: benefits taxable
- Trust earnings are taxable to the insured, as beneficiary of the trust
  - except if annuity or tax-free investment chosen
- Trust reports taxable income, and upon request will reimburse the insured for any taxes paid
- Trust will reimburse the insured for taxes due on employer-paid benefits

NOTE: The trust is in no way equivalent to a tax-qualified retirement plan.
Tax Issues – Termination of Trust

**Taxable investments**

- At termination (age 65 or 67)
  - trust assets can be liquidated or
  - distributed “in kind” (i.e. transferred to the client)
- No income tax due on distribution of assets
- When shares liquidated, potential short- and long-term capital gains
  - e.g. if mutual fund shares sold, increase in value of shares subject to taxation
  - average basis methods can be used to determine tax basis & therefore any tax due
- Trustee advises client on tax consequences of distribution options

**Tax-deferred annuity**

- No income tax due on annuity earnings
- Annuity distributed “in kind”, i.e. transferred to insured
- Portion of annuity payments (attributable to earnings) subject to income taxes, as with any annuity
# Comparison: Group LTD vs. Individual Policy & Trust

<table>
<thead>
<tr>
<th>Group LTD</th>
<th>Individual DI &amp; Trust</th>
</tr>
</thead>
<tbody>
<tr>
<td>Guaranteed issue</td>
<td>Underwritten or guaranteed issue</td>
</tr>
<tr>
<td>Lower cost</td>
<td>Higher cost</td>
</tr>
<tr>
<td>Earnings grow tax-deferred</td>
<td>Earnings are taxable</td>
</tr>
<tr>
<td>Distribution fully taxable</td>
<td>Distribution tax-free</td>
</tr>
<tr>
<td>Plan or employer</td>
<td>Insured owns the coverage</td>
</tr>
<tr>
<td>Not portable</td>
<td>Fully portable</td>
</tr>
</tbody>
</table>

## What are the markets for each approach?

### Markets for RPP

- **Existing clients**
  - individuals who are contributing to a qualified plan
  - especially those who have purchased DI
- **Businesses**
  - current business clients to whom you have sold a pension plan, QSPP, VIP or group LTD plan
- **Anyone concerned about retirement planning**
Markets for RPP

◆ High income professionals and executives
  ● medical professionals who have “maxed out” on DI coverage
  ● attorneys, dentists, CPAs, etc.

◆ Employer-sponsored, multi-life programs
  ● guaranteed standard issue

◆ Existing clients who
  ● own individual DI
  ● contribute sizeable amounts to a qualified plan

Retirement: Eliminating the Disability Gap

◆ Few prospects are aware of the problem

◆ Few agents and brokers are aware of the problem

◆ Translation: Opportunity to...
  ● speak with your clients & prospects about a new idea
  ● complete their disability insurance protection program
Talk about RPP with CPAs

- CPAs advise their clients about retirement plans.
- They appreciate being kept up to date on latest offerings to help their clients.
- Distinguishes you in the eyes of the CPA.

Marketing tools for RPP

- Producer’s Guide to RPP
- A selection of mailers, including letters and colorful postcards
- Brochures with reply cards
- Imprintable broadcast faxes and ads
- Sales presentations to the employer and employee
- Byline articles