

The Financial Planning Newsletter

What to Know and to Ask About Disability Insurance: The Aflac duck (yes, that loud, quacking, and sometimes, humorous duck) has gone a long way to helping people think about individual disability coverage as a way to keep bills paid if the family breadwinner gets sick or injured over an extended period of time.

Yes, it's true, individual disability insurance is more important than most people think, and most working individuals should have it. The key to the right policy is shopping smart.

Why is it a good idea to have personal disability coverage, particularly when most employees can buy such coverage at work for a nominal fee? Most employers offer disability coverage that lasts 12 weeks or less and covers less than 60 percent of a worker's pretax income. In some cases short coverage might be workable, say for a sickness or injury with a quick recovery time on the couch. On the other hand, a diagnosis for even the most curable cancers can put workers with great financial coverage into a devastating financial bind.

If you are self-employed, the need for the best, most flexible long-term disability insurance is even more important. Other than your own resources, the disability insurance coverage may be your only safety net.

Here are some essential considerations about long-term disability coverage. Remember policy language is critical, and try to get a second, helpful set of independent eyes to review what your insurance agent recommends:

If you're considering becoming self-employed or might lose your job due to layoff: The time to buy long-term disability coverage is NOW, before the layoff. Insurers will base your initial coverage limits on what you're earning in your current job, which is important since entrepreneurs and unemployed often earn considerably less, at least for awhile, once they've left their current employer.

Make sure you can purchase more coverage as your income increases: Most workers stand to earn more in future working years, if only based on inflation. You should make sure your benefit levels can rise to meet the demands of replacing a rising income. Obviously, people who expect to make vastly higher salaries in the future need to plan for this, too.

Check for a non-cancellation feature: Make sure once you're approved, the insurer can't cut

your coverage unless it decides to stop writing coverage for everyone in your class of insured individuals. It should also state the insurer can't raise your rates based on the benefits you're to receive.

Compare benefits and premium costs: Get bids from several carriers and consider going to more than one agent. The premium you pay will depend on a wide array of factors and can vary dramatically from person to person, and insurer to insurer. Such things as your age, health and even your gender may be factors in your premium and benefits.

Go for "own occupation" coverage: Even if you are able to work in a different capacity, own-occupation disability insurance will provide you with the income replacement you need if you are unable to work in your current occupation. Make sure you understand how the coverage you're considering fits your current profession. Remember, own-occupation is increasingly difficult to find and usually more expensive.

Know what "elimination period" means: Like a deductible in other insurance, the elimination period is a big cost determinant in disability coverage. Most long-term disability policies will kick in after 30 days after you've been declared disabled. But if you specify an elimination period of 60, 90 or 120 days, your premium will be lower. An important point about the elimination period is the benefits don't start accumulating until you've been laid up for the requisite period after the insurer has ruled you disabled, and you may not get your first payment until a month after that. Be very clear with your insurer about when you'll get your first check based on what elimination period you choose. Be sure to have a cash cushion to cover your financial needs in your emergency fund.

What's your benefit term: For each disabling incident, your policy may pay benefits for a certain period, say two years, five years or until retirement. It's all in how your policy is constructed. Many policies may pay for life if you purchase this benefit and you are disabled prior to age 60.

See if there's a residual benefit feature: Some policies may offer you 'residual benefits' or a partial payment if you're less than 100 percent disabled, but still can't perform all the duties of your job.

Tax Provisions in the New Health Care Laws: Beginning in 2013, a 3.8% surtax on net investment income will be assessed on high-income individuals. What is a high income earner, any way? The high income threshold (MAGI) will be \$200,000 for single filers and \$250,000 for joint filers (\$125,000 for married filing separately). Here's a kicker, these amounts are not indexed for inflation!

The surtax will be assessed on the lesser of net investment income or the excess of income over the applicable MAGI threshold limit. Looking at a simple example, let's say you have \$220,000 of income as a single filer including \$15,000 of net investment income (investment income minus investment expenses). $\$220,000 - \$15,000 = \$205,000$. In this case, there's only \$5,000 of earnings over the limit of \$200,000, while there's \$15,000 of net investment income, so the tax is on the lesser amount, or 3.8% of \$5,000 is equal to a tax of \$190.00.

IRA distributions and Roth conversion income will not be subject to the 3.8% surtax, but may raise overall income above threshold limits subjecting other (investment) income to the 3.8% tax. Distributions from IRAs are not subject to the 3.8% of net investment income. Unfortunately, IRA distributions may be income and therefore could raise your earnings above the threshold limits. For example, again as joint filers, let's say you have \$290,000 of income, and you withdraw \$30,000 from your IRA to do a Roth conversion. Also, you have net investment income of \$50,000 (included in the \$290k). Your total income is now \$320,000, and \$50,000 (all of the net investment income since \$50,000 is less than \$70,000 (\$320,000 minus \$250,000)) is subject to the 3.8% surtax, or an additional tax of \$1,900.00.

The 3.8% surtax may make 2010 Roth conversions more valuable for those who will be at the top tax rates. As always, the conversion tax should be paid from other non-IRA investments to keep that income from being subject to the surtax in 2013 and future years. As we've always emphasized, comparing today's known income tax rate to a future unknown income tax rate places a great burden on the decision maker. And, of course, the emphasis is on income taxes, not other taxes.

The benefits of tax free income sources like Roth IRAs and municipal bonds may increase in value as tax rates increase. One reason municipal bonds may be a better way to "buy" taxes rather than a Roth IRA is the fickleness of Congress. Congress may have the ability to act solely to do way with Roths, or to make distributions from inherited Roths taxable. With municipal bonds, the Supreme Court would have to join Congress in changing this basic Constitutional tenet, and I see that as very unlikely, especially given the outcome of the recent Kentucky case.

When it comes to trusts and trust income, the story is even more depressing. The 3.8% surtax will hit certain IRA trusts hard since it kicks in at much lower income levels, after approximately only \$12,000 of undistributed taxable trust income. Currently, the top tax rates for a trust kick in at \$11,200. In 2013, this top trust tax rate may kick in at a little under \$12,000 when inflation is considered.

In 2013 an *additional* Medicare tax of 0.9% will apply to wages and self-employment income above the \$250,000 (\$125,000) / \$200,000 threshold amounts. Those with both high investment income and high earned income could get hit with both Medicare taxes.

The amount of unreimbursed medical expenses is also increasing, if you want a tax break on those expenses. Your unreimbursed medical expenses will have to exceed 10% of AGI in 2013 (up from 7.5% today) to be deductible. For those 65 and older, this tax law change doesn't begin until 2017. The 10% level also applies to the medical expense exception to the 10% penalty on early IRA or plan withdrawals.

Following are three Tables summarizing some key points.

Table 1, Investment Income:

- Interest, Dividends, Capital Gains (long and short)
- Annuities (but not annuities in IRAs or company plans)
- Royalty Income
- Passive Rental Income
- Other Passive Activity Income

Table 2, NOT Investment Income:

- Wages and Self-Employment Income
- Active** Trade or Business Income (including interest, dividends, capital gains)
- Distributions from IRAs, Roth IRAs, and Company Plans
- Excluded Gain from the Sale of a Principal Residence
- Municipal Bond Interest
- Proceeds of Life Insurance Policies
- Veterans' Benefits
- Gains on the Sale of an Active Interest in a Partnership or S Corporation

Table 3, Top Federal Tax Rates for Certain Income Types by Year

Income Type	2010	2011	2012	2013*
Taxable IRA distributions and Roth conversions (Ordinary Income)	35.0%	39.6%	39.6%	39.6%
Short-term Capital Gains	35.0%	39.6%	39.6%	43.4%
Long-term Capital Gains	15.0%	20.0%	20.0%	23.8%
Interest Income	35.0%	39.6%	39.6%	43.4%
Qualified Dividend Income	15.0%	39.6%	39.6%	43.4%
Qualified Roth IRA Distributions	0%	0%	0%	0%

*In 2013 the top federal tax rate includes income taxes **and** the 3.8% surtax on investment.

Many of the provisions are the same whether discussing distributions from IRAs or qualified plans, such as 401k, 403b and other salary deferral plans. The immediate income reduction of these salary deferral plans may play a key role for some taxpayers. The salary deferral can help

taxpayers reduce income to avoid the 3.8% surtax, but salary deferrals won't matter in the case of the 0.9% additional Medicare tax; you'll still pay that. A consideration for some taxpayers may be to use traditional 401k plans, instead of Roth 401k plans to avoid current taxation.

For some taxpayers, the Roth IRA or Roth conversion may become a more valuable tool. While for other taxpayers, the traditional IRA will remain the investing vehicle of choice. When it comes to the Roth option of a 401k or 403b, the benefit of the Roth or the traditional approach is magnified by the fact that 401k and 403b contributions may range up to \$22,000 for those taxpayers 50 years of age and older who can make "catch-up" contributions. Remember, this contribution amount is nearly four times the amount that can be contributed to an IRA, \$6,000 including the catch-up contributions for 2010, and likely to remain there for 2011.

Two Quick Tips: In 2011, the tax on long term capital gains (those investments held more than one year) will increase to 20% from the current 15%, per the 2001 Tax Act. So, if you happen to have long term capital gains in a taxable account, this might be the year to take those gains.

One final tip, especially for charitably inclined individuals is to gift appreciated investments, and then get a tax deduction for the full fair market value at time of transfer to the charity. You don't even need to worry about knowing what the original cost was or paying tax on the gain. The charitable contribution is equal to the full fair market value upon the completed transfer of the investment. With the charitable contribution, you do not pay the capital gains tax, either. So, this strategy will last into future years, too.