



Disability Buy-Out and Overhead Expense: ***Important and Often Overlooked Extensions of Business Continuation Planning***

By: Jonathan Smith

Producers who work closely with business owners have likely discussed their clients' plans for continuation of the business in the event of death. A natural extension of this planning is to make business clients aware of two equally important needs that are often overlooked: Disability Buy-Out and Overhead Expense Plans.

Business owners readily accept the concept of funding Buy/Sell Agreements with life insurance because while death is certain, the time of death is not. The truth of the matter is that the likelihood of total disability of one of the owners occurring prior to age 65 far exceeds the possibility of premature death. According to the American Association of Health Plans (formerly HIAA) statistically:

- 67% of people who suffer heart attacks – the number one killer in America – survive.
- Cancer survival rates have reached 56%.
- The greatest number of disability cases involves people 30-49 years of age with the average age being 41.
- About 30% of Americans ages 35-65 will suffer at least one disability lasting 90 days or longer at some point during their working careers

The disability of a business owner may create economic problems which are far more devastating than death if a proper plan is not in force. It is essential that financial advisors understand and discuss the ramifications of disability as part of a comprehensive business continuation plan.

Many Buy/Sell Agreements include a disability buy-out provision but are not supported by a funding method. When reviewing a business owner's Buy-Sell Agreement, a review of the policies that will fund the buy-out may reveal that there are no such policies in force. This could create a major economic problem for the business because the Agreement requires the healthy owner(s) to buy out the disabled owner's interest in that company. Without a funding strategy in place, could the healthy owner(s) afford to write that check to purchase the disabled owner's share of the business without liquidating business assets? Would the business be able to continue as a going concern?

Disability Buy-Out Insurance provides the funding for the purchase of a disabled owner's interest in the event of a long term, total disability. Overhead Expense Insurance covers the operating expenses of a business when an owner or key employee can no longer generate

revenue due to a disability. The two products work nicely in tandem. Overhead Expense Insurance fills the gap immediately following the onset of disability to keep the business open. If the disability becomes long term and the Buy/Sell Agreement is properly funded, then the owner(s) can meet their buy-out obligations without placing their company in further financial trouble.

The market for Disability Buy-Out and Overhead Expense Insurance is primarily small, closely held businesses. The owners play an active role in the business, and often their personal service is essential to the business' survival. Disability Buy-Out and Overhead Expense Insurance can address the full line of business continuation needs of this market. Advisors are also in a good position to generate additional compensation by expanding market and product lines.

Overhead Expense Insurance provides the following advantages:

- Helps relieve a “double burden” – disabled business owners have both personal and business expenses. Overhead Expense insurance can help provide the funds to pay the business' ongoing bills and employee salaries.
- Provides a measure of “job security” – business owners have probably spent many years building their business. Overhead Expense Insurance helps protect the business asset.
- Maintains goodwill – Overhead Expense Insurance allows the business to remain on good terms with customers, vendors, and creditors, and helps protect against a drain on business capital.
- Helps retain business value – should an owner be forced to sell the business due to a permanent disability, the ability to keep the operation running smoothly helps ensure the valuation of the business as a going concern.

Disability Buy-Out Insurance provides the following advantages:

- Maintains business continuity and credibility, which are concerns of customers, creditors and employees.
- Assures that the disabled owner and his/her family will not have to manage the business in the event of total disability.
- Assures that the active owner(s) will retain control of the business.
- Assures the disabled owner that his/her financial future is not contingent on the strength of the business: and
- Provides funds needed to pay medical bills and living costs for the disabled owner.

Business owners will consider these issues to be very important asked the proper questions, like:

- **“If one of the owners becomes disabled, how would you want the transfer of ownership to occur?”** or

- **“Do you want the spouse of your disabled partner to assume his/her role at your company?”**

When discussing Disability Buy-Out and Overhead Expense Coverage, it is important to understand:

- Tax Consequences. . Premiums for Buy-Out coverage are not deductible; however, disability benefits are tax free. In the case of Overhead Expense coverage, premiums are deductible and benefits are taxable to the business. However, this tax may be offset by the deductibility of the expenses to the business.
- Payout methods and elimination periods. To save cost and to obtain appropriate buy-out coverage, disability insurance with a longer elimination period, such as 2 years, may be considered. Although the buy-out funding must be available at the time the disability occurs, a cost savings approach is the Installment Payout Method. Monthly disability benefits typically do not continue if the insured dies within the installment or benefit period and, therefore, the costs of funding the disability benefits in this manner are less. To assure full funding of the buy-out obligation, advisors favor the lump sum option, which is handled essentially like a life insurance benefit. If the Insured business owners prefer an installment Buy-Out, the Lump Sum proceeds can be paid to a Trustee to hold, and subsequently release the funds over a stipulated period.

These business continuation products are great door openers and create many new business opportunities such as life insurance, individual or key person disability coverage and other salary continuation plans. Business owners should be made aware of the risks of disability: Bankers are becoming increasingly aware of the impact of disability to borrowers' loan repayment potential because roughly 25% of all bankruptcies are tied to an illness or injury. And the Federal Home Loan Bank has determined the major cause of mortgage loan foreclosures is disablement of the mortgagee; 48% compared to 3% of foreclosures due to death.

Jonathan Smith is Vice President of the Capitas Disability Income Center. He can be reached at (800) 845-7707 extension 514.