Disability income: How is it taxed?

Many Americans receive disability income. You may wonder if — and how — it’s taxed. As is often the case with tax questions, the answer is … it depends.

The key factor is who paid for the benefit. If the income is paid directly to you by your employer, it’s taxable to you as ordinary salary would be. (Taxable benefits are also subject to federal income tax withholding, although depending on the employer’s disability plan, in some cases aren’t subject to the Social Security tax.)

Frequently, the payments aren’t made by the employer but by an insurance company under a policy providing disability coverage or, under an arrangement having the effect of accident or health insurance. If this is the case, the tax treatment depends on who paid for the coverage. If your employer paid for it, then the income is taxed to you just as if paid directly to you by the employer. On the other hand, if it’s a policy you paid for, the payments you receive under it aren’t taxable.

Even if your employer arranges for the coverage, (in other words, it’s a policy made available to you at work), the benefits aren’t taxed to you if you pay the premiums. For these purposes, if the premiums are paid by the employer but the amount paid is included as part of your taxable income from work, the premiums are treated as paid by you.

A couple of examples

Let’s say your salary is $1,000 a week ($52,000 a year). Additionally, under a disability insurance arrangement made available to you by your employer, $10 a week ($520 for the year) is paid on your behalf by your employer to an insurance company. You include $52,520 in income as your wages for the year: the $52,000 paid to you plus the $520 in disability insurance premiums. In this case, the insurance is treated as paid for by you. If you become disabled and receive benefits, they aren’t taxable income to you.

Now, let’s look at an example with the same facts as above. Except in this case, you include only $52,000 in income as your wages for the year because the amount paid for the insurance coverage qualifies as excludable under the rules for employer-provided health and accident plans. In this case, the insurance is treated as paid for by your employer. If you become disabled and receive benefits, they are taxable income to you.

Note: There are special rules in the case of a permanent loss (or loss of the use) of a part or function of the body, or a permanent disfigurement.

Social Security benefits

This discussion doesn't cover the tax treatment of Social Security disability benefits. These benefits may be taxed to you under different rules.

How much coverage is needed?

In deciding how much disability coverage you need to protect yourself and your family, take the tax treatment into consideration. If you're buying the policy yourself, you only have to replace your after tax, "take-home" income because your benefits won't be taxed. On the other hand, if your employer pays for the benefit, you'll lose a percentage to taxes. If your current coverage is insufficient, you may wish to supplement an employer benefit with a policy you take out.