



### **The tax implications of disability income benefits**

Many Americans receive disability income. Are you one of them, or will you soon be? If so, you may ask: Is the income taxed and if it is, how? It depends on the type of disability benefit and your overall income.

The key issue is: Who paid for the benefit? If the income is paid directly to you by your employer, it's taxable to you just as your ordinary salary would be. (Taxable benefits are also subject to federal income tax withholding. However, depending on the employer's disability plan, in some cases they aren't subject to Social Security tax.)

Frequently, the payments aren't made by an employer but by an insurance company under a policy providing disability coverage. In other cases, they're made under an arrangement having the effect of accident or health insurance. In these cases, the tax treatment depends on who paid for the insurance coverage. If your employer paid for it, then the income is taxed to you just as if it was 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 a policy made available to you at work), the benefits aren't taxed to you if you (and not your employer) 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 will be treated as paid by you. In these cases, the tax treatment of the benefits received depends on the tax treatment of the premiums paid.

### **Illustrative example**

Let's say your salary is \$1,050 a week (\$54,600 a year). Additionally, under a disability insurance arrangement made available to you by your employer, \$15 a week (\$780 annually) is paid on your behalf by your employer to an insurance company. You include \$55,380 in income as your wages for the year (\$54,600 paid to you plus \$780 in disability insurance premiums). Under these circumstances, the insurance is treated as paid for by you. If you become disabled and receive benefits under the policy, the benefits *aren't* taxable income to you.

Now assume that you include only \$54,600 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 the employer. If you become disabled and receive benefits under the policy, the benefits *are* taxable income to you.

There are special rules if there is a permanent loss (or loss of the use) of a member or function of the body or a permanent disfigurement. In these cases, employer disability payments aren't taxed, as long as they aren't computed based on amount of time lost from work.

### **Social Security disability benefits**

This discussion doesn't cover the tax treatment of Social Security Disability Insurance (SSDI) benefits. They may be taxed to you under the rules that govern Social Security benefits. These rules make a portion of SSDI benefits taxable if your annual income exceeds \$25,000 for individuals and \$32,000 for married couples.

### **State rules may differ**

If you receive disability benefits, your state may or not tax them. Consult with us to find out and to discuss this issue further.

When deciding how much disability coverage you need to protect yourself and your family, take the tax treatment into consideration. If you're buying a private 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 is paying for the benefit, keep in mind that you'll lose a percentage of it to taxes. If your current coverage is insufficient, you may want to supplement the employer benefit with a policy you take out on your own.