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Taxability of disability income

The key question is: Who paid for the benefit? If the income is paid directly to you by your employer, it is taxable to you just as your 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 they are not subject to the Social Security (FICA) tax.)

Frequently, the payments are not made by the employer but by an insurance company under a policy providing disability coverage or, beginning in '97, 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 insurance 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 are not taxable.

Even if your employer arranges for the coverage, i.e., it's a policy made available to you at work, the benefits are not 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.

Example (1): Max's salary is \$1,000 a week (\$52,000 for the year). Additionally, under a disability insurance arrangement made available to him by his employer, \$10 a week (\$520 for the year) is paid on his behalf by his employer to the ABC insurance company. Max includes \$52,520 in income as his wages for the year: the \$52,000 actually paid to him plus the \$520 in disability insurance premiums. Under these facts, the insurance is treated as paid for by Max. If he becomes disabled and receives benefits under the policy, the benefits are not taxable income to him.

Example (2): The facts are the same as in Example (1) except that Max includes only \$52,000 in income as his 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. Under these facts, the insurance is treated as paid for by the employer. If Max becomes disabled and receives benefits under the policy, the benefits are taxable income to him.

Special rules: In the case of a permanent loss (or loss of the use) of a member or function of the body, or a permanent disfigurement, employer disability payments are not taxed, as long as they are not computed based on amount of time lost from work.

Social Security disability benefits: Please note that this discussion doesn't cover the tax treatment of Social Security disability benefits. These benefits may be taxed to you under the rules that govern Social Security benefits. Please let me know if you'd like me to address this issue separately.

How much coverage do you need? In deciding how much disability coverage you need to protect yourself and your family, you should 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 will not be taxed. On the other hand, if your employer is paying for the benefit, keep in mind that you will lose a percentage of it to taxes. If your current coverage is insufficient, you may wish to supplement the employer benefit with a policy you take out on your own.