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Taxation of Disability Insurance Benefits and Premiums

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What is it?

Like all income, the income you receive from disability insurance may or may not be taxable. The taxability of disability insurance benefits depends on what type of benefits you are receiving, whether the premiums were paid with pretax or after-tax dollars, and who paid the premiums--you or your employer.

Individual disability income insurance

The rules surrounding taxation of individual disability income insurance benefits are generally simple. Because you pay the premiums with after-tax dollars, benefits you receive are tax free. However, unlike health insurance premiums, you can't deduct premiums paid for individual disability income insurance as a medical expense.

Example(s): *Jessie paid $175 per month for her individual disability income insurance policy. When she became disabled, she began receiving disability benefits and had $15,000 in disability income for the year. When she filled out her tax return, she did not have to include that amount as income. However, neither could she deduct the $2,100 premium she paid for disability insurance as a medical expense.*

Caution: *Sometimes, your employer may pay your individual insurance policy premium. This may be the case if you are considered to be a key employee of the business. If so, different rules apply. See the following section on group disability insurance.*

Group employer-sponsored disability insurance

Who pays the premium?

If you are enrolled in a group disability insurance plan sponsored by your employer, the taxability of your benefits depends on who pays the premium. If you pay the total premium using after-tax income, then your benefits will be tax free. Conversely, if your employer pays the total premium, and does not include the cost of coverage in your gross income, then your benefits will be taxable. If your employer pays part of the insurance premium and you pay the rest, then your tax liability will be split as well. Any part of the benefit you receive that is attributable to the employer-paid share of the premium is taxable. Any part of the benefit attributable to your share of the premium is tax free.

Example(s): *Phyllis was covered by a group disability insurance plan at work. Her employer paid 50 percent of the monthly premium, and Phyllis paid 50 percent using after-tax dollars. When she became disabled, Phyllis received a $1,000 benefit monthly for six months. When she filed her income taxes, she only had to pay tax on $3,000 (50 percent of the benefit she had received), the part attributable to her employer's contribution.*

Is your share of the premium paid for with pretax or after-tax dollars?

If you pay any part of the premium for employer-sponsored disability coverage, the type of dollars you use to pay the premium determines whether your benefit will be taxable. If you pay your part of the premium with pretax dollars, you'll owe income tax on any disability benefit you receive that is attributable to that part of the premium. However, if you pay your part of the premium with after-tax dollars, you won't owe income tax on any disability benefit you receive that is attributable to that part of the premium.

How are benefits paid under cafeteria plans?

If your employer offers benefits under a cafeteria plan , you will be allowed to select among certain employee benefits, such as health, life, and disability insurance. You normally pay for these benefits on a pretax basis, but sometimes your employer pays the premium for the benefits you choose up to a certain amount, and you pay (through payroll deduction) for any extra coverage you choose using either pretax or after-tax dollars. If you pay your share of the premium with after-tax dollars, then that portion of your disability benefits will be considered tax-free income. However, if you pay your share with pretax dollars, then that portion of your disability benefits will be considered taxable income. This means that if you pay part of the disability premium with pretax dollars, you'll have to pay income tax on all of your benefit. By comparison, if you pay your share of the premium with after-tax dollars, you'll pay income tax only on that portion of the benefit attributable to your employer's contribution. See Questions & Answers.

Example(s): *Brenda decided to buy health insurance, accidental death and dismemberment insurance, and long-term disability insurance through her employer's cafeteria plan. The total premium cost for all three benefits was $200 monthly. Under her employer's plan, Brenda's share was $100 per month (paid in after-tax dollars), because her employer provided $100 in monthly benefits to each employee. When Brenda became disabled and began receiving benefits, she had to pay tax on only 50 percent of her benefit (the part of her benefit attributable to her employer's contribution), since she had used after-tax dollars to pay her share of the premium.*

Technical Note: *The amount of benefits attributable to your employer's contribution is determined by using regulations set forth in IRC Section 105. If you have questions regarding how your employer's contribution is calculated, consult your tax advisor or other professional.*

Caution: *If you are totally and permanently disabled and you receive disability benefits from an employer-sponsored disability insurance plan that is fully or partially taxable, you may be eligible to claim a tax credit when you file your annual income tax return.*

Group association disability insurance

Disability policies purchased through an association are called group policies because members of the association are offered special terms, conditions, and rates based on the characteristics of that group. However, association policies really function like individual policies, and the tax consequences are similar: If you pay the premiums, the benefits you receive from an association policy are tax free, and premiums you pay are not deductible.

Government disability insurance

Sometimes, benefits are taxable

In general, all or part of the disability benefit you receive through government disability insurance programs will be taxable in certain cases. How much of the benefit is taxable, and under what circumstances, depends on the type of government disability benefit you are receiving.

Social Security benefits

If the only income you had during the year was Social Security disability income, then your benefit usually isn't taxable. If you earned other income during the year or had substantial investment income, however, then you might have to pay tax on part of your benefit if your total income exceeds a certain base amount. The rule is that your Social Security benefit is taxable if your modified adjusted gross income plus one-half of your Social Security benefit exceeds the base amount for your filing status.

Example(s): *Cole becomes disabled and begins receiving Social Security disability benefits. Since he files his taxes as single, his base amount is $25,000. His modified adjusted gross income (taxable income he receives not including his Social Security benefits) is $20,000. He receives another $7,000 in Social Security benefits. Since his modified adjusted gross income plus one-half of his Social Security benefit ($20,000 plus $3,500) does not exceed his base amount, Cole does not have to pay tax on any of his Social Security disability benefit.*

Medicare benefits

When you are disabled, you may be eligible to enroll in Medicare . If you pay premiums for the medical insurance portion of Medicare, you may deduct these premiums as a medical expense (provided, of course, that your medical expenses exceed 10 percent of your adjusted gross income). In addition, Medicare benefits you receive are not taxable.

Caution: *Taxpayers age 65 and over can use the 7.5 percent income threshold until 2017.*

Workers' compensation

Generally, if you receive a disability benefit from workers' compensation , that benefit won't be taxable. Any benefits paid to your survivors are also tax exempt. In certain cases, however, you may be able to return to work and continue to receive payments. If this is the case, then your workers' compensation benefit will then be taxable.

Caution: *If part of your workers' compensation benefit offsets (reduces) your Social Security benefit, that part is considered to be a Social Security benefit. It may then be taxable according to the rules governing Social Security.*

Department of Veterans Affairs (VA) benefits

Disability benefits you receive from the Department of Veterans Affairs (VA) are not taxable, except for certain payments for rehabilitative services.

Military benefits

Most military disability pensions are taxable. However, if you were disabled as a result of injury or sickness resulting from active service in the Armed Forces of any country, your disability benefits may be tax free if any of the following rules apply:

- You were entitled to receive a disability payment before September 25, 1975
- You were a member of a government service or its reserve component, or you were under a binding written commitment to become a member, on September 24, 1975
- You receive disability payments for a "combat-related injury"
- You would be entitled to receive disability compensation from the Department of Veterans Affairs (VA) if you filed an application for it

If none of the above conditions apply, your disability benefit will be taxable. If your benefit is based only partially on a combat-related injury, only that part of the benefit related to combat will be tax free.

Federal employees retirement system (FERS) benefits

Under FERS , if you retire on disability, the payments you receive from a pension or annuity are taxable as wages until you reach minimum retirement age (defined as the age at which you can first receive a pension or annuity if you are not disabled). Beginning on the day after you reach minimum retirement age, payments you receive are taxable as a pension.

Questions & Answers

If you have the option of paying for disability coverage with pretax dollars or after-tax dollars, which is better?

If you pay for disability insurance with pretax dollars, you are, in effect, reducing your taxable income. This means that you won't have income taxes withheld on that portion of your income that pays your disability insurance premium because that money is nontaxable. However, you also have to consider how your benefit will be taxed if you ever begin receiving disability benefits. If you use pretax dollars to pay your insurance premium, then your benefit will be fully taxable because it's considered to be an employer contribution. However, if you use after-tax dollars, your benefit won't be taxable. What it comes down to is this: If you never use your disability benefits, you'll save money by paying your premium with pretax dollars. But if you do use your disability benefits, you'll end up with a lot more money if you used after-tax dollars to pay your premium. Consult with your tax professional for advice.

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