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## TAXATION OF DISABILITY INSURANCE BENEFITS

By Victor Sy, CPA, MBA

As part of our financial responsibility for ourselves and our families, some of us buy or have our employers pay for disability insurance to protect our income if we become disabled and are unable to work.

### **Are benefits collected under an insurance policy taxable income?**

1. If you buy disability insurance and **you pay for it from your own pocket**, you cannot deduct the premiums but benefits received under the policy are tax-free. This is true whether you pay the premiums directly to an insurance carrier, through an association, or in the case of an employee, from payroll withholdings where the premiums are paid from after-tax dollars.
2. On the other hand, if premiums are **paid by your employer**, with pretax dollars in a cafeteria-benefit plan, the benefits are fully taxable.

In the case of a regular C corporation where your employer pays the premiums, such premiums are **deductible by your employer but are taxable to you** when you receive disability benefits. The only exception to this taxability rule is when payments received are due to permanent disfigurement, permanent loss of use, or dismemberment.

When premiums are paid by **pass-through entities such as partnerships, S corporations, limited liability companies (LLCs) and limited liability partnerships (LLPs)**, the company gets a guaranteed payment deduction and you report the premiums as a taxable guaranteed payment income. While employees do not have to report the premium payments as income, partners are generally not considered employees for fringe benefit purposes and, therefore, cannot exclude the premium payments as income. While disability benefits from premiums paid by partnerships are taxable to partners, it appears that shareholder-employees of S corporations can escape this taxation of disability benefits because they are not considered employees for fringe benefit taxation purposes. This is one advantage that S corporations have over regular corporations and partnerships. There is a different story with a different treatment when an S corporation self-insures instead of buying coverage insurance from an insurance carrier. Shareholder-employees of S corporations are then taxed on benefit payments.

Despite all its complexities, disability benefits can be received **tax-free if you follow these two rules:**

1. **Pay the premiums from your own pocket.**
2. **Use an insured plan.**

Watch out for that special “lookback rule.” This applies when an employee attempts to take over premiums previously paid by an employer. A proportionate share of benefits received is taxable to the extent that the employer paid any premiums for the three preceding years. It might be better for you to take out a new individual policy to assure that your benefits are tax-free.