Guardian®

Disability insurance and general tax considerations

The taxation of premiums and benefits for disability income (DI) insurance policies will generally vary according to the ownership choice and beneficiary designations on the policies and whether the policy is personally purchased or provided by an employer. For business owners, disability insurance products can solve many business problems or fulfill personal and business objectives in a potentially tax-advantaged manner.

This brochure provides an overview of the general tax considerations with respect to DI insurance policies based on current federal tax law, which is subject to change. The information provided in this brochure should not be used as tax advice. For questions about your individual situation, consult with your own tax and legal advisors.

Individual disability income insurance

Through a personal purchase

As a general rule, the premiums paid for a DI insurance policy are not a tax-deductible expense. The benefits, however, are typically received income tax free. This ensures that the policy owner receives every dollar of the policy's benefits during the time of a disability claim.

Through employer-provided coverage for employees

Executive Bonus Plan

In an Executive Bonus arrangement, a business provides an employee with additional compensation in the form of a bonus to cover the premium for the policy. Instead of cash, a business pays a premium to the insurance company on behalf of the employee for a personally owned DI insurance policy. The employee recognizes taxable income from this bonus when paid and the business may deduct the bonus as compensation so long as the bonus is deemed "reasonable" in the eyes of the Internal Revenue Service (IRS).

Policy owner and beneficiary	Is premium deductible?	Taxation of DI benefits
Employee	Bonus paid to cover premium by employer may be deductible. Bonus may be included in employee's taxable income.	Generally tax-free

Qualified Sick Pay Plan (QSPP)

A QSPP is a formal written plan that addresses if and how a disabled employee can continue to receive compensation from the business during a period of disability. Without a written QSPP, salary payments made to a disabled employee are not considered deductible business expenses. If compensation is paid to a disabled employee without a written QSPP in place before the disability, any deductions claimed by the business may be disallowed and back taxes, penalties and interest may apply. A written QSPP also helps to avoid claims from other employees of unlawful discrimination.

There are several variations of a funded QSPP. These depend on the business' objectives and financial condition. One method of establishing a QSPP is to fund the plan with DI insurance policies to allow a business to transfer the responsibility for benefit payments and claims administration to the insurance company, and to avoid an unfunded liability weighing down the business' balance sheet or adversely impacting cash flow.

The chart on the next page summarizes popular variations of the funded QSPP and the possible tax treatment of DI insurance premiums and benefits. Assume for all variations — except "Contributory" — that the employer pays the full premium amount.

QSPP variation	Policy owner and beneficiary	Premiums paid by	Is premium deductible?	Taxation of DI benefits
Employer-owned	Employer	Employer	No	Generally, tax-free to Employer
Traditional	Employee	Employer	Yes	Generally, taxable income to Employee.
Contributory	Employee	Employer/Employee	Yes, to the extent of the employer's contribution.	Generally, tax-free in proportion to employee's contribution to the DI insurance premium.

In a Contributory QSPP, the business and the employee share responsibility for DI insurance premium payments. The employee's contribution is generally made through an after-tax payroll reduction. If an employee receives benefits, they may be tax-free in proportion to the employee's contribution to the DI insurance premium. For example, if the business contributed 80% to the premium cost and the employee contributed 20%, 20% of the DI insurance benefits may be received by the employee income tax-free.

Employer provided coverage for owner-employees

An owner-employee may also maintain an individual DI insurance policy paid for by the business. Personal tax consequences and the tax consequences to the business depend on the structure of the business. For example:

- Sole proprietors are considered "self-employed." As such, payments of individually owned DI insurance policy premiums are not deductible to the business even when using the business checkbook. Benefits are generally received income-tax free.
- Premium payments made by a partnership for individually owned DI insurance policies for its partners, or by a limited liability company (LLC) taxed as a partnership for its members, may be considered a form of "guaranteed payments." These guaranteed payments are generally deductible to the partnership or LLC and included in income by the partners or members. Benefits are generally received income tax-free.
- For a shareholder of an S corporation, premium payments made by the corporation for the shareholder are generally deductible by the corporation, provided that the shareholder is either an employee or owns more than 2% of the outstanding shares. The premium payments will typically be included in income by the shareholder-employee. Benefits are generally received income tax-free.
- For a shareholder of a C corporation, premium payments made by the corporation for the shareholder are generally deductible by the corporation provided the shareholder is also an employee. The premium payments may be included in the shareholder-employee's income (as in the Executive Bonus arrangement previously mentioned). If premium payments were included in income, benefit payments will generally be income tax-free; if premium payments were not included in income, benefit payments will generally be taxable.

Disability Buy-Out Insurance

Disability Buy-Out insurance (DBO) is used to fund the purchase of a disabled business owner's business interest pursuant to the terms of a buy-sell agreement. There are two basic variations of a buy-sell agreement: the entity purchase agreement (stock redemption agreement if the entity is a corporation); and the cross-purchase agreement.

Type of buy-sell agreement	Who/what owns the DBO policy?	Who/what is the loss payee of the DBO policy?	Who/what redeems the disabled owner's business interest?
Cross-purchase	Business owner (each owner owns a DBO policy on his/her co-owners)	Business owner	Non-disabled co-owners
Entity-purchase	Business entity	Business entity	Business entity
One-way buy-sell	Intended buyer	Intended buyer	Intended buyer

With entity purchase agreements, premiums paid by the business for DBO insurance are not deductible but benefits likely will be received by the business income tax-free. In a cross-purchase agreement, if the business pays the premiums, the likely tax consequences to the business owner(s) should be the same as discussed in the previous section Employer provided coverage for owner-employees.

DBO insurance benefits are generally received income tax-free to reimburse amounts paid by the business or other owners to purchase the disabled owner's business interest. The disabled owner may, however, be subject to taxes from the sale of his or her ownership share.

Business Overhead Expense Insurance

For Business Overhead Expense insurance (OE insurance) the business is the owner, loss payee, and premium payor of the OE insurance policy. The premiums are generally considered a deductible business expense. Upon the disability of an insured owner, the business will receive the benefits from the OE insurance policy. These benefits are reported as taxable income to the business. The business then uses the policy benefits to pay typical business expenses which then may be deductible to the business.

Policy owner	Is premium deductible?	Taxation of DI benefits
Business or owner	Yes	Generally, reportable as income

Business Loan Protection

Business loan protection is available as either a stand-alone policy or as a rider on an Overhead Expense policy. The policy is typically owned by the business or the owner and the premiums are tax-deductible. Any benefits received are taxed as income.

Policy owner	Benefits paid to	Is premium deductible?	Taxation of DI benefits
Business or owner	Policy owner	Yes	Generally, reportable as income

Key Person Coverage through PayGuard Plus

Key Person Coverage provides a benefit to the business if a covered employee is unable to work due to disability. As this coverage is owned by the business, the premiums are not tax-deductible, however, the benefits are tax-free.

Policy owner	Benefits paid to	Is premium deductible?	Taxation of DI benefits
Business entity	Business entity	No	Generally tax-free

Summary

Consult with your Guardian financial representative to discuss your personal and business needs and objectives to ensure that you are adequately protecting your ability to continue earning income — the source of your livelihood, wealth accumulation, and for business owners, the core to the success of your business.

Throughout this brochure, we reference federal income taxes only. Individual states may have their own local laws with respect to the taxation of premiums and benefits. You must consult with your own tax and legal advisors with knowledge of local laws. Guardian does not provide for employer owned individual disability policies so the Employer Owned QSPP variation is not available with Guardian products.

The Guardian Life Insurance Company of America

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New York, NY

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