Disability benefits may have income tax consequences you don’t expect

Disability insurance is a valuable benefit provided by many employers. It replaces a portion of the insured person’s income — typically 45% to 65% of pre-disability earnings — after a specified waiting period that starts when the person becomes disabled (as defined by the policy’s terms). Whether you’re just beginning to receive disability benefits or you’re evaluating your long-term financial security, it’s important to understand the tax implications of these benefits.

Payment of premiums

Taxability of disability insurance benefits usually hinges on who paid the premiums. If *your employer* paid the premiums, then payouts from the policy generally will be taxed to you just as if the income were paid directly to you by your employer. If *you* paid the premiums, the payments you receive generally won’t be taxable.

Even if your employer arranges for the coverage (in other words, it’s a policy made available to you at work), as long as you pay the premiums, the benefits generally won’t be taxable. For these purposes, if the premiums are paid by your employer but the amount paid is included in your taxable income from work, the premiums will be treated as paid by you.

The rules in action

Let's say your salary is $1,500 a week ($78,000 a year). Under a disability insurance arrangement made available to you by your employer, $20 a week ($1,040 annually) is paid on your behalf by your employer to an insurance company. Your Form W-2 reports $79,040 in income as your wages for the year ($78,000 paid to you plus $1,040 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 *won't be* taxable income to you.

Now assume that only $78,000 is reported on your W-2 as your wages for the year because your employer treats the amount paid for the insurance coverage as excludable under the rules for employer-provided health and accident plans or because the coverage is paid through a cafeteria plan. In this case, the insurance is treated as paid for by your employer. If you become disabled and receive benefits under the policy, the benefits *will be* taxable income to you.

Special rules apply if there's a permanent loss (or loss of the use) of a part or function of the body or a permanent disfigurement.

Other disability benefits

If disability income is paid directly to you by your employer, rather than by an insurance company, it's generally taxable to you just as your ordinary pay would be. Taxable benefits are also subject to federal income tax withholding. However, depending on your employer's disability plan, these benefits might not be subject to Social Security tax.

Different rules apply to the tax treatment of Social Security Disability Insurance (SSDI) benefits. SSDI benefits are taxed under the same rules that apply to Social Security benefits. Depending on your income and filing status, some of your SSDI benefits may be taxable.

More considerations

The tax treatment of disability benefits can have a major impact on what you'll end up with in your pocket. So it's important to consider taxes when determining how much disability coverage you need. Keep in mind that state tax treatment of disability benefits varies.

If you're paying the premiums, you have to replace only your "after tax" (take-home) income because your benefits won't be taxed. But if your employer is paying the premiums, you'll lose a percentage of your benefits to taxes and may need more coverage. We can help you assess how much disability coverage you need depending on the tax consequences and other factors.