**Tax Considerations in Disability Insurance**

Disability insurance - whether acquired via the workplace or through an individual plan - is a must for working people. This is particularly true for younger workers, because in many families, the single most valuable asset the family has is the future earning power of a breadwinner. For working Americans below their mid-40s, disability is a more common economic risk than death. Disability benefits are frequently the difference between a family retaining its dignity on one hand, and destitution, dependency and homelessness on the other.

But too many families are caught unawares when they receive a tax bill for their group disability insurance benefits. Unfortunately, the IRS looks at group disability insurance benefits as income, in most cases - however, there are exceptions. Similarly, some individuals, business owners and executives are surprised to learn that their individual disability insurance premiums are not generally deductible. Here is a look at the general principles of the taxation of disability income insurance.

**Premiums Versus Benefits**

The IRS taxes disability insurance benefits at two levels: On the front end, it taxes the money the policy owner pays in premiums. Generally, individual disability insurance premiums are not tax-deductible to the payor. The IRS charges you tax on premium dollars.

The IRS also charges income tax on the back end, on disability insurance benefits. This is usually the case where an employer has paid premiums on a group disability insurance plan, and has taken a tax deduction on the premiums as an employee compensation expense.

Usually, the IRS taxes on one end of the transaction or the other, but not both. If you own an individual disability insurance policy and you didn't deduct premiums, then the benefits are generally tax-free. In contrast, if you receive benefits on a workplace policy, and the employer deducted the premiums, you can expect your disability insurance benefits to be taxable as ordinary income. For specifics, see IRC section 104(a)(3).

Planning Opportunity: Some smaller businesses - in which everyone in the company is a professional in good health who can qualify for benefits and can afford the premiums - will structure their DI policies as individual policies. The employee does not deduct the premium. The company then bonus each employee an amount equal to their disability insurance premiums each year. In this way, the company pays roughly the same amount of money, retains the tax deduction, but employees don't have to pay income tax on benefits, which can take a big chunk out of an injured or sick workers’ income just when he needs it most.

This may not be appropriate in larger businesses, or in businesses where one or more members of the group have some health challenges and they need to get in on a group policy.

**Business Overhead Insurance Considerations**

What would happen to your business if you were suddenly disabled for a time? If your business would be damaged, you may want to consider some insurance protection to protect yourself. Many companies purchase
business overhead insurance (BOE). This is a policy that pays for basic overhead and operating costs for a period of time in case one or more owners or principals is disabled. Premiums are tax deductible, since BOE insurance is considered a reasonable business expense (unlike personal disability income insurance policies.) Benefits are theoretically taxable. But to the extent you actually use these proceeds to pay business overhead costs as intended, you can deduct these expenses as business expenses. The result is a tax wash. (See Revenue Ruling 55-264, 1955-1 C.B. 11)

**Filing**

If you pay disability insurance premiums as an employee benefit, you can deduct the premiums on a Schedule C or your corporate income tax return. If you buy your own individual policy, you can't take a deduction for the premium. If you receive benefits from a group plan, for which your employer took a tax deduction, you will need to report your disability benefits as income on your 1040 or 1040A individual income tax return. If you receive benefits, and the payor did not take a tax deduction for the premiums, then your disability income benefits are generally tax free.

**Government Benefits**

Generally, you don't need to include government disability benefits in your income. This includes VA disability compensation, welfare benefits related to your disability, SSI, etc. The following excerpt is from IRS Publication 907 - Tax Highlights for Individuals With Disabilities, describing disability-connected payments that are not generally taxable.

- Education, training, and subsistence allowances,
- Disability compensation and pension payments for disabilities paid either to veterans or their families,
- Grants for homes designed for wheelchair living,
- Grants for motor vehicles for veterans who lost their sight or the use of their limbs,
- Veterans' insurance proceeds and dividends paid either to veterans or their beneficiaries, including the proceeds of a veteran's endowment policy paid before death,
- Interest on insurance dividends left on deposit with the VA,
- Benefits under a dependent-care assistance program,
- The death gratuity paid to a survivor of a member of the Armed Forces who died after September 10, 2001, or
- Payments made under the VA's compensated work therapy program.

**Other Payments**

You may receive other payments that are related to your disability. The following payments are not taxable.

- Benefit payments from a public welfare fund, such as payments due to blindness.
- Workers' compensation for an occupational sickness or injury if paid under a workers' compensation act or similar law.
- Compensatory (but not punitive) damages for physical injury or physical sickness.
- Disability benefits under a "no-fault" car insurance policy for loss of income or earning capacity as a result of injuries.
- Compensation for permanent loss or loss of use of a part or function of your body, or for your permanent disfigurement.

For more information, and advice about how to structure your own plan, consult your disability insurance agent. They will be experts on plans available in your state, and how their benefits interact with state income tax laws as well as federal income tax.