Taxability of Disability Benefits

Many employers provide disability benefits to their employees as part of a comprehensive employee benefits package. Disability benefits replace a percentage of pre-disability income if an employee is unable to work due to illness or injury for a specified period of time. Employers may offer short-term disability coverage, long-term disability coverage, or integrate both short- and long-term disability coverage.

Group disability benefits can be structured in a number of ways. The taxability of these benefits generally depends on how the premiums for the coverage are paid. For example, if an employer and its employees split the cost of premiums for disability coverage, and the employees' premiums are paid on a pre-tax basis through a cafeteria plan, the disability benefits are fully taxable to employees.

This Compliance Overview answers common questions regarding the taxability of disability benefits.

Are the disability benefits paid to an individual included in gross income?

Benefits paid under a disability policy are included in the recipient's gross income to the extent that the benefits are attributable to **employer contributions.**

Are the disability benefits paid to an individual included in gross income where the individual has purchased the policy with his or her own funds?

No. Disability benefits are not included in the recipient's gross income where the individual purchases a policy with his or her own funds. Payments that an employer withholds from an employee's paycheck on an **after-tax basis** are considered to be made from an individual's own funds. Where an employer pays disability premiums from employer funds, it may add the amount of premium paid by the employer to the employee's gross income in order to provide nontaxable disability benefits to its employees.

Are the disability benefits paid to an individual included in gross income where benefits are attributable to contributions made by the employer?

Yes. Disability benefits are included in gross income where benefits are attributable to contributions made by the employer. Payments that an employer withholds from an employee's check on a **pre-tax basis** are considered by the Internal Revenue Service (IRS) to be employer contributions. Where an employer pays disability premiums from employer funds and does not include the cost of coverage in the employee's gross income, benefits are also considered attributable to contributions made by the employer.

Are the disability benefits paid to an individual included in gross income where the cost of benefits is shared between the employee and employer?

Yes. Disability benefits paid to an individual that are attributable to the contributions of the employer are included in gross income. Where employees and the employer both contribute to the cost of the disability policy, the three-year look back rule generally determines what portion of the benefits paid to the employee are included in gross income.

What is the three-year look back rule?

The three-year look back rule is contained in Section 1.105-1(d)(2) of the Code of Federal Regulations. The three-year look back rule explains how taxes owed on disability benefits are determined when a group insurance policy was purchased with employer and employee contributions. Similar rules apply to self-funded disability plans.

For insured plans, the three-year look back rule applies if the employer knows the net premiums for disability coverage for at least the last three policy years at the beginning of the calendar year. To use the three-year look back rule, first determine what percentage of the net premiums is attributable to premiums contributed by the employer. The taxable amount of the benefit is the same percentage of the entire benefit received.

The three-year look back rule is illustrated in the following example:

The employer's plan year begins on Jan. 1. On Jan. 1, 2022, the employer determines that it has paid 50 percent of the premium for disability insurance for its employees for at least the last three policy years. During the last three policy years, employees paid 50 percent of the premium for disability insurance with after-tax dollars. Thus, 50 percent of disability benefits received by an employee at any time during 2022 is attributable to contributions of the employer, and, therefore, is included in the employee's gross income.

Are the disability benefits paid to an individual included in gross income where the cost of benefits is paid entirely by employees during the current plan year, but was shared by the employee and employer in prior years?

No. Disability benefits paid to employees during a plan year where the cost of benefits is paid entirely by employees is not included in an employee's gross income. The three-year look back rule only applies to contributory plans. This plan is not contributory because benefits paid during the current plan year are not attributable to employer contributions.

May an employer allow its employees to choose between taxable and nontaxable disability benefits?

Yes. The guidelines set forth in IRS Revenue Ruling 2004-55 explain how an employer that currently offers a contributory plan may amend its plan to provide employees with a choice between:

- Employee payment of the full cost of the benefits, so that benefits received under the policy are excluded from gross income;
- or
- Employer payment of the full cost of the benefits (or a share in the cost), but benefits attributable to employer contributions are included in gross income.

*Note: Not subject to three-year look back rule.

In order to meet the requirements of Revenue Ruling 2004-55, disability benefits received by an employee are excluded from an employee's gross income when the employee has made an irrevocable election, prior to the beginning of the plan year, to have the coverage paid by the employer on an after-tax basis for the plan year in which the employee becomes disabled.

LINKS AND RESOURCES

- IRS Publication 525, Taxable and Nontaxable Income
- Section 1.105-1(d)(2) of the Code of Federal Regulations, which explains the three-year look back rule