

Taxation of Disability Benefits

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Persons collecting disability benefits may still need to file and may owe income taxes on their disability payments. This is true whether the disability payments come from Social Security or from disability insurance plans or both. The rules vary between public and private benefit plans and can be complicated. It is recommended that you consider hiring a tax consultant at least for the first tax year of receiving disability benefits.

While most states' tax laws tend to mirror those of the IRS, there may be minor differences that should be checked when filing. This article deals strictly with federal income taxation by the IRS.

It should also be noted that any earnings from part-time work while also collecting disability would be considered taxable income and may have an effect on how the disability benefits are taxed.

Social Security Benefits

Supplemental Security Income (SSI) - Because SSI is a needs-based program for persons with limited income, it is the rare exception that a person collecting any portion of SSI benefits would owe income taxes. Persons receiving SSI benefits, as their only source of income would not be taxed on that benefit. You may not need to file a tax return; the website at <http://www.irs.gov/individuals/article/0,,id=96623,00.html> will help you determine whether or not you need to file.

Social Security Disability Insurance (SSDI) – Most persons receiving SSDI benefits will need to file an income tax return, even if there may be little or no tax due. However, if there is additional income to SSDI benefits such as wages, self-employment, interest, dividends, pension, taxable disability insurance, this can cause a portion of the SSDI benefits to also be taxable.

Rather than provide a separate, lower tax table for Social Security benefits, the IRS provides a break by taxing only a portion of the Social Security benefits depending on the amount of other income. No one pays federal income tax on more than 85 percent of his or her Social Security benefits based on Internal Revenue Service (IRS) rules. If you:

- **File a federal tax return as an "individual"** and your *combined income** is
 - Between \$25,000 and \$34,000, you may have to pay income tax on up to 50 percent of your benefits.
 - More than \$34,000, up to 85 percent of your benefits may be taxable.
- **File a joint return**, and you and your spouse have a *Combined Income** that is
 - Between \$32,000 and \$44,000, you may have to pay income tax on up to 50 percent of your benefits
 - More than \$44,000, up to 85 percent of your benefits may be taxable.
- **Are married and file a separate tax return**, you probably will pay taxes on your benefits.

- * **Combined income** = Your adjusted gross income
+ Nontaxable interest
+ ½ of your Social Security benefits

If you do have to pay taxes on your Social Security benefits, you can make quarterly estimated tax payments to the IRS **or** choose to have taxes withheld from your benefits. For more information about taxation of benefits, see IRS Publication 915, *Social Security and Equivalent Railroad Retirement Benefits*.

NOTE: These dollar amounts are not indexed for inflation.

Every January you will receive a Social Security Benefit Statement (Form SSA-1099) showing the amount of benefits you received in the previous year. You can use this statement when you complete your federal income tax return to find out if your benefits are subject to tax.

Although you're not required to have federal taxes withheld from your Social Security benefits, you may find it easier than paying quarterly estimated tax payments. To have taxes withheld from your Social Security payments, you should complete IRS Form W-4V (Voluntary Withholding Request). This form is available on line at <http://www.irs.gov/pub/irs-pdf/fw4v.pdf> or by calling the IRS at 1-800-829-3676.

On the W-4V, you can select what percentage of your monthly benefit amount you want withheld either 7%, 10%, 15% or 25%. Only these percentages can be used. Flat dollar amounts are not acceptable. After you've made your selection, sign and return the form to your local Social Security office by mail or in person.

For more information about Social Security benefits and your taxes, there are two IRS publications you will find helpful:

- Publication 554, *Tax Information for Older Americans* and
- Publication 915, *Social Security Benefits and Equivalent Railroad Retirement Benefits*.

You can order these by calling the Internal Revenue Service's toll-free telephone number, 1-800-829-3676, or you may access them on line at <http://www.irs.gov>.

Disability Insurance Benefit Payments

For private disability benefits, the IRS looks to tax **either** the premiums paid for the disability insurance **or** the benefits paid to the claimant, **but not both**. This can best be explained by example:

- A person buys individual disability insurance from an insurance company. He/she pays the premiums with after-tax dollars, that is, the premiums are not deducted from taxable income as a business expense or otherwise. Because the premiums were included in taxable income, any benefits that person receives from the policy due to disability are not income taxable.
- An employer provides short term and long term disability to all eligible employees, and provides them as an employee benefit without cost to the employees. Because the employer deducts such payments from its income as a business expense, the premiums are not taxed so any disability benefits received by disabled employees are fully income taxable.

- An employer provides, without cost to the employees, a long term disability plan that pays 50% of their salary if disabled. Each employee has the right to additionally purchase, through payroll deduction, an additional 16 2/3% benefit to bring the total disability benefit up to 66 2/3% of income. The employee's portion of the premium withheld from the paycheck is included in the W-2 earnings and therefore taxable. In this case, the disability benefits are taxable in proportion to how the premiums were paid. Since the employer deducted the premiums for its coverage, any benefits received from that portion of the plan would be taxable, however, the benefit that comes from the portion the employee purchased with after tax dollars would be income tax free.

Some employers who usually purchase long term disability for their employees will allow employees to elect to pay for their long term disability coverage with after tax dollars through payroll deduction, just for the purpose of making any future disability benefit payments tax free. If your employer offers this alternative, it is recommended that you seriously consider taking advantage of it. Having disability benefits income tax free can greatly enhance the quality of life when income is already lowered by the disability itself.

It should be noted that there is a three year look back period to this rule. This means that once you have paid the premiums with after tax dollars for three years, your benefits will be entirely tax free. If, however, you become disabled before the three years expires, your benefits will be taxable in the same proportion as the premiums paid. If you had paid the premiums for only one year and your employer paid the two prior years, only one-third of the benefit would be tax free. These rules apply to both short-term and long term disability.

As you can see from the explanations above, the taxation of disability benefits whether from Social Security or private insurance is a complicated issue. Persons starting to file taxes for the first time while on disability should either retain experienced tax counsel or take advantage of one of the many programs that offer free income tax assistance.