Taxing Disability Benefits

by Jacques Chambers

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.

Social Security Benefits

Because total income is limited for persons collecting Supplemental Security Income (SSI), 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.

However, some people who get Social Security Disability (SSD), or Social Security retirement, may have to pay income taxes on those benefits based on what other income they may be receiving. This will apply to you only if you have other substantial income in addition to your benefits (for example, wages, self-employment, interest, dividends, pension, taxable disability insurance benefits, and other taxable income that you have to report on your tax return).

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 ever pays income taxes on more than 85 percent of his or her Social Security benefits and some pay on a smaller amount, based on these 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 50 percent of your Social Security benefits.
- If your combined income is above $34,000, up to 85 percent of your Social Security benefits is subject to income tax.
- If you file a joint return:
  - You may have to pay taxes on 50 percent of your benefits if you and your spouse have a combined income* that is between $32,000 and $44,000.
  - If your combined income is more than $44,000, up to 85 percent of your Social Security benefits is subject to income tax.
  - If you are married and file a separate tax return, you probably will pay taxes on your benefits.

*Combined income is the total of your taxable pensions, wages, interest, dividends, and other taxable income, plus any tax-exempt interest income, plus half of your Social Security benefits. If that total is more than a base amount, some of your benefits will be taxable. The base amount is:

- $0 for married persons filing separately who lived with their spouses at any time during the year;

- $25,000 for singles, heads of households, and marrieds filing separately who didn't live with their spouses; and,
- $32,000 for those who are married filing jointly.

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, 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 10% benefit to bring the total disability benefit up to 60% of income. 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 their 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.