How taxes can impact the benefits you choose

Understanding tax implications for disability benefits

Taxes are complex. And because group disability benefits can be structured in different ways from a taxation perspective, it's important to understand the implications. In a nutshell, the impact of taxes on disability benefits comes down to one thing—who's paying the premium.

Principal® offers a variety of benefit approaches you can choose from based on your needs. Let's take a look at different ways to structure disability coverage, and how that affects the way the benefit is taxed.

Approach	Who pays the premium?	Is it paid pre- or post-tax?	Is the benefit taxable?
Non-contributory	Employer (100%)	Pre-tax	Yes, 100% taxable and premiums are not reported as taxable income to the employee.
Bonus-up (Gross-up)	Employer (100%)	Post-tax	No, the benefit is tax-free and premiums are reported as taxable income for the employee through their Form W-2 or other income report.
Tax choice (Rev. Rul. 2004-55)	Employer (100%)	The employee chooses whether to pay tax on the premium or on the benefit. They can choose: **1) Annual**: Employee elects taxation annually. **2) One-time:** Employee makes an irrevocable election when they become eligible for coverage. **3) Negative:** Employer pays premiums post-tax unless employee formally elects pre-tax.	Yes, if the employee chooses to not be taxed on premiums, then benefits are 100% taxable. No, if the employee chooses to be taxed on premiums, the benefits are tax-free.
Contributory	The employer and employee share premium cost, with the employer determining the portion they pay.	Both	Yes, partially taxed. The portion of the premium paid by the employer is the taxable portion of the benefit.
Core/Buy-up	The employer pays the premiums for a base level of coverage, and employees can purchase additional coverage and pay the associated premiums.	Both	Yes, the core portion is 100% taxable. No, the buy-up portion is tax-free because the employee pays the premium post-tax.
Voluntary	Employee (100%)	Post-tax	No, the benefit is tax-free.

What's the three-year look-back rule?

To determine what portion—if any—of the disability benefit is taxable, federal tax regulations require a look-back period of three years. This takes into account the percentage of premium the employer paid during the three policy years before the calendar year a disability takes place.

It looks like this:

Percentage of taxable benefit = Percentage of premium contributed by the employer over three years

Moving coverage to another carrier doesn't reset the look-back period. But if the coverage has changed significantly, that means new coverage is in place and the percentage test starts over. Coverage under the tax choice approach isn't subject to this rule, and changing the approach to tax choice exempts it from the rule immediately.

How do taxes affect the benefit amount?

Whether the premium is paid pre- or post-tax can have an impact on the monthly benefit payable to an employee out on disability. This is known as the replacement ratio,* or the percentage of the employee's income paid during a claim.

Let's look at a couple of examples that show the impact post-tax payment of premium can have on the benefit an employee receives. You'll see the significant difference in the replacement ratios.

	Employee earning $60,000/year	
	60% benefit, pre-tax premium	60% benefit, post-tax premium
Gross monthly income	$5,000	$5,000
Take-home pay (22% tax bracket)	$3,900	$3,900
Gross monthly benefit	$3,000	$3,000
Tax on benefit (22% tax bracket)	$660	$0
Payable monthly benefit	$2,340	$3,000
Replacement ratio	60%	77%

	Employee earning $165,000/year	
	60% benefit, pre-tax premium	60% benefit, post-tax premium
Gross monthly income	$13,750	$13,750
Take-home pay (32% tax bracket)	$9,350	$9,350
Gross monthly benefit	$8,250	$8,250
Tax on benefit (32% tax bracket)	$2,640	$0
Payable monthly benefit	$5,610	$8,250
Replacement ratio	60%	88%

* The replacement ratio is calculated by dividing the payable monthly benefit by take-home pay.

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