

In This Issue

Taxation of disability benefits and the accompanying reporting requirements can be very confusing to both the employee receiving the benefits as well as to the company plan sponsor. This issue of the Advisor will address the following issues pertaining to the taxation of group disability insurance benefits:

- *When are benefits taxable and when are they tax-exempt?*
- *How is taxation affected when the employer and covered employees share in the premium costs?*
- *How is taxation affected when the cost-sharing formula between employer and employee contributions changes?*
- *Who is responsible for federal income tax, Social Security and Medicare tax withholding for group disability insurance benefits?*

We welcome your comments and suggestions regarding the McGraw Wentworth Benefit Advisor. Additional copies of this issue are available on the McGraw Wentworth web site at www.mcgrawwentworth.com.

Employee Disability Benefits

A LOOK AT THE TAXATION AND REPORTING REQUIREMENTS

Generally, “**company-paid** group disability benefits” received by an employee are subject to income taxation. Conversely, “**employee-paid** group disability benefits” received by an employee are not subject to income taxation. Company-paid amounts include both direct payments by an employer that are not included in an employee’s W-2 income report and also any contributions made by an employee using pre-tax (IRC Section 125) dollars. Employee-paid amounts would include only payroll deducted after-tax contributions. Group disability benefits would include both Short Term Disability income plans and Long Term Disability income plans, regardless of whether they are insured or self-funded arrangements.

HOW TAXES ARE APPLIED

If the disability benefits are determined to be company-paid, income taxes will be payable as follows:

Federal Income Taxes

The disabled employee will be required to pay full/normal Federal income taxes on any disability benefits received.

State and Local Income Taxes

The disabled employee may or may not be required to pay state and local income taxes on any disability benefits received. The rules vary by state and locality. In Michigan, full state income taxes are payable on any disability benefits received.

Social Security and Medicare Taxes

The disabled employee will be required to pay Social Security and Medicare taxes for six full months of benefits following the last day of active work. Because the measurement period calls for full *calendar* months, an employee whose last day of



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work falls in the middle of a month must satisfy a six month period that begins on the first day of the month following his/her last day of active work. For example, an employee disabled on March 2 would have Social Security and Medicare taxes withheld until September 30, (6 months, 29 days).

The normal Social Security wage limit, \$72,600 for 1999, would continue to apply to withholdings for the disabled employee.

Federal Unemployment Taxes

The disabled employee will also be required to pay Federal unemployment taxes for the first full six months of benefits following the last day of active work. The six calendar months are measured using the same standard that applies to Social Security and Medicare taxes.

FUTA taxes are withheld until the disabled employees' benefits reach the earlier of the FUTA wage limit (\$7,000 in 1999) or the end of a full six calendar months of disability benefits.

WHEN PREMIUM COSTS ARE SHARED

When premium costs are shared, the amount of insured disability benefits subject to taxation is based upon the percentage of premium that is defined as company-paid. As reviewed earlier, company-paid either means that the employer paid premiums directly or that the em-

ployee paid premiums on a pre-tax basis through a Section 125 plan. In both instances, benefits defined as being company-paid are subject to taxation.

In general, disability benefits subject to taxation are determined by calculating the percentage of premium defined as company-paid. In the example below, the company pays 50% of disability premium costs, and the employee pays the other 50% of costs on a post-tax contribution basis:

Annual disability benefit payment from the insurer	\$50,000
Employer Pays 50% of disability insurance premium	x .50
50% of the disability benefit is defined as taxable income	\$25,000

Variations to the formula illustrated above can occur when the premium split between the employee and employer changes over time. For example, when pre-

mium rates increase and the company or employee contribution is fixed. When this occurs, the percentage of company-paid disability insurance premium is calculated using the average company contributions (on behalf of the disabled employee) for the *lesser* of the most recent three years or the time that the employee has been covered under the plan. In the example below, we assume that the employee has been covered under the insured disability plan for at least three years (see Table 1 at the bottom of the page):

Using the 3 year average calculated below, taxable disability benefits to the disabled employee would be calculated as follows:

Total disability benefit payments to employee	\$50,000
Average employer contribution of 30% of premium	x .30
30% of disability benefits are taxable income	\$15,000

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TABLE 1

Year	Total Premium Cost Per Employee	Company Premium Payments Per Employee	Company Premium Percentage Per Employee
1998	\$200	\$50	25%
1997	\$150	\$50	33%
1996	\$150	\$50	33%
3 year average	\$167	\$50	30%

**RESPONSIBILITY
FOR WITHHOLDING
TAXES AND REPORTING
DISABILITY INCOME**

Insured and self-insured disability benefit plans are subject to the same general taxation provisions noted earlier. However, as we will review in the sections that follow, the withholding and reporting requirements may vary between insured and self-funded plans.

If the disability benefits are determined to be company-paid, withholding responsibility is as follows:

Federal Income Tax

In an insured benefit plan, an insurer making disability benefit payments to an employee is not required to withhold federal income taxes. However,



the employee can arrange to have taxes withheld by filing form W-4S with the insurance carrier. The withholding amount is subject to a \$20 minimum per week (\$88 per month), and cannot result in a net benefit payment of less than \$10 to the disabled employee.

For self-funded disability plans, the third party administrator making the benefit payments *is required* to withhold federal income taxes. The disabled employee is required to provide the administrator with a W-4 form, or have federal income taxes automatically withheld at a rate of 28%.

State and Local Income Taxes

Withholding requirements for state and local income taxes vary by jurisdiction. In Michigan, disability insurance carriers will typically process withholding for state and local income taxes,

as well as for federal and Social Security/Medicare taxes. Generally, insurance carrier withholding practices do not distinguish between insured and self-funded disability plans, except as noted above.

Social Security and Medicare Tax

Under both insured and self-funded group disability plans, the insurance carrier is required to withhold the employee portion of Social Security and Medicare taxes from the taxable portion of a disabled worker's benefit payment. Withholding is subject to the six calendar month limitation noted above.

With regard to the employer liability for matching Social Security and Medicare payments, responsibility for reporting and making matching deposits can either be assumed by the insurer or transferred to the employer. The insurer and employer responsibilities under both approaches are outlined in the following paragraphs.

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McGraw Wentworth Team

NAME	PHONE	EMAIL	NAME	PHONE	EMAIL
Bill Wentworth	822-6201	wdw@mcgrawwentworth.com	Katy O'Brien	822-6219	kobrien@mcgrawwentworth.com
Tom McGraw	822-6202	tpm@mcgrawwentworth.com	Christi Soussan	822-6206	christi@mcgrawwentworth.com
Bryan Hirn	822-6203	wbh@mcgrawwentworth.com	Susan Rocchio	822-6215	srochio@mcgrawwentworth.com
David Hoisington	822-6204	hois@hois.com	Mark Kramer	822-6209	mkramer@mcgrawwentworth.com
Patty Lusk	822-6208	plusk@mcgrawwentworth.com	Kimberly Kulas	822-6211	kimberly@mcgrawwentworth.com
Linda Sevek	822-6212	lsevek@mcgrawwentworth.com	Stephanie Rutkowski	822-6218	srutkow@mcgrawwentworth.com
Susan Mathiesen	822-6216	suem@mcgrawwentworth.com	Leanne Gremel	822-6205	lgremel@mcgrawwentworth.com
Stacy Steinberg	822-6214	ssteinberg@mcgrawwentworth.com	Elena Prendes	822-6213	eprendes@mcgrawwentworth.com
Rebecca McLaughlan	822-6224	bmclaughlan@mcgrawwentworth.com	Rhonda Varner	822-8000	rvarner@mcgrawwentworth.com
Sue Emery-Scott	822-6220	semery-scott@mcgrawwentworth.com			

When the Employer Retains Withholding Liability

When the employer retains liability for tax withholding and reporting, the insurer is still responsible for withholding and depositing the employee portion of Social Security and Medicare taxes from benefit payments. In addition, the insurer will notify the employer of the claimants for which taxes were withheld and deposited, as well as the withholding amount. All of these steps must be taken within the time limit specified by the Internal Revenue Service.

It is the employer's responsibility to deposit matching Social Security and Medicare taxes with the IRS. In addition, the employer is responsible for filing the "Employers Quarterly Federal Tax Return" (Form 941), which reports employer tax liability. Finally, the employer must pay federal and state unemployment taxes for the benefits received by each claimant.

When the Insurer Retains Withholding Liability

Where the insurer retains liability for both withholding and reporting of taxes, the insurer is responsible for depositing both the employer and employee portions of Social Security and Medicare taxes with the IRS. The insurer files Form 941 and also prepares W-2 forms for disability benefit recipients. The employer still retains responsibility for paying federal and

state unemployment taxes for disability benefit recipients.

Self-Insured Withholding And Reporting Responsibilities

For self-insured disability plans the employer and insurance carrier or third party administrator jointly determine how withholding and reporting will be handled. In most instances, the insurance carrier or third party administrator will take responsibility for withholding Social Security and Medicare taxes, filing Form 941 and filing W-2 forms for disability benefit recipients. The employer typically retains responsibility

for paying federal and state unemployment taxes.

Summary

Determining responsibility for the taxation and reporting requirements associated with



company-sponsored disability plans will vary based upon plan funding and the specific needs of the employer.

Our McGraw Wentworth Account Directors and Account Managers will be pleased to assist you and your staff in working through the myriad of withholding and reporting issues to determine the package that will best meet your needs. *-MM-*

NOTABLE THOUGHTS

ONE ONLY NEEDS TWO TOOLS IN LIFE: WD-40 TO MAKE THINGS GO, AND DUCT TAPE TO MAKE THEM STOP.

G. WEILACHER

Our technical bulletins are written and produced by the McGraw Wentworth staff and are intended to inform our clients and friends on general information relating to employee benefit plans. They are not intended to provide either legal or tax advice. Consult your legal counsel or tax advisor in matters that directly affect your benefit plans.

McGraw Wentworth
3310 West Big Beaver Road Suite 105
Troy, MI 48084
Telephone: 248-822-8000 Fax: 248-822-4131
Internet: www.mcgrawwentworth.com