Unit 15: Tax Aspects of Disability Insurance Products

DI and Taxes - Why Learn About It?

The sophisticated people in our markets - the business owners, professionals and executives in your client file - are especially interested in tax matters. You must be well versed in this area so you can communicate effectively on this important subject.

With disability income insurance, such knowledge can have a positive effect on the sale. When your clients learn how favorably disability income insurance is treated from a tax standpoint - and when they see how attuned you are to their concerns in this area - it will be that much easier for them to say "yes" to your recommendations.

Tax Treatment in General

As a general rule, when premiums for a personal disability income policy are paid with after-tax dollars, the benefits received under the policy are tax-free. In a few business situations (which we'll cover in more detail later in this chapter), disability income premiums may be deducted as a business expense; in these cases, the benefits received under the policy are taxable as income.

A Selling Point

This favorable tax treatment is similar to the tax treatment accorded life insurance proceeds. These tax advantages are a reflection of just how important our legislators feel these benefits are in protecting the financial security of insureds and their families.

With that general rule as a reference point, let's now look specifically at the tax aspects of each of the sales situations and products discussed so far in this program.

Personal Disability Income Insurance

The premiums on personal disability income policies may not be deducted. This means that benefits will be received tax-free. This rule applies to any situation in which the policy is purchased for the benefit of the individual paying the premium.

For example, if a sole proprietor purchased a policy to replace his or her own income, it wouldn't matter whether the premium was paid from the personal or the business account - it would not be deductible, and benefits would be received tax-free. The same principle holds for other individuals who purchase coverage with personal dollars. (An exception is made for partners and owners of S corporations - see charts on the following pages.)

Business Disability Products

As noted earlier, it is when policies are purchased for business purposes that premiums may sometimes be considered a deductible business expense. Premiums are not, however, deductible in all business situations.

Overhead Expense

Premiums for overhead expense policies are deductible by the business. This rule applies to unincorporated businesses and professional practices as well as corporations.

The benefits received under the policy are, therefore, taxable as income to the business. However, the benefits received are used to pay business expenses, which are tax-deductible.

Disability Buy-Out

Premiums paid for disability buy-out policies are never deductible, regardless of who pays the premiums, i.e., the business itself or the owners. Benefits are, therefore, not taxable as income. But there may be capital gains tax due on the sale of the business interest itself. If the disabled owner receives more for his or her share than he or she originally put into the business, the amount of the gain is taxable.

Key Executive Indemnification

If a business is designated to receive the benefits of a disability income policy insuring a "key person," the premium is not deductible. The benefits are received tax-free; this is the case for unincorporated businesses as well as corporations.

Business Reducing Term

The premiums on Business Reducing Term are not tax-deductible as a necessary business expense. The business receives the benefits tax-free. This is why a Business Reducing Term policy will be issued only for the amount representing the after-tax cost of the obligation to the business.

Qualified Sick Pay Plans

Premiums paid by an employer on behalf of employees covered by a qualified sick pay plan are deductible by the business. This fact means that benefits received are taxable to the covered employee. In addition, these benefits are also subject to Social Security tax for the first six months after the employee stops working.

In a C-corporation, the owners (stockholders) working in the business are considered to be employees. Therefore, the corporation can deduct premiums paid for coverage on owner-employees.

Sole proprietors can only deduct the premiums paid on behalf of employees other than themselves. If they purchase coverage for themselves through a Qualified Sick Pay Plan, they are in essence purchasing personal coverage, and the rules for personal disability income plans apply.

A partnership or S-corporation may deduct premiums for disability income coverage paid on behalf of a partner or 2% plus shareholder/employee. This is allowed under IRS Revenue Ruling 91-26, provided these payments qualify as "guaranteed payments" and consideration for services rendered. Unlike other employees of the business, the partner or shareholder must include such premiums as part of their taxable income. Benefits paid under the policy would therefore be received free of income tax.

You might ask: so what? It is the same as if the owner were merely purchasing the insurance individually. A definite marketing opportunity does exist in many cases. Often these owners take a draw from the business to cover their routine financial needs. Any undistributed income left in the partnership or S-corporation account is, however, taxable to the owners at the close of the tax year. Funding the owner's disability protection needs by using any additional cash in the business can still help reduce the overall tax burden of these owners.

Another type of Qualified Sick Pay Plan is known as the Executive Bonus Plan, or "Section 162" plan, after the IRS regulation governing such plans.

Briefly, an executive bonus plan is a simple arrangement in which an employer gives an employee a salary bonus equal to the premium on a life or disability insurance policy. In practice, the employer pays the premium directly to the insurance company. The amount of the premium is treated as a "bonus" and included in the employee's taxable income. The employer therefore can deduct the amount paid for the policy premium. Benefits paid to the disabled employee are received tax-free, since technically the employee has purchased the policy with his or her bonus.

The following chart provides a quick reference for the material covered in this chapter.

Summary of Disability Income Tax Aspects

Personal Disability Income Insurance

Premium Paid By	Benefits Paid to	Policyowner	Tax Treatment: Premiums	Tax Treatment: Benefits
Individual (including a sole proprietor)	Individual	Individual	Nondeductible (IRC Sec. 213 & 262)	
Employer (key person coverage or business reducing term)	Employer	Employer	Nondeductible (IRC Sec. 265)	Tax-Free (IRC Sec. 104)
Employer (under a QSPP)	Employee (including C-corp. owners)	Employee	Deductible by employer (IRC Sec. 162). Employer-paid premium excluded from employee's taxable income (IRC Sec. 106)	Reported as Income (IRC Sec. 105)
Partnership, S-corporation (under a QSPP)	Partner, S-corp. owner	Partner, S-corp. owner	Deductible by partnership or S-corp. Included in partner's or S-corp. owner's personal taxable income (Rev. Ruling 91-26)	Tax-Free (Rev. Ruling 91-26)
Employee (under an Executive Bonus Plan)	Employee	Employee	Bonus paid to cover premium by employer is deductible. Bonus is included in employee's taxable income (IRC Sec. 162)	Tax-Free (IRC Sec. 104)

Overhead Expense

Premium Paid by	Benefits Paid to	Policyowner	Tax Treatment	
			Premiums	Benefits
Business or Owner	Business or Owner	Business or Owner	Tax Deductible Revenue Ruling 55-264	*Reportable as Income, Revenue Ruling 55-265

*Although the benefits are taxable as income, the actual business expenses are deductible.

Disability Buy-Out

Premium Paid by	Benefits Paid to	Policyowner	Tax Treatment	
			Premiums	Benefits
Partnership or Corporation (under Entity Purchase Agreement)	Partnership or Corporation	Partnership or Corporation	Nondeductible IRC Sec. 265	Tax-Free* IRC Sec. 104
Partnership or Corporation (under a Cross Purchase Agreement)	Insured's Partner or Fellow Shareholder	Insured's Partner or Fellow Shareholder		

*Benefits are paid to reimburse amounts paid to purchase disabled owner's business interest. The disabled owner may be subject to capital gains tax.

Action Assignment

1. Review each of the cases you have been working on in light of the tax aspects. Determine when the premium will be deductible or not deductible, and whether benefits will be taxable or tax-free.

2. Prepare, in your own words, statements that you will use to describe the tax benefits to your client in each case. Rehearse these with your trainer.