

Disability Benefits – Tax Implications

When a participant, John, is eligible for a \$200 disability benefit because he was absent from work due to an accident or illness, questions arise as to the tax implications arising therefrom to John. Because of the multiple variables, the analysis is done by a logic path.

1. Was the contribution, or funding, of the \$200 benefit from John or employer?
 - a. From John
Stop. Where John was the contributor, there are not tax consequences to John.
 - b. From Employer
Go to 2. Where employer was the contributor, there are tax consequences to John.
 - c. From Employer and John
Go to 2. Where John and employer were co-contributors, the tax consequences are shared. Complicated sharing rules are available and include the three-year look-back practice.
2. Is the \$200 a *sick pay* or a *welfare plan* benefit? The welfare plan benefit would be described in the plan document and SPD and made part of any DOL/IRS Form 5500. The sick pay benefit is not so described or included.
 - a. Sick Pay Benefit
Stop. Treat as a payroll matter with established employer practices, deductions, etc. Plan supervisor is not involved unless such plan supervisor is also retained to administer payroll.
 - b. Welfare Benefit
Go to 3.
3. Two Tax issues must be considered.
 - a. Income Tax
Go to 4. Income tax is Federal, but may include state.
 - b. FICA

Go to 5. This is tax for Social Security and Medicare.

4. There is income tax to be paid on the \$200 and the plan document and SPD should state how it is to be reported.
 - a. By W-2
John receives a benefit check of \$146, e.g. The participant is clearly notified that such withholding will be made.
 - b. By 1099
John receives a check of \$200 and is provided a year-end 1099 by the employer of \$200.

How the plan supervisor and employer divide the tax reporting responsibilities is set forth in the Plan Supervisor Agreement.

5. The definition of wages in the Social Security Act (42 USC §409) is extraordinarily broad. Thus welfare benefits, in the form of disability income, are to be treated as wages with FICA taxes deducted from wages and transmitted by means of the quarterly IRS Form 941.
6. Several Questions Might Be Asked:
 - a. Where the FICA tax is withheld from the \$200 benefit, might John object?
Answer. John's interest are well-served by the deduction; the employer must match it and the \$200 is a determinant in John's future benefits. Even so, the preferred practice is to show that FICA tax will be withheld in the plan document.
 - b. What are the pros and cons of Having John's contributions paid through a premium option plan?
Answer. Such conversion of the benefit to employer-pay-all gives John a smaller take-home benefit payment, but makes the employer contribute more and increases John's social wage base.
 - c. What are the pros and cons of having John's contributions, where there are such, allocated to the cost of the disability benefit?
Answer. Such allocation converts the benefit to employee-pay-all and the pros and con in (b), above, are reversed.
 - d. Where employer crafts the document in a manner so as to make the plan pay the \$200 with the income reported on an IRS Form 1099, is there authority to say such practice is correct or incorrect as far as the IRS is concerned?
Answer. The writer knows of any authority that the practice is correct or incorrect.

- e. If no withholding is made must there be a signed W-4 statement showing no withholding is requested?
Answer. For sick pay a W-4 is needed; for welfare benefits a W-4 is not needed.