



TAXATION AND TAX COMPLIANCE ISSUES SHORT- AND LONG-TERM DISABILITY BENEFITS (INSURED AND SELF-INSURED)

This paper is intended to serve as a general reference for issues relating to taxation, tax withholding and tax reporting of insured and self-insured short- and long-term disability benefits. This paper serves as a guide which explains CIGNA Group Insurance position on these issues. This paper may be provided to employers and producers as a source of general background information. However, it is not intended to be relied on by third parties as legal advice.

Employers are also encouraged to review IRS Publication 15-A, which, among other things, provides a thorough explanation of the income tax, FICA, withholding and reporting rules applicable to sick pay (taxable disability benefits).

A. IN GENERAL – TAXABILITY OF BENEFITS

1. Are disability benefits subject to income tax?

Under IRC Section 105(a), disability benefits are subject to income tax, to the extent that the cost of the coverage was borne by the employer, and has not been included in the income of employees. Thus, where coverage is paid for entirely by the employer, the benefit is taxable. It is also taxable if the cost of the coverage is paid for by employees on a pre-tax basis (i.e. through a Section 125 plan). The disability benefit is not subject to income tax if it is paid for by employees on a post-tax basis (conventional payroll deduction). Some employers have plans which are employer-paid, but under which the employer's cost is reported to employees as wages, and subject to income tax; in this case, benefits are also not subject to income tax.

2. What if the cost of the disability program is shared between employers (pre-tax) and employees (post-tax)?

IRS Regulation §1.105-1 provides generally that, in the case of partially contributory plans, a portion of the benefit is taxable. The portion is the percentage of the total premiums for the program which are paid for by the employer (or otherwise on a pre-tax basis), measured over the last three policy years ending before the current calendar year. This is sometimes referred to as the "three-year look-back." There are special rules in the regulation for dealing with plans that have been in force for less than three years, or where premiums are retroactively adjusted by dividend.

3. When is the taxable percentage determined with respect to a claim?

We believe that the taxable percentage of a claim is determined on the date that the claim is incurred. This is consistent with the fact that a disability claim is vested on the date of disability,

and won't be affected by subsequent amendments or termination of the policy. Various recent IRS rulings have suggested that the IRS agrees with this interpretation. Once the taxable percentage of a particular claim is set, that percentage is taxable for the duration of the claim, even if there is a change in the plan's funding.

4. How are benefits taxed where there are different classes of employees, each paying a different portion of the total cost of coverage?

IRS Regulation §1.105-1(c)(2) also provides that, if the employer's plan has more than one class of employees, based on employment-related conditions, and if the employer keeps records allocating premiums and contributions among the classes, then the taxable percentage is figured separately for each class. Otherwise, the taxable percentage for all employees is based on premiums for the plan as a whole. The IRS has released a number of rulings which recognize that employers may treat different groups separately where they are classified based on date of hire or date of participation (e.g. plans providing different funding schemes for grandfathered employees, or based on date of hire), or on whether they are included or excluded from a collective bargaining arrangement.

5. What about a core/buy-up plan, where the employer pays the full cost of the core benefit, and employees pay the additional cost of the buy-up layer of coverage on a post-tax basis?

In Letter Ruling 9709051, the IRS ruled that, in this case, the employer's plan should be treated as if it had two classes. One class consists of employees who have not elected to participate; the taxable percentage will be 100% (non-contributory). The other class consists of employees who have elected to participate; their taxable percentage will be based on the percentage of premiums with respect to this class which are paid by the employer. It follows that the employer must be able to determine what portion of overall policy premium relates to employees who have elected to enroll for the buy-up benefit.

6. What happens if the employer changes its plan's funding, e.g. from contributory to non-contributory (or partially contributory)?

The so-called "three-year look-back" (see Q&A 2) only applies to plans which are at some point in time partially contributory. It does not apply to any plan which is, at all times, either entirely employer-paid, or entirely employee-paid. Thus, if an employer changes from an entirely employer-paid (pre-tax) plan, to an entirely employee-paid (post-tax) plan, then the taxable percentage changes immediately from 100% to 0% on the effective date of the change, with respect to claims thereafter incurred. The "three-year look-back" does not apply.

There are a number of rulings addressing plans that changed from partially contributory to non-contributory (or fully contributory), or from non-contributory or fully contributory to partially contributory. In general, unless there's some other fundamental change in the plan which would allow the plan to be treated as a new plan, the rulings have applied the "three-year look-back" role in these situations, taking into account periods of time when the employer pre-tax funding was 0% or 100%.

7. Is it better for disability coverage to be paid for on a pre-tax or a post-tax basis?

There are many different views expressed on this subject. Some advisors have recommended that benefits be paid for on a post-tax basis in order to maximize the disability benefit. We believe this view is mistaken and that it is normally better for disability benefits to be paid for on a pre-tax basis, for the following reasons:

- a. It defers taxation from the present to the future.
- b. It trades an uncertain tax benefit (only claimants benefit) for a certain tax benefit (all employees benefit).
- c. It shifts taxable income from a higher to a lower income tax bracket. Active employees will pay income tax at their highest marginal rate on post-tax premiums. By contrast, disability claimants will likely pay income tax on taxable benefits at a much lower effective rate.
- d. Any tax benefit from a post-tax plan is limited to the net benefit. Since benefit offsets (Social Security and worker's compensation being most common) are usually income tax free, this reduces the tax advantage that a post-tax plan enjoys at time of claim.
- e. FICA taxes are payable on premium contributions under a post-tax plan, but in most cases FICA taxes are not payable on benefits paid under a pre-tax plan.

Contributory plans are administratively simpler if they are pre-tax. This is because the taxable percentage is always 100% and there's no need for concern about the complicated rules dealing with partially contributory plans (see Q&A 5). Note, contributory pre-tax plans are subject to Section 125; in particular, this means that (other than new hires, or in the event of certain changes in family status) participation can't be elected except during the annual cafeteria plan election period.

8. Can employees elect whether benefits should be paid for on a pre-tax or post-tax basis?

The IRS has released Revenue Ruling 2004-55, which permits this under certain conditions. Specifically, each individual's coverage must be either wholly employer-funded (pre-tax) or wholly employee-funded (post-tax). Rev. Rul. 2004-55 does not permit this type of arrangement where the plan was previously partially contributory. This is because the "three-year look-back" rule applies in such cases. And, under Reg. §1.105-1(c)(2), the taxable percentage under a partially contributory plan must be based on the plan as a whole, or based on classes of employees based on conditions related to employment.

Rev. Rul. 2004-55 requires that employees make an irrevocable election prior to the start of each year, similar to the Section 125 rules. Whether the benefit is taxable or not depends on the date the claim is incurred, and is either 0% (post-tax) or 100% (pre-tax); it remains the same for the life of the claim. The "three-year look-back" rule does not apply.

Note, such "elective" plans may create incentives that are detrimental to the stability of the plan. This is because the benefit percentage may be at a high enough level that, if the benefit is paid for on a post-tax basis, the benefit may approach or even exceed the employee's pre-disability, after-tax earnings, thus removing financial incentives to return to work.

B. INCOME TAX WITHHOLDING

All that follows relates solely to that portion of the benefit, if any, which is taxable. To the extent that a disability benefit is subject to income tax, then there are important further questions (addressed below) regarding FICA, income tax withholding, and information returns (Form W-2). To the extent that disability benefits are not taxable, these further requirements do not apply.

9. Are disability benefits subject to income tax withholding?

The answer depends on how the plan is funded. In the case of fully insured plans, income tax withholding is not mandatory. However, claimants may voluntarily elect to have income tax withheld, by filing IRS Form W-4S with the insurance company. (Note: employees who do not elect withholding may find themselves owing significant income taxes at the end of the year, and may be required to file estimated tax returns.)

For self-insured plans, income tax withholding is generally mandatory. An exception is where the benefits are paid by a trust which “bears an insurance risk.” Such payments are subject to voluntary withholding, on the same basis as insured benefit payments. In all other cases – e.g. where benefits are paid by the employer from its general assets – withholding is mandatory.

10. What is a “trust which bears an insurance risk”? Is it the same thing as a VEBA, or a 501(c)(9) trust?

While the IRS hasn't released any rulings on this, we believe that a trust “bears an insurance risk” if the trust (rather than the employer) is legally liable for all benefit payments, and if the employer doesn't bear the risk of funding claims if the trust's assets are inadequate. Typically, the employer will be funding the trust on a level basis (as if it was paying an insurance premium to the trust), rather than funding paid claims as they are due. A VEBA (described below) is one example of a trust which bears an insurance risk.

“VEBA” stands for “Voluntary Employee Beneficiary Association” and is the same thing as a 501(c)(9) trust. What distinguishes a VEBA is the fact that (1) the employer can (within limits, as provided in IRC Sections 419 and 419A) deduct contributions made to it; and (2) income earned by the trust's assets is exempt from income tax. Because LTD plans are paid out over a long period of time, both of these features are important to LTD plans. For STD, however, where most benefits are paid in the year in which they are incurred, and where reserves (and earnings on reserves) are insignificant, the tax benefits of Section 501(c)(9) aren't as important.

The major drawback to using a 501(c)(9) trust is that, under IRC Section 505, any plan funded through such a trust cannot take into account annual compensation that exceeds \$245,000 (inflation-adjusted figure effective for 2010). For a 60% LTD plan, this limits the monthly benefit to \$12,250 (60% of \$245,000 ÷ 12 = \$12,250). This is such a significant drawback as to make the use of a VEBA for disability benefits in many cases undesirable. For LTD, the usual way to avoid this limitation, while getting the best tax result and the lowest cost, is by insuring the benefit. For STD, it is usually not a significant concern to use a trust that hasn't been qualified under Section 501(c)(9), or to pay benefits from general assets.

Under ERISA regulations, §2510.3-102, employee contributions are generally considered to be plan assets. In general, under Section 403(a) of ERISA, plan assets must be held in trust. The Department of Labor has exempted pre-tax contributions under Section 125 from the trust requirements (ERISA Technical Release 92-1). Thus, a contributory self-insured plan funded in whole or part with after-tax employee contributions would require a trust in any case.

Setting up and maintaining Section 501(c)(9) trusts is complex, and such trusts are subject to numerous requirements. An employer desiring to use a Section 501(c)(9) trust should have assistance of its own legal counsel.

11. If a self-insured disability benefit isn't paid by a "trust which bears an insurance risk," is income tax withholding mandatory? At what rate?

Yes, withholding is mandatory. The rate applicable to withholding depends on whether the payments are made by the employer, or by an agent of the employer (e.g. an ASO administrator).

If the benefits are paid by an ASO administrator, payments are treated as "supplemental wages" and are generally subject to mandatory withholding at a rate of 25% of the taxable amount. This rate has in recent years varied between 25% and 28% and was most recently lowered to 25% as part of the 2003 income tax reductions.

If the benefits are paid directly by the employer (e.g. advice-to-pay, payments made by the employer's payroll system), withholding is required as if the payments were regular wages. This means that the amount to be withheld is based on the IRS withholding tables (found in IRS Publication 15-T), and will depend on the employee's marital status and the number of withholding allowances claimed on Form W-4.

Mandatory withholding of 25% will most often result in significant refunds at the end of the year, and is usually considered to be undesirable. It can be avoided in one of five ways: (1) insure the benefit (withholding becomes optional); (2) establish a trust which bears an insurance risk (withholding becomes optional); (3) use an "advice-to-pay" arrangement and have payments made using the employer's payroll system (withholding is mandatory but more likely to reasonably reflect actual tax liability); (4) have the employer perform all withholding calculations (based on IRS regulations) and advise the ASO administrator of the dollar amount of taxes to be withheld from each benefit payment; or (5) have the insurance company calculate withholding based on the employee's W-4 elections.

12. Who is responsible for reporting and depositing withheld income taxes with the IRS? Whose employer identification number (EIN) is used?

On insured business, the insurance company is responsible for paying (depositing) taxes withheld from employees with the IRS, and reporting the payments it makes (using Form 941) using the insurance company's EIN.

On self-insured business, normally the insurance company will return amounts withheld from employees to the employer, and the employer is required to report and pay those amounts to the IRS, using the employer's EIN.

IRS regulations do permit an agent of the employer (e.g. an ASO claim administrator) to enter into a "Limited Agency Agreement" with the employer, under which certain tax compliance responsibilities can be assumed by the agent using its EIN. This service is included when CIGNA provides employer FICA service on self-insured plans (see Q&A 18). In addition to the Limited Agency Agreement (available from implementation coordinators), unless the ASO benefits are funded by a trust which bears an insurance risk (see Q&A 10), IRS Form 2678 (to be coordinated by the Tax Compliance Unit) must be filed with the IRS.

The employer is responsible for all withholding and payment of withheld taxes on advice-to-pay cases.

C. INCOME TAX REPORTING (FORM W-2)

13. Are taxable disability benefits required to be reported to the employee and to the IRS?

Yes. Taxable disability benefits are considered to be "sick pay" and must be reported to the employee and to the IRS on form W-2.

14. Who is responsible for preparing and filing W-2 forms?

Under IRS regulations, it is the employer that is responsible for preparing and filing W-2 forms, including W-2 reports of sick pay. W-2 forms must be filed with the IRS and provided to the employee by January 31st following the end of the taxable calendar year.

On insured business, the insurance company is required to provide the employer with an annual statement identifying amounts paid as sick pay. This statement is due by January 15th and covers sick pay paid during the prior calendar year. This information is used by the employer to prepare W-2's. On ASO business, reports containing this information are also furnished to the employer.

On insured business, as a standard service option, CIGNA will enter into a limited agency agreement with the employer under which the insurance company will prepare W-2 forms for sick pay, and will file those W-2 forms using its own EIN. On ASO business, preparation of W-2 forms using the employer's EIN is available as an optional service. Preparation of W-2 forms using the claim administrator's EIN is available for ASO business only in conjunction with the employer FICA service, or if benefits are funded through a risk-bearing trust (see Q&A 10).

15. Who is responsible for determining the amount of taxable sick pay?

As the first part of this paper explained, it is only the taxable portion of a disability benefit which is subject to reporting and withholding requirements. And the taxable portion is based on the portion of the cost of the program which is paid for by the employer (or by employees on a pre-tax basis).

Where only a portion of the disability benefit is taxable as sick pay, the nontaxable portion is also reported on form W-2 (Box 13, code J). Disability benefits that are nontaxable are not reported.

Determination of the portion of benefits which is considered paid for by the employer (and therefore taxable) is the employer's responsibility. CIGNA requires this information from the employer in order to comply with its own requirements under FICA (explained below), or to perform withholding or reporting functions under a Limited Agency Agreement. This information is elicited using the Tax Communication Form (part of the implementation process). This form must be obtained when a case is installed and should be updated when an employer makes changes in the funding of its plan (and annually in the case of a partially contributory plan). CIGNA is able to track taxable percentages separately for each claim, but must rely on the employer to provide that information.

D. FICA (SOCIAL SECURITY) TAX

16. Are taxable disability benefits subject to FICA?

The Federal Insurance Contributions Act (FICA) is the law under which so-called FICA taxes (Social Security and Medicare taxes) are paid. In general, a portion of wages must be withheld for FICA taxes, and there is a matching amount of FICA taxes (employer FICA) directly payable by the employer.

Taxable disability benefits are subject to FICA if they are paid to the employee during the six calendar months following the last month in which the employee worked for the employer. Any payment made after that date is not subject to FICA.

Because of the typical 180-day elimination period, most LTD benefit payments won't be subject to FICA. However, this will not be the case if the employee returns to work part-time, intermittently, or in a different position. Taxable sick pay is subject to FICA if the employee has worked for the employer at any time during the six calendar months prior to the date the payment is made.

The above information applies equally to insured and self-insured benefits.

17. Who is responsible for withholding the employee portion of FICA taxes?

On insured business, the insurance company is directly responsible for withholding the employee portion of FICA taxes, and for reporting and paying the withheld taxes to the IRS using the insurance company's EIN.

On self-insured business, the employer is responsible for reporting and depositing FICA taxes withheld from employees, using its own EIN. On full ASO business, CIGNA provides weekly payment reports to the employer for this purpose. Amounts equal to the employee FICA taxes will be charged to the employer's claim account, and CIGNA will pay the withheld amounts to the employer on a monthly basis. The employer, however, is responsible for the timely payment of both employee and employer FICA taxes to the IRS.

Where the employer has established a trust which bears an insurance risk (see Q&A 10), CIGNA can enter into a limited agency agreement under which, in addition to filing W-2 forms, it can also withhold and pay employee FICA taxes using its EIN. The employer remains responsible for the employer share of FICA taxes (see Q&A 18, below).

Where benefits are paid directly by the employer (advice to pay), calculating, reporting and depositing withheld FICA tax is the employer's responsibility and should be a function performed by the employer's payroll system.

18. Who is responsible for paying the employer's share of FICA taxes?

In general, employers are responsible for paying the employer share of FICA taxes using their own EIN. On both insured and self-insured business, CIGNA provides weekly reports of benefit payments and taxes withheld, which the employer uses to calculate and pay its own share of FICA tax.

On insured business, CIGNA also offers an enhanced FICA match feature, under which the employer's share of FICA taxes is provided as an additional benefit, and deposited with the IRS under the insurance company's EIN along with FICA withheld from employees. This feature is generally available with policies which are funded in whole or in part by the employer, and which provide a benefit which is partly or wholly taxable. For more information about this feature, contact your CIGNA Group Insurance sales representative or account manager.

On ASO business, normally the employer remains responsible for depositing withheld taxes along with the employer FICA tax. As an optional service, CIGNA can deposit FICA taxes (employer and employee portion). However, unless the plan is funded by a trust which bears an insurance risk (see Q&A 10), this requires filing of IRS Form 2678 and IRS approval to act as the employer's agent.

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