



Tax & Business Alert

NOVEMBER 2021

IS DISABILITY INCOME TAXABLE?

Many Americans receive disability income. If you're one of them or know someone who is, you may wonder whether it's taxable. As is often the case with tax questions, the answer is "it depends."

KEY FACTOR

The key factor is who paid it. If the income is paid directly to you by your employer, it's taxable to you as ordinary salary would be. Taxable benefits are also subject to federal income tax withholding — though, depending on the disability plan, they sometimes aren't subject to Social Security tax.

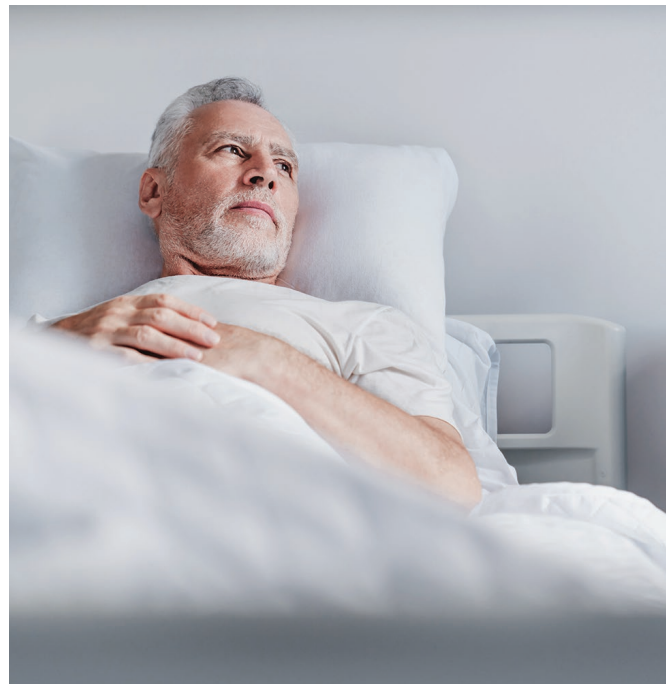
Frequently, the payments aren't made by the employer but by an insurer under a policy providing disability coverage or under an arrangement having the effect of accident or health insurance. In such cases, the tax treatment depends on who paid for the coverage. If your employer paid for it, then the income is taxed to you just as if paid directly to you by the employer. On the other hand, if it's a policy you paid for, the payments you receive under it aren't taxable.

Even if your employer arranges for the coverage (in other words, it's a policy made available to you at work), the benefits aren't taxed to you if you pay the premiums. For these purposes, if the premiums are paid by the employer but the amount paid is included as part of your taxable income from work, the premiums are treated as paid by you.

TWO EXAMPLES

Let's say your salary is \$1,000 a week (\$52,000 a year). Under a disability insurance arrangement made

available to you by your employer, \$10 a week (\$520 for the year) is paid on your behalf by your employer to an insurance company. You include \$52,520 in income as your wages for the year: the \$52,000 paid to you plus the \$520 in disability insurance premiums. In this case, the insurance is treated as paid for by you. If you become disabled and receive benefits, they aren't taxable income to you.



Now, let's look at an example with the same facts as above. Except in this case, you include only \$52,000 in income as your wages for the year because the amount

HOW MUCH COVERAGE IS NEEDED?

In deciding how much disability coverage you need to protect yourself and your family, take tax treatment into consideration. If you're buying the policy, you need to replace your after-tax, "take-home" income because your benefits won't be taxed. On the other hand, if your employer pays for the benefit, you'll lose a percentage to taxes. If your current coverage is insufficient, you may wish to supplement an employer benefit with a policy you take out.

paid for the insurance coverage qualifies as excludable under the rules for employer-provided health and accident plans. In this case, the insurance is treated as paid for by your employer. If you become disabled and receive benefits, they are taxable income to you.

Note: There are special rules in the case of a permanent loss (or loss of the use) of a part or function of the body, or a permanent disfigurement.

ANY QUESTIONS?

This discussion doesn't cover the tax treatment of *Social Security* disability benefits, which may be taxed under different rules. Contact us if you'd like to discuss this further or have questions about regular disability income. ■

4 WAYS TO WITHDRAW CASH FROM A CORPORATION

Owners of closely held corporations often want or need to withdraw cash from the business. The simplest way, of course, is to distribute the money as a dividend. However, a dividend distribution isn't tax-efficient because it's taxable to the owner to the extent of the corporation's earnings and profits. It also isn't deductible by the corporation. Here are four alternative strategies to consider:

1. Capital repayments. To the extent that you've capitalized the corporation with debt, including amounts that you've advanced to the business, the corporation can repay the debt without the repayment being treated as a dividend. Additionally, interest paid on the debt can be deducted by the corporation.



This assumes that the debt has been properly documented with terms that characterize debt and that the corporation doesn't have an excessively high debt-to-equity ratio. If not, the "debt" repayment may be taxed as a dividend. If you make future cash contributions to the corporation, consider structuring them as debt to facilitate later withdrawals on a tax-advantaged basis.

2. Compensation. Reasonable compensation that you, or family members, receive for services rendered to the corporation is deductible by the business. However, it's also taxable to the recipient(s). This same rule applies to any compensation (in the form of rent) that you receive from the corporation for the use of property. In both cases, the compensation amount must be reasonable in terms of the services rendered or the value of the property provided. If it's considered excessive, the excess will be a nondeductible corporate distribution (and taxable to the recipient as a dividend).

3. Property sales. You can withdraw cash from the corporation by selling property to it. However, certain sales should be avoided. For example, you shouldn't sell property to a more than 50%-owned corporation at a loss, since the loss will be disallowed. And you shouldn't sell depreciable property to a more than 50%-owned corporation at a gain, since the gain will be treated as ordinary income, rather than capital gain. A sale should be on terms that are

comparable to those in which an unrelated third party would purchase the property. You may need to obtain an independent appraisal to establish the property's value.

4. Loans. You can withdraw cash tax-free from the corporation by borrowing money from it. However, to prevent having the loan characterized as a corporate distribution, it should be properly documented in a loan agreement or note. It should also be made on terms that are comparable to those

in which an unrelated third party would lend money to you, including a provision for interest (at least equal to the applicable federal rate) and principal. Also, consider what the corporation's receipt of interest income will mean.

These are just a few ideas. If you're interested in discussing these or other possible ways to withdraw cash from a closely held corporation, contact us. We can help you identify the optimal approach at the lowest tax cost. ■

ONE-TIME THING: IRA TO HSA TRANSFERS

Did you know that you can transfer funds directly from your IRA to a Health Savings Account (HSA) without taxes or penalties? According to the IRS, you're permitted to make one such "qualified HSA funding distribution" during your lifetime.

Ordinarily, if you have an IRA and an HSA, it's typically a good idea to contribute as much as possible to both to make the most of their tax benefits. But if you're hit with high medical expenses and have an insufficient balance in your HSA, transferring funds from your IRA may be a solution.

CALLING IN THE CAVALRY

An HSA is a savings account that can be used to pay qualified medical expenses with pre-tax dollars. It's generally available to individuals with eligible high-deductible health plans. Currently, the annual limit on tax-deductible contributions to an HSA is \$3,600 for individuals with self-only coverage and \$7,200 for individuals with family coverage. If you're 55 or older, the limits are \$4,600 and \$8,200, respectively. Those same limits apply to an IRA-to-HSA transfer, reduced by any contributions already made to the HSA during the year.

Here's an example illustrating the potential benefits of a qualified HSA funding distribution from an IRA: Joe is 58 years old, with a self-only, high-deductible health plan. In 2021, he needs surgery for which he incurs \$5,000 in out-of-pocket costs. Joe is strapped for cash and only has \$500 left in his HSA, but he does have a \$50,000 balance in his traditional IRA. Joe may move up to \$4,600 from his IRA to his HSA tax- and penalty-free.

CONSIDERING OTHER FACTORS

If you decide to transfer funds from your IRA to your HSA, keep in mind that the distribution must be made directly by the IRA trustee to the HSA trustee, and the transfer counts toward your maximum annual HSA contribution.



Also, funds transferred to the HSA in this case aren't tax deductible but, because the IRA distribution is excluded from your income, the effect is the same (at least for federal tax purposes).

EXPLORING THE OPPORTUNITY

IRA-to-HSA transfers are literally a once-in-a-lifetime opportunity, but that doesn't mean they're the right move for everyone. If you're interested, our firm can help you explore the concept in the context of your distinctive tax and financial circumstances. ■