

Publications

IRS Ruling Confirms Tax-Planning Opportunities for LTD Plans

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The Internal Revenue Service (Service) recently issued Revenue Ruling 2004-55, which clarifies the tax treatment of disability benefits under plans that give employees a choice of whether or not to include employer-paid premiums in income. The ruling formalizes a helpful and surprisingly favorable position IRS has taken in a series of private letter rulings over the past few years.

Rev. Rul. 2004-55 holds that a group plan may be designed to enable an employee to elect to have employer payments for disability coverage reported as income on the employee's W-2 so that, in the event the employee becomes disabled, the disability benefits may be excluded from the employee's gross income. In particular, the ruling states that, if the employee elected the coverage entirely on an after-tax basis, benefits are excluded from the employee's gross income under Code section 104(a)(3). Conversely, for coverage provided solely on a pre-tax basis, benefits shall be included in an employee's gross income under Code section 105(a). Significantly, the ruling confines the application of the longstanding "3-year lookback" rule (Treas. Reg. 1.105-1(c)) to group plans where disability premiums are partially paid by employer contributions and employee after-tax contributions. Under the 3-year lookback rule, the disabled employee is taxed on the proportion of benefits equal to the percentage of total employer contributions, over the total plan contributions for the three years preceding the plan year the employee becomes disabled (e.g., if the employer paid 50% of the total premiums for each of the 3 preceding policy years, the rule would require the employee to include 50% of the disability benefits in gross income).

The new IRS ruling applies to both short-term and long-term disability benefits, and permits separate pre- or post-tax elections for each (if the underlying plan permits them). The employee's election must be irrevocable, and be made prior to the beginning of the plan year for which the election is effective. A plan may provide that, in the absence of an election, premiums will be included in the employee's gross income. Additionally, once an election is made, the plan may permit such election to carry over to subsequent plan years until affirmatively revoked by the employee.

The ruling does not address the tax treatment of disability benefits paid with pre-tax employee contributions under Code section 125 "cafeteria plans." Technically, the 3-year lookback rule may apply to plans that permit such contributions, although that does not reflect common practice.

Employers that currently fund a base level of disability coverage for their employees may wish to consider modifying their plans to take advantage of this IRS position.