



# Tax Implications of Disability Income Insurance



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Business owners have a variety of ways they can organize their company.

If you are considering disability income insurance for your company, it is important that you and your advisors familiarize yourselves with any tax implications.

The following provides a general overview only.  
Please consult your own tax or legal counsel.

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# Sole Proprietors

A sole proprietor is the sole owner of a business. The sole proprietor is personally taxed on all business income — the business is not a separate legal entity or taxpayer. Sole proprietors file a Schedule C (with their individual IRS Form 1040) to report business income and expenses.

## To determine earned income for Sole Proprietors, for disability income insurance purposes, we use:

- Net profit of the business

## In addition, other considerations for a Sole Proprietor are:

- Sole Proprietors are not considered to be employees, but rather self-employed individuals.
- Individual disability income insurance premiums paid by a Sole Proprietor are not deductible, therefore, benefits received are tax-free.
- Sole Proprietorships may not make a deductible contribution to a pension or profit sharing plan on behalf of an owner. Instead, any contribution is deducted on the sole proprietor's individual Form 1040.
- W-2 wages are not paid to the sole proprietor. Instead, the net income of the business is reported on the proprietor's Form 1040 and is subject to self employment tax (SECA).





# Partnerships

Partnerships do not pay federal income tax. Instead income or loss flows to the partners who are taxed on the partnership earnings in proportion to their ownership interest.

Partnerships file informational tax returns and issue Forms K-1 to partners. The Form K-1 reports the partner's share of income, credits and deductions and is used to prepare the partner's individual tax return.

## To determine earned income for individual partners, for disability income insurance purposes, we use:

- Insured's share of business profit/loss
- Any guaranteed payments (also found on schedule K-1) made to the partner

## In addition, other considerations for Partnerships are:

- Partners are not considered to be employees, for disability income insurance purposes, but rather self-employed individuals.
- Individual disability income insurance premiums paid by the partnership may be deducted as a guaranteed payment by the Partnership. As such, they are included in the insured partner's current income; benefits paid under the policy are tax-free.
- Partnerships may not deduct contributions made to a pension or profit sharing plan on behalf of a partner.
- W-2 wages are not paid to individual partners. Instead, each partner's share of partnership income is reported on their Form 1040 and is subject to SECA tax.

# S Corporation

Like a Partnership, an S corporation does not pay federal income tax. Instead, income or loss of the business flows through the individual shareholders in proportion to their ownership interest.

An S corporation also shares some similarities with C corporations, such as limited liability of owners and issuance of wages paid to shareholder/employees. S corporations file informational tax returns and issue Forms K-1 to shareholders. The Form K-1 reports the shareholder's share of income, credits and deductions and is used to prepare the shareholder's tax return (individual or corporation). Shareholders who are also employees are typically paid a salary for their services as an employee (which will be reported on Form W-2), as well as having a right to a share of the profits of the business as a shareholder.

## **To determine earned income for S-Corporation shareholders, for disability income insurance purposes, we use:**

- Insured's share of business profit/loss
- Insured's salary
- Contribution to pension/profit sharing plan made on the insured's behalf by the S corporation

## **In addition, other considerations for S corporations are:**

- Individual disability income insurance premiums paid may be deducted by the S corporation. Because more than 2% shareholder/employees are treated as self-employed for accident and health benefit purposes, the premiums are included in the shareholder's taxable income, resulting in tax-free benefits.
- The business entity may make contributions to a pension or profit sharing plan on behalf of individual shareholder/employees<sup>1</sup>.

# C Corporation

A C corporation is a common form of business organization; some characteristics include limited liability of owners and issuance of shares.

C corporations are distinct legal identities that file their own tax return and pay their own tax. Shareholders who are also employees are typically paid a salary for their services as an employee (which will be reported on Form W-2) as well as having a right to a share of the profits of the business as a shareholder.

## **To determine earned income for C corporation shareholders, for disability income insurance purposes, we use:**

- Insured's share of business profit/loss
- Insured's salary
- Contributions to a pension/profit sharing plan made on the insured's behalf by the C corporation

## **In addition, other considerations for C corporations are:**

- Disability insurance premiums may be paid and deducted by the C corporation.<sup>2</sup>
- If premiums paid by the C corporation are excluded from the shareholder/employee's W-2 income, such as accident & health insurance premiums, then any benefits paid under the policy will be taxable.
- If those premiums paid are instead included in the shareholder/employee's W-2 income, a non-taxable benefit will result.
- The business entity may also make a contribution to a pension or profit sharing plan on behalf of the shareholder(s).



## What about a Business Overhead Expense (BOE) disability insurance policy?

- Premiums paid for BOE are considered a business expense and deductible regardless of how the business is organized.
- It is recommended that the business always own the BOE policy so that the benefit flows through the business.
- While the BOE benefit is considered taxable income to the business (assuming the business is the owner of the policy), the overhead expenses will generally offset the benefits paid to eliminate a taxable gain.

## What about a Disability Buy-Sell policy?

- Buy-Sell coverage protects an interest in a business and is considered a personal insurance purchase.
- Buy-Sell premiums are not tax-deductible and any benefits are paid tax-free.
- When the disabled owner's interest is purchased, he/she will generally recognize a capital gain on the difference between his/her basis in the business and the purchase price.



<sup>1</sup> Shareholders must also be an employee, receiving wages reported on Form W-2, in order to be eligible for qualified plan contributions made by the business entity.

<sup>2</sup> This only applies if the premium is paid on behalf of the insured in his or her capacity as an employee. If it is paid only because of his or her status as a shareholder, it will be considered a taxable dividend, and the premium would be included in shareholders' income.

The information provided is not written or intended as specific tax or legal advice. MassMutual, its employees and representatives are not authorized to give tax or legal advice. Individuals are encouraged to seek advice from their own tax or legal counsel.

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