Revenue Ruling 2004-55

June 28, 2004

Disability insurance benefits. This ruling addresses the income tax treatment of short-term and long-term disability benefits under sections 104 (a) (3) and 105 (a) of the Code.

ISSUE

Under the Amended Plan described below, are long-term disability benefits received by an employee who becomes disabled excludable from the employee's gross income under § 104 (a) (3) of the Internal Revenue Code?

FACTS

The Employer provides long-term disability benefits to its eligible employees pursuant to a written plan. Long-term disability benefits are provided through a group insurance policy with a third-party insurance carrier. Under the terms of the plan, the Employer pays the entire premium for the coverage and does not include the cost of the coverage in the employee's gross income (i.e., the premiums are paid on a pre-tax basis and are not reported on the employee's Form W-2 for that year).

The Employer amends the plan (the Amended Plan) to provide that the Employer will continue to pay the long-term disability coverage on a pre-tax basis for eligible employees. However, each eligible employee may also irrevocably elect to have the Employer pay for the long-term disability coverage on an after-tax basis (i.e., elect to be taxed currently on the premiums paid by the Employer). An employee's election applies to the entire cost of the coverage that the Employer pays to the third-party insurance carrier, so that an employee may not elect after-tax treatment for only a portion of the premiums. If an employee elects after-tax treatment, the Employer allocates the appropriate proportion of the group premium to that employee and includes that amount in the employee's gross income for the year in which the payments are made (i.e., the premiums are reported on the employee's Form W-2 for that year).

Under the Amended Plan, the employee's election to pay for the cost of long-term disability coverage on an after-tax basis is irrevocable once the plan year begins and must be made prior to the beginning of the plan year in which the election becomes effective. The employee has the ability to make a new irrevocable election for each plan year prior to the beginning of that plan year. In lieu of a new election for each plan year, the Employer may provide that an employee's prior election, once made, continues from one year to the next unless affirmatively changed before the beginning of the new plan year. The Employer may also provide that the long-term disability premiums will automatically be included in the employee's gross income for the year

unless the employee affirmatively elects otherwise prior to the beginning of the new plan year. Under the Amended Plan, an employee who becomes eligible for long-term disability coverage during a plan year (e.g., a newly hired employee) may make an irrevocable prospective election for the remainder of that plan year.

LAW AND ANALYSIS

Section 61 (a) (1) and § 1.61-21 (a) (3) of the Income Tax Regulations provide that, except as otherwise provided in Subtitle A, gross income includes compensation for services, including fees, commissions, fringe benefits, and similar items.

Section 104 (a) (3) states that except in the case of amounts attributable to (and not in excess of) deductions allowed under § 213 for any prior taxable year, gross income does not include amounts received through accident or health insurance (or through an arrangement having the effect of accident or health insurance) for personal injuries or sickness (other than amounts received by an employee to the extent such amounts are attributable to contributions by the employer which were not includible in the gross income of the employee, or are paid by the employer).

Section 1.104-1 (d) states that if an individual purchases a policy of accident or health insurance out of his own funds, amounts received thereunder for personal injuries or sickness are excludable from his gross income under § 104 (a) (3). Conversely, if an employer is either the sole contributor to such a fund, or is the sole purchaser of a policy of accident or health insurance for his employees (on either a group or individual basis), the exclusion provided under § 104 (a) (3) does not apply to any amounts received by his employees through such fund or insurance. Section 1.104-1 (d) refers to § 1.105-1 for rules relating to the determination of the amount attributable to employer contributions.

Section 1.105-1 (b) provides that all amounts received by employees through an accident or health plan which is financed solely by their employer are subject to the provisions of § 105 (a).

Under § 105 (a), amounts received by an employee through accident or health insurance for personal injuries or sickness must be included in gross income to the extent such amounts (1) are attributable to contributions by the employer which were not includible in the gross income of the employee, or (2) are paid by the employer.

Section 1.105-1 (c) (1) provides that in the case of amounts received by an employee through an accident or health plan which is financed partially by his employer and partially by contributions of the employee, § 105 (a) applies to the extent that such payments are attributable to contributions of the employer that were not includible in the employee's gross income. The portion of the amounts which is attributable to the contributions of the employer shall be determined in accordance with § 1.105-1 (d) in the case of insured plans.

Section 1.105-1 (c) (2) provides that a separate determination of the portion of the amounts received under the accident or health plan which is attributable to the contributions of the employer shall be made with respect to each class of employees in any case where the plan provides that some classes of covered employees contribute but others do not, or that the employer will make different contributions for different classes of employees, or that different classes of employees will make different contributions, and where in any such case both the

contributions of the employer on account of each such class of employees and the contributions of such class of employees can be ascertained.

Section 1.105-1 (d) (2) provides that if the accident or health coverage is provided under or is part of a group insurance policy purchased by contributions of the employer and of the employees, and the net premiums for such coverage for a period of at least three policy years are known at the beginning of the calendar year, the portion of any amount received by an employee which is attributable to the contributions of the employer for such coverage shall be an amount which bears the same ratio to the amount received as the portion of the net premiums contributed by the employer for the last three policy years which are known at the beginning of the calendar year bears to the total of the net premiums contributed by the employer and all employees for such policy years. This provision is known as the "three-year look back rule."

The term "class of employees" as used in § 1.105-1 (c) (2) is dependent solely on the contribution method used by the plan. The regulations do not refer to length of service, duties, or other factors as determinative of a "class of employees." Accordingly, under the Amended Plan, the group of employees that elects after-tax treatment of the long-term disability coverage is a separate class of employees under § 1.105-1 (c) (2).

In addition, when a plan that provides long-term disability benefits is amended as described above, the Amended Plan is a new plan in computing the contributions of the Employer and the employees. With respect to each employee, the Amended Plan is financed either solely by the Employer or solely by the employee. At no time is the coverage under the Amended Plan financed by both Employer and employee contributions. Therefore, the Amended Plan is not a contributory plan within the meaning of § 1.105-1 (c) (1) and, because the Amended Plan is not described in § 1.105-1 (c) (1), the "three-year look back rule" set forth in § 1.105-1 (d) (2) does not apply.

Finally, the applicable statutes and regulations do not distinguish between short-term and long-term disability plans. Thus, if an employer offers both short-term and long-term disability plans and permits employees to separately elect the contribution payment method for each plan, the law does not require aggregation of the contributions paid for each plan in determining the taxation of benefits. Benefits paid under a short-term or long-term disability plan will be taxed according to the contribution payment election made for each type of coverage.

HOLDING

Under the Amended Plan, long-term disability benefits received by an employee who has irrevocably elected, prior to the beginning of the plan year, to have the coverage paid by the Employer on an after-tax basis for the plan year in which the employee becomes disabled are attributable solely to after-tax employee contributions and are excludable from the employee's gross income under § 104 (a) (3).

Under the Amended Plan, long-term disability benefits received by an employee whose coverage is paid by the Employer on a pre-tax basis for the plan year in which the employee becomes disabled are attributable solely to pre-tax Employer contributions and are includible in the employee's gross income under § 105 (a).

These holdings are equally applicable to short-term disability benefits.

DRAFTING INFORMATION

The principal author of this revenue ruling is Barbara E. Pie of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). For further information regarding this revenue ruling, contact Ms. Pie at (202) 622-6080 (not a toll-free call).