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The Three-Year Look-Back Rule

Understanding the taxation of employer-sponsored disability income benefits

When premiums are paid with **pre-tax dollars**, deductions are taken from the employee's gross income before taxes are calculated.

In contrast, when premiums are paid using **post-tax dollars**, the premiums are included in the employee's gross income and are subject to tax.

Group disability income insurance comes in many flavors. It can be employer-paid, employee-paid, or a combination of both. When paid by employees, premiums can be paid with pre- or post-tax dollars. Which option fits best depends on the needs and preferences of the policyholder (employer) and covered employees. Employers should be aware, though, that these various options have differing effects on the taxation of the plan's benefits.

Group disability benefits are subject to specific tax rules under the federal Internal Revenue Code (IRC). When employees receive disability benefits, those dollars may be considered taxable income, depending on who pays the premium and, if paid by the employee, whether the premium is paid on a pre- or post-tax basis.

For both short- and long-term disability income benefits, the following rules apply:

If the employer pays 100% of the premium	100% of the benefit is taxable income to the employee
If the employee pays 100% of the premium	**with pre-tax dollars,** 100% of the benefit is taxable income to the employee
	with post-tax dollars, none of the benefit is taxable income to the employee
If the employer pays a portion of the premium	**and the employee pays the balance with pre-tax dollars,** 100% of the benefit is taxable income to the employee
	and the employee pays the balance with post-tax dollars, a portion of the benefit is taxable income to the employee*

* If an employer transitions from a partial contributory plan to one where employees pay 100% of the premium with post-tax dollars, a new set of rules may apply. See the section titled "Maximizing disability benefits" on Page 3 for more information.

In the last case—when taxes are owed on only a portion of disability benefits—the percentage of benefits to be taxed is calculated using a formula established by the IRS known as the "Three-Year Look-Back." Understanding the Three-Year Look-Back Rule can help employers discuss the tax implications of disability benefits with employees.

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How the Three-Year Look-Back works

To calculate the tax, the rule “looks back” to the three years prior to the calendar year in which the disability occurs. The total amount of premium paid by the employer over those three years is then compared with the total amount of premium paid by the employer and all employees over the same period. For these purposes, premiums deducted from an employee’s salary on a pre-tax basis are treated as paid by the employer instead of the employee. In other words:

Total premium paid by employer over past three policy years

Total premium paid by employer over past three years

Total premium paid by all employees over past three years on a post-tax basis

For example, assume an employee is injured in 2020. The Three-Year Look-Back Rule would calculate the percent of benefit that is taxable by comparing the premiums paid—using the formula above—in years 2019, 2018 and 2017.

Policy year ending	Employer contributions	Employee contributions	Total contributions
2019	$5,000	$9,000	$14,000
2018	$3,000	$6,000	$9,000
2017	$2,000	$5,000	$7,000
Total	**$10,000**	**$20,000**	**$30,000 = 33% Taxable**

If the employer paid total premiums of $10,000 and the employees paid total premiums of $20,000, the taxable percentage of the benefit would be 33%.

Again, the Three-Year Look-Back Rule only applies when the employer pays a portion of the premium and employees pay the balance with post-tax dollars. In addition, it may continue to apply even when employees pay the entire disability premium on an after-tax basis if the employer paid a share of the premium during any one of the prior three years. Since some type of employee contribution is a frequently selected option, employers and covered employees should be aware of the tax implications when disability benefits are taken.

continued >

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Maximizing disability benefits

While most employees are appreciative of contributory plans that share the premium expense of disability insurance, the taxes due on benefits are a downside. What's more, because of the Three-Year Look-Back Rule, taxes may continue to be due on benefits for three years even if an employer transitions to a plan where employees pay 100% of the premium with post-tax dollars. Fortunately, the IRS provides a road map that allows employees to receive tax-free disability benefits the first year this type of plan is in effect.

Revenue Ruling 2004-55 permits employers to implement a disability benefit plan where employees choose whether to pay premiums on a pre- or post-tax basis. Any disability benefits paid as a result of an event occurring during a plan year in which an employee elected to pay disability premiums on a post-tax basis will be received tax-free, maximizing the available benefit.

In order to give employees this option, the sponsoring employer must adopt a new disability benefit plan or formally amend its existing disability benefit plan. In either case, the plan must expressly require employees to irrevocably elect, prior to the beginning of each plan year, to pay their disability premiums with either pre- or post-tax dollars.

To ensure the desired tax treatment for employees, we recommend consulting with a tax professional before implementing a disability benefit plan.

For more information about the Three-Year Look-Back Rule, talk with your group benefits representative or consult a tax professional.

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