

The Health Care Reform and Disability Income Insurance

Summary

Good news – the nondiscrimination and Cadillac plan penalty tax provisions of the 2010 Health Care Act do not apply to employer-provided disability income plans.

Related Information

[Disability Wage Continuation Plans](#); [Disability Wage Continuation Plans in brief](#)

Background

Employers who provide a comprehensive benefit package for their employees typically include a disability income benefit (i.e., disability wage continuation plan). Federal tax rules encourage the use of disability income insurance in these employee benefit plans by affording favorable income tax treatment for the value of the protection provided by the benefit plan.

Specifically, the employer-paid premium is excluded from the employee's income, but benefits are taxed if and when they're paid (if and when the employee is disabled).¹ The tax treatment is different for self-employed individuals, such as partners in a partnership or 2% shareholders in an S corporation. They are not allowed to be treated as employees for this purpose, so they cannot exclude business-paid premiums from income on the front-end,² but benefits paid are excluded from income on the back-end.³

As we've explained in a previous article,⁴ the 2010 Health Care Act made the tax rules for health insurance more complicated by adding nondiscrimination rules that apply to employer-provided health benefit plans and a penalty tax for "Cadillac" plans that provide benefits that exceed a specified level.

Luckily, although disability benefits bear a resemblance to health benefits, they are not subject to these new restrictions. The following discussion explains why.

¹ §§ 106 and 105(a).

² §§ 105(g), 401(c)(1), and 1372(a)(2).

³ § 104(a)(3).

⁴ See [Health Care Reform and Long-Term Care Insurance](#), *Advanced Planning Bulletin*, March 2011.

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Nondiscrimination Rules

The Health Insurance Portability and Accountability Act of 1996 imposes a penalty if a group health plan fails to meet certain benefit requirements.⁵ The penalty is \$100 per day per individual to whom such failure relates.

The Patient Protection and Affordable Care Act,⁶ part of what is generally referred to as the “2010 Health Care Act,” added nondiscrimination rules to the Public Health Service Act.⁷ These rules⁸ mandate that all group health plans comply with § 105(h) of the Internal Revenue Code, which imposes nondiscrimination rules on self-insured medical reimbursement plans. A group health plan violates § 105(h) if it discriminates in favor of highly-compensated employees with respect to eligibility or benefits.⁹

The 2010 Health Care Act added § 9815, which incorporates these nondiscrimination rules and applies to them to group health plans generally (it exempts self-insured plans). If the group health plan impermissibly discriminates, it is subject to a penalty tax under § 4980D.

Importantly, however, § 9831(b) states that the group health plan requirements do not apply to those plans that provide “excepted benefits” described in § 9832(c)(1). That section in turn describes several excepted benefits, including those that provide “coverage only for accident, or *disability income insurance*, or any combination thereof.”¹⁰

Thus, disability income plans are exempt from these nondiscrimination rules.

The “Cadillac Tax”

Through new Code § 4980I, the 2010 Health Care Act also imposes a penalty tax on high cost employer-sponsored health coverage.¹¹ This so-called “Cadillac plan tax” becomes effective in 2018, and will be imposed on any benefit in excess of a specified cost and is equal to 40% of the excess benefit.¹²

Section § 4980I(d) states that this Cadillac plan tax can apply to any “applicable employer-sponsored coverage” that provides an excess benefit, including coverage under any group health plan that is excludible from the employee’s gross income under § 106.¹³ At first this might look like it could apply to disability income plans, but § 4980I(d)(1)(B) provides certain exceptions,

⁵ § 4980D.

⁶ P.L. 111-148 (enacted March 23, 2010).

⁷ The other part of the “2010 Health Care Act” is the Health Care and Education Reconciliation Act, P.L. 111-152.

⁸ Title XXVII, Part A, § 2716 of the Public Health Service Act.

⁹ Highly-compensated employees include any one of the five highest paid officers, any shareholder who owns, with the application of attribution rules, more than 10% of the stock of the employer, or any employee among the highest paid 25%.

¹⁰ § 9832(c)(1)(A).

¹¹ § 4980I.

¹² This tax will apply to individual coverage with an annual cost of \$10,200 as adjusted for increases in health care costs and \$27,500 for coverage other than individual coverage as adjusted for increases in health care costs.

¹³ § 4980I(d).

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including plans that provide “any coverage (whether through insurance or otherwise) described in section 9832(c)(1).”¹⁴

So, as with the nondiscrimination rules, we are sent to § 9832(c)(1), which, again, excludes those plans that provide “coverage only for accident, or *disability income insurance*, or any combination thereof.”¹⁵

Thus, disability income plans are exempt from the Cadillac tax rules as well.

Observations

Regardless of whether you are a fan of the 2010 Health Care Act, one thing you don’t have to worry about is the effect of its nondiscrimination and Cadillac plan penalty tax provisions on employer-sponsored disability income (wage continuation) plans. Those new tax rules do not apply to such plans, so they are basically as viable as ever.

Source: [Advanced Planning Bulletin, April 2011](#)

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¹⁴ In our March 2011 article – where we explained why these nondiscrimination and Cadillac plan tax rules don’t apply to long-term care (LTC) plans provided through individually-owned LTC insurance policies – we also addressed other portions of the Cadillac penalty tax provisions that *possibly* could be interpreted as providing different rules for *self-employed* taxpayers. See [Health Care Reform and Long-Term Care Insurance](#), *supra*, at n. 4. There’s no need to address that issue here, as self-employed taxpayers are afforded no special treatment for *disability income* plans anyway (they are essentially taxed as any individual who buys a disability policy without any business involvement).

¹⁵ § 9832(c)(1)(A).