Disabled Individuals

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Quick Tax Briefing

Overview
Numerous tax provisions provide special rules or exceptions to taxpayers who are disabled. The most common exceptions to certain penalties for distributions from retirement, health and education accounts. There are also rules excluding certain types of disability payments from income and a credit for certain low income disabled taxpayers.

Tax Highlights

- The most widely used tax definition of "disabled" is the one found in Section 72(m)(7), which states that "an individual shall be considered to be disabled if he is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or to be of long-continued and indefinite duration."
- Social Security disability benefits are treated the same as other Social Security benefits. They are partly taxable if a taxpayer's income exceeds certain threshold amounts.
- Supplemental Security Income (SSI) disability benefits are not taxable. These benefits are payable to adults or children who are disabled or blind, have limited income and resources, meet certain living arrangement requirements and are otherwise eligible.
- How income received from disability insurance policies is taxed depends on who paid the policy premiums.
- Certain military and government disability pensions are not taxable.
- Veterans' benefits paid under any law, regulation or administrative practice administered by the Department of Veterans Affairs (VA) are not taxable.
- Certain amounts paid as accelerated death benefits under a life insurance contract or viatical settlement before the insured's death are excluded from income if the insured is terminally or chronically ill.
- Certain improvements made to accommodate a home for a taxpayer's disabled condition, or that of his spouse or dependents who live with him, do not usually increase the value of the home, and the cost can be included in full as medical expenses.
- Although employees business expenses normally are subject to a 2%-of-AGI limit, impairment-related work expenses are not subject to the limit.
- Taxpayers under age 65 at the end of the tax year qualify for the elderly and disabled credit only if they retired on permanently and total disability before the close of the year and have taxable disability income.
- A taxpayer under age 65 must have a physician complete a statement certifying that he was permanently and totally disabled on the date of retirement before the credit can be claimed.

Key Terms

Disabled. For most tax purposes, individuals are considered to be disabled if they are unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or to be of long-continued and indefinite duration.
Handicapped individual. Defined in the Code [Section 190(b)(3)] as "any individual who has a physical or mental disability, (including, but not limited to, blindness or deafness) which for such individual constitutes or results in a functional limitation to employment, or who has an physical or mental impairment (including, but no limited to, a sigh or hearing impairment) which substantially limits one or more major life activities of such individual."
Impairment-related work expenses. Allowable business expenses for attendant care at the workplace and other expenses in connection with the workplace that are necessary for a disabled person to work.
Permanent and total disability. Unable to engage in any substantial gainful activity because of a physical or mental condition which can be expected to result in death or which has lasted or can be expected to last for a continuous period of not less than 12 months.
Sheltered employment. Certain work offered at qualified locations to physically or mentally impaired persons.
Substantial gainful activity. The performance of significant duties over a reasonable period of time while working for pay or profit, or in generally done for pay or profit.
Supplemental Security Income (SSI) disability benefits. Nontaxable benefits paid to adults or children who are disabled or blind, have limited income and resources, meet certain living arrangement requirements and are otherwise eligible.
Terminally ill individual. A person who has been certified by a physician as having an illness or physical condition that can reasonably be expected to result in death within 24 months from the date of the certification.
Viatical settlement. The sale or assignment of any part of the death benefit under a life insurance contract to a viatical settlement provider.

Income

The following income items are often received by disabled individuals:

Social Security Disability Benefits

The Social Security Administration (SSA) pay disability benefits through two programs: (1) the Social Security disability insurance program and (2) the Supplemental Security Income (SSI) program (for certain low-income individuals.)
Disability under Social Security for an adult is based on his inability to work because of a medical condition To be considered disabled:

- He must be unable to do the work he did before and SSA decides that he cannot adjust to other work because of a medical condition.

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- His disability must last or be expected to last for at least one year or to result in death.

Social Security pays only for total disability. No benefits are payable for partial disability or short-term disability.

Note: Social Security Disability Insurance (SSDI) is financed with Social Security taxes paid by workers, employers and self-employed persons. To be eligible for a Social Security benefit, the worker must earn sufficient credits based on taxable work to be "insured" for Social Security purposes. Disability benefits are payable to blind or disabled workers, widow(er)s or adults disabled since childhood, who are otherwise eligible. The amount of the monthly disability benefit is based on the Social Security earnings record of the insured.

Social Security Disability–
SSA's Five-step Evaluation Process

Step	Description
1. Is the individual working?	If the individual is working and his earnings average more than a certain amount each month, SSA generally will not consider him disabled. For 2010, the substantial gainful activity (non-blind) amount is $1000 per month. If the individual is not working, or his monthly earnings average the earning limit or less, his state's Disability Determination Services agency then looks at the individual's medical condition.
2. Is the individual's medical condition "severe"?	For the state agency to decide that an individual is disabled, the medical condition must significantly limit his ability to do basic work activities– such as walking, sitting, and remembering– for at least one year. If the medical condition is not that severe, the state agency will not consider him disabled. If the condition is that severe, the state agency goes onto step five.
3. Is the individual's medical condition on the List of Impairments?	The state agency has a List of Impairments that describes medical conditions that are considered so severe that they automatically mean that the individual is disabled as defined by law (see www.ssa.gov/disasbility/professionals/bluebook/listing-impairments.htm). If the person's condition (or combination of medical conditions) is not on this list, the state agency looks to see if the condition is as severe as a condition on the list. If the severity of the medical condition meets or equals that of a listed impairment, the agency will decide that he is disabled. If it does not, the agency goes onto step four.
4. Can the individual do the work he did before?	At this step, the state agency decides if a person's medical condition prevents him from being able to do the work he did before. If it does not, the state agency will decide that he is not disabled. If it does, the state agency goes onto step five.
5. Can the individual do any other type of work?	If the person cannot do the work he did in the past, the state agency looks to see if he would be able to do other work. It evaluates the medical condition, age, education, past work experience and any skills that could be used to do other work. If he cannot do other work, the state agency will decide that he is disabled. If he can do other work, the state agency will decide he is not disabled.

Taxability—Social Security disability insurance program payments. Social Security disability benefits are treated in the same manner as other Social Security benefits under Section 86, so they are partly taxable if a taxpayer's income exceeds certain threshold amounts.

If the individual received income during the year in addition to Social Security or equivalent tier 1 railroad retirement benefits, part of his benefits may be taxable if all of the other income shown on his tax return, including tax-exempt interest, plus half of the benefits are more than:

- $25,000 for single, head of household or qualifying widow(er) filers,
- $25,000 if married filing separately and spouses lived apart all of the year,
- $32,000 if married filing jointly or
- $-0– if married filing separately and lived with spouse at any time during the year.

Taxability—SSI disability benefits. SSI disability benefits are not taxable. These benefits are paid to adults or children who are disabled or blind, have limited income and resources, meet certain living arrangement requirements and are otherwise eligible. The monthly payment varies up to the maximum federal benefit rate, which may be supplemented by the State or decreased by countable income and resources.

Disability Policy Payments

Whether disability payments received from disability insurance policies are taxable depends on who paid the policy premiums.

- Disability payments are not taxable if the individual paid the premiums on the disability policy or contributed (on an after-tax basis) to an employer-sponsored– disability plan.
- Disability payments are taxable if an employer contributes to a funded plan or pays the policy's premiums for the employee.

Joint payments to employer group plan. For group policies purchased with both employer and employee contributions, the taxable portion of any benefits received is determined by the ratio of premiums paid by the employer to total net premiums for the three most recent years for which net premiums are known. This three-year "look back" rule can cause a portion of benefits paid under group disability insurance to be taxable if the employer has paid some or all of the premiums in the past, even if the employee paid all the premiums in the year the benefits are received.

Loss of use or function of the body. Disability payments for loss of use or function of the body (for example, limb) are always nontaxable.

Military and Government Disability Pensions

Certain military and government disability pensions are not taxable.

Service-connected disability. Individuals may be able to exclude from income amounts received as a pension, annuity or similar allowance for personal injury or sickness resulting from active service.

VA benefits. Veterans' benefits paid under any law, regulation or administrative practice administered by the Department of Veterans Affairs (VA) are not taxable. These include:

- Education, training or subsistence allowances.
- Disability compensation and pension payments for disabilities paid either to veterans or their families.
- Grants for homes designed for wheelchair living.
- Grants for motor vehicles for veterans who lost their sight or the use of their limbs.
- Veterans' insurance proceeds and dividends paid either to veterans or their beneficiaries, including proceeds of a veteran's endowment policy paid before death.
- Interest on insurance dividends left on deposit with the VA.
- Benefits under a dependent-care assistant program.
- The death gratuity paid to a survivor of a member of the Armed Forces who died after September 10, 2001 or
- Payments received by a veteran under the VA's "compensated work therapy" (CWT) program.