SELF-EMPLOYED
HEALTH INSURANCE TAXATION

STATUS

The Small Business Jobs Act, Public 111-240, provides for a temporary deduction for the self-employed from the self-employment tax for 2010 for their health care insurance costs.

Representatives Ron Kind (D-WI) and Wally Herger (R-CA) have introduced the Equity for Our Nation's Self-Employed Act. The bill number is H.R. 1470.

Senators Jeff Bingaman (D-NM) and Orrin Hatch (R-UT) introduced the senate companion bill, S.725.

ANALYSIS

All employees who receive compensation from an employer pay FICA taxes. FICA is comprised of Social Security (6.2 percent) and Medicare (1.45 percent) taxes. Employers are required to withhold 7.65 percent for FICA from gross compensation. In addition to the FICA withheld from the employee, the employer is required to "match" the FICA withholding. Therefore, the employee and employer contribution for FICA taxes is 15.3 percent of compensation (subject to applicable annual earnings limits for the social security portion - $106,800 for 2009).

The self-employed also pay into Social Security and Medicare funds at the combined rate of the employee and employer. The FICA tax for the self-employed is called the "self-employment tax" (Officially, the Self Employed Contributions Act (SECA) tax). The self-employment tax is computed at the same rates (15.3 percent) as employee/employer FICA, and is subject to the same annual limits.

Prior to 1986, the tax code treated the deduction of health insurance premiums for business owners differently depending on the structure of the company. If the entity operated as a C corporation, the premiums were fully deductible by the corporation, were not income to the owner, and therefore were fully tax deductible from both the income tax and the FICA tax. If the same entity operated exactly the same in every detail, except the entity was not a C corporation, that is, it operated as a sole proprietor, partnership, or some S corporations, the health insurance premiums for the sole-proprietor, partner, and S corporation shareholder were not deductible from either income tax or the FICA tax liability.

The self-employed health insurance deduction, authorized by the Tax Reform Act (TRA) of 1986, began to address this problem. The TRA allowed self-employed taxpayers to deduct a portion of the premiums. As a result of subsequent changes in the law, 100 percent of health insurance premiums for the self-employed are now deductible from income tax liability. However, this does not fully level the playing field. Since the self-employed health insurance deduction was (and is) not considered an ordinary and necessary business expense for the self-employed, as it is for the corporate entity, the premiums, while deductible from the income tax, are still subject to the self-employment tax. Schedule C filers (sole-proprietors), Schedule E filers (partners in partnerships with earned income) and some S corporation shareholders do not receive a "business deduction" for health insurance premiums. The deduction for their health insurance premiums, on page one of Form 1040, is authorized under the rules for the "self-employed health insurance deduction" and is not included on Schedule C, Schedule E, or Schedule SE. Therefore, the premiums are not deductible for the purposes of the self-employment tax and, accordingly, the sole proprietor, and some partners and some S corporation owners pay self-employment tax (15.3 percent on self-employment income) on health insurance premiums.

Supporters of changing the law argue that it is a matter of fairness. The "self-employed" are the only individuals that have to pay this tax on their health insurance. With over 14 million people filing as sole proprietors, partners, and S corporation shareholders, supporters contend that changing the law will target tax relief to those that really need it.

Opponents of changing the system contend that the cost is prohibitive. The cost to the Social Security Trust Fund would average between $2 and $3 billion a year. They claim that at a time of deficits and with the baby boomers coming into their retirement years, now is not the time to take money from the trust funds.

LEGISLATION

The bills would allow the self-employed to reduce the amount of their income that is subject to the self-employment tax by the amount paid for health insurance.

OUTLOOK

The challenge with passing legislation to alleviate this disparity is overcoming Congress' "PAYGO" budget rules that will require a revenue increase elsewhere as an offset. The fact Congress acknowledged the legitimacy of the issue by passing temporary relief is a positive step.