
Small Business Prescription for National Healthcare Reform

Tax Equity for the Self-Employed

Introduction

Under the current tax code, the nation's 21 million self-employed individuals (sole proprietors) are unable to deduct premiums as a business expense and are required to pay an additional 15.3 percent self-employment tax¹—their payroll tax—on their healthcare costs. These business owners are at a significant tax disadvantage to larger businesses, which do not pay payroll taxes on the health insurance they provide employees. This is one of a number of significant barriers these Americans face in trying to find affordable health insurance for themselves and their families.

Background

As described by the Coalition for Supporting Equity for Our Nation's Self-Employed²:

All employees who receive compensation from employers pay FICA taxes. FICA comprises Social Security (6.2 percent) and Medicare (1.45 percent) taxes. Employers are required to withhold from gross compensation 7.65 percent for FICA. 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 is 15.3 percent of compensation (subject to applicable annual limits). The self-employed pay FICA at a rate equivalent to employees and employers, 15.3 percent. FICA tax for the self-employed is called "self-employment tax."

All business entities other than sole-proprietors receive a deduction for health insurance premiums as an ordinary and necessary business expense for all employees including owners. Employees and the owner pay for their health insurance premiums pre-tax therefore they are not subject to FICA taxes. However, sole-proprietors (Schedule C filers) do not receive this benefit. The premiums are not paid with pre-tax dollars and are exposed to self-employment tax. Again, sole proprietors are the only business entity that does not receive a full deduction of healthcare costs.

While 100 percent deductibility of health insurance premiums has phased in by Congress, it does not solve this tax inequity. One hundred percent deductibility relates only to income tax and not self-employment tax.

Impact on Small Business

The best way to see the impact of current tax laws is to use an example of a self-employed family farmer. In this example, Mr. Jones pays \$12,000 per year in health insurance premiums for his family. The effect of the current tax law can be calculated by multiplying the self-employment tax rate by the annual insurance premiums. In this case, the amount is \$1,836.

In other words, Mr. Jones is paying an extra \$1,836.00 for his healthcare each year.

¹ Gurley-Calvez, Tami (2006). *Health insurance deductibility and entrepreneurial survival*. Report to the U.S. Small Business Administration, Office of Advocacy, under contract no. SBAHQ-04-M-0536; Internal Revenue Code, Title 26, Sec. 162 (l)(4).

² Coalition for Supporting Equity for Our Nation's Self-Employed, <http://www.setaxequity.org/policypaper.asp> (accessed May 26, 2009).

Proposed solution

The self-employed should be allowed to fully deduct their health insurance premiums for the purposes of their income tax and self-employment tax. We propose that the Internal Revenue Code of 1986, section 162, subsection (l) (relating to special rules for health insurance costs of self-employed individuals) be amended by striking paragraph (4), which currently disallows sole-proprietors from taking a business deduction (Schedule C) for health insurance.

The rationale

Allowing self-employed small business owners to fully deduct their health insurance premiums would provide them with the same tax treatment that big businesses already have. This is money that could be used to reinvest and grow their businesses, or cover out-of-pocket expenses of their current health coverage. The self-employed are the only segment of the business population that pays this extra tax on health insurance. This is a serious financial burden on the country's 21 million self-employed, including two million family farmers and ranchers. This benefit can be implemented immediately.

Summary and Conclusion

The self-employed should be allowed to fully deduct their health insurance premiums for the purposes of their income tax and self-employment tax. This will establish equity with other businesses and provide a financial benefit to the nation's 21 million self-employed to help offset the possible negative impacts of other comprehensive reform elements.