Legislative Fiscal Bureau

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Medical Care Insurance Deduction for Self-Employed Persons (General Fund Taxes -- Income and Franchise Taxes)

[LFB 2019-21 Budget Summary: Page 140, #12]

CURRENT LAW

Under both federal and state law, self-employed persons are entitled to deduct 100% of amounts paid for health insurance for themselves, their spouse, and their dependents to the extent that such premiums do not exceed net earnings from self-employment.

GOVERNOR

Modify the limitation on the deduction under the individual income tax that self-employed persons may claim for medical care insurance for themselves, their spouse, and their dependents. Beginning in tax year 2020, sunset the current law provisions that limit the deduction for all persons to the person's aggregate net earnings from a trade or business that are subject to Wisconsin tax and, instead, limit the deduction to the person's aggregate wages, salary, tips, unearned income, and net earnings from a trade or business that are subject to Wisconsin tax.

Beginning in tax year 2020, sunset the current law provisions that prorate the deduction for nonresidents and part-year residents based on the percentage of the person's net trade or business earnings that are subject to Wisconsin tax relative to the person's total net trade or business earnings and, instead, prorate the deduction based on the percentage of the person's wages, salary, tips, unearned income, and net trade or business earnings that are subject to Wisconsin tax relative to the person's wages, salary, tips, unearned income, and total net trade or business earnings. Relative to the proration, specify for married persons filing separately that “wages, salary, tips, unearned income, and net earnings from a trade or business" means the separate wages, salary, tips, unearned income, and net earnings from a trade or business of each spouse, and specify for married persons filing jointly that “wages, salary, tips, unearned income, and net earnings from a trade or business" means the total wages, salary, tips, unearned income, and net earnings from a trade or business of both spouses.

Repeal obsolete provisions regarding medical care insurance deductions that were sunset in prior tax years (originally, these provisions were sunset, rather than repealed, to allow taxpayers to file amended returns). Remove cross-references to repealed medical care insurance deductions under the itemized deduction credit. Reduce individual income tax collections by an estimated $9,500,000 in 2020-21. The reduction is estimated at $9,100,000 annually in subsequent years.

DISCUSSION POINTS

1. Federal adjusted gross income (AGI) is the starting point for calculating Wisconsin individual income taxes. When determining Wisconsin AGI, differences between the federal and state definitions of income become adjustments to federal AGI. Under both federal and state law, self-employed persons are entitled to deduct 100% of amounts paid for health insurance for themselves, their spouse, and their dependents, to the extent that such premiums do not exceed net earnings from self-employment.

2. Because Wisconsin has adopted the federal definition of income in most instances, Wisconsin does not generally authorize deductions for expenses which are the subject of federal deductions unless there is a difference between the state and federal treatments. For federal tax purposes, insurance plans of self-employed individuals must be established under the business, although if the individual is in a partnership or is more than a 2% stakeholder in a S corporation, the policy can be either in the name of the individual or the business. In the latter case, either the individual or the business may pay the premiums. However, if the individual pays the premiums, the business must reimburse the individual and report the premiums as guaranteed payments in the case of partnerships or as wages in the case of S corporations. The Wisconsin deduction is not limited in the preceding ways and simply allows self-employed individuals to deduct amounts paid for medical care insurance. Self-employed individuals claiming the state deduction must reduce the amount claimed for state tax purposes by the amount claimed under the federal deduction.

3. Both the federal and state deductions limit the amount that a self-employed individual may deduct to the net earnings or net profits from the business. For federal purposes, the net profit from the business must be reduced by amounts deducted as payments to a SEP, SIMPLE, or other retirement plan authorized for use by small businesses, but this reduction is not required for Wisconsin tax purposes. The Governor's proposal would lessen the limitation on the state individual income tax deduction for health insurance payments made by self-employed persons by allowing the deduction to offset most types of other income subject to the state individual income tax.

4. Self-employed individuals who are under the age of 65 may purchase nongroup health insurance through one of the marketplaces established under the Affordable Care Act or through an organization outside those marketplaces. For 2018, the Congressional Budget Office (CBO) estimates that 244 million noninstitutionalized civilians under the age of 65 in the United States had health insurance, including 15 million individuals with nongroup health insurance coverage (6%). Almost two-thirds of the insured population had employment-based health insurance. Employer spending on

employer-sponsored health insurance premiums is not subject to tax. The employer contribution is not considered taxable income of the employee and is a deductible business receipt of the employer. Further, any portion of the premium that is the responsibility of the employee may be paid with pre-tax income if the employer has established a "cafeteria plan" under Section 125 of the Internal Revenue Code. The National Bureau of Economic Research reports that such plans are available to 80% of the employees with an employer-sponsored health plan.

5. Three additional deductions are allowed under the Wisconsin state income tax for health insurance premium payments. These deductions extend to payments by individuals: (a) who are employees not covered by employer-provided medical insurance; (b) who have no employer and no self-employment income; and (c) who have insurance through their employment but their employer does not pay the entire premium. These deductions are authorized without limitation, except for reasonable limitations, such as not allowing the same expense to be deducted more than once and not allowing expenses that were not paid by the claimant.

6. DOA's Budget in Brief, 2019-21 notes that the proposed modification is intended to "help self-employed individuals better afford health insurance." It goes on to state that the proposed modification would be particularly helpful to individuals who are starting a small business and working another job as the business becomes established.

7. In a 2018 report on federal subsidies for health insurance coverage, the CBO estimated that 29 million, or 11.3%, of all noninstitutionalized civilians under the age of 65 were uninsured. Data on health insurance status by employer firm size is included in the U.S. Census Bureau's Current Population Survey and reports that, among the 17 million employed individuals between the ages of 18 and 64 who were uninsured, 55.8% were employed at firms with fewer than 25 employees, and workers at these firms were more than two and a half times as likely to be uninsured as workers employed at larger firms.

8. A nonemployer business is a business that has no paid employees. The U.S. Small Business Administration (SBA) reports that nonemployer businesses comprise 80% of all businesses, and income from some other source is the primary income for over 60% of the owners of nonemployer businesses. While the SBA classifies any business with fewer than 500 employees as a small business, almost 90% of small business startups have one to four employees in their first year. Only 78.5% of small businesses survive their first year, with the survival rate dropping to 67.2% at two years, 59.4% at three years, 53.3% at four years, and 48.2% at five years. At the end of ten years, only 33.5% of small business startups are still operating. Despite these survival rates, the small business startup rate has exceeded the small business exit rate over the 11-year period between 2004 and 2014, except for the three years coinciding with the recession from 2007 to 2009. Between 2000 and 2017, small businesses accounted for 66% of the country's net new jobs.

9. The SBA indicates that 57% of new businesses utilize the owner's personal savings as startup capital and 17% use other forms of self-financing, including personal credit cards, home equity loans, and other personal assets. Bank loans and business loans provide startup capital to 10% of new businesses, and over 20% of new businesses begin with no startup capital. These are largely nonemployer firms. Over 43% of employer firms used over $25,000 in startup capital, compared to only 12% of nonemployer firms. New business' use of self-financing may demonstrate that they have

not yet generated the earnings needed to finance the business venture, nor might they have the taxable business earnings to fully deduct the cost of health insurance with only those earnings.

10. If the Committee believes the state limitation on the deduction for medical care insurance for self-employed persons should be lessened sooner, the Governor's proposal could be modified to take effect in tax year 2019 (Alternative 2). This action would have the effect of reducing state individual income tax collections by an additional $9.1 million compared to the bill. The estimated reduction would equal $9,500,000 in 2019-20 and $9,100,000 in 2020-21. The ongoing reduction is less than in the initial year due to a one-time effect. If the Committee does not believe the limitation should be lessened, it may want to retain that part of the Governor's proposal that repeals obsolete provisions regarding medical care deductions that were sunset in prior tax years (Alternative 3).

ALTERNATIVES

1. Approve the Governor's proposal to modify the limitation on the deduction under the individual income tax that self-employed persons may claim for medical care insurance for themselves, their spouse, and their dependents, beginning in tax year 2020. Repeal obsolete provisions regarding medical care insurance deductions that were sunset in prior tax years. Remove cross-references to repealed medical care insurance deductions under the itemized deduction credit. Reduce individual income tax collections by an estimated $9,500,000 in 2020-21.

ALT 1	**Change to**	
	Base	**Bill**
GPR-Tax	-$9,500,000	$0

2. Modify the Governor's proposal to modify the limitation on the deduction under the individual income tax that self-employed persons may claim for medical care insurance by making the modification effective beginning in tax year 2019. Reduce individual income tax collections by an estimated $9,500,000 in 2019-20 and by $9,100,000 in 2020-21. Compared to the bill, this alternative reduces tax collections by an additional $9,100,000.

ALT 2	**Change to**	
	Base	**Bill**
GPR-Tax	-$18,600,000	- $9,100,000

3. Delete the Governor's proposal to modify the limitation on the deduction under the individual income tax that self-employed persons may claim for medical care insurance, beginning in tax year 2020. However, retain those parts of the proposal repealing obsolete provisions regarding medical care insurance deductions that were sunset in prior tax years and removing cross-references to repealed medical care insurance deductions under the itemized deduction credit. Compared to current law, there would be no change in individual income tax collections. Compared to the bill, individual income tax collections would be higher by an estimated $9,500,000 in 2020-21.

ALT 3	**Change to**	
	Base	**Bill**
GPR-Tax	$0	$9,500,000

4. Take no action.

ALT 4	**Change to**	
	Base	**Bill**
GPR-Tax	$0	$9,500,000

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