

Tax Subsidies for Health Insurance

An Issue Brief

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Most workers pay both federal and state taxes for wages paid to them by their employers. If, however, their employer also contributes to the cost of a health insurance plan, these funds are usually excluded from taxable income. In fact, almost 160 million non-elderly people in the United States obtain health insurance through an employer in large part because the tax system subsidizes the purchase of employer-sponsored health insurance (ESI). Recent proposals by presidential candidates have included various ways to alter this arrangement with the aim of either expanding coverage to those without access to employer coverage, or limiting the health insurance exclusion to discourage the purchase of very generous health coverage. Because workers pay different percentages of their income for taxes, the current tax treatment of health insurance premiums and the proposals to change it can have a different impact for workers depending on their income and their family circumstances.

This issue brief provides some illustrations of how families with different incomes benefit from current tax subsidies for private health insurance. The federal and state tax systems play an important part in the financing of private health insurance. The largest tax subsidy for private health insurance -- federal exclusion from income and payroll taxes of employer and employee contributions for employer-sponsored health insurance -- was estimated to cost the U.S. Treasury around \$200 billion in lost revenue in 2007,¹ or more than one-half of the estimated net federal outlays for the Medicare program for that year. Other prominent tax subsidies for private health insurance include the exclusion of health insurance premiums from state income taxes, the federal tax deduction for the self-employed, and the health care deduction for health expenses (including premiums) exceeding 7.5% of adjusted gross income.

Despite the important role that the tax system plays in subsidizing private coverage, the amount of the benefit received by individuals and families in different circumstances is often not well understood because the tax code is complex, and the value that families receive from tax exclusions and other tax subsidies can vary substantially with income and individual circumstances. Another complicating factor is that a large share of private health insurance premiums is paid by employers. Although the benefit of the spending and of the tax subsidies from employer contributions flows to employees and their families, it does so in an indirect way. Many families with employer coverage

¹ See Note 1 in David Auerbach and Stuart Hagen, "CBO's Health Insurance Simulation Model: A Technical Description," Congressional Budget Office, October 2007, p. 1. Available online at: www.cbo.gov/doc.cfm?index=8712.

probably do not understand that the federal and state tax exclusions for private health insurance provide a subsidy to them of at least several thousands of dollars a year.

To assess how tax subsidies relate to people in different circumstances, we look separately at families with ESI, families purchasing non-group insurance, and families with a self-employed worker. The examples focus on taxes for 2006, the latest year for which the tax simulation model that we are using provides complete estimates. For families with ESI, we assume a health insurance premium of \$11,500 (about the average cost of premiums for a family of four with ESI in 2006).² For families purchasing non-group insurance and for families with a self-employed worker, we look at two illustrative premium levels: \$11,500, representing a fairly comprehensive policy, and \$6,000, representing a policy with somewhat higher deductibles and more cost sharing. However, we recognize that non-group policies can be much cheaper and much more expensive, depending on the coverage and cost sharing.³

I. Federal and State Tax Exclusions for ESI

When a health plan is sponsored by an employer, typically both the employer and the employee who wishes to sign up for coverage contribute to paying the premium, or cost, of the health plan. For tax purposes, the employer portion of the premium is not included as taxable income, reducing employee tax liability. This lowers the amount workers owe to federal and state governments for income taxes, and for the payroll taxes paid to help support Medicare and Social Security (known as FICA, or the Federal Insurance Contributions Act taxes).⁴ And while many employees pay for their share of the premium with after-tax income, federal law also allows employees to contribute to premiums with pre-tax income, in which case taxes would also not be paid on the employee share.

Exclusion of Employer Premium Contributions for ESI

The largest source of tax subsidy for private health insurance is the exclusion of employer premiums for ESI from income and payroll taxes. What this means is that families that receive

² Kaiser Family Foundation/Health Research and Educational Trust, “Employer Health Benefits 2006 Annual Survey,” September 2006. Available online at: <http://www.kff.org/insurance/7527/index.cfm>.

³ We looked at premiums for non-group coverage for a sample family of four in California (Menlo Park zip code) using eHealthInsurance (www.ehealthinsurance.com). Premiums varied widely depending on coverage specifics. Several companies offered plans with moderate cost sharing (e.g., \$1,500 deductible per family, 30% coinsurance) for a premium that was similar to the average premium for employer-sponsored insurance, so we chose to use that level as one of our examples. The \$6,000 premium level is more typical of plans with higher deductibles or other limits.

⁴ See 12 United States Code Chapter 21.

compensation from their employers in the form of health insurance premiums do not include the value of those premiums when calculating adjusted gross income for federal or state income tax. In addition, the value of employer premium contributions is not considered when assessing federal payroll taxes that go to support Social Security and Medicare.

Consider the following simplified example that looks only at federal income and payroll taxes, illustrated in Table 1. Person A works at a job and is paid wages of \$50,000. Person A's employer does not provide health insurance. Person B works at a job and is paid wages of \$40,000. Person B's employer contributes an additional \$10,000 for health insurance to cover Person B and his family. Person B pays the remainder of the premium (\$1,500) from his take-home pay.

Table 1: Compensation and Tax Liabilities of Two Workers: With and Without Health Insurance, 2006

	Person A (without health insurance)	Person B (with health insurance)	Difference (A-B)
Total Compensation	\$50,000	\$50,000	\$0
<i>Taxable Wages</i>	\$50,000	\$40,000	\$10,000
<i>Employer Contributions to Health Insurance Premiums</i>	\$0	\$10,000	-\$10,000
Taxes	\$10,810	\$7,780	\$3,030
<i>Federal Income Taxes</i>	\$3,160	\$1,660	\$1,500
<i>Employer FICA</i>	\$3,825	\$3,060	\$765
<i>Employee FICA</i>	\$3,825	\$3,060	\$765

Both Person A and Person B receive \$50,000 in compensation from their employers, but the taxes that they would pay are very different. Person A would pay federal income tax (assuming a family of four and no other deductions) of \$3,160. Person A and Person A's employer each would pay FICA taxes, based on \$50,000 salary, of \$3,825 (for a total of \$7,650).⁵ In contrast, Person B would pay federal income tax of \$1,660, and Person B and Person B's employer each would pay FICA taxes of \$3,060 based on \$40,000 salary (totaling \$6,120). The result of the tax exclusion is that federal income tax liability is reduced by \$1,500 and federal payroll taxes are reduced by \$1,530, or a

⁵ Although employers pay one-half of the FICA tax amount, economists generally assume that the incidence of the tax falls on employees and not on employers (with an exception for employees earning the minimum wage and subject to the FICA Social Security earnings limit discussed below). Because employers know that they will have to pay a payroll tax of \$.0765 for each dollar they pay to an employee, it is assumed that the employer will adjust the employee's pay downward to account for that expenditure. In other words, if the FICA tax did not exist, it is assumed that the employers would pay employees 7.65% more.

combined reduction of \$3,030. This is equal to about 30% of the employer premium contribution of \$10,000. Additional examples, which include the subsidy value of state income taxes, are included in a later section.

Exclusion of Employee Premium Contributions for ESI

In the example above, Person B paid for his share of the premium (\$1,500) from his take-home pay with wages that had already been taxed. Section 125 of the Internal Revenue Code permits employers to sponsor arrangements that allow employees to pay for their share of insurance premiums with funds deducted from their wages before they are taxed. In this case, amounts that are deducted from payroll to pay for the employee share of health insurance payments would not be counted in determining employee income for income or payroll taxes. Table 2 compares the tax liabilities of two individuals – one whose employer does not offer a Section 125 plan (Person B1) and one whose employer does (Person B2). Since Person B2 is able to pay the \$1,500 employee premium share through a Section 125 plan, Person B2's taxable wages falls from \$40,000 to \$38,500. Federal income tax liability will fall by \$220, and employer and employee federal payroll taxes will fall by \$230, for a combined tax reduction in federal taxes of \$450,⁶ about 30% of the employee premium contribution. Consideration of state income tax liability would increase the amount of the tax subsidy.

Table 2: Compensation and Tax Liabilities of Two Workers Offered Health Insurance: With and Without a Section 125 Plan, 2006

	Person B1 (without 125 plan)	Person B2 (with 125 plan)	Difference (B1-B2)
Total Compensation	\$50,000	\$50,000	\$0
<i>Taxable Wages</i>	\$40,000	\$38,500	\$1,500
<i>Employer Contributions to Health Insurance Premiums</i>	\$10,000	\$10,000	\$0
Taxes	\$7,780	\$7,331	\$450
<i>Federal Income Taxes</i>	\$1,660	\$1,440	\$220
<i>Employer FICA</i>	\$3,060	\$2,945	\$115
<i>Employee FICA</i>	\$3,060	\$2,945	\$115

Note: Amounts may not sum to totals due to rounding effects.

Impact of Exclusion for Employer and Employee Premium Contributions by Income

The previous sections show that the exclusion of employer-sponsored health insurance

⁶ Amounts are rounded to the nearest dollar.

premiums reduces tax liability. In this section we illustrate how the tax reductions vary with family income and earnings. There are two primary reasons why the tax reduction varies with income. One reason is progressive income tax schedules, particularly for federal income taxes. Under the federal income tax system, the percentage of income that is taxed increases for each portion of income that exceeds predefined thresholds. Table 3 shows the federal income tax rates for married families filing jointly in 2006. Under the schedule, a family with \$75,000 of taxable income⁷ would pay a tax equal to 10% of the first \$15,100 of income (or \$1,510), 15% of their next \$46,200 of income (\$6,930) and 25% of the last \$13,700 of income (\$3,425), for a total tax payment of \$11,865. What this means for the tax exclusion for employer and employee premium payments is that the value of the exclusion (i.e., the amount by which taxes are reduced) grows as income increases. For example, the family with \$75,000 of taxable income in the example would save \$0.25 in federal income tax for each dollar reduction in their taxable income, but a family with \$50,000 in taxable income would save only \$0.15 in federal taxes for each dollar reduction in taxable income. The percentage rate at which the last dollar of family income is taxed is referred to as the family's marginal tax rate.

Table 3: Income Tax Brackets, Tax Rates, and Taxable Income, Married Couples, 2006⁸

Taxable Income Bracket		Tax Rate	Taxable Income
<i>Lower Limit</i>	<i>Upper Limit</i>		
\$0	\$15,100	10%	10% of the amount over \$0
\$15,100	\$61,300	15%	\$1,510 plus 15% of the amount over \$15,100
\$61,300	\$123,700	25%	\$8,440 plus 25% of the amount over \$61,300
\$123,700	\$188,450	28%	\$24,040 plus 28% of the amount over \$123,700
\$188,450	\$336,550	33%	\$42,170 plus 33% of the amount over \$188,450
\$336,550	No limit	35%	\$91,043 plus 35% of the amount over \$336,550

The other major reason that the amount of tax reduction from the exclusion varies by income is that there is an annual cap on the portion of federal payroll tax payments that support the Social Security program (which, in combination with tax payments to support Medicare, is known as the FICA tax). Under the Social Security portion of the payroll tax, most employees pay taxes of 6.2% of wages to support the program. Their employers pay the same amount, resulting in a total Social Security-related payroll tax of 12.4%. However, the 12.4% employee-employer assessment to support Social Security is capped; the assessment is only collected on wages up to an annual per employee earnings limit. The limit in 2006 was \$94,200 per worker. This means that, for workers with wages

⁷ Taxable income means the amount of income that a taxpayer has after deductions and exemptions.

⁸ U.S. Department of the Treasury, Internal Revenue Service, "2006 Federal Tax Rate Schedules, Schedule Y-1." Available online at: <http://www.irs.gov/formspubs/article/0,,id=150856,00.html>.

lower than the annual limit, the exclusion of employer and employee premium payments from the Social Security portion of FICA results in a tax reduction of \$0.124 for each dollar excluded, regardless of whether their spouse has earnings in excess of the limit. Workers with wages above the annual limit, however, have already stopped paying the Social Security portion of FICA for wages earned beyond the annual limit, so additional income shielded by the tax exclusion would not be subject to the 12.4% Social Security portion of FICA.

The Medicare payroll tax is different from that of Social Security. The Medicare tax is uncapped; every dollar in taxable wages is subject to it. Like the Social Security tax, both employers and employees contribute a fixed percentage, which in this case is 1.45% of wages or (2.9% in total), to support Medicare. The combined employee and employer portions of the Social Security and Medicare payroll tax for workers below the Social Security earnings limit is 15.3% of taxable wages.

Demonstrating Varying Impact of Exclusion by Family Income

The amount of tax reduced by the health insurance tax exclusion varies with family income. To make the examples simple, in most cases we assume the following characteristics of a family relating to their tax liability:

- the family has four members, two of which are working spouses and two are dependent children;
- the family has only wage income;⁹
- wages are equally divided between the spouses;
- one spouse receives a family health insurance policy valued at \$11,500 through his or her employer;
- the employer contributes \$10,000 toward the cost of the policy and the family contribution of \$1,500 is paid through a Section 125 plan;
- the family does not itemize deductions.

The scenarios are calculated for families residing in the state of California, which has a progressive income tax schedule. See Appendix A for a description of how the tax reduction is calculated.

⁹ The effect of the exclusion from income tax operates based on total family taxable income, while the effect of the exclusion from payroll taxes operates only on earnings. For simplicity, we assumed that families have only wage income. For families with a mix of wage and other sources of income, their tax rates would vary, which would change the tax liabilities we show.

Figure 1 shows the tax reduction for an employer-sponsored health insurance premium valued at \$11,500 for sample families with annual wages at four different earnings levels: \$40,000, \$80,000, \$120,000, and \$150,000.¹⁰ The income tax reductions and the total tax reduction grow steadily with income, reflecting the progressive income taxes at the federal and state level. The FICA reduction is the same in each case, reflecting how the tax is a flat percentage on wage income up to an annual earnings limit per worker. In these examples, while family income exceeded the threshold for Social Security taxes for the two highest family income categories, since we assumed the family has two wage earners making equal amounts, no individual worker's salary exceeded the limit, so each had a \$1,760 reduction for \$11,500 in premiums. The total tax reduction varies from almost \$3,700 at the lower end of the income range presented to over \$6,000 at the higher end, or between 32% and 53% of the total premium value.

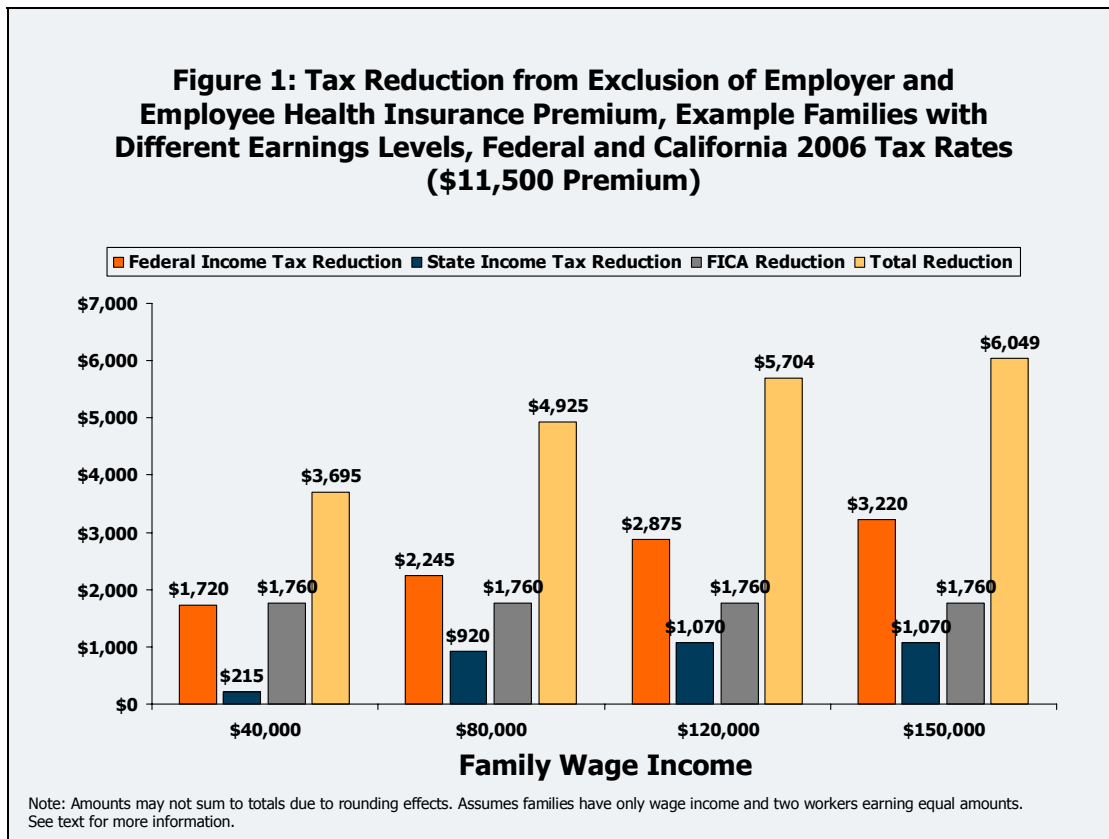
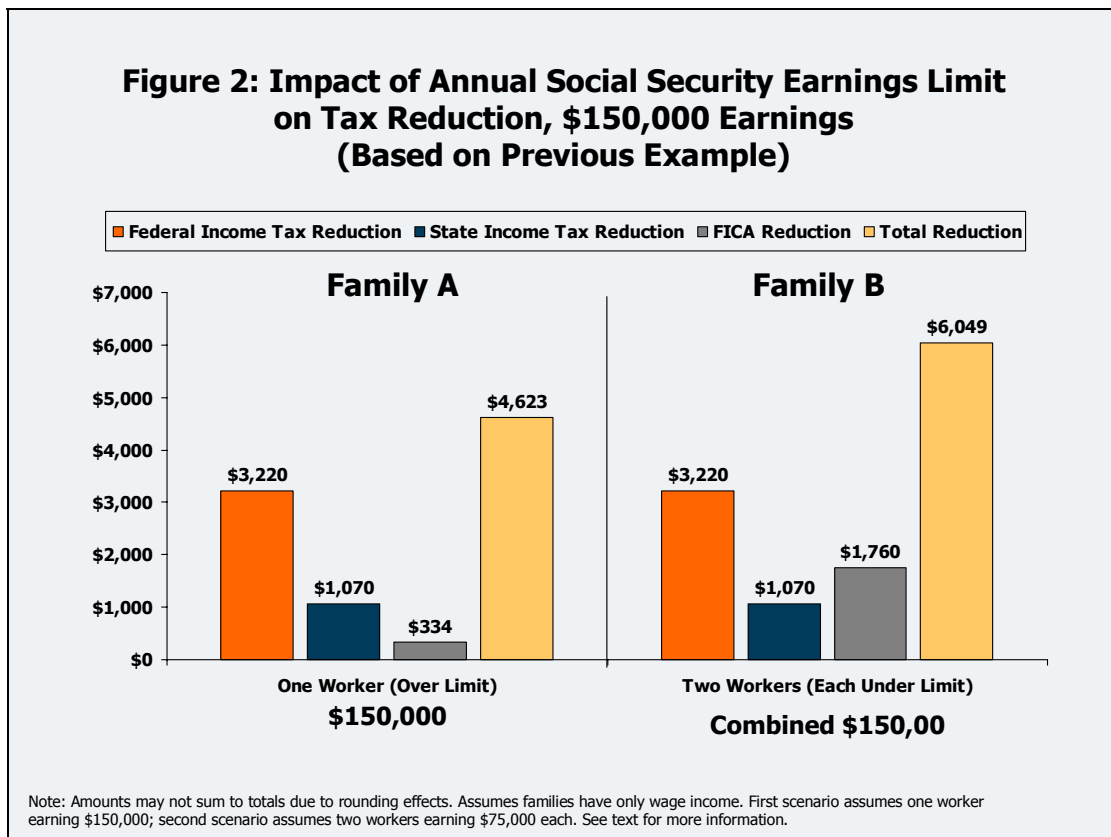


Figure 2 demonstrates the impact of the annual Social Security earnings limit for FICA tax liability. Two similar families are considered, each with \$150,000 of wage earnings and each receiving

¹⁰ These are the wage amounts before the \$1,500 contribution through the Section 125 plan, which has the effect of reducing adjusted gross income by \$1,500.

an \$11,500 health insurance policy through an employer (\$10,000 employer contribution plus the employee contribution of \$1,500 paid through a Section 125 plan). Family A has one worker with \$150,000 in wage earnings. Family B has two workers, each with \$75,000 in wage earnings, which means that all of this family’s earnings are below the annual Social Security earnings limit of \$94,200 in 2006. On the other hand, the worker in Family A stops paying the Social Security portion of FICA once his or her wages reach \$94,200 for the year, so the tax exclusion for health insurance does not reduce the FICA contribution that that worker makes for the Social Security portion of FICA (although the Medicare portion of FICA is reduced by \$334 since this tax applied to every dollar in taxable wages). The worker in Family B that receives the health insurance policy is being taxed for the full FICA assessment for each additional dollar of earnings, so the tax exclusion reduces the FICA tax on that workers’ earnings by the full FICA tax rate (\$0.153 for each dollar of earnings). The tax exclusion for Family B is over \$1,400 larger than the exclusion for Family A because each worker in Family B earns less (\$75,000) than the FICA cap (\$94,200) even though their total earnings (\$150,000) exceeds the cap in 2006.



These examples show that the federal tax exclusion for employer-sponsored health insurance

results in substantial levels of tax reduction for families at different earnings levels and that the total tax reduction increases with family earnings. The primary reason that the tax reduction increases with family earnings is progressive income tax rates – the marginal tax rate for each dollar of income tends to be higher as income grows (until family income reaches the top federal and state income tax rates).

Of course, actual families have much more complicated earnings and income situations than we have shown. For example, some families will have itemized deductions which will lower their taxable income and may lower their marginal tax rate, effectively lowering the amount of tax reduced by the exclusion. Conversely, families may have other types of income, such as interest income, that would increase their total taxable income, potentially raising their marginal tax rate and the amount of tax reduced by the exclusion. The situation can be even more complex for lower-income families, because employer contributions for ESI are not considered as income when considering eligibility for programs such as the earned income tax credit (EITC) or the child care tax credit. While there are many potential scenarios that could be provided with differing family circumstances and differing tax reduction impacts, the important point is that, because health insurance is so expensive, the decision not to tax employer and employee premium payments often has a significant impact on family tax liability.

II. Federal Tax Deduction for Health Insurance Premiums for Non-Group Coverage

Unless they are eligible for public coverage, people who are not offered health insurance from an employer and wish to be insured usually must buy health insurance directly from an insurer. This type of insurance is often termed individual or non-group health insurance. When compared to the substantial tax assistance provided through the tax system for ESI, federal tax assistance for families purchasing non-group insurance is fairly modest. Generally, families that itemize their deductions can deduct the portion of their medical expenses, including health insurance premiums, that exceed 7.5% of their adjusted gross income. Medical expenses which qualify for this deduction include out-of-pocket expenses paid for the receipt of health care or insurance premiums. So even if a family purchases a health insurance plan with a low premium, such as a high-deductible plan, they may still claim the deduction if they had total costs (out-of-pocket costs for services plus premium payments) exceeding the 7.5% threshold. It is important to note that this medical expense deduction is an income tax deduction which, unlike the tax exclusion for ESI discussed above, works only to reduce income tax liability and not the amount of FICA taxes paid.

There are three important limitations associated with the medical expense deduction. The first is that it is only available to families who itemize their deductions. Families generally itemize their deductions when the amount of itemized deductions exceeds the amount of the standard deduction otherwise available to tax filers; in 2006 the standard deduction amounts were \$5,150 for people who were single or married couples filing separate tax returns, \$10,300 for married couples filing a joint tax return (or certain widowers with dependent children), and \$7,550 for people filing as head of household.¹¹ Federal tax law permits itemized deductions for a number of different expenses, including medical and dental expenses, certain state and local taxes paid by the family, real estate and property taxes, interest on a home mortgage loan (and other home mortgage expenses), charitable gifts, casualty and theft losses, and certain business expenses.¹² Families that pay mortgage interest, for example, are likely to benefit from itemizing their deductions, and may then be able to deduct a portion of their non-group health insurance premiums as well.

The second limitation is that the medical and dental expense deduction is limited to expenses that exceed 7.5% of adjusted gross income. For example, the family with \$80,000 of wage income in the example from Figure 1 would have adjusted gross income of \$80,000. This means that a family could deduct medical expenses in excess of \$6,000 (7.5% of \$80,000 is \$6,000). If the only medical expense for the family was the \$11,500 family non-group premium, the family could deduct \$5,500 of the premium (\$11,500 premium minus \$6,000). The amount of tax deduction would depend on the family's marginal income tax rate, which would be largely determined by the amount of their other deductions; at a marginal tax rate of 15% the tax reduction would be about \$900, and at a marginal tax rate of 10% the tax reduction would be about \$600. Note that a family with \$80,000 of adjusted gross income with the lower non-group premium of \$6,000 could not take a deduction in this case, because 7.5% of their adjusted gross income (\$6,000) equals the premium amount. Families with higher incomes are unlikely to be able to take a deduction for their non-group premiums unless their premiums are fairly large or the family has a significant amount of other medical expenses such that their total medical expenses (including their premiums) exceed 7.5% of income.

¹¹ See Tax Facts, Urban Institute and Brookings Institution Tax Policy Center, 2006 Individual Income Tax Rates, Standard Deductions, Personal Exemptions, and Filing Thresholds, October 2006, at http://www.taxpolicycenter.org/taxfacts/Content/PDF/individual_rates.pdf.

¹² "2007 Instructions to Schedules A & B (Form 1040)," Internal Revenue Service, accessed on June 19, 2008, at <http://www.irs.gov/pub/irs-pdf/i1040sa.pdf>.

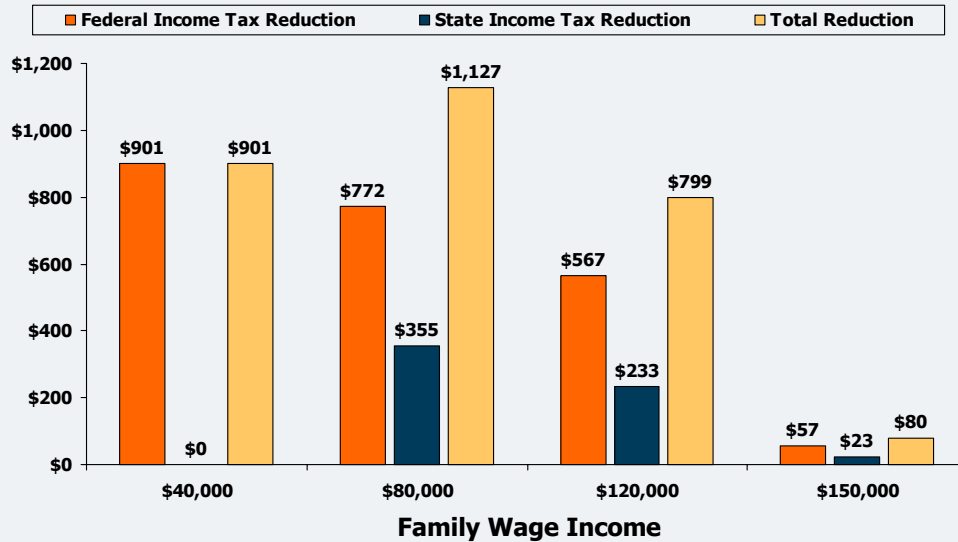
A third limitation is that the deduction has little value if the family has no federal tax liability. Many lower-income individuals and families do not owe federal income tax, so the deduction does not make health insurance more affordable for them. For some families eligible for the Earned Income Tax Credit (EITC), which is a refundable tax credit, having itemized deductions could increase the amount of the credit that they receive. This credit is provided for lower-income individuals and families with earned income below certain thresholds (ranging in tax year 2006 from \$12,120 for a single taxpayer without children to \$38,343 for married filers filing jointly with at least two children) and limited investment income. To benefit from a deduction for their health insurance premiums, families would need to be eligible for the EITC, have itemized deductions in excess of the standard deduction amounts, and have medical expenses (including their health insurance premiums) exceeding 7.5% of their adjusted gross income.

Figure 3 shows examples of how the medical expense deduction could work for families with different incomes. The examples are based only on the \$11,500 premium because only the \$40,000 income family can take a deduction for the \$6,000 plan.¹³ The examples assume families with different levels of wage income and no other income, similar to the examples above, but these families are not offered health insurance at work. The families are assumed to purchase a non-group health insurance policy with an annual premium of \$11,500 and have no other medical or dental expenses to deduct. To ensure that the families have sufficient deductions to itemize, we also assume that the families pay \$10,000 in mortgage interest and take deductions for state taxes (the amounts deducted vary with income and are calculated through the model). Federal and state income tax liability is calculated first with each family deducting the portion of the \$11,500 premium that exceeds 7.5% of adjusted gross income and then calculated without taking the deduction. The differences in tax liability are shown in the Figure 3.¹⁴

¹³ For the other families, 7.5% of adjusted gross income equals or exceeds \$6,000. Families in these cases could deduct a portion of their health insurance costs if they had other medical expenses that bring the total above the 7.5% threshold.

¹⁴ We note that the comparisons shown in Figure 3 were created to allow reasonable comparisons across the income scale, but are probably not very realistic in some regards. It is unlikely, for example, that families at these different income levels would choose to buy the same level of policy, or that many families with \$40,000 of income could afford to pay for a mortgage with \$10,000 of interest and for a health insurance policy costing \$11,500. It is also unlikely that families with these different incomes would have the same mortgage interest.

Figure 3: Tax Reduction from Medical Expense Deduction for Non-Group Health Insurance Premium, Federal and California 2006 Tax Rates (\$11,500 Premium)



Note: Amounts may not sum to totals due to rounding effects. Assumes families have only wage income, have no medical expenses other than premiums, take \$10,000 mortgage interest deductions, and deductions for state taxes. See text for more information.

The total tax reduction amounts shown in Figure 3 do not vary significantly over the first three families, but fall substantially for the family with \$150,000 in income. This pattern is the result of several factors. First, the amount that families can deduct falls with income because of the 7.5% of adjusted gross income provision. For example, this means that the family with \$40,000 in income can deduct \$8,500 (7.5% of adjusted gross income is \$3,000 so the amount that can be deducted is \$11,500 minus \$3,000). Likewise, the family at \$80,000 can deduct \$5,500, the family at \$120,000 can deduct \$2,500, and the family at \$150,000 can deduct only \$250. Partially offsetting the impact of falling deduction amounts is that the marginal tax rates increase with income, so families at higher incomes save a larger share of the smaller amount that they can deduct (see Table 3). For example, the family at \$40,000 can deduct \$8,500, but because their tax rate is relatively low, their federal savings are only about 11% of their deduction. This family also has no state tax savings because their state tax liability is \$0 with and without the deduction. In contrast, the family at \$120,000 can deduct only \$2,500, but their federal tax reduction is about 23% of the amount deducted, due to their higher tax rate. The family at \$120,000 also has state tax savings.

Comparing Figure 3 to Figure 1 shows that the tax reductions for non-group insurance that can

result from the medical expense deduction are far lower than the tax reductions that result from the exclusion of ESI. This occurs for three reasons: first, the tax exclusion means that the employer contribution for health insurance is not considered income to the family, so a family with \$40,000 of wage income is really receiving compensation of \$50,000 with the last \$10,000 not subject to taxation; second, the exclusion for ESI applies to the entire premium amount, while the medical expense deduction is only for expenses exceeding 7.5% of adjusted gross income; and third, the tax exclusion for ESI reduces both income and payroll taxes while the medical expense deduction reduces only income tax liability. The substantially larger subsidies available for health insurance purchased at work is a primary reason that job-based health insurance is so prevalent. Among the non-elderly, about 158 million people were covered by employer-sponsored insurance in 2006, compared with fewer than 15 million people covered by non-group coverage.¹⁵

III. Special Tax Deduction for Health Insurance Premiums for the Self-Employed

People who are self-employed also often look to the non-group market for health insurance. Self-employed individuals are subject to federal income tax as well as self-employment tax, which is the equivalent to the federal payroll tax.¹⁶ A special tax provision permits the self-employed to take a deduction when calculating their income tax for the amount paid for health insurance for themselves and their spouse or dependents.¹⁷ To qualify for the deduction, the health insurance must be established under the self-employed person's business. This deduction, however, has several limitations. First, the deduction may not be taken if the self-employed individual or his or her spouse were eligible for subsidized coverage offered by an employer. For example, if a self-employed individual was eligible for health benefits offered by the spouse's company from January through March but the self-employed individual was paying premiums for an individual plan, those premiums would not be eligible for the self-employed health insurance tax deduction. A second limitation is that the amount deducted cannot exceed the net profit and other earned income from the business under which the health insurance plan

¹⁵ *The Uninsured: A Primer*, Table 1, Kaiser Family Foundation, October, 2007, <http://www.kff.org/uninsured/upload/7451-03.pdf>.

¹⁶ The self-employment tax is the equivalent of the Social Security and Medicare taxes paid by workers. However, instead of the employee and the employer each paying equal shares of the tax, the self-employed pay the entire 15.3% payroll tax themselves. Half of the self-employment tax may be deducted when calculating adjusted gross income.

¹⁷ A self-employed health insurance deduction is available to individuals who are either: (1) self-employed with a net profit reported on Schedule C (Form 1040), Schedule C-EZ (Form 1040), or Schedule F (Form 1040); (2) a partner with net earnings from self-employment reported on Schedule K-1 (Form 1065); or (3) a shareholder owning more than 2% of the stock of an S corporation with wages from the corporation reported on Form W-2. See IRS Publication 535, available online at: <http://www.irs.gov/publications/p535/>.

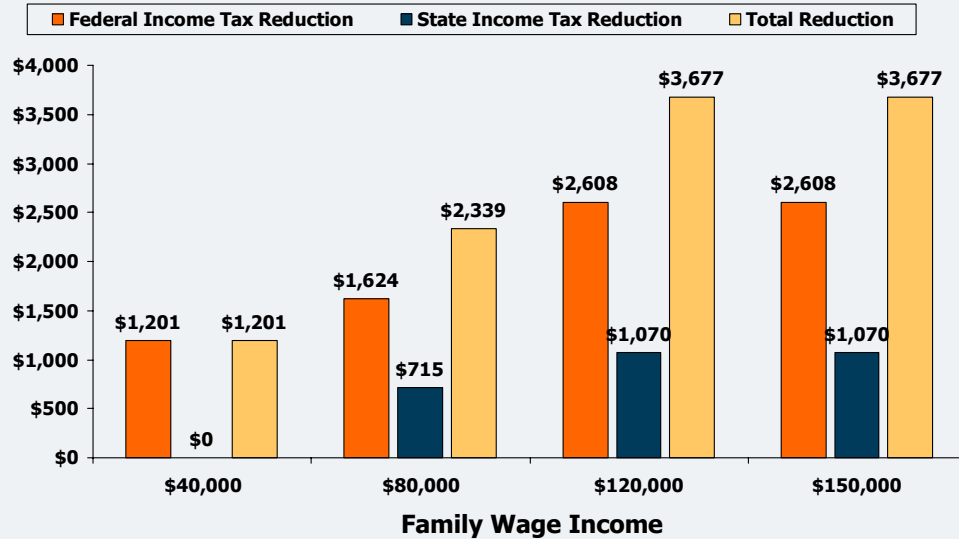
is established. For example, a person with a small amount of self-employment income and additional income from other sources cannot deduct the full amount of his or her health insurance premiums if the premiums exceed the net profit from self-employed person's business. A third limitation is that the self-employment health insurance deduction reduces income for income tax purposes only and may not be deducted when calculating the net earnings subject to the self-employment tax.

Figures 4 and 5 show examples of the tax reductions that may occur due to the self-employed health insurance deduction. Figure 4 assumes a \$11,500 health insurance premium, and Figure 5 assumes a \$6,000 premium. The scenarios are the same as those assumed under Figure 3, except that families now have sufficient income from self-employment to permit them to deduct the full amount of the health insurance premium. The reduction amounts shown are calculated by computing each family's taxes with a deduction for health insurance and without any deduction for health insurance. For this table we did not assume that families would take the medical expense deduction if the self-employed health insurance deduction were not available. (The differences between the amounts shown in Figures 3 and 4 show the additional value provided by the self-employed health insurance deduction compared with the medical expense deduction.)

As Figures 4 and 5 show, the tax reduction from the self-employed health insurance deduction generally increases with income, which results from subtracting a constant deduction amount (the \$11,500 or the \$6,000 premiums) from income and taxing the remainder at rates that increase with income. Comparing the impact of different tax policies using the higher (\$11,500) premium level, it is clear that the tax reductions in Figure 4 are much higher than those in Figure 3, reflecting that fact that the self-employed can deduct the full amount of health insurance premiums while people taking the medical expense deduction can only deduct expenses exceeding 7.5% of adjusted gross income. At the same time, the reduction amounts in Figure 4 are much lower than the amounts in Figure 1, largely because the self-employed tax deduction only reduces income taxes while the tax exclusion for ESI reduces both income and payroll taxes.¹⁸

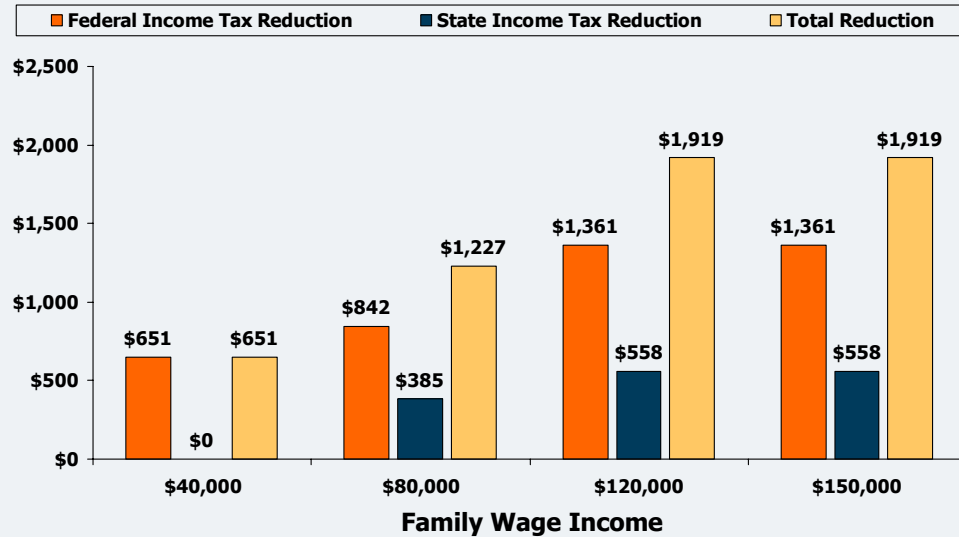
¹⁸ The federal and state tax reduction amounts also differ somewhat in part because the effective income is higher for the families receiving ESI (they receive a \$10,000 contribution from their employer, which means that their effective income is higher than their wage income).

Figure 4: Tax Reduction from Self-Employed Health Insurance Deduction, Federal and California 2006 Tax Rates (\$11,500 Premium)



Note: Amounts may not sum to totals due to rounding effects. Assumes families have sufficient income for self employment to deduct full amount of premiums, have only wage income, have no medical expenses other than premiums, take \$10,000 mortgage interest deductions, and deductions for state taxes. See text for more information.

Figure 5: Tax Reduction from Self-Employed Health Insurance Deduction Federal and California 2006 Tax Rates (\$6,000 Premium)



Note: Assumes families have sufficient income for self employment to deduct full amount of premiums, have only wage income, have no medical expenses other than premiums, take \$10,000 mortgage interest deductions, and deductions for state taxes. See text for more information.

IV. Conclusion

This paper provides some examples of how families with different incomes benefit from current tax subsidies for private health insurance. As policymakers propose changes to the tax system to make health insurance more affordable, it is important that they and the public clearly understand who benefits and does not benefit from current tax subsidies for private health insurance and how those benefits vary across families with different incomes. For example, understanding the substantial tax advantages provided for ESI, particularly for families at relatively high incomes, may help provide perspective on the appropriate tax credit level for lower-income families. The tax system is a key part of the financing for the private health insurance system, and no doubt changes to the tax system will be a large component of any health care reforms that may emerge. Although the system is complicated, understanding how tax subsidies are distributed under current law is a necessary first step to understanding how the system may be improved.

Key Terms

Pre-tax income. The term "pre-tax" is used to describe compensation that an employee receives from an employer that is not subject to income tax or FICA payroll taxes. Normally, if an employee earns a dollar in wages, the employee must pay federal and state taxes on that dollar. Federal law provides that certain types of compensation received by an employee, including employer contributions to health insurance, are not subject to federal income tax or FICA taxes. Federal law also permits employers to establish arrangements that permit employees to pay their share of health insurance premiums with income that is not subject to income or payroll taxes.

Adjusted gross income (AGI). AGI is defined as: "taxable income from all sources . . . minus specific deductions such as education expenses, the IRA deduction, student loan interest deduction, tuition and fees deduction, Archer MSA deduction, moving expenses, one-half of self-employment tax, self-employed health insurance deduction, self-employed SEP, SIMPLE, and qualified plans, penalty on early withdrawal of savings, and alimony paid by [the tax payer]." (Available online at: http://www.irs.gov/app/freeFile/html/moreInfo/more_info_agi.html.)

Deduction. A deduction is an amount that a person can subtract from their adjusted gross income when calculating the amount of tax that they owe.

Standard deduction. The basic standard deduction is a specified dollar amount that taxpayers can deduct from their income in determining their taxes. (See Table 7, available online at <http://www.irs.gov/publications/p501/ar02.html>.) The amount varies with the filing status (e.g., single, married filing jointly, etc.) of the taxpayer. A taxpayer can take the standard deduction or can take deductions related to specified expenses (referred to as itemized deductions).

Credit. A tax credit is an amount that a person can subtract from the amount of income tax that they owe. If a tax credit is refundable, the taxpayer can receive a payment from the government to the extent that the amount of the credit is greater than the amount of tax that the individual would otherwise owe.

Personal exemption. A personal exemption is an amount that a taxpayer can deduct for themselves and their dependents when calculating taxable income.

FICA. The Federal Insurance Contributions Act requires individuals and employers to pay a tax on compensation to fund Social Security and Part A of Medicare. Both the employer and the employee pay 6.2% (12.4% combined) on earnings up to the Social Security wage base (\$102,000 in 2008) for the Social Security Program. Both the employer and the employee pay 1.45% (2.9% combined) of all wages for Part A of Medicare. The total combined FICA contribution on a dollar of earnings (for 2008) is 15.3% for wages up to \$102,000 and 2.9% for wages above \$102,000.

Medical expense deduction. Federal law permits taxpayers to deduct the portion of medical expenses, including premiums for health insurance, that exceeds 7.5% of adjusted gross income as an itemized deduction. (See IRS Publication 502 for more information, available online at: <http://www.irs.gov/publications/p502/ar02.html>.)

Appendix A. Calculation of Tax Reduction for ESI Tax Exclusion Examples

The tax reductions shown in this paper were calculated using Taxsim Version 8, which is a program that permits users to calculate federal and state taxes for individuals and families with various characteristics.¹⁹ For this exercise we calculated each family's tax liability under current law and then recalculated it assuming that the family received the amount of the employer contribution for health insurance as additional wage income. The differences in the federal and state income tax liability and the FICA tax liability are the reduction amounts shown in the figures. For example, one of the sample families has \$40,000 in wage income and a \$10,000 health insurance contribution from their employer. The family contributes their share of the \$11,500 premium, or \$1,500, through a Section 125 plan. For the comparison, we first reduced the family's wage income to \$38,500, reflecting that the family is able to pay their \$1,500 share of the premium with pre-tax income, and then calculated the federal, state, and FICA taxes. We then recalculated the family's tax liability assuming wage income of \$50,000 (\$40,000 of wage income, all of it subject to tax, plus \$10,000 of income equal to the employer's contribution to health insurance). The tax liability differences between these two scenarios are the tax reduction amounts shown in the figures.

¹⁹ Available online at: <http://www.nber.org/~taxsim/>.



The Henry J. Kaiser Family Foundation

Headquarters

2400 Sand Hill Road
Menlo Park, CA 94025
(650) 854-9400 Fax: (650) 854-4800

**Washington Offices and
Barbara Jordan Conference Center**

1330 G Street, NW
Washington, DC 20005
(202) 347-5270 Fax: (202) 347-5274

www.kff.org

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