



Documents for Podcast 005  
Self-Employed Health Insurance Deduction  
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The IRS issued a Chief Counsel's notice on June 17, 2005 related to two issues involving the self-employed health insurance deduction found at §162(l). This guidance is found at: <http://www.irs.gov/pub/irs-wd/0524001.pdf>

## **General Rule**

Section 162(l) provides the general rule under which we operate for the deduction for self-employed individuals. That provision is found in Appendix 2. There has been very limited official guidance on just what this provision means, which is why this Chief Counsel Memorandum has attracted such attention.

In general, self-employed individuals (and those S corporation shareholders treated as self-employed for employee benefits purposes) had a problem before this provision came into the law in 1986. §106, which allows employers to deduct while employees do not include in their income health insurance premiums. However, there is no provision similar to the one for qualified plans that allows a self-employed individual to be treated "as if" they were an employee for these purposes.

This provision was added to partially address this concern. Initially it allowed only a partial above the line deduction for health insurance premiums, but in 2003, after a couple

of law changes, the deduction was increased to potentially allow a deduction for the full amount of the premium paid.

However, while there are few conditions on the §106 exclusion (it simply needs be a plan of the employer), there are some special restrictions in the self-employed world. Those restrictions are generally found under §162(l)(2).

### ***Income Limitation***

The first limitation is found at §162(l)(2)(A) which limits the deduction to the taxpayer's earned income (as computed under §401(c)) from the trade or business with respect to which the plan is established.

Part of this is rather familiar—IRC Section 106 also requires an “employer provided... plan.”<sup>1</sup> to obtain the exclusion. The IRS has taken a rather broad view of a plan, allowing employers to count payments made to employees to reimburse them for individual policies so long as there is proof of payment by the employee.<sup>2</sup> As well, the employer can simply pay these individually written policies on behalf of the employees. So it's clear that while a traditional group health plan program written by an insurance carrier qualifies for the exclusion, that group health plan is not a prerequisite of obtaining the tax benefits.<sup>3</sup>

Since the language in Section 162(l) is similar to that found in Section 106, and the legislative commentary accompanying this provision surrounding the 1986 Tax Act made it clear this was meant to address unfairness regarding the inability to gain the benefit of Section 106, it would seem to make sense that the same view of a “plan” should apply for purposes of Section 162(l).

The CCM issued this year agrees with that position. One of the two questions involved whether a policy issued in the individual's name as opposed to the business name was deductible under §162(l), assuming all other requirements are met. The CCM issued agrees that such a deduction is allowed under the law.<sup>4</sup>

Must such a plan be written? Most likely we again look at the history on Section 106 where it is generally held that no formal written plan is required under the law—the issue is simply whether a plan exists. Such a plan, as noted above, can simply be one where the employer reimburses the employee for premiums paid. Unlike other provisions of the

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1 §106(a)

2 See Revenue Rulings 61-146 and 75-241 for the details on the requirements

3 Readers are warned if they are looking at setting up such a system that there may be other, tax and nontax implications, including HIPAA and COBRA requirements, as well as state insurance regulation issues. It has been reported by some CPAs that in certain states a program of reimbursing employee premiums has been deemed to be the offering of a group plan that would be subject to state insurance department regulation. But that issue may not be a problem for a one person activity that we are often talking about in the self-employed arena.

4 Chief Counsel Advice 200524001 This ruling can be downloaded from the IRS directly at <http://www.irs.gov/pub/irs-wd/0524001.pdf>

law (most importantly, Section 125(d)(1) which covers all cafeteria plans, including premium only plans), neither Section 162 nor 106 explicitly demand a written plan exist for the benefits to be obtained.

If there are employees, the plan must be communicated to the employees to exist (that makes some sense), but since there are no discrimination rules in this area there may be little real impact of that matter—generally, any employee benefiting under the plan generally would be aware of it, while excluded employees would not have to be so informed.<sup>5</sup>

Finally, note that the deduction is limited to income from the trade or business for which the plan is established. The CCM makes clear this is measured on a business by business basis, and not based on overall earnings from self-employment.<sup>6</sup>

This can be both a trap and a benefit to the self-employed individual. It can be a trap if the individual has two trades or businesses, but pays the insurance only from a single business. Note, as well, it would appear under this theory the IRS could force you to show which business the plan of insurance was established under and, at least in theory, argue that if that cannot be shown then no plan existed.

While the CCA doesn't make it clear, it would appear that this decision could not be made after the fact—the payments had to be *made* under a plan—so the present tense wording would suggest the plan had to be in place when the payment was made. Thus, you might find at the end of the year you had a plan under Business A, but Business B was the only one with sufficient income to allow the entire deduction.

On the positive side, this ruling opens up the opportunity to obtain the benefits of a deduction for health insurance even if a new start up business is generating a net loss.

### **Other Coverage**

The second limitation on the deduction is one unique to the self-employed—the taxpayer is ineligible for the benefit for any calendar month in which, for any part of the month, the taxpayer was “eligible to participate in any subsidized health plan maintained by any employer of the taxpayer or of the spouse of the taxpayer...”<sup>7</sup>

There has been little official or unofficial guidance on the definition of these terms, many of which aren't necessarily clear. We'll consider two key terms that may give tax professionals real problems.

*Employer.* That term can be a problem when the issue of benefits available to a retired individual and/or that individual's spouse are considered. Does the term “employer”

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5 Of course, if you claim to follow a written plan, that plan would have you cover more employees than you do, and you don't give that to the employees, you may have actually harmed your case by having a written plan.

6 Chief Counsel Advice 200524001

7 §162(l)(2)(B)

noted in that provision apply to entities which previously had an employment relationship with the employee, or does it only apply to an entity for which the individual has a current employment relationship?

Some argue for the broad view, under the viewpoint courts use in interpreting the tax law that deductions should be interpreted narrowly. In that view, any previous employer would count for this purpose, since Congress had a limited purpose of addressing a very specific problem—those individuals who had no access to tax favored coverage. Of course, taken to its logical conclusion, any person who was eligible for Medicare coverage and had ever had \$1 of FICA wages would be ineligible to ever qualify for the self-employed health insurance deduction—the employer had paid ½ of the Medicare tax during employment, making that a “subsidized” plan offered by the employer (the fact the employer had no choice isn’t necessarily relevant).

However, the “current employer only” camp would argue that the courts also look to how “undefined” words are used in general, and how they’ve been interpreted in other contexts under the Internal Revenue Code. There the argument is that in the qualified plan arena it’s clear that “employee” means current employee for purposes of plan participation and qualification. As well, the argument goes, if Congress meant past employers they would have said so.

Clients need to be counseled about the options available and risks inherent in each in order to choose which reporting position the client wishes to take.

## **Is an HSA the answer?**

One item some clients might wish to consider to avoid this problem is a health savings account and related insurance policy. While the insurance policy still has to clear all of the hurdles noted above, the HSA contribution itself is not subject to the limits noted above. However, many clients find the qualifying insurance policy is a problem for them—some will not want to change carriers or policies, some may be unable to do so due to health problems that render them unable to qualify for the policy, and some will simply find the restrictions too onerous (particularly what will eventually apply to prescription drug benefits).

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## Appendix 1 – §162(l) Text

**162(l)** SPECIAL RULES FOR HEALTH INSURANCE COSTS OF SELF-EMPLOYED INDIVIDUALS. --

**162(l)(1)** ALLOWANCE OF DEDUCTION. --

**162(l)(1)(A)** IN GENERAL. --In the case of an individual who is an employee within the meaning of [section 401\(c\)\(1\)](#), there shall be allowed as a deduction under this section an amount equal to the applicable percentage of the amount paid during the taxable year for insurance which constitutes medical care for the taxpayer, his spouse, and dependents.

**162(l)(1)(B)** APPLICABLE PERCENTAGE. --For purposes of subparagraph (A), the applicable percentage shall be determined under the following table:

<i>For taxable years beginning in calendar year</i>	<i>The applicable percentage is --</i>
1999 through 2001 .....	60
2002 .....	70
2003 and thereafter .....	100

**162(l)(2)** LIMITATIONS. --

**162(l)(2)(A)** DOLLAR AMOUNT. --No deduction shall be allowed under paragraph (1) to the extent that the amount of such deduction exceeds the taxpayer's earned income (within the meaning of [section 401\(c\)](#)) derived by the taxpayer from the trade or business with respect to which the plan providing the medical care coverage is established.

**162(l)(2)(B)** OTHER COVERAGE. --Paragraph (1) shall not apply to any taxpayer for any calendar month for which the taxpayer is eligible to participate in any subsidized health plan maintained by any employer of the taxpayer or of the spouse of the taxpayer. The preceding sentence shall be applied separately with respect to --

**162(l)(2)(B)(i)** plans which include coverage for qualified long-term care services (as defined in [section 7702B\(c\)](#)) or are qualified long-term care insurance contracts (as defined in [section 7702B\(b\)](#)), and

**162(l)(2)(B)(ii)** plans which do not include such coverage and are not such contracts.

**162(l)(2)(C)** LONG-TERM CARE PREMIUMS. --In the case of a qualified long-term care insurance contract (as defined in [section 7702B\(b\)](#)), only eligible long-

term care premiums (as defined in [section 213\(d\)\(10\)](#)) shall be taken into account under paragraph (1).

**162(l)(3)** COORDINATION WITH MEDICAL DEDUCTION. --Any amount paid by a taxpayer for insurance to which paragraph (1) applies shall not be taken into account in computing the amount allowable to the taxpayer as a deduction under [section 213\(a\)](#).

**162(l)(4)** DEDUCTION NOT ALLOWED FOR SELF-EMPLOYMENT TAX PURPOSES. --The deduction allowable by reason of this subsection shall not be taken into account in determining an individual's net earnings from self-employment (within the meaning of [section 1402\(a\)](#)) for purposes of chapter 2.

**162(l)(5)** TREATMENT OF CERTAIN S CORPORATION SHAREHOLDERS. --This subsection shall apply in the case of any individual treated as a partner under [section 1372\(a\)](#), except that --

**162(l)(5)(A)** for purposes of this subsection, such individual's wages (as defined in [section 3121](#)) from the S corporation shall be treated as such individual's earned income (within the meaning of [section 401\(c\)\(1\)](#)), and

**162(l)(5)(B)** there shall be such adjustments in the application of this subsection as the Secretary may by regulations prescribe.