



Legislative Fiscal Bureau

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Joint Committee on Finance

Paper #315

Income Tax Deduction for Health Insurance Premiums (General Fund Taxes -- Individual and Corporate Income Taxes)

Bill Agency

[LFB 2007-09 Budget Summary: Page 151, #1]

CURRENT LAW

There are a number of provisions under current law that provide income tax exclusions and deductions related to health insurance premiums. Under current federal law, to which Wisconsin conforms, employers may offer fringe benefits in the form of cafeteria plans, which allow employees to choose between receiving cash (or other taxable benefits) or certain qualified benefits (including health benefits) for which the law provides an exclusion from wages for income tax purposes. Therefore, under a cafeteria plan, employees may select to have their share of employment-based medical care insurance paid with pre-tax dollars, thereby reducing the employee's taxable wages by the amount paid for the medical care insurance.

Current state law also provides deductions for 100% of long-term care insurance premiums, and for medical care insurance paid for by self-employed individuals that do not exceed net earnings from a trade or business that is taxable by this state. Wisconsin also provides a deduction related to premiums paid by an employee whose employer did not contribute anything toward the cost of the medical care insurance. In such cases, prior to tax year 2006, Wisconsin law permitted a deduction of 50% of the premiums paid by the employee. Effective with tax year 2006, as provided under 2005 Act 25, an employee whose employer did not contribute anything toward the cost of the medical care insurance may deduct 100% of the premiums paid by the employee. For purposes of these deductions, "medical care insurance" means a medical care insurance policy that covers a taxpayer, the taxpayer's spouse, and the taxpayer's dependents and provides surgical, medical, hospital, major medical, or other health

service coverage. The deduction may not exceed the individual's aggregate wages, salary, tips, unearned income, and net-earnings from a trade or business that are taxable by this state.

In addition to the deductions described above, Act 25 created a deduction for medical care insurance premiums paid by an individual with no employer and no self-employment income, to be phased in over a three-year period beginning in tax year 2007 as follows: (a) 33.4% of the cost of such premiums are deductible in tax year 2007; (b) 66.7% will be deductible in tax year 2008; and (c) 100% of such premiums will be deductible in tax years 2009 and thereafter. As with the deduction for an individual whose employer did not contribute anything toward the cost of the medical care insurance, this deduction may not exceed the individual's aggregate wages, salary, tips, unearned income, and net-earnings from a trade or business that are taxable by this state.

For non- and part-year residents, the current law deductions for medical care insurance premiums of employees and unemployed individuals must be pro-rated based on the share of total income that is taxable to Wisconsin. For self-employed individuals who are non- or part-year residents, the medical insurance premium deduction must be pro-rated based on the individual's share of income earned from a trade or business taxable to Wisconsin.

Finally, certain medical care insurance premiums are also eligible to be included in the calculation of the state's itemized deduction credit. The itemized deduction credit is equal to 5% of the excess of allowable itemized deductions over the sliding scale standard deduction. Medical expenses that conform to those permitted as federal itemized deductions, which include medical expenses exceeding 7.5% of federal adjusted gross income (AGI), are generally allowable for calculating the state itemized deduction credit. However, medical care insurance premiums that are subtracted from Wisconsin income (under one of the income tax deductions described above) are disallowed for purposes of the state's itemized deduction credit.

GOVERNOR

Provide an individual income tax deduction for medical care insurance premiums paid by an employee whose employer pays for some portion of the employee's health insurance costs. Provide the same definitions and general parameters as those generally in effect for the current law deductions for medical care insurance. As with the current law deductions for employees and unemployed individuals, provide that a non- or part-year resident would have to pro-rate the proposed deduction for medical care insurance premiums based on the individual's share of total income that is taxable to Wisconsin.

Specify that the additional deduction would be phased in over a four-year period. For tax year 2008, 10% of the portion of medical care insurance premiums paid by an employee (whose employer pays for some portion of the employee's health insurance costs) would be deductible. The percentage would increase to 25% for tax year 2009, 45% for tax year 2010, and to 100% for tax year 2011 and thereafter.

The administration estimates that the proposal would reduce state tax revenues from the individual income tax by the following amounts: (a) \$11.8 million in 2008-09; (b) \$31.9 million in 2009-10; (c) \$62.0 million in 2010-11; and (d) \$149.0 million in 2011-12 and annually thereafter.

DISCUSSION POINTS

1. Under the bill, an income tax deduction would be provided for medical care insurance premiums paid by an employee whose employer pays for some portion of the employee's health insurance costs. The proposal would specifically benefit employees whose payments for medical care insurance are not made with pre-tax dollars (which would be the case when the payments are not being made under a cafeteria plan).

2. Under current law, an employee whose employer contributes nothing toward the employee's medical care insurance premiums may claim an income tax deduction for such premiums. However, if an employer contributes even a small amount toward the payment of such premiums, the employee is not eligible for the deduction.

3. As a result of the expanded deductions for medical care insurance premiums provided under Act 25, the primary group of taxpayers who are not currently eligible to deduct even a portion of medical care insurance premiums consists of employees whose employers pay for some, but not all, of employee medical care insurance premiums. This proposal is intended to address what could be considered to be inequitable treatment of this group of taxpayers under current law by providing an income tax deduction for any amount of premiums paid for by such an employee.

4. Under current law, medical care insurance premiums that are subtracted from Wisconsin income (under one of the income tax deductions described above) are disallowed for purposes of the state's itemized deduction credit. The administration's intent is to provide similar provisions for the proposed deduction under the bill. However, as drafted, the bill would not disallow such premiums from the calculation of the itemized deduction credit. The administration has requested a modification to the bill to achieve this intent. The estimated fiscal effect of the provision included in the bill assumed that medical care insurance premiums deducted under the proposal would not also be eligible to be included in the calculation of the itemized deduction credit. Therefore, compared to the bill, the modification would not have a fiscal effect.

5. The estimated fiscal effect of the proposal was derived from information provided by the State of Iowa, which allows a general exemption for medical insurance premiums. The Iowa data was used because detailed information is unavailable on current expenditures for medical care insurance by Wisconsin taxpayers who would be affected by the Governor's proposal. However, with certain exceptions discussed below, in combination with the existing deductions for medical care insurance premiums, the proposal would result in medical care insurance premiums paid for by a taxpayer being generally deductible for Wisconsin income tax purposes. Therefore, an estimate of

the cost of the proposed tax deduction could be made by estimating the cost of exempting medical care insurance premiums, generally, and then reducing that figure by the estimated fiscal effect of the existing deductions as if the Act 25 provisions were already phased in.

6. Based on the data from Iowa, after adjusting for estimated growth in health insurance premiums and differences in the number of taxpayers in the two states, the administration's estimates appear to be reasonable

7. In combination with current law, the proposal is intended to result in medical care insurance premiums being deductible for all taxpayers (once the phase-in periods under Act 25 and the bill are complete). It should be noted, however, that the deduction for self-employed individuals is limited to net earnings from a trade or business that are taxable by this state (which is interpreted to mean net earnings from self-employment). This limitation would not affect a taxpayer whose net earnings from self-employment exceeded the cost of health insurance premiums. However, there could be self-employed individuals for whom the limitation would mean they could not fully deduct health insurance premiums (for example, an individual in the start-up phase of a business or in a business downturn). In addition, it is unclear whether, for a taxpayer who has limited income from self-employment and is otherwise either employed or unemployed, the self-employment deduction (including the limitation) or one of the deductions for employees or unemployed individuals would apply. This potentially confusing and arguably inequitable situation could be eliminated by eliminating the current limitation on the deduction for self-employed taxpayers. Such a modification would not affect the estimated fiscal effect included in the bill, as the estimate was based on the assumption that the proposal would result in all medical care insurance premiums being fully deductible by the end of the phase-in period.

8. Tax deductibility for medical care insurance premiums is one way of reducing the costs of purchasing medical care insurance. There are other methods that could be used to assist individuals with health care costs as well, including, for example, providing some form of universal health care coverage or conforming to federal provisions on health savings accounts. However, regardless of additional proposals that could be considered, unless the current deductions for medical care insurance premiums were either eliminated or extended to include taxpayers whose employers pay a portion of employee medical care insurance premiums, an inequity could be considered to exist in terms of the tax treatment of medical care insurance premiums paid by such taxpayers.

ALTERNATIVES TO BILL

1. Approve the Governor's proposal with a modification to specify that medical care insurance premiums that are subtracted from Wisconsin income under the proposal would be disallowed for purposes of the state's itemized deduction credit. There would be no change to the estimated fiscal effect included in the bill.

ALT 1	Change to Bill Revenue	Change to Base Revenue
GPR	\$0	- \$11,800,000

2. Approve the Governor's proposal with a modification to specify that medical care insurance premiums that are subtracted from Wisconsin income under the proposal would be disallowed for purposes of the state's itemized deduction credit. In addition, modify the current law deduction related to a self-employed taxpayer to specify that, as is the case under the current deductions for medical care insurance premiums and under the Governor's proposal, this deduction may not exceed the individual's aggregate wages, salary, tips, unearned income, and net-earnings from a trade or business that are taxable by this state. Under this alternative, there would be no change to the estimated fiscal effect included in the bill.

ALT 2	Change to Bill Revenue	Change to Base Revenue
GPR	\$0	- \$11,800,000

3. Delete provision.

ALT 3	Change to Bill Revenue	Change to Base Revenue
GPR	\$11,800,000	\$0

Prepared by: Faith Russell