

Key changes affect the self-employed's health insurance deduction for 2010 - Feb.28, 2011

Self-employed taxpayers and their advisers should be aware that on the 2010 return there are a number of key changes, almost all positive, that affect the Code Sec. 162(l) self-employed's health insurance deduction. This article surveys what's new for this key deduction on the 2010 return.

Background. A self-employed individual (or a partner or a more-than-2%-shareholder of an S corporation) can deduct as a business expense 100% of the amount paid during the tax year for medical insurance. (Code Sec. 162(l)(1)(B)) No deduction is allowed to the extent the deduction exceeds the individual's earned income as defined in Code Sec. 401(c) (net earnings from self-employment) derived from the trade or business for which the plan providing the coverage is established. (Code Sec. 162(l)(2)(A)) For purposes of applying the earned income limit to the deduction of a more-than-2% S corporation shareholder, that shareholder's wages from the S corporation are treated as his earned income. (Code Sec. 162(l)(5)(A))

Changes to keep in mind. The following changes affect the self-employed's health insurance deduction for the 2010 year.

- The self-employed individual's health insurance deduction is also allowed in calculating net earnings from self-employment for purposes of the self-employment tax for tax years beginning in 2010. (Code Sec. 162(l)(4), as amended by the 2010 Small Business Act, P.L. 111-240, 9/27/2010) Net earnings from self-employment are generally an individual's trade or business income, less the deductions permitted by the Code that are attributable to that trade or business, plus the individual's distributive share of partnership income or loss. For tax years beginning before 2010, a self-employed individual's health insurance costs, although deductible for income tax purposes, weren't deductible in determining net earnings from self-employment. Thus, business owners couldn't deduct the cost of health insurance for themselves and their family members for purposes of calculating their self-employment tax. This new deduction under the 2010 Small Business Act only applies for one year: it doesn't apply for tax years beginning before Jan. 1, 2010, or after Dec. 31, 2010.
- IRS has changed its position and concluded that Medicare B premiums are deductible as a Code Sec. 162(l) self-employed health insurance expense, as indicated by the Instructions to Form 1040 (2010) (Line 29, Self-Insured Health Insurance Deduction). Medicare B is supplemental medical insurance. Premiums that a taxpayer pays for Medicare B are a deductible medical expense under Code Sec. 213; thus, a taxpayer who applies for it at age 65 or after he becomes disabled can include the monthly premiums he pays in his medical expenses. In the past, IRS had argued that Medicare Part B premiums didn't qualify for a deduction because they weren't paid under a health insurance plan established by the taxpayer under a trade or business; rather Medicare Part B was a federal program available only to those who qualify under the statute. (Field Service Advice 3042) There was limited case law supporting this position.

(Reynolds, (2000) TC Memo 2000-20, affirmed on another issue (2002, CA7) 90 AFTR 2d 2002-5294))

- The self-employed health insurance deduction, effective Mar. 30, 2010, is available for any child of the taxpayer who has not attained age 27 as of the end of the year. (Code Sec. 162(l)(1)(D), as amended by the Health Care and Education Reconciliation Act (Reconciliation Act, P.L. 111-152, 3/30/2010)) The expanded definition of children for whom the self-employed deduction for health insurance premiums may be claimed also applies to more-than-2% S corporation shareholders entitled to claim the deduction.

Observation: A taxpayer could claim a deduction for the cost of health insurance for a child before Mar. 30, 2010, but only if that child was the taxpayer's dependent (and the other requirements for the Code Sec. 162(l) deduction were satisfied). Under the Reconciliation Act, a self-employed taxpayer may claim a deduction for health insurance premiums paid for a child who is under age 27 as of the end of the tax year, whether or not the child is the taxpayer's dependent for tax purposes. For example, an adult child who has not turned 27 years of age need not meet the dependency tests for a qualifying child under Code Sec. 152(c)(1)—and thus the deduction is available—regardless of (a) child support thresholds, (b) the child's place of abode, or (c) the child's tax filing status.

- The limitation on a self-employed individual's deduction for health insurance premiums where there's an employer-subsidized health plan has been changed. (Code Sec. 162(l)(2)(B), as amended by the Reconciliation Act) Before Mar. 30, 2010, no individual who was eligible to participate in any subsidized health plan maintained by any employer of the individual or of the individual's spouse was entitled to the deduction. Under the Reconciliation Act, the deduction is also not available for any month in which the self-employed individual is eligible to participate in a subsidized health plan maintained by any employer of any dependent, or any child of the taxpayer who hasn't attained age 27 as of the end of the tax year.

Because this rule applies on a calendar-month basis, if a self-employed individual is eligible to participate in a subsidized plan that's maintained by an employer of the individual, his spouse, his dependent, or his under-age-27 child for, say, only one calendar month (e.g., December), the deduction is still available for premiums paid during the other months of the year. The eligibility test is applied separately to (1) plans that provide coverage for qualified long-term care services, or are qualified long-term care insurance contracts and (2) plans which don't include such coverage and aren't such contracts. (Code Sec. 162(l)(2)(B)) Thus, an individual eligible for employer-subsidized health insurance may still be able to deduct long-term care insurance premiums, so long as he isn't eligible for employer-subsidized long-term care insurance.