

**NORTH CAROLINA GENERAL ASSEMBLY**

**LEGISLATIVE FISCAL NOTE**

**BILL NUMBER:** House Bill 191 (First Edition)

**SHORT TITLE:** Self-Employed Health Insurance Deduction

**SPONSOR(S):** Representatives Hurley, Goodwin, et al.

<b>FISCAL IMPACT</b>					
	<b>Yes (X)</b>	<b>No ( )</b>	<b>No Estimate Available ( )</b>		
	(\$million)				
	<u><b>FY 2001-02</b></u>	<u><b>FY 2002-03</b></u>	<u><b>FY 2003-04</b></u>	<u><b>FY 2004-05</b></u>	<u><b>FY 2005-06</b></u>
<b>REVENUES</b>					
General Fund	(\$22.6)	(\$20.3)			
<b>EXPENDITURES</b>					
General Fund		No estimate available			
<b>PRINCIPAL DEPARTMENT(S) &amp; PROGRAM(S) AFFECTED:</b> Department of Revenue					
<b>EFFECTIVE DATE:</b> This act is effective for taxable years beginning on or after January 1, 2001.					

**BILL SUMMARY:** This bill allows a self-employed individual to claim a state income tax deduction equal to the difference between the federal income tax deduction for health insurance costs and the full cost of the health insurance premium.

**BACKGROUND:** Section 162(l) of the Internal Revenue Code allows self-employed individuals to deduct a percentage of their health insurance premiums from their adjusted gross income (AGI). The tax deduction is allowed for premiums paid for the taxpayer, the taxpayer's spouse, and the taxpayer's dependents. The federal income tax deduction is equal to 60% of premiums in 2001, 70% in 2002, and 100% in 2003. For itemizers, the premiums not deducted from adjusted gross income can be added to medical expenses on Schedule A if the taxpayer's total medical expenses exceed 7.5% of AGI.

**ASSUMPTIONS AND METHODOLOGY:** The U.S. Small Business Administration (SBA) reported 261,000 self-employed persons in North Carolina in 1998. The North Carolina self-employed represented 2.53% of the U.S. total of 10.3 million self-employed. Also in 1998, 3.4 million self-employed in the U.S. claimed a 45% self-employed health insurance deduction on their federal tax return. Since no North Carolina specific data is

available on the federal self-employed health insurance tax deduction, this fiscal note uses the SBA data and assumes that 2.53% of the federal returns were from North Carolina residents. Thus in 1998, it is assumed that 85,536 North Carolinians took advantage of the federal deduction.

To determine how many North Carolina self-employed would use the deduction in 2001 and 2002, the years covered in this bill, the 1998 data was inflated by 5.9% each year. This was the growth rate in the number of incorporated businesses formed between 1988 and 1994 as reported in an April 1998 study entitled “Small Business Research Study: Changing Characteristics of the Self-Employed”. Using the 5.9% rate produces 101,587 N.C. self-employed taking the health insurance deduction in 2001 and 107,580 in 2002.

The Census Bureau’s Summary Characteristics of Business Owners and Their Businesses published in 1992, provides the age and marital status needed to estimate the cost of health insurance premiums paid by the self-employed. The chart below shows the breakdown by age and marital status for the projected North Carolina self-employed taxpayers using the health insurance deduction in 2001. The number of the married self-employed equals 69.6% and the number of the single (separated, divorced, widowed) self-employed equals 30.4%.

<u>Age</u>		<u>All</u>	<u>Married</u>	<u>Single</u>
under 25	2.3%	2,337	1,626	710
25 to 34	14.2%	14,425	10,040	4,385
35 to 44	27.1%	27,530	19,161	8,369
45 to 54	22.9%	23,263	16,191	7,072
55 to 64	17.5%	17,778	12,373	5,404
65 and older	10.4%	10,565	7,353	3,212
not reported	5.6%	5,689	3,959	1,729
		101,587	70,705	30,882

Since the type of health insurance purchased by North Carolina’s self-employed is unknown, this fiscal note assumes deductibles and co-insurance requirements similar to the State of North Carolina Comprehensive Major Medical Plan. The basic options of the state plan are a \$250 deductible, 20% coinsurance for the first \$5,000, and \$10 office copay. To receive a premium quote on these options, the Internet service eHealthInsurance.com was used. The rates quoted on the Internet site were from Celtic Life Insurance Company, a Chicago firm with an office in Charlotte. Since the company insurance rates are based on the age and sex of the applicant and the applicant’s dependents, this fiscal note assumes the married taxpayer is a male that pays for insurance for his spouse and one child. It also assumes the spouse is of a similar age. For the single taxpayer, the fiscal note assumes a male. The premium rates for single males are less than females, but the rates for married males and females are approximately the same. The company used for quotes does not offer coverage to seniors over age 65, thus the cost of a premium for those over age 65 is assumed to be same as the premium for age 55 to 64. For the portion of the group where the age was not reported, the average premium for the 6 age groups was used. All premium quotes are based on indemnity plans where the insured choose their health providers. The rates assume no tobacco use.

The chart below shows the estimated number of self-employed in North Carolina that will take the health insurance deduction on the federal tax return. The chart breaks down the group by age and marital status. The premium amounts are quotes from Celtic Life Insurance Company.

## 2001

age	69.60% Married			30.40% Single			Total Premiums
	Monthly Premiums	Annual Premiums	Total Premiums	Monthly Premiums	Annual Premiums	Total Premiums	
under 25	1,626	\$443	\$5,316	710	\$150	\$1,800	\$1,278,533
25 to 34	10,040	\$485	\$5,820	4,385	\$163	\$1,956	\$8,577,662
35 to 44	19,161	\$594	\$7,128	8,369	\$225	\$2,700	\$22,596,687
45 to 54	16,191	\$799	\$9,588	7,072	\$338	\$4,056	\$28,684,359
55 to 64	12,373	\$1,211	\$14,532	5,404	\$555	\$6,660	\$35,993,493
65 and older	7,353	\$1,211	\$14,532	3,212	\$555	\$6,660	\$21,390,419
not reported	3,959	\$790	\$9,480	1,729	\$331	\$3,972	\$6,869,245
Premiums	70,705		\$683,101,847.69	30,882			\$125,390,398
total premiums			\$808,492,245.42				
state deduction			40%				
reduction in taxable income			(\$323,396,898)				
state tax rate			7%				
GF loss			(\$22,637,782)				

The chart above shows \$808.5 million in premiums paid by North Carolina's self-employed that will be submitted as a federal income tax deduction in Tax Year 2001. Since the federal deduction is 60% in Tax Year 2001, this group will be eligible for a state income deduction equal to 40% (the difference between 100%-60%). Multiplying 40% times the \$808.5 million premium amount produces a \$323.4 million reduction in taxable income. Assuming a 7% state income tax rate, this reduction in tax liability will reduce income tax collections by \$22.6 million and thus reduce General Fund revenue by a like amount. This fiscal note assumes that taxpayers will not change their tax withholding and will take the deduction for Tax Year 2001 on their returns in the spring of 2002. The \$22.6 million revenue loss for Tax Year 2001 will be taken in FY 2001-02.

The chart below shows a similar analysis for Tax Year 2002. The self-employed are projected to submit \$967.5 million in health insurance premiums for the federal income tax deduction. Since the federal deduction is 70% in Tax Year 2002, this group will be eligible for a state income deduction equal to 30% (the difference between 100%-70%). Multiplying 30% times the \$967.5 million premium amount produces a \$290.3 million reduction in taxable income. Assuming a 7% state income tax rate, this reduction in tax liability will reduce income tax collections by \$20.3 million and thus reduce General Fund revenue by a like amount. This fiscal note assumes that taxpayers will not change their tax withholding and will take the deduction for Tax Year 2002 on their returns in the spring of 2003. The \$20.3 million revenue loss for Tax Year 2002 will be taken in FY 2002-03.

2002

<u>age</u>	Monthly			<u>Total</u>	Monthly			<u>Total</u>
	<u>69.60% married</u>	<u>Indemnity Premiums</u>	<u>Annual Premiums</u>		<u>30.40% Single</u>	<u>Indemnity Premiums</u>	<u>Annual Premiums</u>	
under 25	1,722	\$501	\$6,007	\$10,345,037	752	\$170	\$2,034	\$1,529,973
25 to 34	10,632	\$548	\$6,577	\$69,924,690	4,644	\$184	\$2,210	\$10,264,570
35 to 44	20,291	\$671	\$8,055	\$163,439,191	8,863	\$254	\$3,051	\$27,040,619
45 to 54	17,147	\$903	\$10,834	\$185,773,058	7,489	\$382	\$4,583	\$34,325,510
55 to 64	13,103	\$1,368	\$16,421	\$215,170,466	5,723	\$627	\$7,526	\$43,072,080
65 and older	7,787	\$1,368	\$16,421	\$127,872,734	3,401	\$627	\$7,526	\$25,597,122
not reported	4,193	\$893	\$10,716	\$44,932,596	1,831	\$374	\$4,488	\$8,219,511
	74,876			\$817,457,773	32,704		\$4,488	\$150,049,385
total premiums				\$967,507,158.22				
state deduction				30%				
reduction in taxable income				\$290,252,147.47				
state tax rate				7%				
				\$20,317,650.32				

**TECHNICAL CONSIDERATIONS:** The Department of Revenue is concerned that this state deduction may provide a double benefit for some taxpayers. Those taxpayers taking the federal deduction for a percentage of their health insurance premiums can claim the remaining percentage of their premium cost as a deductible medical expense if they itemize on their federal return. The state deduction provided in this bill can be taken even if the taxpayer uses 100% of the premium on the federal return. The taxpayer could also receive a double benefit by taking the state tax deduction as well as the tax credit for purchasing child health insurance and long-term care insurance.

**FISCAL RESEARCH DIVISION 733-4910**

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**APPROVED BY:** James D. Johnson

**DATE:** April 30, 2001



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