HEALTH INSURANCE PREMIUM TAX DEDUCTIONS FOR THE SELF-EMPLOYED

HEARING

BEFORE THE

SUBCOMMITTEE ON HEALTH

OF THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

ONE HUNDRED FOURTH CONGRESS

FIRST SESSION

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HEALTH INSURANCE PREMIUM TAX DEDUCTIONS FOR THE SELF-EMPLOYED

FRIDAY, JANUARY 27, 1995

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON HEALTH,
Washington, D.C.

The subcommittee met, pursuant to call, at 12:06 p.m., in room 1310, Longworth House Office Building, Hon. Bill Thomas (chairman of the subcommittee) presiding.

[The advisory announcing the hearing follows:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON HEALTH

FOR IMMEDIATE RELEASE
January 23, 1995
No. HL-2

CONTACT: (202) 225-3943

THOMAS ANNOUNCES HEARING ON TAX TREATMENT OF HEALTH INSURANCE COSTS OF SELF-EMPLOYED INDIVIDUALS

Congressman Bill Thomas (R-CA), Chairman of the Subcommittee on Health of the Committee on Ways and Means, today announced that the Subcommittee will conduct a hearing on allowing self-employed individuals to deduct a portion of their health insurance premiums. **The hearing will be held on Friday, January 27, 1995, in 1310 Longworth House Office Building, beginning at 12:00 noon.**

This hearing will feature invited witnesses only. In view of the limited time available to hear witnesses, the Subcommittee will not be able to accommodate requests to be heard other than from those who are invited. Those persons and organizations not scheduled for an oral appearance are encouraged to submit written statements for the record of the hearing.

BACKGROUND:

Under present law, the tax treatment of health insurance depends on whether the taxpayer is an employee and whether the taxpayer is covered under a health plan paid by the employee's employer. An employer's contribution to a plan providing accident or health coverage for the employee and the employee's spouse and dependents is excludable from an employee's income for income and payroll tax purposes. In addition, businesses can generally deduct, as an employee compensation expense, the full cost of any health insurance coverage provided for their employee. In the case of self-employed individuals (i.e. sole proprietors or partners in a partnership), no equivalent exclusion exists. However, prior law provided a deduction for 25 percent of the amount paid for health insurance for a self-employed individual and the individual's spouse and dependents. The 25-percent deduction, which expired at the end of 1993, was not extended because it was anticipated that it would be addressed in the health care reform legislation of 1994.

The 25-percent deduction was first enacted on a temporary basis by the Tax Reform Act of 1986 (for taxable years beginning before January 1, 1990). Certain technical corrections to the provision were made by the Technical and Miscellaneous Revenue Act of 1988. The Omnibus Budget Reconciliation Act of 1990 extended the deduction through the end of 1991. The Tax Extension Act of 1991 then extended the deduction through June 30, 1992. The Omnibus Budget Reconciliation Act of 1993 extended the deduction through the end of 1993.

DISCUSSION:

Under present law, the Federal tax laws encourage the provision of health care insurance coverage by providing favorable tax treatment for an employer's contribution to a health plan for an employee and his family. Self-employed individuals have been entitled to a deduction of a portion of their health insurance costs.

The availability of the 25-percent deduction disadvantages self-employed individuals compared to individuals who organize their businesses in corporate form under subchapter C of the Code. In such a case, the individual could be the sole shareholder and the employee of the company. Any employer contributions for health care insurance would be fully excludable by the employees. Thus, an inequity exists between self-employed individuals and other employers and employees.

From a policy perspective, it is difficult to justify different federal tax subsidies for health insurance expenses based upon the status of an individual's employment or the form in which an entity does business. One of the key questions remaining is: What tax treatment of health insurance costs is likely to increase self-employed individuals' willingness to purchase insurance for themselves, their families and their employees?

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS

Any person or organization wishing to submit a written statement for the printed record of the hearing should submit at least six (6) copies of their statement by the close of business, Friday, February 10, 1995, to Phillip D. Moseley, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth Building, Washington, D.C. 20515. If those filing written statements wish to have their statements distributed to the press and interested public at the hearing, they may deliver 200 additional copies for this purpose to the Subcommittee on Health, room 1136 Longworth House Office Building, at least one hour before the hearing begins.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be typed in single space on legal-size paper and may not exceed a total of 10 pages.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. Statements must contain the name and capacity in which the witness will appear or, for written comments, the name and capacity of the person submitting the statement, as well as any clients or persons, or any organization for whom the witness appears or for whom the statement is submitted.

4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and the public during the course of a public hearing may be submitted in other forms.

*****

Chairman THOMAS. Welcome to the Health Subcommittee hearing on tax deductibility of health insurance premiums for the self-employed. This afternoon, we do want to focus on all the issues surrounding the question of tax deductibility of health insurance premiums for the self-employed.

As many of you know, I assume all of us know, the 25-percent health insurance premium deduction expired on December 31, 1993. It was anticipated that a permanent resolution, and I think we can almost say it has been permanently anticipated, that a permanent resolution of the self-employed health insurance tax deduction would be addressed in the health care reform legislation of 1994.

With the failure to enact any form of health care reform, we find ourselves once again dealing with the retroactive window either in a stopgap procedure or a look-back, look-forward discussion.

I do want to announce that yesterday I introduced a bill cosponsored by all of the Majority Members of the Ways and Means Committee, H.R. 697, to deal with the 1994 year and the legislation is a very simple document. It says, strike December 31, 1993, and change it to December 31, 1994, in the hopes that we can move just that provision through Congress in time for people to make realistic decisions for the 1994 tax year.

That means, as far as I am concerned, considerably before April 15 which is a deadline certainly but not one that I would define as reasonable for most people to fully appreciate, understand, and use this provision.

Chairman Archer and I are committed to making every effort possible to get this legislation through the House and the Senate as quickly as possible.

We have also, obviously, a prospective question to deal with. Just because Chairman Archer and I are more than willing to make sure that the Band-Aid extension is handled, we still want to push for the right tax policy in terms of the self-employed on health insurance deductibility. Today's hearing is intended to continue to get information.

The first panel will be our colleagues in terms of their views on this question, and then I believe we have an excellent series of panels which will give us a broad understanding from folks who have been looking at it from afar and from people who have been living it on a daily basis.

Part of the concern that I have is that we have tended to be almost formula-like in our responses to the question of the self-employed. It was 25 percent, so we renewed the 25 percent. Then there is a discussion of a march on fixed percentages up to 100 percent.

One of the things I hope to get out of this hearing is the reaction from the real world not about theoretical equity, that is the potential for 100 percent deductibility, but to what extent is the real world operating at a percentage which is below that and would it be meaningful for us to explore a realistic relationship rather than the theoretical capability for deduction.

These are some of the questions I am looking forward to getting answers to and also, for the record, a feeling from the real world about our failure to make a permanent change and how difficult it is for people not to know what tomorrow brings in this area.

With that, I would yield to my friend from California.

[The prepared statement follows:]

OPENING STATEMENT OF CHAIRMAN THOMAS HEARING ON THE TAX DEDUCTIBILITY OF HEALTH INSURANCE PREMIUMS FOR THE SELF-EMPLOYED

January 27, 1995

Welcome to today's hearing of the Ways and Means Health subcommittee. This afternoon our hearing will focus on the issues surrounding the tax deduction of insurance premiums for the self employed. As many of you know, the twenty-five percent health insurance premium tax deduction for the self-employed expired in December of 1993. It was anticipated that a permanent resolution of the self-employed health insurance tax deduction would be addressed in the health care reform legislation in 1994.

With the failure to enact health care reform we find ourselves once again moving a expedite retroactive tax provision -- a stop gap measure -- in order that hundreds of thousands of self-employed individuals can prepared their 1994 tax returns with some level of certainty and avoid having to submit amended returns later.

My Republican colleagues on this committee joined me yesterday in introducing a bill (H.R. 697) to do just that. I want to emphasize that Chairman Archer and I are committed to making every effort possible to get this legislation over to the Senate as quickly as possible. We are also encouraged by the Senate's interest in this legislation. We urge our colleagues in the House and Senate, however, to keep the legislation focused on the problem at hand and to avoid attaching any extraneous, unrelated or non-germane provisions which will hamper or prevent its timely passage.

Because Chairman Archer and I do not intend to end our interest in this area with the passage of a simple " band-aid" extension. -- we will continue to push for the right tax policy on health insurance deductibility for the self-employed. The intention of today's hearing is to examine the issues a permanent deduction. for the insurance costs of the self-employed and the level at which such a deduction should be set. Our purpose today is to listen -- to listen to the people who are most affected by this deduction and to gain a better understanding of the hardships of living with this erratic, uncertain and inequitable tax policy.

We are here to seek the help of experts who have studied the effects of the temporary deduction on the purchase of health insurance for the self-employed , their families and their employees.

We are also here to seek guidance on what policy makes the most sense. Is the twenty-five percent deduction adequate? or should it be increased? What level of deduction would be "real world" comparable to that of employees in c corporations? Is there some deduction level that is less than one-hundred percent which will encourage the purchase of health care insurance -- some level that will help optimize the number of people who are covered by insurance and limit rewarding the purchases that would have occurred anyway? What these are the questions we are seeking to answer with this hearing. These are the questions that I believe need to be answered as we proceed toward future congressional action.

Mr. STARK. I thank the Chair, and I want to help see this tax question resolved and I think we have an opportunity. I think there is bipartisan interest, and I think we have an opportunity to improve the health care situation for many Americans and reduce their fear with no cost to the Federal Government and, as a matter of fact, I think no cost basically to the private sector. It is one of those win-win situations.

I would like to note early on that we are going to spend at least $2 billion over the 5-year window if we go to 25 percent. My hope is we will not attempt to pay for that out of the Medicare trust fund. That is just my hope.

I would like to suggest that if a small businessperson is to receive more than the 25 percent, it should be a requirement that that small businessperson makes available to his or her employees the same insurance, whether or not they have to pay for it. I don't care whether they have to pay for it, but they should make it available. Second, employees who for one reason or another must pay for their own health insurance, who are not self-employed, should also be able to avail themselves of the 25 percent. Those should be modest improvements and not difficult for both sides.

The most important part is to expand the program that has served since its bipartisan inception in this subcommittee, 45 million Americans who otherwise would have lost their health insurance, and that is the COBRA, Consolidated Omnibus Budget Reconciliation Act, extension of benefits upon termination. It costs the Federal Government nothing.

I see no reason at this point—we may wish to change it later when other great reforms are made—for us not to extend the COBRA time indefinitely for a person who is laid off or otherwise loses their job. For them to be able to continue at 102 percent of the cost of their benefits under a group plan seems to me to be the first small step that this subcommittee could take to taking the fear of losing your job and with it your health insurance coverage off the minds of Americans. It is something I hope this subcommittee will consider seriously.

We give an advantage to the insurance companies by allowing deductibility of insurance premiums. The modest inconvenience that we may cause for the extension of COBRA benefits, I think, is far outweighed by the great relief that we can offer to working Americans who fear that they may indeed lose their benefits, and I hope that my colleagues will consider what I believe are compassionate amendments to this legislation.

Mr. Chairman, I thank you for calling these hearings. I look forward to hearing the witnesses. I hope they are quick so they can get back up here and help us pass this legislation.

[The prepared statement follows:]

Opening Statement of Congressman Pete Stark
Ways and Means Health Subcommittee
January 27, 1995

Mr. Chairman:

If we can find the money, it would be nice to assist the self-employed, the uninsured, and really everyone in America buy health insurance so that the uninsured problem would end.

The key is finding the money, and I hope today's witnesses will offer some suggestions.

I hope they do not suggest more Medicare cuts. The Republican Contract on America already cuts $15 billion out of the Medicare Hospital Trust Fund. The Democratic professional staff on the Joint Economic Committee have also estimated the impact of the Balanced Budget Amendment on Medicare. If Social Security, defense, and interest on the debt are exempt from cuts, then in the year 2002, each beneficiary will see a Medicare cut of $2,223. That means $2,223 in higher copays, deductibles, or reduced access because of provider cuts.

Again, I urge that we not pay for the self-employed deduction out of Medicare.

I also urge that we put some conditions on a tax deduction for the self-insured:

1) they should provide health insurance for their co-workers.
We shouldn't provide tax relief for people who are likely to be the highest paid in a business without also assisting those who are paid less.

2)We should also extend the same tax deductibility to individual workers who purchase insurance for themselves when it is not provided by their employers.

Let's not kid ourselves. The Republican proposals do little or nothing to reduce the number of uninsured. They do not address the problem that health insurance premiums are too high--particularly for small groups and individuals. For example, I have just received a letter from a 59 year old self-employed realtor in California--a man who has no serious medical conditions. Several years ago, he was divorced and used COBRA to keep his wife's Prudential group rate policy of $275.96 per month. At the end of his COBRA health continuation period, he asked Prudential to convert to an individual policy. As the gentleman wrote me, that's when Prudential 'dropped a piece of the Rock' on him. The monthly cost of a $100 deductible policy was $1,714.29--- or $20,571 a year! For a $1000 deductible, the monthly premium was $1,030---or $12,360 per year.

Mr. Chairman, in order to help address the issue of affordability, I urge the Subcommittee to use this bill to extend the COBRA time limits indefinitely. Once you are in a group policy you should be able to stay in at the group rate plus an administrative fee.

Thank you.

Chairman THOMAS. I thank the gentleman. I also thank my colleagues for their continued interest in this area. I would say to each of you that your prepared remarks would be made a part of the record and you can proceed as you see fit, and that I would prefer we hear testimony from each of our Members before we go to questions.

I would start with our friend and colleague on the subcommittee, Ben Cardin.

STATEMENT OF HON. BENJAMIN L. CARDIN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MARYLAND

Mr. CARDIN. Thank you, Mr. Chairman. Let me thank you very much for these hearings. I am pleased to hear about H.R. 697 and I hope that our subcommittee will move that quickly.

Let me say from the outset that I do think we need to move forward on health care reform whenever we can. Reinstating the deductibility for the self-employed is an important step forward and we should move it quickly. I agree with the chairman.

I was pleased to hear President Clinton in the State of the Union Address speak about the need for this Congress to deal with health care reform. I hope that we will move forward on this issue of health care for the self-employed, the COBRA issue that Mr. Stark referred to, and other issues that may come before our subcommittee.

The number of uninsured, as President Clinton pointed out in his speech, has increased over the past year. Those people who are self-employed are one-and-a-half times more likely to be uninsured than a person who is employed for a corporation.

We must take action to reverse that. I have introduced H.R. 691. Like the chairman's bill, it would extend for 1994 the self-employed deduction at 25 percent but would then, beginning in 1995, institute an 80-percent deduction. Let me just talk about that for one moment, if I might.

I think the Tax Code should be a positive reinforcement of the people to be insured. For the people who work for companies, for corporations, it has been a powerful tool for those companies to provide health benefits for their employees. For the self-employed, at 25 percent, it is an incentive but it does not offer parity for those people who work for corporations. Eighty percent, I believe, under the current circumstances would provide parity.

The average company that provides health benefits pays 80 percent of the premium cost with the individual employee paying 20 percent. To provide parity for the self-employed, I believe 80 percent would provide that goal. It is interesting, of course, that the Ways and Means Committee last year did approve legislation to use the 80-percent mark.

I look forward to working with the chairman to not only reinstate the deduction for 1994, but to permanently establish a policy that will encourage more people who are self-employed to have insurance.

[The prepared statement follows:]

TESTIMONY OF REP. BENJAMIN L. CARDIN
ON THE TAX DEDUCTIBILITY OF HEALTH INSURANCE PREMIUMS
PAID BY THE SELF-EMPLOYED

before the
SUBCOMMITTEE ON HEALTH
COMMITTEE ON WAYS AND MEANS

January 27, 1995

Chairman Thomas, fellow members of the Subcommittee: As this is the only hearing scheduled to take up this important matter, let me express my appreciation for the opportunity to testify regarding my proposal to amend the Internal Revenue Code of 1986 as it applies to the self-employed.

Yesterday I introduced a bill to first restore, and then to increase, the income tax deduction for health insurance premiums paid by those who are self-employed, at a rate of 25% for 1994, and 80% for 1995 and thereafter.

Fully one-quarter of self-employed Americans - 3.1 million farmers and craftsmen, professionals and small business proprietors - have no health insurance. Compared to all other workers, the self-employed are one and a half times more likely to lack essential health care coverage.

As we search for methods to increase access to necessary medical services and reduce the crushing burdens of uncompensated care, which threaten the fiscal stability of both affected individuals and the entire health care system, there can be no doubt that U.S. tax code should encourage the self-employed to purchase health care insurance. Instead, current regulations discriminate against the self-employed and discourage the individual initiative that has always been a bedrock of the American economy.

As part of the expense of employee compensation, businesses can deduct the full cost of any health insurance provided to employees. Similar treatment of health care premium costs has never been fully available to the self-employed. And, unless we act quickly, the loss of the limited deduction in effect during recent tax years will soon be keenly felt by the self-employed. In order to provide consistent tax treatment of medical insurance expenses, my bill restores for 1994 the 25% deduction that has enjoyed nearly a decade of strong bipartisan support.

The availability of this deduction should not only be renewed, it should be adjusted equitably. Because businesses, on average, contribute - and fully deduct as an expense - 80 % of the total cost of employee health insurance premiums, my bill increases the percentage of premium costs which can be deducted by self-employed persons to 80%, effective with tax year 1995. This is similar to the provision thoughtfully considered and passed by the Ways and Means Committee of the 103rd Congress.

With approximately 41 million medically uninsured persons in the United States currently, measures which encourage working people to provide for their health care coverage within the private sector are essential. The particular form of an individual's employment situation should not determine the tax treatment of health care costs incurred as part of the cost of doing business. Rather, as nearly as possible, parity of deductibility should be obtained within the tax code.

In the interests of both fairness and sound health care policy, I urge my colleagues to join me in support of H.R. 691.

Chairman THOMAS. I thank the gentleman for the content and brevity of his statement.

Our colleague from Massachusetts, a Member of the full committee, Mr. Neal.

STATEMENT OF HON. RICHARD E. NEAL, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MASSACHUSETTS

Mr. NEAL. Thank you very much, Mr. Chairman. I agree with your opening remarks as well as was pleased to hear of your intent.

First, let me thank you for allowing me to testify here at the Health Subcommittee on the issue of health insurance tax deduction for the self-employed. This is an important issue on which the Congress should be able to agree and take swift action.

On the opening day of the 104th Congress, I introduced legislation to restore and increase the deduction for the health insurance costs of self-employed individuals. This is identical to the legislation that Mr. Grandy and I offered last year as well. Self-employed businessowners and small businesses should be able to share in the same tax treatment of health benefits as large corporations.

Prior to 1993 self-employed businessowners were allowed to deduct as a business expense up to 25 percent of their medical insurance payments for an individual, an individual's spouse and dependents provided that that individual or the individual's spouse was not able to participate in an employer-subsidized health insurance program. This provision was extended as part of the Reconciliation Act of 1993. The deduction that expired on December 31, 1993, I believe, should be restored. I was pleased to hear the chairman's comments a few moments ago.

Unfortunately, before the 103d Congress adjourned, agreement on health care could not be reached. However, consensus was reached on one issue, the ability of the self-employed to deduct the cost of the health care insurance. A major health care reform proposal included a provision to allow self-employed workers this 100 percent deduction. I hope we can reach agreement on this issue and take quick action.

I recently introduced legislation which restores the 25-percent deduction and gradually increases the deduction to 100 percent. I think the testimony by you and Mr. Stark this morning indicates that there is room for consideration of these numbers and, at the same time, there also is room for I think some compromise.

The bill phases in the deduction over a period of 4 years. For calendar years 1994 and 1995, health insurance would be 25 percent deductible. In 1996 and 1997, it would become 50 percent deductible. In 1998, and thereafter, it would be 100 percent deductible.

When I first came to the Congress, I served on the Committee on Banking, and one of the issues I worked on diligently was business lending. Small businesses, for a long period of time in New England, were not able to receive financing as easily as large corporations. I worked to have included in the banking reform legislation a provision that required the promulgation of a regulation addressing the disclosure of loans made to small businesses.

Since I joined this subcommittee, I tried to make permanent the deduction of health care costs for the self-employed. It was the first

tax issue I undertook as a Member of the subcommittee, and I hoped that small businesses could receive the same favorable treatment as corporations.

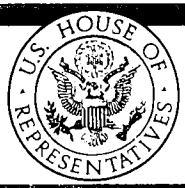
Mr. Chairman, my district includes several small businesses in small towns and rural areas, and many of the constituents that I represent fall into this category of self-employed. Increasing the deduction would allow businessowners to spend more of their resources on health care. This legislation gives businesses an opportunity and an incentive to purchase health care insurance.

The deduction should be made permanent to give individuals certainty. An individual should not have to wait for action by the Congress next year to know if they will be able to take and make a deduction for health care insurance. Individuals should be able to plan for their health care and the health care of their families.

I thank you for your time, and I also thank you for allowing me this opportunity. I do have constituents waiting for me, and I am sure that you and Mr. Stark will offer representative views of the entire body that is known as Ways and Means.

[The prepared statement follows:]

Congressman
RICHARD E. NEAL



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January 27, 1995

Testimony of Congressman Richard E. Neal of Massachusetts
Health Subcommittee of Ways and Means
Health Insurance Tax Deduction for the Self-employed

Mr. Chairman, first of all, I would like to thank you for allowing me to testify before the Health Subcommittee on the issue of the health insurance tax deduction for the self-employed. I believe this an extremely important issue on which Congress should be able to agree and take swift action.

On the opening day of the 104th Congress, I introduced legislation to restore and increase the deduction for the health insurance costs of self-employed individuals. Self employed businesses owners and small businesses should be able to share the same tax treatment of health benefits as large corporations.

Prior to December 1993, self-employed business owners were allowed to deduct as a business expense up to 25% of their medical insurance payments for an individual, an individual's spouse and dependents, provided that the individual or the individual's spouse was not able to participate in an employer subsidized health insurance plan. As many of you know, this provision was extended as part of the Omnibus Reconciliation Act of 1993. The deduction expired on December 31, 1993. The deduction was only extended to the end of 1993 because we believed this issue was going to be adequately addressed in health care reform.

Unfortunately, before the 103rd Congress adjourned, agreement on health care could not be reached. However, consensus was reached on one issue--the ability of the self-employed to deduct the cost of health care insurance. Major health care reform proposals included a provision to allow self-employed workers this 100% deduction. We should be able to reach agreement on this issue and take quick action.

I recently introduced legislation which restores the 25% deduction and gradually increases the deduction to 100%. The bill phases in the deduction over a period of four years. For calendar years 1994 and 1995, health insurance would be 25% deductible, in 1996 and 1997 it would become 50% deductible. In 1998 and thereafter, health insurance would become 100% deductible.

As many of you know, when I first came to Congress I served on the House Committee on Banking. One of the issues I worked on was small business lending. Small businesses are not able to receive financing as easily as large corporations. I worked to include a provision in banking reform legislation to require the promulgation of a regulation addressing the disclosure of loans made to small businesses.

Since I joined the Ways and Means Committee, I have tried to make permanent the deduction of health care costs for the self-employed. It was the first tax issue I undertook as a Member of the Committee. Small businesses should receive the same favorable treatment as corporations.

Corporations are permitted to deduct 100% of the cost of providing health insurance. The self-employed should receive the same treatment. One of the basic principles of tax policy is fairness. One dimension of tax fairness has been described as the "equal treatment of equals." This can be interpreted as the imposition of similar tax burdens on taxpayers in similar circumstances. Why should health care costs of one type of business be treated differently than the health care costs of another type of business? It does not seem fair.

Small businesses and the self-employed are the engine of economic growth for our economy. The ranks of the self-employed include the likes of farmers, craftsmen, shop keepers, day laborers, ranchers as well as accountants, lawyers, and doctors who practice either in partnerships or as sole practitioners. As you can see, this provision affects a wide variety of individuals.

My district includes several small towns and rural areas. Many of my constituents fall into the category of the self-employed. Increasing the deduction would allow business owners to spend more of their resources on health care. This legislation gives businesses an incentive to purchase health care insurance. The deduction should be made permanent to give individuals certainty. Individuals should not have to wait for action by Congress to know if they will be able to make a deduction for health insurance. Individuals should be able to more easily plan for their health care needs.

I look forward to working with the Health Subcommittee and the full committee on a quick resolution of this issue.

Chairman THOMAS. Thank you very much, Mr. Neal. Your suggested solution is one of the four in front of us. Neither one—and none of the four are exactly identical, and you provide an approach which we have discussed at some time and we appreciate that approach.

The chairwoman of the Small Business Committee, who is not here, her approach is a 25-percent fixture, both for the retroactive year and prospectively, so you have given us a nice smorgasbord of choices and I thank the gentleman.

Mr. NEAL. Thank you, Mr. Chairman.

Chairman THOMAS. Our next witness is someone who is not new to this subcommittee and was of enormous help to us as we were trying to put together health care reform in the last Congress, because in his former life as the insurance commissioner in North Dakota, he had wrestled with a number of these decisions and had overseen the decisions that had to be made at the State level.

It is a pleasure to have you, Earl, once again in front of us.

STATEMENT OF HON. EARL POMEROY, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NORTH DAKOTA

Mr. POMEROY. Mr. Chairman, thank you. It is a pleasure to be back in the subcommittee and it is a pleasure to see Chip Kahn back behind you and back in public service. I worked with Chip back with my first trip to Washington as an insurance commissioner. I have the highest regard for his polish and expertise in this area.

I also want to commend you for H.R. 697. Our people are telling us that if they have to chase after this 25 percent deductibility through an amended return, the cost of an amended return is $75 to $125 depending on your accountant, it pretty well wipes out the deduction. So you are quite right, we need to move it and move it quickly. It is a component of H.R. 52 which I have sponsored. I am delighted that you have created a vehicle that might allow it to move on a faster track.

Of the proposals before us, I would represent the most generous deduction, the 100 percent, but it isn't a Pomeroy bill. It is very much a bipartisan bill, 60 cosponsors, and they are split about even between Republican and Democrat support for this measure.

The plight of the people who have to write their own premiums is that they are not in an employer group so their premiums are higher. I have observed this as an insurance commissioner. Second, they get no tax deduction for it and so it is kind of a double hit. I think that as we deal with this matter, we need to make permanent a component of deductibility of individually written health insurance and then the amount we discuss is debatable. I strongly favor the 100-percent approach.

Just let me give you a couple of reasons that would, in a very real way, help people that month to month write their premium checks. I have 32,000 farmers, an awful lot of self-employed people in the State of North Dakota. A typical young farm family in my State makes $20,000 a year, pays about $2,700, even though they are age rated at the young end of the age scale in a Blue Cross & Blue Shield policy. If this deduction was at 100 percent, they would save $400 a year. For many, that is the difference, on a

monthly basis, between affordability of premium and nonaffordability of premium.

Also, I have seen age ratings take its effect just before Medicare eligibility gets socked, paying in excess of $5,000 a year, $500 a month on coverage. For them, a married couple aged 60 struggling on the farm, the savings would be $750 a year. This is a group that is beginning to most acutely understand their need for coverage and all too often inability to afford it.

You and I have often seen eye to eye, Mr. Chairman, on our preference for private sector approach to health care financing. I think deductibility of premium can really be a cornerstone for meaningful health care reform achieved entirely through the private sector. If we pass H.R. 52 making coverage more affordable, followed by insurance reforms to deal with some of the underwriting questions, we will have gone a long way to dealing with some of the coverage gaps under our present system.

That concludes my initial comments. I would be quite happy to engage in any questions on what amount might be the appropriate deductibility level.

[The prepared statement follows:]

TESTIMONY OF REPRESENTATIVE EARL POMEROY
HOUSE COMMITTEE ON WAYS AND MEANS
SUBCOMMITTEE ON HEALTH
JANUARY 27, 1995

Mr. Chairman, I want to commend you for holding this hearing. The subject matter is very important and very urgent and your efforts to call attention to the issue are much appreciated.

On the opening day of this Congress, I introduced H.R. 52, a bill to retroactively reinstate the 25% deduction for health insurance premiums for the self-employed for 1994, and to expand the deduction to 100% in future years. My bill now has 58 cosponsors, almost evenly split between Democrats and Republicans. This is not a partisan issue, it is a fairness issue.

As the Congress approaches a reworking of the tax code in order to provide well-deserved relief for the middle-class, I believe the very first item of tax business must be to address this unfinished business from last year.

Self-employed taxpayers in my state North Dakota are rightfully shocked and angry that Congress allowed the 25% deduction to expire. When they ask me what they should do, all I can say is either go ahead and file, hope that Congress acts, and if it does, file an amended return. Or, simply wait as long as they can before filing.

I have never been able to understand why the self-employed are treated any differently than other workers. Not only do the self-employed pay taxes on the income used to buy their health insurance, they also generally pay higher rates because they do not purchase their insurance through a group plan. This is blatantly unfair!

Granted, increasing the deduction to 100% will not be cheap, but it can be done for a fraction of what is being talked about in terms of other tax cuts. And it will provide real help to families that need help the most.

The health care reform debate that fizzled out last year was aimed at making health care more affordable and extending coverage to more Americans. Well, here is one easy step that we should all be able to agree on which will help achieve both goals.

I have 32,000 farmers and thousands of other self-employed workers, such as real estate agents, in North Dakota who need our help. Let me give you a couple examples.

A typical young farm family in my state pays about $2700 per year for a standard Blue Cross/Blue Shield health policy. Bringing their deduction into line with the tax treatment of health insurance for other workers will save that family over $400 per year, assuming they're in the 15% tax bracket.

For a married couple age 60, who would pay about $5000 per year for coverage, the savings would be almost $750. That is true middle-class tax relief.

Thank you again Mr. Chairman for holding this hearing. I hope you will exert all the influence your Subcommittee can generate to help us get this matter addressed just as quickly as possible.

Chairman THOMAS. I thank the gentleman for his testimony. Obviously the argument that the cost of the insurance is relatively high and therefore 100 percent is worth more hopefully will be dealt with in this Congress like it should have been in the last Congress with some form of health reform, even if it is just a slimmed-down package of insurance reforms, some kind of a voluntary pooling concept for individuals or small businesses or malpractice reform and the rest.

What I really am interested in getting out in this hearing is the theoretical 100 percent match, my friend from Maryland's 80 percent parity concept. Then I would hopefully conclude today with some questions to some people that will begin to provide us with the answer of what is the behavioral tip percentage because they may or may not be the same.

Given the timeframe that we are going to be in in terms of the amount of money that we can provide for this kind of a benefit which I think is essential, should be enough to make sure that we maximize the number of people who avail themselves of this opportunity which will provide much-needed insurance. But I am not anxious to provide a percentage beyond that which, in essence, is a windfall to people which would have produced a behavior at a lower percentage, and I do not want to perpetuate the feeling that the self-employed are somehow second-class citizens under the Tax Code because they chose to organize themselves for economic or business reasons along a certain line versus another line of organization.

So I am open to any suggestion. Your argument on the need to go to 100 percent immediately is because of, in essence, the relative cost difference for these people in terms of their real life situation?

Mr. POMEROY. No. Actually, I was arguing that as a further point. There are two principal points of equity behind the approach represented by H.R. 52. First, parity means identical treatment. Business corporations, 100 percent deductibility. Parity for the individual or self-employed is 100 percent deductibility. Parity is a simple concept, identical treatment of tax treatment. Second—that is the tax fairness component. The affordability of coverage is the second, I think, compelling rationale behind H.R. 52 or the other related proposals as well.

First of all, let me discuss the graduated approach and then the less than 100-percent concept. As to the graduated approach, I don't think we should proceed that way. I believe this will be the Congress that passes middle-class tax relief. I think the compelling rationale behind this particular tax relief ought to have it at the front of the line as we address middle-class tax relief.

To give you some rough comparison figures, we still have got our request in front of Joint Tax for evaluation purposes, but I believe it is about $11 billion a year cost at 100 percent deductibility. That compares to $17 billion on the Social Security tax repeal, OBRA 93, which is contained in the contract, $56 billion to the capital gains feature in the contract, or $107 billion annual contained in the contract for the child tax credit.

Now, if you compare with Clinton's tax credit proposals, tax relief proposals, $11 billion compares very favorably to the $21 billion for his education deductibility and $36 billion to the President's child

credit tax credit deductibility. I think the rationale is more compelling.

We give people necessary tax relief. We lay the foundation for private sector health insurance reform. We ought to put this at the front of the line. I think if we graduated in, Mr. Chairman, economic reality, it will force us to freeze the graduation before we get to the end of the line. We will have 100 percent and 50 percent or 80 percent at the end of the day, but we will stop at the 25 percent before we get there.

As to 80 percent, I believe that people buying their own coverage are generally buying more skeletal coverages than businesses are making available. So if you try to do a parity deal based on business providing 80 percent coverage, I think the individual purchasing the coverage is buying higher deductibles and copayments than is generally afforded in employer plans. That is why 100 percent deductibility is appropriate.

Mr. CARDIN. Let me speak to that point—and Earl, I think we need to work this out and we can debate this in committee—if in fact you get tax favored treatment, it seems to me that the self-employed would want to make sure that they include in their policies the expected out-of-pocket costs, because they could then use it as a tax deferred payment rather than having to pay after-tax dollars on it. That is another reason why I am trying to develop parity between the self-employed and an employed person who works for a company, but you do raise a good point.

Mr. POMEROY. You raise a good point as well. I would say the focus of my legislation is the people that aren't covered now because they just can't afford it. I mean, if we bring them into the net, and that is my target market.

Chairman THOMAS. I am always nervous about talking parity with someone from North Dakota. If you go back and look at farm legislation, somehow parity wound up way above 100 percent. The other problem I have is that when you talk about giving it to the self-employed, you have got the problem of the employer and employee being one in the same.

Although the employer may have 100 percent deductibility if they only provide that 80 percent to the employee, the employee only gets the 80-percent benefit. I prefer, in terms of looking at parity or equity, the employee side of the self-employed and still looking for that behavioral tip point which I assume somebody has some knowledge on, and if we don't, then I am interested in why we haven't. We have got about 6 minutes. We will recess.

Mr. POMEROY. I said it is $11 billion a year. It is over 5 years.

Chairman THOMAS. It is about $2 billion a year. We will talk on the way to the vote. We will be back.

[Recess.]

Chairman THOMAS. Resuming the Member's panel. We want to thank the chairwoman of the Small Business Committee for coming before the panel. I know she has held hearings on the deduction for the self-employed as well.

I would tell the gentlewoman that we have had among the four Members as presentation of what amounts to, I think, a universe of options from your simple 25 percent to a 25, 50, 100 percent. The gentleman from North Dakota offered 25 percent retroactive 100

percent prospective. The gentleman from Maryland, Ben Cardin, offered 25 percent but moved to a parity that he believed to be 80 percent which was contained in a package.

So we would very much like to hear from you. Your written testimony will be made a part of the record and anything that you would like to say at this time.

The chairwoman of the Small Business Committee.

STATEMENT OF HON. JAN MEYERS, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF KANSAS

Mrs. MEYERS. Thank you very much, Mr. Thomas.

I appreciate being here today and hearing the options that you just mentioned. I like any and all of them. The reason my bill was introduced as it was—to make the 25-percent deduction retroactive and permanent—is because I wanted something that could move very quickly. If we don't move very quickly on the retroactivity, a lot of people are going to have to file an amended return. It is a hassle and an expense for small business to do that. So we would like to move as fast as we can.

We have had experience with the cost of the 25-percent deduction. Later I will introduce a bill taking it to 100 percent or perhaps cosponsor one of the others, because I certainly support that concept. But knowing that paying for it is going to be difficult, I started with retroactivity and making the 25-percent deduction permanent.

I might say that we heard, when we had hearings in the Small Business Committee, from Ms. Damon who is herself a small businesswoman, speaking for the National Association of Home-Based Businesses; Jeanie Morrissette who is also a small businesswoman from the National Association of the Remodeling Industry; from the National Association of the Self-Employed; from the NFIB, National Federation of Independent Business; and from the U.S. Chamber of Commerce. All of those that spoke to us were small businesspeople themselves with the exception of the individual from the Chamber of Commerce.

We appreciate the consideration by this subcommittee, and I won't go into all of the concerns and problems. I think you all understand the issue very well. I would like to mention that if we are going to address the problem of health care incrementally, that this is an extremely important component.

It has been estimated that 400,000 people in this country have health insurance because of this 25 percent deduction, and that is a great many people. I appreciate your consideration and I thank you for allowing me to speak.

[The prepared statements and attachment follow:]

TESTIMONY OF THE HONORABLE JAN MEYERS (R-KS-3)

before the

COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
on
HEALTH INSURANCE DEDUCTION FOR THE SELF-EMPLOYED

January 27, 1995

Mr. Chairman, Thank you for the opportunity to appear before you this morning to discuss the importance of the 25% health care deduction for self-employed individuals and small business people, and I congratulate you for holding this very timely hearing. I believe we should act immediately to make this deduction retroactive to December 31, 1993, and to make it permanent.

Last week our Small Business Committee held a hearing on this very subject, and I would like to submit the statements of our witnesses to you for the record. Most of them are self-employed people, and I am certain their testimony about the importance of this deduction will be helpful to this Committee.

I think it is important to know the history of this deduction: It was first enacted in the Tax Reform Act of 1986 (P.L. 99-514) for a period of three years. The deduction was the extended for nine months in the Omnibus Budget Reconciliation Act of 1989. In 1990 it was extended for one year, through 1991. In 1991 it was again extended through June 30, 1992. Then it expired, but Congress included a provision in the Omnibus Budget Reconciliation Act of 1993 which applied retroactively, and extended the credit to December 31, 1993. Then it expired again.

Congress failed to act on an extension last year, and because we have been consistent since 1986, I am sure many small business people provided health insurance and felt as if the rug had been pulled from under them when we failed--without any warning--to renew the deduction. We should act now to make the deduction retroactive and permanent.

I sponsored a bill last year, and reintroduced it early this month (H.R. 442) to retroactively restore the deduction, and to make it permanent. The bill currently has more than 70 cosponsors. Several other Members who are concerned about this matter have introduced similar proposals--are several are here to testify.

The 25% tax deduction was available to self-employed individuals, including sole proprietors, working partners, and employees of S Corporations who own more than 2% of the corporation's stock. A self-employed business person who offers coverage to an employee could also take the deduction for the premiums. No deduction was permitted if the self-employed individual is eligible

to participate on a subsidized basis in a health plan of an employer of the self-employed individual or individual's spouse. According to information presented to our Small Business Committee, approximately 400,000 people have health care insurance because of this deduction.

Unfortunately, as I mentioned, Congress has allowed this deduction to expire several times, and on previous occasions, has only reauthorized it on a temporary basis. As a result, some small business people have dropped their insurance coverage because they simply cannot rely on the 25% deduction which they need in order to afford coverage.

Most small business people must develop a financial plan prospectively, and I believe we should make the 25% deduction permanent so that in their planning, they can count on this tax deduction. As you know, C corporations have the advantage of a 100% permanent tax deduction for health care premiums, and I hope we can move toward providing this same benefit to self-employed individuals in the not-too-distant future.

Since the IRS has already mailed out tax forms for 1994, we must act immediately to restore this deduction so that small business owners can deduct 25% of their health insurance costs for themselves and their families. They believed that this deduction would be available to them and planned accordingly. Congress should keep its word, and immediately reinstate this deduction retroactively.

I also believe we should make the deduction permanent so that these small entrepreneurs can avoid the year-to-year anxiety over whether they will be able to afford health insurance for themselves and their families. And, hopefully in the future, we can give our smallest business people the same benefit we extend to our largest corporations: a permanent, 100% deduction of health insurance premiums. This action would go a long way in extending health care coverage to the uninsured, a goal we all support.

I realize there is a cost involved in extending this benefit to our smallest businesses, and I don't advocate this lightly. However, the ever-increasing costs of medicaid and medicare demand that we take every action possible to expand the availability of private health care coverage. By extending and increasing this tax deduction, more people will have access to health care coverage, and we will probably save federal dollars in the long run.

Thank you again, Mr. Chairman, for the opportunity to come before you today to discuss this is important issue. I'll be happy to answer any questions you or other members of the Committee may have.

Statement of
Jeanie Morrissette, Homestead Construction Co., Inc.
before the
House Small Business Committee
regarding the
Reinstatement of the Self-Employed Health Care Deduction
January 20, 1995

Madam Chairman, honorable members of the Committee, I am honored to provide testimony on the proposed reinstatement of the self-employed health care deduction. My name is Jeanie Morrissette and I am the owner of Homestead Construction, Company, Inc. Homestead Construction is a small remodeling firm located in Annandale, Virginia, specializing in residential remodeling. I am also a past president of the Metro Washington chapter of the National Association of the Remodeling Industry (NARI).

Homestead Construction is a Subchapter S Corporation that currently provides health care insurance to its shareholders— that being myself and my husband. While Homestead can deduct one-hundred (100) percent of the health insurance premiums, under current tax law, as shareholders, we must report the value of the premium, which is over $5,000 a year, in our W-2s. This then subjects that value to federal and state income tax on our individual returns. In our case, the taxes are more than one-third (⅓) of the value of the premiums. The tax could easily be

over fifty (50) percent of the premium, based on an individual's state of residence and tax bracket.

For tax years prior to January 1, 1994, we were entitled to deduct twenty-five (25) percent of the value of the premium as an adjustment to income, on Page One (1) of Form 1040. The twenty-five (25) percent deduction has now been eliminated, since Congress has not passed any legislation to extend the deduction that expired on December 31, 1993. The elimination of this partial deduction, along with the taxation of our health insurance premiums, results in fewer spendable dollars. These dollars could be used to reinvest in my business, to fund a retirement plan, or to save for our child's education. With the continued rise of health care costs and the associated tax burden, we, as small business owners, will have to seriously consider whether continued coverage is possible.

Besides the question of affordability, I believe it is patently unfair for S Corporation shareholders and other self-employed individuals to pay tax on these benefits, while C Corporations and their employees enjoy 100 percent deductibility with no strings attached. Please do not misunderstand me, I am not

advocating that all employee health care benefits be taxed. I sincerely believe that more small business owners would be able to afford health care coverage if provided the appropriate tax incentives. I do not understand why the tax code discriminates against the self-employed. We are the ones that need the most help in being able to provide health care coverage for ourselves and our employees. If we cannot take any deductions, our ability to provide coverage, at all, is severely hampered.

I understand this deduction was established in the Tax Reform Act of 1986 for a three-year period. NARI members have actively pursued the continuance of this deduction every year since 1989, when it was first set to expire. We've been fortunate enough to extend the deduction until last year. It is time this deduction was made permanent and increased to 100 percent. While I realize that tax deductions cost the U.S. Treasury money, so does the rising cost of Medicare and Medicaid for those people who require care and have no insurance. Encouraging greater employer-provided coverage through this tax incentive may end up saving the government money. Equal treatment for all types of business organizations,

large and small, will go a long way in reducing the number of uninsured in this country. I think that is a goal everyone can agree on.

I understand there is growing Congressional support for the permanent extension and gradual expansion of this deduction. On behalf of the 6,000 NARI members companies, I soundly applaud those efforts. Extension and expansion of the deduction makes sense for the following reasons:

1. It is a matter of equity and common sense. There is no practical argument for the current distinction between the treatment of C corporations, which enjoy one-hundred (100) percent deductibility, and S corporations and the self-employed, who no longer enjoy even a twenty-five (25) percent deduction.

2. Reinstating the twenty-five (25) percent deduction and increasing it to one-hundred (100) percent will reduce the number of uninsured and ease the government burden of caring for these individuals.

3. Health care insurance is a significant cost to small business, one that is often priced out of the range of affordability. A complete deduction and cost controls will bring it back into the realm of possibility for many that have had to drop coverage.

4. Enhancing this deduction will help many people. According to a study by the Employment Benefits Research institute, nearly a quarter of small business owners have no health insurance and half of all the uninsured are either self-employed or work for small firms. A complete tax deduction for health insurance is a strong incentive for small businesses to provide such an important employee benefit.

I appreciate the concern of this Committee and truly hope that immediate action is taken to restore the deduction retroactively for 1994 and that serious thought be given to expansion of the deduction to one-hundred (100) percent.

Again, I thank you Madam Chairman, for inviting me to appear before you and your committee today to bear witness to the need for this positive legislation. I am willing to answer any questions I can.

Respectfully Submitted,

Jeanie Morrissette
Homestead Construction Co., Inc.
3909 Annandale Road
Annandale, VA 22203
703/642-2366

NARI is a not-for-profit trade association with nearly 6,000 member companies nationwide, representing over 40,000 remodeling industry professionals. NARI members are primarily residential home improvement contractors, and include national manufacturers and distributors of home improvement products and services.

Residential remodeling constitutes a $100 billion industry that has grown over 130 percent in the last ten years. With over 50 years of experience, NARI is committed to enhancing the professionalism of the remodeling industry and serving as an ally to homeowners. NARI is dedicated to the growth and betterment of the remodeling industry and related small businesses. For more information about NARI, contact Patti Burgio, director of government affairs, NARI, 4301 North Fairfax Drive, Suite 310, Arlington, VA 22203, 703/276-7600.

The 25% Medical Insurance Deduction for the Self-Employed

by: Betty Kohls Stehman, CIA
President and CEO, Entrepreneurial Financial Services, Inc.
National Director and Chief Financial Officer, American Association of Home-Based Businesses
Recently applied for CPA license in the state of Maryland

The 25% self-employed medical insurance deduction expired on December 31, 1993. The effect of this missing deduction is to have the self-employed pay more in taxes when they already carry a heavy burden in the United States Taxation System. Just how big a problem is this?

According to the IRS statistics for 1992, 21.3 million business tax returns were filed. The breakdown of these returns is as follows:

Sole Proprietorships	15.10 million	70.9%
Partnerships	1.60 million	7.5%
Small Corporations	4.48 million	21.0%
Large Corporations	.02 million	.6%

Of the 21.3 million businesses, 5.7 million or 26.8%, are large enough to have employees. From these statistics one can conclude that approximately 15.6 million businesses are one-person shops or family run businesses.

In the IRS Code, Section 162 is titled ITEMIZED DEDUCTIONS FOR INDIVIDUALS AND CORPORATIONS. The tax code in Sec. 162 begins with "There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. . . ." All forms of business entities are included in this section because business entities pay taxes either at the corporate level or at the shareholder/partner/individual level. C Corporations are allowed to deduct 100% of the medical insurance premiums and expenses that they incur for their employees which also includes the owners of the corporation or its five top officers. Based on the statistics above, only 21.6% of all business entities get the 100% deduction. Sub-Chapter S corporations are included in this 21.6% figure and their medical insurance premiums and expenses are passed through to the individual shareholders. Thus, they do not receive the 100% deductibility of their medical insurance costs. Although I was unable to find out how many Sub-S tax returns are in the corporate numbers above, I believe we can safely conclude that less than 1 in 5 businesses can deduct 100% of their medical insurance premiums and expenses.

What level of deductibility do 80% of the businesses receive for their medical insurance premiums and expenses? Under the pre-

January 1, 1994 tax provision, 25% of the medical insurance premium expense was totally deductible. The remaining 75% is first subjected to the 7.5% Personal Adjusted Gross Income exclusion that individuals are not allowed to deduct. Since income levels can be any amount, it is not possible to state in dollar terms how much money is lost in the medical insurance premium deduction at the individually taxed business entity level. It can be said that the maximum amount that could be deducted under the old laws is 67.5%. Thus, 80% of the businesses only receive a partial deduction for their medical insurance premium expenses.

The above information for 80% of the businesses only concerns the medical insurance premiums. Yet, there are other medical insurance expenses that only 20% of the businesses can deduct 100% of the cost 100% of the time; the other 80% of the businesses cannot deduct this same type of expenses 100%of the time for 100% of the amount spent. While we do not have information concerning the dollars involved in this issue, we can say that 80% of the business entities are not entitled to the same level of deductions for medical insurance expenses that large corporations are entitled to. We do know that, at a minimum, 80% of the business entities lose at least 7.5% of their medical insurance expenses forever. The reason the 7.5% dollar amount is lost forever is that there are no carryforward or carryback provisions for this type of deduction in the individual tax code which is where these businesses are taxed.

Suggestions for law changes

In order to foster equity between all business entities, the tax code needs to treat all business entities in the same manner. As quoted in my third paragraph, the present code states that ALL necessary and ordinary expenses should be deductible for individuals and corporations. At the present time, only C corporations are allowed to deduct all necessary and ordinary expenses incurred in their trade or business. Since the maximum percentage of entities which are allowed to do this is 21.6%, 78.4% of the business entities have been singled out to carry an additional burden in the tax system. The business entities which range in size from 0-4 employees created 2.6 million jobs during the time period of 1989-1991. Large companies (500+ employees) created 122 thousand jobs during this same time. All other business size classes lost jobs during this time. The constant downsizing of large corporations continues to place a heavy burden on the small business sector in terms of tax revenue, job creation, and the associated business expenses. Medical insurance premiums and expenses are some of the associated business expenses that increase with job creation. Without full deductibility of these medical costs, small business may not be able to offer medical benefits to their employees and/or their families/dependents. The additional problem of uninsured people spills over into other areas of our

society. Thus, it is essential that the medical insurance premium and expenses deduction be equalized for all business entities, regardless of how they are taxed.

Resource Material

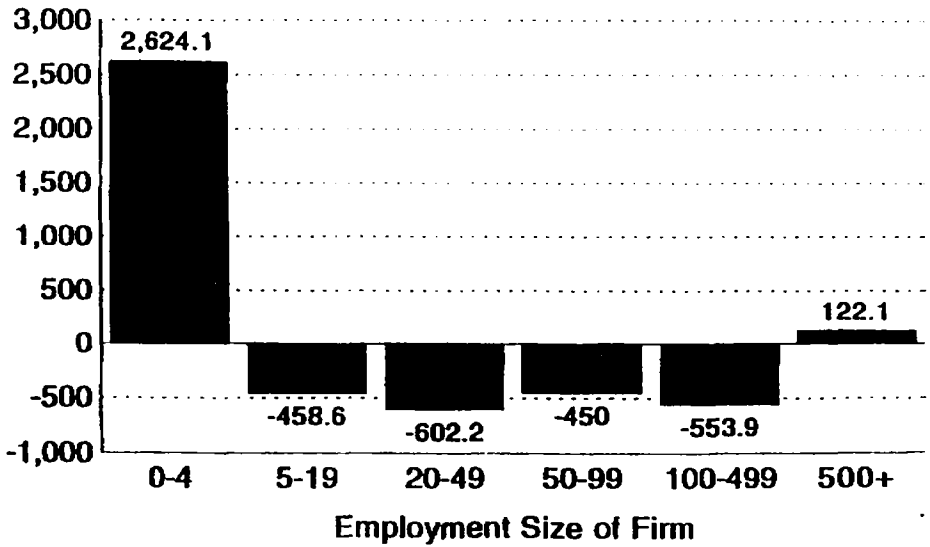
1. The Internal Revenue Code as amended through August 15, 1993

2. The White House Conference on Small Business Issue Handbook.

3. Small Business Administration resource material.

4. Hands-on experience with home-based and small business.

Net Job Creation in All Industries by Employment Size of Firm, 1989-1991 (in Thousands)



Source: U.S. Small Business Administration Off

Chairman THOMAS. I thank the gentlewoman for her testimony. I just want to inform you, as I said earlier to the other Members, that I have introduced a bill with the cosponsorship of all the Republican Members of the Ways and Means Committee to simply move retroactively on the 25-percent fix for 1994 because of the very same concerns the gentlewoman has about a time line. I understand also that two gentlemen from Maryland, Roscoe Bartlett and Kweisi Mfume—so apparently we have a 696 and 697.

So we are thinking along the same lines in trying to do an adjustment in time so as not to have to file amended returns, but look prospectively at some options that may begin with the 25 percent on a permanent basis but then possibly offer some other alternatives.

I wonder if the gentleman from North Dakota had any final statement?

Mrs. MEYERS. If the gentleman would excuse me for a second, I would like to say that in the Small Business Committee, the hearing indicated one thing that is different from large business and small business and that is the matter of cash flow. Our small businesses need the permanence of the 25 percent because of planning.

Again, I thank you very much.

Chairman THOMAS. Absolutely. Thank you.

Mr. POMEROY. I have nothing further to add, Mr. Chairman, other than commending you for your attention as well as the Chair of Small Business who held a hearing last week. This is a vital topic and I hope we can move it quickly.

Chairman THOMAS. I thank you both very much. I appreciate all the Members taking their time out to testify.

If we could have the panel of Jere Glover and Jonathan Gruber, please, SBA, U.S. Small Business Administration, and Associate Professor of Economics at MIT.

Mr. Glover, would you begin, please.

STATEMENT OF JERE W. GLOVER, CHIEF COUNSEL FOR ADVOCACY, U.S. SMALL BUSINESS ADMINISTRATION

Mr. GLOVER. Thank you very much, Mr. Chairman and Members of the subcommittee, for holding this hearing and giving me the opportunity to testify.

Let me tell you just a little bit about the unique role of the Office of Advocacy at the U.S. Small Business Administration. First thing, this is one of the few jobs in Government which requires that the President appoint someone from the private sector to give a little different perspective. Second, we are able to present views before Congress that are unique and perhaps somewhat different from views of other agencies.

Our job is to represent the views and interests of small business. Specifically concerning the subcommittee's hearing today, we have the duty to determine the impact of tax structures on small business and make legislative and other proposals for altering the tax structure to enable small business to realize their potential for contributing to improving the Nation's economy.

Given this role, my testimony is pretty much what you would expect it to be. Small business needs, deserves to have—especially

the self-employed and partnerships—need to have the deductibility for their health insurance restored.

There is a process going on throughout the country where White House conferences on small business are being held in each of the States. To date, we have been to 38 different conferences. I was in the conference at Birmingham, Ala., yesterday. The one issue which has come out of each of these conferences, the only issue that has unanimous support in every one of the States is the restoring of the deductibility of health insurance to 25 percent and going to full 100 percent deductibility for health insurance. So the small businesses in this grassroots process throughout the country are speaking very loudly and very clearly on this one specific issue.

Now, I think that we also have a situation where the entire small business community is behind this. There is unanimity and we are speaking basically with the same voice.

There have been some discussions about the impact. One of the impacts is very subtle and that is that we have a pattern of retroactively approving this deduction for small business.

We did it in 1993. Basically, we had a lot of people say at the end of last year that this was going to be renewed. Clearly we have a situation where, while it is not ideal, at least let's not create a pattern of promises and then not do it again. So that is one of the subtle reasons.

The other reason—Professor Bruce Kirchoff did a study for the National Association for the Self-Employed. He is the former chief economist for the Small Business Administration. He did a study in which he indicated that 400,000 individuals took health insurance because of the deduction. Without that, they would not have taken health insurance. There is another factor that we need to consider. Ordinarily, one would think the 25-percent deductibility might not be that important, but let me put it in context for the subcommittee.

The average sole proprietorship makes less than $15,000 per year in total income. So we are talking about an amount of money that is very important to those small businesspeople. While the average income is $15,000, there are many, many more that make far less than that. So the deductibility, not only the 25 percent but hopefully the full deductibility, is of critical importance to those small businesses, especially those who have very small incomes.

Let me just conclude by saying that I think it is important that this subcommittee is considering this issue. I would urge you prompt consideration of the 25-percent deductibility for last year, and I would urge you to raise that as much as you possibly can looking toward 100 percent or something close thereto in the future.

Thank you very much.

[The prepared statement follows:]

STATEMENT OF JERE W. GLOVER, CHIEF COUNSEL FOR ADVOCACY
U.S. SMALL BUSINESS ADMINISTRATION

Thank you Mr. Chairman and Members of the Subcommittee for this opportunity to appear before you today to discuss an issue of vital importance to this nation's small business community. I appear as Chief Counsel for Advocacy to express my own views which may not reflect the views of the Administration.

Prior to my appointment by the President as Chief Counsel I established and operated several small corporations in addition to managing a private law practice. As a result, I have "hands-on" experience with the issues challenging small business. I might add that private sector experience is a statutory requirement for the job. When Congress created the Office of Advocacy in 1976, it had the wisdom to specify that the Chief Counsel should come from "civilian life" to ensure that the occupant of the office would have a clear perspective of the impact of public policy on small business and the needs of small enterprise.

I congratulate the Chairman and this Subcommittee for moving so quickly to give serious consideration to extending the deduction for health care premiums to the self employed, including sole proprietorships, partnerships and subchapter "S" corporation. Hopefully, these hearings will convince the subcommittee of the need to extend the deduction and to increase it to 100% of the insurance premiums paid by business owners.

The overall mission of the Office of Advocacy is to represent the views and interests of small business. And in the context of this hearing, the Office has the specific duty to

> "....determine the impact of the tax structure on small businesses and make legislative and other proposals for altering the tax structure to enable all small businesses to realize their potential for contributing to the improvement of the Nation's well-being".

Given this mandate, my testimony will come as no surprise to you. I support treating the health insurance cost of self-employed small business men and women as a fully deductible business expense. I join prior Chief Counsels who also supported the deduction when the issue was before Congress in prior years.

My reasons are rather straightforward. The deduction should be allowed because:

- it's fair - there is no rationale for treating unincorporated business owners differently than incorporated business owners, and
- it is consistent with a national objective to encourage health care coverage for all working people.

Mr. Chairman, I and other members of my staff have spent the last several months in meetings across the country with thousands of small businesses in preparation for the White House Conference on Small Business which will be held in Washington this summer. One of the top recommendations expressed at every one of these meetings is continuation of the deductibility for health insurance premiums.

I was encouraged by the President's State of the Union address when he mentioned that he wants to make health care insurance more affordable for everyone, including small businesses. The proposal you are considering today is a good start towards achieving that goal. Allowing the owners of sole proprietorships and "S" corporations to deduct the cost of their insurance provides a greater incentive to offer health insurance to their employees. You can count on the full support of small business and, judging by recent history, widespread support here in Congress.

Small businesses have been encouraged by the level of support shown in Congress last year for restoring the 25% deduction for the self-employed for tax year 1994. They are still hopeful this can be done retroactively. In addition, although some small business owners may have had differences over health care reform, there was no disagreement in the small business community over the proposal contained in most of the health care bills to make premiums paid 100% deductible.

HISTORY OF THE TAX DEDUCTION FOR THE SELF EMPLOYED

It has long been the policy of the United States, as expressed by Congress, that health benefits provided by employers should have a special status in the tax laws. Section 106 of the Internal Revenue Code makes employer contributions to accident and health plans fully deductible. The Conference Committee which adopted the original self-employed health care deduction had this to say about the public policy of health care deductions in general:

> "...the tax-favored treatment of employer-provided employee benefits reduces the Federal income tax base and reduces Federal budget receipts. However, the Committee believes these costs are justified because employer-provided employee benefits fulfill important social policy objectives, such as increasing health insurance coverage among taxpayers who otherwise would not purchase or could not afford such coverage. For example, employer provided health insurance and life insurance coverage is currently provided to more than 80 percent of workers in the United States". (Conference Committee Report which accompanied the Tax Reform Act of 1986, P.L. 99-514; H. Rept. 99-841, p. 650)

In 1986, during consideration of H.R. 3838, the Tax Reform Act of 1986 (P.L. 99-514) the Senate amended the House originated version of the bill by adding a section which provided a 50% deduction of health insurance premiums paid by self-employed individuals under certain circumstances. The Senate Finance Committee offered the following paragraph to justify its inclusion:

> "The committee believes the present-law rules relating to the exclusion from income for benefits under employer accident or health plans create unfair distinctions between self-employed individuals (the owners of unincorporated businesses) and the owners of corporations. The ability to exclude health benefits to the extent provided by a corporate employer creates tax incentives for incorporation that the committee believes leads to inefficient tax-driven decision making.
>
> "More importantly, the committee is aware that access to employer health plans is lowest with small employers (particularly with small, self employed employers). The need for adequate health coverage is so important that the committee believes it is essential to encourage a narrowing of the gap in health coverage. The committee concludes that a partial exclusion for health plans maintained by self employed individuals will accomplish this goal." S. Rept. 99-313, p. 666

The Senate also concluded that if small businesses were to have the same benefits as large businesses, they should also abide by the non-discrimination rules which apply to plans which are purchased by incorporated businesses.

The Conference Committee in an effort to reconcile the House bill, which contained no deduction, and the Senate bill, approved a compromise which cut the proposed deduction to 25% and, in the

interest of simplicity for small businesses, excluded the non-discrimination requirements.

The deduction for the self-employed was to sunset in 5 years but was subsequently extended to 1992 under the Tax Extension Act of 1991, and finally through 1993 under the Omnibus Budget Reconciliation Act of 1993. Though there was widespread support for extending the provision last year, Congress adjourned without acting on the matter and the deduction will be unavailable for 1994 tax returns.

IMPACT ON SMALL BUSINESS

If the deduction is not restored, the House Small Business Committee has estimated that this could cause an increase in the number of uninsured self-employed of more than 400,000 individuals.

As it is, currently 26% of the unincorporated self-employed lack health insurance, compared with 8.8% of the incorporated. It is clear from the data that incorporated businesses are more likely to provide health insurance coverage for the owners as well as employees.

In evaluating the impact of the tax deduction on the self-employed, it is important to keep in mind that the average age of a business in the U. S. is seven years. During the first two years, these businesses just survive and show little profit. Of the 21 million entities filing business tax returns (15 million of which are unincorporated businesses), only 4-5 million have actually taken advantage of the deduction in the past. The average annual net income of the self-employed is between $15,000 and $25,000. From a public policy perspective, anything that can raise the bottom line, i.e. net profit, is significant for the survival of these firms.

The pre-tax deductibility of insurance premiums as a business expense involves real money to small business. Why should they pay more taxes merely because of their legal structure? If health insurance costs are a necessary cost of doing business for corporations, why are they not a necessary business expense for the unincorporated self-employed? A further inequity is the fact that their tax payments indirectly underwrite the deduction of corporations.

HEALTH CARE AVAILABILITY-PUBLIC POLICY

We now know how right the Conference Committee that considered the Tax Reform act of 1986 was in their analysis of the need for a deduction. The world has changed a great deal since 1986 and high cost of health care coverage has moved to center stage. Small businesses have become the dominant creator of new jobs in this country. Now, more than ever before, it is clear that it is in the public interest to encourage as full a participation as possible in health insurance plans. Yet, if the present law remains unchanged, it is estimated that 9 million small business owners (approximately 10% of the working population) will be unable to deduct their health care premiums. Our research shows that there are 2.6 million uninsured self-employed Americans, making that group one of the largest groups of uninsured citizens. Within this group are 2.3 million unincorporated entities and 300 thousand incorporated self-employed. The House Small Business Committee Chairman, Jan Meyers, has estimated that the number of uninsured self-employed could increase by more than 400,000 due to the loss of the deduction. Clearly, if public policy is to encourage the participation of as many income producing citizens as possible in private health insurance plans, small business owners is the easiest and largest group to choose.

COST

The main objection to the adoption of a deduction for self-employed health insurance costs will be the costs to the treasury. The original cost estimate for the 25% deduction was projected to be $481 million by 1991. Costs estimates of the 100% deduction are very speculative since the figures are dependent on the cost of a plan an individual chooses, how much a business earns and which businesses decide to purchase coverage. The costs attributed to the 100% deduction provision during the consideration of last year's major health-care proposals ranged from $500 million to $2.5 billion. The Congressional Research Service, specifically Health Care Policy analyst, Beth Fuchs, who has been keeping track of the estimates, says that she feels $2 billion is a reasonable figure.

Costs could be kept down by phasing in the deductions over a number of years or by continuing the requirements which existed under the 25% deduction, which are:

1. premiums can be deducted only to the extent of income;
2. no person who could qualify for a subsidized plan (or be covered by the subsidized plan of a spouse, can receive the deduction.

FUNDAMENTAL FAIRNESS AND SIMPLICITY

The legislators who first drafted the health insurance deduction for the self-employed had the right idea, both from the public policy standpoint and also from a fundamental fairness standpoint. I ask you to consider the following:

Congress made the decision long ago that the cost to the government of the deduction by corporations of health care insurance for their employees was far outweighed by the public benefit of having those employees covered by insurance. Congress should do not less for the sole proprietorships, partnerships and subchapter "S" corporations.

Corporations have a 100% deduction, unincorporated self-employed business owners have none.

Corporations, generally because of their size, can negotiate favorable rates for their health plans. Small businesses have a difficult time finding any affordable health plan. Without a deduction, their costs are even greater.

Finally, self-employed individuals, left without a deduction for tax year 1994 will see their tax bill go up!

In conclusion, I urge this subcommittee to act favorably on this proposal and restore the 25% deduction for the 1994 tax year.

Further, I ask that the self-employed, partnerships and subchapter "S" corporations be given the same tax treatment as is given to corporations, namely, 100% deductibility of health insurance premiums.

Finally, for ease of compliance with the tax code, I believe any qualifiers should be as simple as possible so that small businesses will have no confusion about what is deductible. I believe Congress was on the right track back in 1986 when it threw out the non-discrimination requirements as they applied to these very small privately owned businesses because they were too cumbersome and complex under the circumstances.

Thank you Mr. Chairman. I sincerely hope that this subcommittee will recommend that the playing field be leveled so that the tax code treats all business entities the same as far as health insurance premiums are concerned.

Chairman THOMAS. Thank you very much.

Professor.

STATEMENT OF JONATHAN GRUBER, ASSOCIATE PROFESSOR OF ECONOMICS, MASSACHUSETTS INSTITUTE OF TECHNOLOGY, CAMBRIDGE, MASS.

Mr. GRUBER. Thank you.

Thank you for allowing me to speak to you today about the tax treatment of health insurance expenditures for the self-employed. Let me start by just saying one word of background about the tax treatment of health insurance for both employed and self-employed individuals. For the past 50 years, the value of employer provided health insurance has not been included in an individual's taxable income. This provides a substantial subsidy to the purchase of health insurance by employed individuals amounting to roughly 35 percent of the cost of health insurance.

For self-employed individuals, however, there has not traditionally been such a subsidy and perhaps as a result, insurance coverage rates among the self-employed were about 20 percent below those of employed persons. To partially remedy this discrepancy, Congress introduced in 1986 the 25-percent partial tax deduction. In research with my colleague, James Porterba at MIT, we found that this partial tax subsidy had a dramatic increase on the health insurance coverage of the self-employed.

We estimated that the introduction of this subsidy lowered the uninsured rate among the self-employed by about 13 percent; or to put it in other words, this partial subsidy reduced the gap between self-employed and employed individuals in insurance coverage by about one-fifth. So this suggests that the insurance demand of the self-employed is very sensitive to the price that they pay and sensitive to the kind of tax subsidization that we are discussing today.

Now, in that research, we had one other finding which is of interest I think for the subcommittee's deliberation today which is that the response to this subsidy was mostly concentrated among the high income self-employed. That is, coverage rose only slightly for lower income self-employed persons. But for those with income above $50,000 a year, it rose dramatically.

This reflects the fact that a tax subsidy is much more valuable for higher income taxpayers because it is worth more in dollar terms since they have a higher tax rate.

Now, with that background in mind, what I would like to do is talk about a couple of notions that that leads to in terms of thinking about future tax policy.

First of all, I think the generosity of the tax subsidy for the self-employed could and should be increased. Insurance coverage among the self-employed remains roughly 15 percent below that for the employed, and since my research suggests that the insurance coverage of the self-employed is sensitive to the tax treatment of their health insurance expenditures, increasing the tax subsidy could further narrow this inequity between employed and self-employed individuals.

But second, I would suggest that we think about the insurance deductibility being replaced with a limited refundable tax credit. For example, the self-employed individual could be offered a credit

up to 50 percent of the cost of a typical employee's health insurance plan. A limited tax credit has two advantages relative to tax deductibility. First of all, a credit offers equal benefits to both low and high income self-employed individuals, rather than deductibility which favors high income self-employed individuals. By making the tax credit refundable, the subsidy could extend even to those low-income self-employed individuals whose tax credit would exceed their tax liability, such as individuals who may be starting up new businesses.

Second, a limited credit offers incentives for the self-employed to seek out low-cost insurance plans, while an unlimited deduction equally subsidizes efficient low-cost insurance and excessive—what are known as "Cadillac" policies. Many analysts have expressed concerns that rising medical care costs in the United States are due to excessively generous insurance policies so that limiting the amount of the subsidy would offer incentives to avoid these types of policies.

Third, the tax subsidy should be more effectively advertised. Whatever the form of this tax subsidy, be it deduction or credit, whatever the amount, a critical problem with effectiveness appears to be a lack of awareness on the part of the self-employed. My coauthor and I estimated that fewer than one-half of the individuals who are eligible for this subsidy took it up only on their tax forms.

This suggests that individuals may be unaware of their entitlement which may in turn limit the effectiveness of this subsidy and is especially important if you are thinking about extending it further. So any expansion of the subsidy must be accompanied by an advertising effort which is designed to make the uninsured self-employed aware of their entitlement under the tax law.

Thus, in summary, I would recommend a nationally advertised refundable 50 percent credit for insurance costs up to the national average costs of a group insurance plan. That is, for example, if the national average cost of a family insurance policy in the United States is $4,000 today, the self-employed person would have a credit of one-half of the cost of the insurance up to $2,000. Such a policy would increase insurance coverage for the self-employed and would do it equitably between low and high income self-employed persons.

Let me conclude by raising one final important issue which has not really, I think, come up today which is how do we set the required floor for self-employment income?

The current tax subsidy can only be taken up to the amount of your self-employment income. The policy I described can be designed in the same way. Individuals could deduct up to $2,000, say, but only if their self-employment income is at least $2,000. But by raising or lowering this required floor of self-employment earnings, Congress can target this subsidy to very specific populations. This is because there are large segments of the population which are not self-employed but which also don't have access to employer provided health insurance, like the unemployed or those employees who work in firms that don't offer insurance.

If this floor were very low, for example, there were no floor at all, then I anticipate many individuals relabeling themselves as self-employed just to get this subsidy. As the floor rises, the credit

will be targeted more specifically to the truly self-employed. So in setting the floor, I think the goal of this tax policy has to be clearly delineated.

Is the goal to use this effective instrument to redress coverage differences between the self-employed and employed? If so, I would suggest that a reasonably high floor be set. However, is the goal to introduce a tax policy which might more broadly address inequities between those that have access to health insurance and those that don't? If that is the goal, then a lower floor might be more sensible.

Thank you very much.

[The prepared statement follows:]

Health Insurance Tax Subsidies for the Self-Employed

Testimony of

Jonathan Gruber

Assistant Professor of Economics, Massachusetts Institute of Technology
Faculty Research Fellow, The National Bureau of Economic Research

before the

House Ways and Means Committee
U.S. Congress
January 27, 1995

Thank you for allowing me to speak to you today about the tax treatment of health insurance expenditures by the self-employed. For the past 50 years, the value of employer-provided health insurance benefits has not been included in an employed individual's taxable income. This provides a substantial subsidy to the purchase of insurance by employed persons, amounting to a reduction in the price of insurance of roughly 35%, relative to the price of other goods. For self-employed individuals, however, there was traditionally no such tax subsidy to the purchase of insurance. Perhaps as a result, insurance coverage rates among the self-employed were 20% lower than the coverage rates of the employed.

To partially remedy this discrepancy, Congress introduced in 1986 a partial tax subsidy for the self-employed: they could now deduct 25% of the cost of their insurance policies from their taxable income, up to the amount of their self-employment earnings. In research with my colleague James Poterba of MIT, we found that this partial tax subsidy had a dramatic effect on the insurance coverage of the self-employed. We compared the insurance coverage of the self-employed before and after this tax subsidy was put in place, and contrasted that to the coverage of the employed over this same time period. We estimated that *this subsidy raised the coverage of the self-employed by 4 percentage points*. In other words, this partial subsidy reduced the coverage gap between employed and self-employed by one-fifth. This suggests that the insurance demand of the self-employed is quite sensitive to the tax subsidization of insurance purchase.

In that research, we had one other findings of interest for the design of future tax incentives to the self-employed: *the response to the subsidy was mostly concentrated in higher income self-employed*. Among self-employed persons with incomes below $20,000, only 15-20% claimed this subsidy on their tax forms; but for those with incomes above $50,000, over 50% claimed the subsidy. As a result, while coverage rose by only slightly for lower income self-employed persons, for those self-employed with incomes above $50,000 per year coverage rose much more rapidly. This reflects the fact that the tax subsidy was much more valuable for those higher

income self-employed persons, who faced higher marginal tax rates. That is, if your tax rate is high, a deduction from taxable income has a much greater dollar value, so that the subsidy had its greatest impact on high income self-employed.

Designing an Improved Tax Subsidy for the Self-Employed

The results from our research suggest three ways in which the tax subsidy for the self-employed could be improved. *First, the generosity of the tax subsidy could be increased.* Insurance coverage among the self-employed remains roughly 15% below that of the employed. Since we find that the insurance coverage of the self-employed is quite sensitive to having a tax subsidized price, increasing this subsidy could reduce the coverage disparity between the two groups.

Even with equal tax treatment of the two groups, however, insurance coverage rates among the self-employed would most likely remain below those of the employed. The self-employed, by the nature of their career choice, have revealed themselves to be less averse to risk in general, so that they are probably less likely to feel that they need medical insurance, all else being equal. Nevertheless, increasing the tax subsidy would almost certainly help to reduce the coverage gap of the self-employed

Second, the tax deduction could be replaced with a limited refundable tax credit. For example, the self-employed could be offered a credit equal to 50% of the cost of their insurance, up to the average cost of a typical insurance plan. A limited tax credit has two advantages relative to an unlimited tax deduction. First, a credit offers equal benefits to low and high income self-employed persons, while a tax deduction offers larger benefits to higher income taxpayers. By making the tax credit refundable, the subsidy would extend even to those low income self-employed whose tax credit exceeds their tax liability. Second, a limited credit offers incentives for the self-employed to seek out low cost insurance plans, while an unlimited deduction equally subsidizes efficient low cost insurance and excessive "cadillac" policies. Many analysts have expressed concern that rising medical care costs are due to excessively generous insurance policies in the U.S., so that limiting the amount of the subsidy would offer incentives to avoid these types of policies.

Third, the tax subsidy could be more effectively advertised. Whatever the form of the tax subsidy, a critical problem with effectiveness appears to be low awareness of its existence. Even among the high income self-employed, for whom there is a large subsidy under current law, takeup of this subsidy is only 50%. This suggests that individuals may not be aware of their entitlement, which may in turn limit the effectiveness of this subsidy in increasing insurance coverage. So any expansion of this subsidy should be accompanied by an advertising effort which is designed to make the uninsured self-employed aware of this opportunity to buy subsidized insurance.

A final design issue is the *required floor for self-employment income.* The

current tax subsidy can only be taken up to the amount of self-employment income. Such a rule is important if the goal of the policy is to restrict the tax benefit to the truly self-employed. Otherwise, individuals with only marginal amounts of self-employment income will claim this credit. This could lead to the establishments of artificial self-employment jobs for persons who do not otherwise have access to group insurance, in order to claim this credit.

Combining these four considerations, a sensible policy for the tax subsidy to the self-employed could take the form of a *nationally advertised, refundable 50% credit for insurance costs up to the national average cost of a group insurance plan, that can be taken up to the amount of your self-employment income*. That is, if the national average cost of a family insurance policy is $4000, the self-employed persons could have a credit of one-half of the cost of their insurance, up to $2000 or their self-employment income, whichever is lower. Such a policy would increase insurance coverage among the self-employed, and would do so in an equitable way across high and low income self-employed persons.

Costs and Benefits of Restricting to the Self-Employed

In conclusion, let me focus on a broader question that must be considered in the design of this tax subsidy: why the self-employed? There are two additional groups of persons in the U.S. that do not have access to the employer-provided insurance subsidy: the unemployed, and those in firms that do not offer insurance. Why should we favor the self-employed relative to these other groups?

This question is important for the final consideration mentioned above, the floor of self-employment income required to claim the tax credit. If this floor were zero, then this credit would essentially be available to any person who decided to call themselves self-employed, so that it would extend to members of both of these other groups. As the floor is raised, the credit is restricted more and more to the "truly" self-employed.

So, in setting the floor, the goal of tax policy must be clearly delineated. If the goal is to use this effective instrument to redress coverage differences between the self-employed and employed, then the floor should be set reasonably high. But, if the goal is to more broadly address inequities between individuals who have access to employer-provided health insurance and those who do not, a lower floor, and perhaps no floor at all, would be more sensible.

Chairman THOMAS. Does the gentleman from Nebraska have any questions?

Mr. CHRISTENSEN. I don't, Mr. Chairman, not at this time.

Chairman THOMAS. Thank you.

Mr. Glover, Mr. Gruber talked about the apparent lack of awareness of this obviously desirable deductible provision, and I know that we have been inundated by a number of groups representing small business and others.

Do you have any kind of studies or indication of outreach programs in trying to deal with the awareness, or do you in fact agree with the professor that there is a problem of awareness?

Mr. GLOVER. I agree very much and it is probably out of my bias or prejudice over the years dealing with the Internal Revenue Service some years ago. Generally speaking——

Chairman THOMAS. In a personal or professional way?

Mr. GLOVER. I personally have always done all right. I wouldn't get through Senate confirmation if I had done anything that didn't work out. But professionally, what we see is if it is a benefit to small business, it often times doesn't even make it on the form. For example, right now we are in a situation in which we were last year when we extended it late in the game.

Often there is not even a blank on the tax form for it. The IRS doesn't do much to promote those kinds of things. One other thing, we had a job tax credit some years ago, and one of the reasons the IRS said that it should be abolished was because small businesses weren't using it. The fact is, there was nothing on the form that indicated you could.

Clearly there is an education problem. Small businesspeople often don't know about the deductions permitted. Given the reaction we are getting in the White House conferences, small businesspeople are fully aware of the fact that the deduction for health insurance has been taken away. Clearly promoting it would probably help. We are hearing a lot of noise and very articulate concerns about it in each of those State conferences.

Chairman THOMAS. In addition, Mr. Gruber indicated that there were options like a tax credit. I think also within that, as you saw in the testimony of the Members, we tend to be almost locked into a ritual in terms of the options available to us. Not only could you look into a tax credit structure, but you could also get into that percentage where the behavioral tip is to try to motivate.

You could also talk about a top end which would be a flat dollar amount that would be available. Has the Small Business Administration done any polling or studies among small businesspeople to determine if there have been indications of which profiles would be more acceptable or more desirable?

Mr. GLOVER. One of the things that I would caution the subcommittee on is that at any given time, 30 to 40 percent of sole proprietorships and partnerships are losing money. The average income I gave you of under $15,000 includes those that make money and those that lose money. When you have income restrictions, there are often years in which small businesspeople simply don't make very much money and especially in the beginning years.

Now, I don't want the deduction to be extended to those who are not engaged in the ordinary course of trade and commerce and ac-

tually involved in business, but the income restrictions can be a hardship for those businesses especially where they are starting off. One of the things that we have found is there are an awful lot of barriers to just starting your business.

In most States you are charged more for unemployment compensation in the first year. They give you the highest rates then. You are hit immediately with self-employment taxes. You are hit with the burden of learning how to do all these things and, quite frankly, our indications are the first 2 or 3 years of people starting businesses, they almost always lose money. I would be careful to try to outline any restrictions on income in such a way that those businesses who were just getting started would still be permitted a tax break, provided they could meet some other ordinary course of business test that we see in the Code for other reasons.

Mr. GRUBER. I think that is actually a very important point and that comes back to why I think a tax credit makes a lot more sense than a tax deduction. If you consider a business that is starting out maybe making $15,000, $20,000 a year, they are in the 15-percent tax bracket. Compare them to the established business and now it could go up to the 39-percent tax bracket.

Why do you necessarily want to give a tax break that is almost three times as large to that established business as opposed to maybe the person who needs it more which is the start-up business. A tax credit gives it equally to both and that is an argument for doing that.

Chairman THOMAS. Obviously, we need to explore that at greater length. In that regard, once again, Mr. Glover, in terms of any research, we have heard testimony from Members in terms of a mix and match of ways in which to deal with the percentages.

I am most interested in wondering if there have been any studies, Professor, about the behavioral tip point. Clearly, it is a question of whether or not you have made any money or not, but I would love to see some indication that at 50 or 75 percent, you get a percentage of people who respond to it above which we simply are giving away a portion of a tax deduction because you don't get any marginal behavioral benefit from it.

Do you have anything like that at all?

Mr. GLOVER. I think we have some related information depending on the wide variety of earnings that you have. Clearly, as for the smaller firms, you are not going to be having the same tip point for a firm that is making $7,000 a year and who is looking at a 50-percent deductibility versus someone who is making—for example, a lawyer—who is making $300,000 a year. The tip point may be entirely different for those two individuals.

The credit idea is something I just heard about today, but I will tell you it certainly has some real merit, especially for the smallest of the firms that are just getting started. Very interesting proposal.

Mr. GRUBER. I think, unfortunately, we don't have a lot of evidence on the tip point. I think I agree that the tip point argument is once again an argument for why you would want a credit, because a lawyer earning $300,000 a year, even 50 percent deductibility, is largely not going to affect their behavior. But I do think one thing we do have evidence on that comes back to this question of how you set the floor is that the choice of form in terms of self-

employment or nonself-employment is something which is fairly fungible.

If you make it very generous, then you have got to realize what is going to tip is a lot of people are going to start calling themselves self-employed and that is something where we do have evidence on the tip point. We don't have evidence as to specific numbers, but it is something to keep in mind in terms of cost estimates.

Chairman THOMAS. OK. I appreciate your testimony very much and, without objection, I will make the written testimony part of the permanent record, and I believe I want to include your study.

Mr. GRUBER. That would be great.

Chairman THOMAS. Thank you very much.

[The study is being retained in the committee files.]

Chairman THOMAS. Call the second panel.

The next panel is Bob Vice, listed as an avocado and nursery plant grower in Sacramento. I also know him as the President of the California Farm Bureau, so that he can speak not only in terms of the large group but as a businessman himself. Sal Risalvato, who is a small businessman himself in New Jersey; and Sally Nelson who is an insurance agent from Portland, Maine.

I guess we will begin with you, Bob. We will make any written testimony that you have a part of the record, and we would request that you proceed how you see fit in the 5 minutes that have been allotted to you.

Mr. Vice.

STATEMENT OF BOB L. VICE, PRESIDENT, CALIFORNIA FARM BUREAU FEDERATION, SACRAMENTO, CALIF.

Mr. VICE. Thank you, Congressman. Mr. Chairman, good afternoon. My name is Bob Vice and I am a citrus and an avocado grower in San Diego County. I also serve as President of the California Farm Bureau which represents about 42,000-member farm families who produce over 250 different commodities throughout our State. Most of our members are self-employed and they have a great interest in tax fairness issues. We appreciate this opportunity to make comments on the tax treatment of health insurance premiums.

The Farm Bureau strongly supports allowing self-employed taxpayers and all others who pay the full cost of their health and dental and disability insurance to deduct them as an expense. We seek no special treatment. We simply feel that from the standpoint of fairness, that the self-employed deserves the same considerations as corporations. The motivation is not simply about leveling the playing field for various categories of business in this country. This is important, but even more so is providing all citizens the same tax incentives to pay for health insurance and health care costs.

A tax deduction for the costs of insurance premiums would go a long way toward helping the self-employed provide for their own insurance needs, and this is especially true with farmers and ranchers because we have a relatively high insurance premium cost due to the hazardous nature of our industry.

Many farmers reduce their coverage or drop it entirely because they cannot afford it. Tax deductibility would soften the blow. Of course, medical savings accounts would also help.

I know I do not need to remind this subcommittee that the 25-percent deduction expired on December 31, 1993. It is urgent that this be reinstated soon before farmers, ranchers, and people throughout this country have to file their 1994 taxes. Of course we, too, would join the voices of previous panel members advocating that 100 percent deduction would be the next logical step.

Congressman Thomas, you have been a great friend to agriculture and all small business over the years. We have not forgotten, for example, your leadership in incorporating a targeted export assistance program in the 1985 farm bill, a successful trade program which basic components are alive and well and taking on even more importance today as a consequence of our recently signed international trade agreements, which you also can take some credit for. This important subcommittee which you now chair will provide you many more opportunities to exert the type of leadership that small business in this country needs. We thank you for putting this tax treatment of health insurance high on your list. We hope that your next project will be to provide estate tax relief to the owners of so many small businesses, such as farmers and ranchers, who are now finding it nearly impossible to transfer their life's work to the next generation.

We thank you again for inviting us to speak before this subcommittee, and we look forward to seeing this broadly supported proposal turned into law.

Thank you.

Chairman THOMAS. Thank you, Mr. Vice.

Mr. Risalvato.

STATEMENT OF SAL RISALVATO, OWNER, RIVERDALE TEXACO AND PRECISION ALIGNMENT CENTER, RIVERDALE, N.J., ON BEHALF OF NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Mr. RISALVATO. Good afternoon. Mr. Chairman and Members of the subcommittee, I thank you very much for allowing me to come here this afternoon to explain to you as a small businessowner how this legislation will have an effect on both my business and the small businesses of other small businessowners across the country.

Mr. Chairman, I have to specifically thank you for your introduction of H.R. 697. I think that it shows that you are in tune, and I think it is going to be a great step to getting the ball rolling.

We are here to address the on-again/off-again deduction of our health care premium, and I say on-again/off-again because it is debated every year and it is baffling to me that in 1986, when Congress first put this in place, why it was given a sunset of 1989. I don't understand why something like this would have even been allowed to continue. But it did and we have debated it every year, and hopefully we are going to do something about it permanently here today.

I would like to accomplish two objectives here this afternoon. I would like to make you understand the plain, simple, and obvious unfairness about the lack of deductibility or only a 25-percent deductibility. It is blatantly unfair in comparison to everybody else. The other thing that I would like to help make you understand is that we can use this as sort of an incentive for small

businessowners to get into the insurance market if they are not in it or to continue in it if they are in it presently.

As you know, free enterprise must thrive and it thrives on incentives and rewards, and this 25 percent deduction would be considered an incentive.

I got into the insurance market in my business back in 1983, I believe it was, or 1981. At that time I was very young. I had never had a job for anybody. I worked in my own business all my life and I never really thought about health care insurance. At that time, because I wanted to compete in the marketplace for better employees, one of the things I decided I would do is provide health care benefits because I wanted to keep the good employees that I had.

I always had difficulty making comparison with my business and other businesses in terms of what the pay scales were. There is no real way of learning what another business pays its employees without some sort of espionage or spying so you kind of put feelers out, but you want to make sure you are paying your employees in a competitive fashion.

One thing that was real easy to learn was that the other shops were not providing these benefits, so I knew if I provided health care benefits and paid for them, that this was a reason for my employees to stick with me. This, by the way, is participating in a marketplace. The marketplace I call it, the playing field of free enterprise. I was competing because I was offering something, I am competing for my employees.

Now, at the time that I provided these benefits, I was totally unaware of the fact that I could not deduct it. I just was using some common sense and figured that I am writing a check at the end of every month to pay for these benefits, and I did not learn until the end of year from my accountant that we had to subtract mine out because I couldn't deduct that. I was very, very angry. My first reaction was, well, then I am not going to provide these benefits. Of course that was senseless and I did continue the benefits.

In 1986 I was very, very pleased when we got a 25-percent deduction. But I have to tell you, quite frankly, I felt like I was being thrown a bone. The 25 percent was just something to keep us quiet for a while. It did end in 1989, and right now we are faced with—all small businesses across America—not being able to deduct their own health care for 1994.

I think that we are going to lose the incentive that should be provided to get small businessowners to provide this for their employees, and in the time right now where we are talking about health care reform and we are trying to get more people into the marketplace, it is very important that we do that.

I see my time is up, so I will cease and I will be able to answer any questions that you may have.

[The prepared statement follows:]

STATEMENT OF

SAL RISALVATO

OWNER
RIVERDALE TEXACO
RIVERDALE, NEW JERSEY

Before: Subcommittee on Health
Committee on Way and Means
U.S. House of Representatives

Date: January 27, 1995

Subject: Self-Employed Health Insurance Deductibility

Good afternoon. Thank you Mr. Chairman for giving me the opportunity to explain to you what it is like to own a small business, and to endure the unfairness in our tax code. I am here to speak about the on again off again deduction for health care premiums paid by the owners of small business.

I am one of the owners of a small business. I, along with my brother Vinny, own Riverdale Texaco, a gasoline service station in Morris County, New Jersey. I have been in the service station business since 1978.

As I am sure you know, the 25 percent deduction on health care premiums for the owner of a small business expired on December 31, 1993. I am here to urge this committee to extend the 25 percent deduction retroactive to January 1, 1994. I hope to accomplish several objectives today. First, I hope to make you understand the plain, simple, and obvious unfairness with the tax treatment of health care premiums as they relate to the owners of small businesses. Second, I would like you to understand how that treatment is working against any solutions in the reform of health care.

I first started to provide health care benefits for myself and my employees in 1981. Previously, I myself was not insured. I had always owned my own business from the day I graduated from high school. As a healthy, inexperienced youth, I was not yet wise enough to realize the dangers of being uninsured for serious illness. Had I gotten seriously ill while I was in my early twenties, I would have had no means of paying for my illness, thereby becoming one of those that burden the health care system. I am sure you are all aware of the term "cost shifting". Had I become seriously ill back then, I would have been guilty of "cost shifting".

I cannot say that it was a sudden rise in the level of my wisdom, or the realization that I was a health care deadbeat, that propelled my business into providing health care benefits for myself and my employees. The very force that made me provide health care benefits back in 1981 is the exact same force that is the best solution to your health care crisis today. That force is identified as "the market-place". The market-place is the playing field for free enterprise. It produces quality, efficiency, and excellence. It is sparked by incentive and reward. If it is doused by taxes, punishing regulation, and unfairness then it produces inefficiency and mediocrity.

I had some pretty good employees back in 1981. I hoped I was paying them well enough to keep them. I just wasn't sure. I tried to compare their salaries with those of other shops, but never felt comfortable with the accuracy of the comparisons. One thing I knew for sure was that many shops, with the exception of auto dealerships, did not provide health care benefits for their technicians.

It didn't take a genius to figure out that I could compete for employees better if I provided something only big business was providing. By competing for and keeping better skilled and motivated employees, I was able to sell a better product. When I sold a better product, I attracted more customers. When I attracted more customers, I earned more money. When I earned more money, I spent more money, I saved more money, I invested more money, and yes, I paid more taxes. That simply put is a free enterprise market-place and how it operates. It is not more complicated than that. I hope it is simple enough for Congress to understand.

My accountant at the time almost spoiled the fun of participating in this new benefits game. When it came time to do the end of year tax returns, he pointed out to me that the portion of the health care premium I had paid for myself could not be deducted as an expense, and therefore would be added to my income. I was so angry I felt like canceling the whole benefit. In fact I was a lunatic, being unable to understand why I was being treated so unfairly. It just didn't make any sense. Of course I came to my senses and recognized the whole reason I started the benefits in the first place was for the employees. I would simply have to live with it. But I didn't like it.

I always ask my self, "What decision would I have made if I knew beforehand I would be unable to deduct my share of the premiums?". I still do not know the answer to that question. Perhaps it may have delayed my decision to provide health benefits for my employees.

In 1986 Congress threw me a bone. They now allowed me to deduct 25 percent of my premium. I still can't figure the rationale. If it was unfair to tax me on 100 percent of my premium, why has it now become fair to tax me on 75 percent? It still does not make any sense! Why am I different from the person that works for me? Why am I different from the President of General Motors? I pay the same income taxes as they do, perhaps more or less based on our incomes. Neither my employees, nor the President of General Motors have the amount of their health care premiums added into their incomes at the end of the year. Why do I? Let me ask that question again. Why do I?

The 25 percent deduction wasn't any great thing, but it was better than nothing. Like any begging dog, I took the bone and chewed on it. Unlike the majority of the senseless things that Congress sees fit to impose on small business, they had a built in bone throwing stopper for this dog. Congress built right into the tax reform act of 1986 a sunset for the 25 percent deductibility of my health care premium. The deduction ended in 1989.

Every year since then, Congress has debated extending the 25 percent deduction. Every year Congress makes the same mistake. They don't do the fair and sensible thing. They don't do the one thing that will add incentive to small employers to seek heath care benefits for them and their employees. Congress doesn't make the deduction permanent, and they don't make it a 100 percent deduction.

Instead after each annual debate and holding the dogs at bay, they always choose to spare another bone. Congress has extended the 25 percent deduction every year since 1989 with the exception of 1994.

It is now time to pay taxes for 1994. A few years ago, I hired another accountant. Every year he calls and asks me to retrieve the invoices from my health care carrier from the file in order to calculate how much of the premium was paid for myself and my brother. Each year I dutifully retrieve them. I guess that makes me a Retriever. I report the numbers knowing that only 25 percent of those numbers will actually be deducted as expenses. My bone. The remainder is added to my income. I would like some meat on my bone thank you.

Unfortunately, I am here begging for my bone again. Congress has not extended the 25 percent deduction for 1994. If Congress does not act quickly, small businesses throughout America will not get any deduction this year. At a time when most small businesses are finding it difficult to continue providing health care benefits for themselves and their employees, it is bad for the market-place to not provide them with as much incentive as possible.

I ask you, in the spirit of fairness and in the spirit of concern for health care reform, please to pass legislation that will permanently restore the deduction on health care premiums for the owners of small businesses. I also ask that you make the deduction retroactive to include 1994. Most importantly, I ask that you phase in 100 percent deductibility, with an immediate increase to 50 percent. Members of the Committee, I think this will be a great first step, and a great signal that health care reform will be brought to a successful conclusion in this Congress.

I apologize if there seems to be a facetious tone to my testimony. I mean no disrespect. I make the analogy of the dog and the bone only as a means of highlighting the silliness of this debate. This debate should be over and done with. I am frustrated, and my fellow small business owners are frustrated by the obvious and blatant unfairness of this tax policy. I do detect a new aura in Washington. I was here last week to testify on regulatory reform, and I felt a renewed electricity in the halls of Congress. It felt good. I think the time is right to act on the legislation I have requested here today. I wish you well in your efforts to achieve a more fair tax policy for all Americans.

Chairman THOMAS. Thank you very much.
Ms. Nelson.

STATEMENT OF SALLY I. NELSON, PRESIDENT, LONGVIEW GROUP, PORTLAND, MAINE, AND PRESIDENT, ASSOCIATION OF HEALTH INSURANCE AGENTS, A CONFERENCE OF THE NATIONAL ASSOCIATION OF LIFE UNDERWRITERS

Ms. NELSON. Thank you. Good afternoon, Mr. Chairman and Members of the subcommittee. My name is Sally Nelson and I am a professional health insurance agent. My clients are almost all self-employed small businessowners and their employees. I myself am a small businessowner with three employees. I am president of my professional association's conference on health insurance, and for myself, my employees, my clients, and my fellow association members, I thank you for this opportunity to share with you our views.

We each know personally just how important it is to us that you extend the deduction for health insurance premiums paid by the self-employed. The deduction is vital to achieving maximum quality health insurance protection for, literally, millions of small businessowners and their employees.

First, let me state the obvious. It is unfair to treat incorporated businesses and their owners and employees more generously than unincorporated firms. An incorporated business can provide its employees and owners health insurance that is 100 percent tax free. On the other hand, the owner of a small business can deduct no part of the cost of his or her own employer-provided health insurance premium. Until 1993 we could deduct only 25 percent of our insurance costs.

We know of no policy reason for this difference in treatment which is based solely on the form of our business organization. It is not fair and we urge you to change it. We recognize real revenue considerations may prevent a speedy resolution to this issue. We support your effort to address this problem in a fiscally responsible manner, and we would be most pleased to work with you and your staff to find a way to achieve fairness.

Let me spend just a moment describing my own situation, and the situation of two of my clients. These real world scenarios demonstrate just how important it is to at least extend retroactively the 25-percent deduction that expired at the end of 1993.

The yearly premium for health insurance for the four of us employed by my unincorporated business, The Longview Group, was $5,900 in 1994. Our insurance requires a $500 deductible and an 80-percent copayment up to a maximum of $1,000 out-of-pocket costs. Until last year, I could deduct 25 percent of the cost of my share of the premium. I planned on being able to deduct it this year. I planned on it because, although section 162(l) had been scheduled to expire, it had been extended over and over again. Once it had been extended retroactively. In total, it has been extended four times in the last 8 years. Never had it been allowed to expire in a way that resulted in a lost deduction.

One of my clients, Corson Auto Supply in Rockland, Maine, is in much the same position. In 1993 their health insurance premium was $6,500. In 1994 it went up $2,150 to $8,650 a year. If Mr.

Corson loses his 25 percent deduction for his share of that $8,650, as will happen unless you act quickly, he tells me he will be forced to revise his company's coverage. It is likely his group plan will cost 7 to 12 percent more in 1995 and he just cannot afford to absorb that increase and the cost of the lost deduction as well. He will look at increasing deductibles or decreasing benefits for himself, his employees, and his family.

Whitten Architects of Portland is another of my clients. Mr. Whitten employs three people. Over 50 percent of the 1994 annual cost of his group plan is due to his personal family coverage. In 1993 with his 25 percent deduction, his out-of-pocket costs for his family coverage was approximately $2,800 a year. In 1994, without the deduction, his out-of-pocket costs for his family coverage was $4,384.

That is approximately a 60-percent increase in 1 year. He seriously worried about how to handle this. Should he shrink benefit levels, increase deductibles, ask for employee contribution? Right now he is waiting for my recommendation.

Mr. Chairman, what do I tell my clients, that Congress wants to provide the deduction? I am afraid that won't be good enough when it comes time to make the decisions that will be followed by writing a check.

I hope, Mr. Chairman, that you will at least extend section 162(l) before April 15. Save us the extra cost of having to file amended returns if in fact the deduction is extended. I understand that over 60 Senators have signed a letter pledging not to amend a one-issue bill that would extend section 162(l). This would solve our 1994 problem and give us more time to work out a way to extend the deduction.

I thank you very much. My association, my clients, and I offer whatever help you need and I would be happy to answer any questions you have.

[The prepared statement follows:]

STATEMENT OF SALLY I. NELSON, PRESIDENT, THE LONGVIEW GROUP, AND PRESIDENT, THE ASSOCIATION OF HEALTH INSURANCE AGENTS, A CONFERENCE OF THE NATIONAL ASSOCIATION OF LIFE UNDERWRITERS

Good afternoon, Mr. Chairman and Members of the Subcommittee. My name is Sally Nelson. I am here today as a self-employed small business owner, and as a professional insurance agent whose client base consists primarily of self-employed small business owners. I am a member of the National Association of Life Underwriters–NALU, a trade association of over 135,000 professional life and health insurance agents whose businesses are much like mine. I am also President of the Association of Health Insurance Agents (AHIA), a conference of NALU, which represents more than 10,000 insurance agents who specialize in health insurance matters. On behalf of myself, my clients, AHIA and NALU, I thank you for this opportunity to present our views on this important issue.

When I was called earlier this week and asked if I could fly down here today to testify on the value of the deduction for the cost of health insurance for self-employed people, I was struck by just how appropriate the request was. I am one of the people most affected by this issue. I am a full-time, self-employed health insurance agent in Portland, Maine. My business, the Longview Group, employs 3 full-time people. I not only sell individual and group health insurance to self-employed people with small firms of their own, but also I am a self employed person with my own small business. I buy what I sell. My employees and I myself are every bit as personally affected by the outcome of the effort to extend the deduction for health insurance for the self-employed as are my clients. I hope you'll agree that this means that my perspective on the value of a deduction for the cost of health insurance for self-employed people is uniquely personal, and hopefully uniquely valuable.

First and foremost, I must comment on the fairness issue. To condition the availability of a deduction for the cost of health insurance on a person's form of business organization is blatantly unfair. My self-employed clients and I need affordable health insurance for ourselves, our families and our employees just as much as the owners and employees of firms that have incorporated. There is no policy justification for differentiating between incorporation, SubChapter S, sole proprietorship, partnership or any other form of business organization in determining whether or not to provide a tax incentive for the purchase of health insurance. Equally, there is no policy justification for providing a 100% deduction for owners of incorporated businesses, but only a 25% deduction for the self-employed business owner. However, we do understand that there is a compelling issue with respect to the availability of Federal funds with which to pay for an expansion of the 25% deduction. Therefore, while we support without qualification the need to enact a permanent, equalized deduction of 100% for the cost of health insurance premiums for all forms of employers, we acknowledge that fiscal reality may make this difficult to do. We would be most pleased to work with you and your staff, however, in trying to find a way to maximize the health insurance deduction for unincorporated businesses.

While ultimately we support a permanent, 100% deduction for all forms of businesses for the cost of health insurance, that is not the issue in question here today. Today we are here to discuss the ability of the Congress to, at a minimum, extend the now-expired provision of the tax code–Section 162(l)–that allows self-employed people to deduct up to 25% of the cost of their health insurance. That provision expired on December 31, 1993. So, currently, no amount of health insurance premium is deductible by people who are self-employed. This of course makes an already unfair distinction between incorporated and unincorporated businesses even more egregious.

As you well know from years of dealing with this issue, one major factor in an employer's decision to purchase health insurance is its cost. Particularly for small businesses–and almost all self-employed people operate small businesses–affordability is a key issue. Of course, the price of a small group health insurance policy is not a function of whether or not the premium is deductible. But the deductibility of the premium has a direct effect on the scope of the insurance purchased. Where an employer has determined that a certain amount of money can be spent on providing health insurance, then decisions regarding how to get the most value for the money must be made.

For example, in my own firm the premium for health insurance for me and my employees costs $5,900 a year. That insurance provides for a $500 deductible and an 80% copay up to a maximum of $1,000. I pay 100% of the cost of coverage for myself and my employees. To that $5,900 a year I must now add the value of the lost 25% deduction for my portion of the premium. The loss of the tax deduction effectively raises my cost by that amount. I can reduce my contribution to the cost of coverage for my employees. Or, I can shop for

alternative insurance that is less expensive–probably because of fewer benefits, higher copays or bigger deductibles. So, the loss of the deduction affects the quality of coverage I can provide, along with its price.

There is another, complicating factor that makes this issue even more frustrating and expensive both for small self-employed business people themselves and for those of us who earn our living by serving these people. And that's unpredictability. It takes time and it costs money to locate and analyze the coverage available to small businesses. The frustration of having to spend that time and to incur that expense as a result of needing to make adjustments to existing coverage caused by the expiration of a tax deduction is compounded by not knowing whether the deduction is lost for good, for a year, or not at all. Not only that, both I and my clients are right now in the process of preparing and filing our 1994 tax returns. If there is too much delay in resolving this issue, we face the possibility of additional expense in order to pay for the filing of amended returns.

As you know, Section 162(l) has always contained a provision dictating that the deduction would expire at a specified point in time. That "sunset provision" has been extended time and time again over the past decade, once retroactively. We are here now talking about extending retroactively a deduction that expired December 31, 1993. That means we are talking about whether the cost of insurance coverage for 1994–last year–a cost already incurred–may change by a significant amount.

Some of my clients, basing their decision on historical Congressional action and public, bipartisan Congressional statements, kept existing levels of coverage in place. We believed that it was almost certain that Congress would again extend the deduction's availability even if Congress turned out to be unable to expand it and/or make it permanent. (Of course, as you'll recall, the focus of last year's debate on this issue was on finding a way to make it a permanent, 100% deduction. The need to extend the deduction at a 25% level was minimalized because of the effort to expand it.) We are now faced with the possibility of having to absorb a higher health insurance cost because we guessed wrong. And at the same time we are facing the need to guess again about how to handle our health insurance purchasing decisions for 1995 and 1996.

Mr. Chairman and Members of the Subcommittee, it is wrong to impose on America's small businesses a requirement that they have to guess at whether a tax rule will operate in a way that can cause one of their major costs to fluctuate so widely. The lack of certainty or even predictability over whether this basic, important, widely-supported deduction will continue can cause real damage.

For me and most of my clients, the cost of 1994 health insurance will be, unless you act, substantially higher than any of us had budgeted for. We will lose extra dollars that we already spent on enhanced coverage. We will have to decide for both ourselves and our employees whether next year we'll provide an insurance plan that costs less. We'll have to cope with determining how to absorb the higher-than-anticipated cost of 1994's coverage. We'll be forced to choose between fewer benefits, higher copays, bigger deductibles, less of an employer contribution or some combination of these painful alternatives. And those choices may be even rougher because similar quality coverage may not be available at the lesser amount of premium dollars we'll have to spend. And as I make my own personal decision on these issues, I'll also have to decide how to advise my clients who are in exactly the same position.

The bottom line is that Congress' inability to stabilize the existence of the deduction for self-employed health insurance, or to establish with some certainty the size of it, could cause America's self employed small business people to choose health insurance coverage that is considerably less valuable than they would otherwise purchase. This adds to the costs of the employees of these businesses. It could ultimately add to the cost of the government's share of the total health care bill as well. There will be those instances where businesses choose to forego providing insurance due to the higher cost; there will be other instances where employees will skip insurance for themselves or for their families where employer shares of the premium shrink; and there will be instances where coverage levels fall short in meeting people's health care needs and government will have to step in and help out.

I would like to share with you two examples of the affect of this deduction on my clients, in addition to the information I've already given you about the affect of the deduction on my own business. Two of my small business clients, firms that are not incorporated, have authorized me to tell you their particulars.

First, let me tell you about Corson Auto Supply Company, an auto parts company in Rockland, Maine. In 1993 the cost of Corson's health insurance was $6,500 a year. Last year, it was $8,650 a year. Thus, Corson's health insurance cost went up $2,150 in 1994 over 1993, and that doesn't include the lost deduction of 25% of the value of the portion of the premium that the business owner, Mr. Corson, paid for his own insurance. I am just now reviewing his coverage as it's up for 1995 renewal. He's probably looking at a 7-12% increase in premium for the same level of coverage. He just told me that if in fact he loses the tax deduction, he will be forced to either increase his deductible or decrease the benefits he provides.

Another of my clients is Whitten Architects of Portland, Maine. Whitten employs three people. Their 1993 health insurance premium was $6,700. In 1994, the premium was $8,500. In 1993, Mr. Whitten, the self-employed owner of the firm, paid $3,688 for his own and his family's coverage under the group plan. In 1994, his family coverage share of the total premium rose to $4,384. With the 25% deduction, his 1993 out-of-pocket premium cost was $2,766 rather than $3,688. Without the deduction for his 1994 $4,384 premium, his yearly increase in cost was 58%! Mr. Whitten is seriously considering whether he can afford to insure his employees when his own costs are subject to such an astronomical annual increase. The availability of the tax deduction is key to his decision, and he is waiting for my recommendation about what he should do in 1995.

What am I to tell my clients? That Congress wants to allow a deduction? Unfortunately, wanting to allow the deduction is simply not a good basis on which to make a business decision about what kind of health insurance to purchase.

Mr. Chairman and members of the Subcommittee, we are of course very much aware of the ambitious and important Contract with America agenda items facing your committee. We know that this deduction is not among the issues to be addressed as part of the Contract with America. However, we also know that a retroactive extension of the deduction for 1994 health insurance purchases really must be done by the time tax returns are due on April 15, 1995. We also know that enactment of a single issue tax bill such as this is usually difficult to accomplish, especially on short notice. This is particularly true, we know, because of the risk of amendment under the very different rules in the Senate. However, we believe that the commitment of well over half of all U.S. Senators to oppose any amendments to a clean, single issue bill that would simply extend Section 162(l) so that it covers 1994 could resolve that worry. That commitment is in writing, in a bipartisan letter signed as of January 25 by 58 Senators. I sincerely hope you will be able to at least extend Section 162(l) prior to April 15 even if it takes somewhat longer to accomplish the larger goal of expanding the deduction.

In summary, Mr. Chairman and Subcommittee Members, thank you again for this opportunity to provide input. And thank you for your effort to extend the deduction quickly, and to expand it ultimately. May I repeat that we are sensitive to the tension between a conviction that a permanent, 100% deduction available to all businesses is the right policy coming in the context of very scarce Federal dollars. We do understand that enacting the right policy must be conditioned on finding sufficient revenue from an acceptable source. Again, we would be very pleased to work with you and your staff as we strive together to resolve this very important issue.

Thank you. I'd be glad to answer any questions you might have.

Chairman THOMAS. Thank you very much.

Mr. Christensen.

Mr. CHRISTENSEN. Thank you, Mr. Chairman. I would just make a brief statement.

Mr. Vice, I am a member of the Farm Bureau. Mr. Risalvato, I am a member of the NFIB. Ms. Nelson, I am a member of National Life Underwriters as well as the Association of Health Underwriters. It is hard to present any question on which I disagree with you.

The one matter I want you to know that we are working on is to make sure that we are able to pay for everything, and we want to make sure that the deduction is reinstituted as soon as possible.

I know that, Mr. Vice, it would mean a great deal to your association and the number of small businessowners out there to get this done by March 1, and I know we are going to try everything we can to make sure that that would happen. But, as you know, it takes time.

I appreciate that the chairman has pushed this issue to the forefront and he has done a great job, and I really don't have any questions for you. You have done a wonderful job. I want to thank you for your time.

Ms. NELSON. Thank you.

Chairman THOMAS. Thank you very much. I do have a question. Mr. Vice, probably given the number of people that you talk to in your position, to what extent do you have any information to corroborate what Mrs. Nelson is saying? Obviously, on this on-again/off-again, I am most interested in not so much the level of frustration Mr. Risalvato clearly indicates would be present when it is on-again/off-again, but full change of insurance coverage or plan being offered because of, although it is certainly not adequate, the 25-percent difference.

Do you know of any situations of people who are talking about the fact that, given the margins they are dealing with, if they don't get the 25-percent deduction, they are simply going to not offer or change substantially the insurance?

Mr. VICE. I think probably agriculture among small businesses is unique in one aspect and that is with the market in agriculture, and we are going through the floods right now. There will be many farming operations that won't even exist in terms of gross income much less any net income this year. You always have that spike and it is a year-to-year proposition.

I think most of us who like to provide health insurance for our employees believe that that deduction helps at least level that part of it out. The frustration level is not only in terms of this just being a year-to-year proposition and never knowing when it is going to be there. That is bad enough. But then to have the 25 percent versus what they really believe should be treatment like everyone else at 100 percent, it really raises a two-step frustration level with our members.

We constantly hear about it. One of the things that is very high on our agenda is to have this reinstituted for 1994 policy.

Your comments, Congressman Christensen, about March 1, reminds me that a lot of people in agriculture file at that time, file their estimates, so it is not April 15, it is March 1 for a lot of our

members, so it is immediate. The frustration level is high and we hope that you can find a mechanism for getting it addressed by then.

Chairman THOMAS. For the record, and what I hear when I try to discuss it with people who aren't as familiar with the choices that would be available, the immediate response is, "Why don't you just go ahead and incorporate?" If you see this disadvantage between a particular structure versus a C Corporation, why don't you just go ahead and change your structure?

Mr. RISALVATO. If you change your structure, then you are going to actually be paying a double tax on all of the income of the corporation because right now as an S Corporation, we are paying tax. It gets passed through as personal income which you look at. It makes it even more unfair because the income that is being added to our W–2 is not cash. It is already spent and we are being charged for income being taxed on income that we haven't received. So it makes it that much more difficult.

If we change to a C Corporation, then the corporation pays taxes, what is left over gets distributed to us as stockholders, so we would lose either way.

Mr. VICE. The reality is there are other differences between sole proprietorships and corporations; some are positive, some are negative. The filing date alone in agriculture, you file March 1 and you don't have to file the estimated return. That can't be done if you incorporate. There are more tradeoffs between the two than just this issue.

Chairman THOMAS. The real answer, if you are provided a choice in the Code, should not be determined in terms of something that we are trying to have people have a real incentive going for. I just wanted to get that on the record.

Mr. RISALVATO. Mr. Chairman, it really is just very, very impelling. This is an issue that should have been done a long time ago and I can tell you, both for myself and for the small businessowners, we need this to be passed. We need it to be retroactive to 1994 and we really need to start phasing in the one—up to 100 percent deductibility.

Chairman THOMAS. Obviously, you know that I am committed in dealing with the retroactivity. I wonder if you will allow us some leeway on a prospective. Maybe you have heard the earlier discussion whereon the 100 percent theoretically versus what is actually being offered versus an upper limit which might be a fixed dollar amount, or even the potential for a cap so that we can deal with costs versus providing the option to you, and that, quite frankly, we might be able to lead changes in the corporate areas as well as in terms of fringe benefits.

So I am looking for just a little bit of leeway there. But clearly from the bottom end up, it is a question of equity, and we will do everything we can to make sure that you get that 25 percent for 1994 and you get it in time not only for the April 15 date, but at a time when you can actually use it before you have to file an amended return.

Mr. RISALVATO. I just wanted to let you know there are a lot of small businessowners that, when I have told them that their 25

percent deductibility is not going to happen for 1994, that it is expired, they don't even believe me.

Chairman THOMAS. On that point, from an earlier panel, the awareness question. Do you find that even with the possibility of the 25 percent, people aren't aware of it, but of course they haven't followed the fact if they knew they had it, they didn't get it?

I am concerned about the fact that even if it is only 25 percent, there are people who are not aware of it which of course might mean that they may not be offering some form of insurance that they would otherwise offer.

Ms. Nelson.

Ms. NELSON. I think my comment to that would be, if in fact we have someone doing our taxes for us, we are going to know because that adviser is going to tell us. I think what is happening, you have got some of these self-employed people who can do their taxes themselves, they think, and they miss that and they don't know that it is there. Unless they belong to an association, talking to someone else you find out or their agent, hopefully, tells them, they don't know.

Chairman THOMAS. We have 7 minutes.

Of course the problem is compounded by the on-again/off-again. If you were able to get some certainty to it over the years, people would go into it with that knowledge, and it would become an automatic part of the decisionmaking process. That is obviously our goal.

I want to thank this panel very much. We are going to run over and vote and be right back for the third panel.

Thank you.

[Recess.]

Chairman THOMAS. If we could start the third panel, I would appreciate it. I would ask Jack Faris, Don Dressler, Lisa Sprague, and I believe Julia Whitt is going to be with us instead of Bennie Thayer.

All of your written testimony will be made a part of the record without objection. You will have 5 minutes to proceed as you see fit in the timeframe.

I guess, Jack, we will start with you.

STATEMENT OF JACK FARIS, PRESIDENT AND CHIEF EXECUTIVE OFFICER, NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Mr. FARIS. Mr. Chairman, thank you, first of all, for inviting us to be here today on a subject that is close to the heart and pocketbook of everyone on Main Street, everyone on a farm, and everyone that is gainfully employed trying to be a successful entrepreneur. We do want to applaud you for the bill you have introduced to get the 25 percent as a matter of the retroactivity, to be assured when small businessowners are filing their taxes they will know that they can still have 25 percent for last year.

I am representing the National Federation of Independent Business. We are the Nation's largest and oldest organization of our type representing over 600,000 small businessowners from all 50 States. Our typical member has five employees, $250,000 a year in gross annual sales, and we set our policy based on the regular poll-

ing of our membership. They have spoken loudly and clearly for years about this particular issue.

My compadres at the table today will get into more of the detail, I am sure, as it relates to the self-employed. What I would like to focus on, and just for few minutes, is the word fairness because that is in reality what this is all about.

In Nashville, Tenn., and maybe it is true in California, but we would call this a no-brainer. Just to think about the fact that General Motors is able to have 100 percent deductibility for purchasing insurance and the person who is buying the Chevy pickup on Main Street who is self-employed does not get the 100 percent but only gets 25 percent. But yet we are a nation of entrepreneurs and we say it is the backbone of our economy and we say that is what is really important about America. Small businessowners are ready to say, "Let's put some walk in our talk." We talk good entrepreneurship. Now let's let the votes show it.

What we do not understand is why it is not 100 percent. You say, well, it is an economic situation. If it is an economic situation, then if we take the 45 point—right at $45.6 billion that are now being deducted by all of those covered under deductibility and we add approximately $2 billion, it would cause the entrepreneurs to be the 100-percent deductibility. We just average that out and say, let's all be fair and pay the same. It would be until 95.2 percent.

We are ready to play by the games General Motors plays, but we do not think we should finish the road of inequity and unfairness for the new job generators in America that are on every Main Street in every congressional district that were saying on November 8, and they are saying today, walk the walk.

I want to applaud this subcommittee and you, Mr. Chairman, for having these hearings, putting forth this legislation. It is time to get on with the program for the entrepreneurs so we can continue to keep that American dream alive of entrepreneurship.

Thanks again for allowing me to come and speak today.

[The prepared statement follows:]

TESTIMONY OF
JACK FARIS
PRESIDENT AND CEO
NATIONAL FEDERATION OF INDEPENDENT BUSINESS (NFIB)

Before: Subcommittee on Health
Committee on Ways and Means
U.S. House of Representatives

Date: January 27, 1995

Subject: Self-Employed Health Insurance Deductibility

Thank you, Mr.Chairman. My name is Jack Faris, and I am President and CEO of the National Federation of Independent Business (NFIB). NFIB is the nation's largest small business advocacy organization, representing over 600,000 small business owners from all fifty states. The typical NFIB member has five employees and has $250,000 a year in gross annual sales. NFIB sets its public policy positions through regular polling of the membership.

I want to take this opportunity to thank you for inviting NFIB to participate in this hearing today, and also to commend you for bringing attention and urgency to the issue of health insurance deductibility for self-employed Americans -- sole proprietorships, partnerships, and subchapter S corporations. I am very hopeful that this hearing will begin a process by which a major unfairness in our tax code will be eliminated.

Attaining full tax deductibility for the self-employed has been a top priority for NFIB for many years. Eighty-two percent of NFIB members support full deductibility of health insurance premiums, according to a 1993 survey. Health insurance deductibility has also been designated a top priority in several state conferences leading up to the 1995 White House Conference on Small Business.

Approximately half of our more than 600,000 members own unincorporated businesses. In fact, a majority of all businesses in this country are self-employed. Self-employed businesses are the cradle of job creation and the American dream: the newer and smaller the business, the more likely it is to be unincorporated. These self-employed business owners are the very people whose firms need to start, survive, and grow in order to create the jobs of the future. These are often people with very little cash, a good idea and talent -- struggling to make it work. And once they do make it work, they are a major part of the group that creates nearly all new jobs in our economy. Government data shows that small business has created two of every three net new jobs since the 1970s, and a substantial majority of those jobs were created in the smallest firms -- those with fewer than five employees. Firms of this size, which constitute 60 percent of all employers in this country, tend to be unincorporated.

These unincorporated business owners -- some with employees, some working on their own -- experience the worst of all possible worlds in the health insurance marketplace: an insufficient product for a high price and denial of the same incentives and tax treatment enjoyed by big business.

The High Cost of Health Insurance

Self-employed business owners often pay approximately 30 percent more than larger companies for similar benefits because of higher administrative costs. In addition, they often pay another 30 percent in premiums because of costly state mandates for specific types of insurance coverage, which prevent self-employed business owners from shopping for only the basic care that they and their employees might need. Larger firms that self insure, by contrast, are not subject to these costly mandates. The self-employed usually lack access to cost-saving managed care arrangements because of a reluctance by insurers to create and market them in small towns and rural areas. Additionally, a small, unincorporated firm is far more likely than others to feel the painful brunt - both economic and emotional - of the pre-existing condition exclusion or, when an employee gets sick, the 20 percent to 300 percent premium hike or sudden cancellation of insurance. Insurance companies are much more likely to require exclusions, raise premiums or cancel policies to shield themselves from risk when insuring a small firm or a one person firm rather than a large business.

All of this accounts for a trend found in NFIB Education Foundation studies that began in 1986. In that year, small business owners -- both self-employed and incorporated -- for the first time identified the cost of health insurance as their number one problem in a study entitled Small Business *Problems and Priorities*. That trend has continued ever since, with the cost of health insurance proving to be twice as critical a problem as the number two problem (federal taxes on business income) in a follow up study published in 1992. With health insurance premiums still growing faster than the rate of inflation today, this problem has not abated.

No Deductibility

On top of all this, self-employed Americans cannot deduct any of their health insurance premiums. C corporations have a permanent, 100 percent deduction; self-employed business owners have none. The self-employed had a 25 percent deduction until December 31, 1993, when it expired. The 103rd Congress adjourned without renewing the deduction for 1994, (despite your great efforts and those of your bipartisan cosponsors). This means that self-employed business owners will experience a tax increase on their 1994 returns -- unless Congress acts before April 15.

Using Joint Tax Committee cost estimates and Foster-Higgins survey data on premiums, NFIB estimates that approximately 1.4 million self-employed business owners will have their taxes go up if the 25 percent deduction is not retroactively renewed for 1994. Mr. Chairman, we are encouraged by your commitment to prevent this tax increase.

Even before the 25 percent deduction expired, self-employed business owners were buying health insurance on a tax policy playing field that was vastly uneven. The difference between a 25 percent deduction for the self-employed and a 100 percent deduction for C corporations is terribly unfair and arbitrary. But it is not only a philosophical matter of fairness; it is a matter of dollars and cents. Under current law, it would cost a sole proprietor buying the exact same health insurance policy from the exact same insurance company as the owner of a C corporation substantially more in after tax dollars because of the deductibility gap.

Recommendation

NFIB strongly urges this subcommittee to end the health insurance tax deductibility status quo and address the tax fairness issue head on. Specifically, NFIB urges you to retroactively restore the 25 percent deduction to the self-employed and to send a clear signal that business as usual is a thing of the past by increasing the deduction to at least 50 percent and making a commitment to reaching parity as soon as fiscally possible.

Ending the status quo -- setting a course toward 100 percent deductibility -- accomplishes the following:

(1) **Parity.** Full deductibility for the self-employed would end the idea that an executive for a Fortune 500 company can get a full deduction for a gold plated health insurance policy but a self-employed business owner receives no deduction at all -- solely because of the way the business is legally organized.

Some may argue that limited deductibility for the self-employed should be preserved at some level in an effort to make Americans more sensitive to the actual cost of their health care, thereby making the market place more competitive. NFIB believes that concerns about the impact of the tax code on health care cost sensitivity are legitimate. However, any approach to this issue which says that limited deductibility is good policy for the self-employed but not simultaneously for C corporations is unfair and unacceptable.

(2) **Incentive for the self-employed to purchase health insurance for themselves and their families.** Self-employed Americans are one of the largest groups of uninsured citizens. There are nearly three million self-employed Americans without health insurance. The 25 percent deduction is a small but meaningful incentive for unincorporated business owners to purchase health insurance for themselves and their families. If this group of business owners were given the 100 percent deduction, many more would purchase insurance, substantially reducing the number of uninsured Americans in this country. Consider the following example:

A self-employed caterer purchases a health insurance plan for $3,781 per year. [The actual amount would actually be less or more depending on whether the caterer was purchasing an individual or a family policy; $3,781 was the average per person premium in a Foster-Higgins survey of 1993 premiums. A self-employed person would usually pay more than this average because of many of the disadvantages of buying health insurance individually.] The caterer is in the 28 percent tax bracket.

After-tax savings from a 25 percent deduction: $264.67
After-tax savings from a 100 percent deduction: $1058.68

Most self-employed business owners survive on tight margins -- they keep the business afloat on cash flow, not profit. The typical NFIB member makes less than $40,000 a year. Affordability is the most important factor to small business owners when deciding whether to buy health insurance. To people in this position, the savings shown in the example above can make a real difference when making a decision on whether to buy an important, but very expensive product.

(3) ***Incentive for the self-employed to purchase health insurance for their employees.*** NFIB strongly believes that full deductibility for the self-employed would also reduce the number of uninsured among the employees of the self-employed. Under current law, a self-employed business owners find themselves in the peculiar position of being permitted to deduct the health insurance costs of their employees, but not their own premiums. If they have no incentive to purchase health insurance for themselves, they are far less likely to consider buying it for their employees. Full deductibility would change that.

(4) **Tax Fairness: Ending politics as usual.** The 25 percent deduction has been temporarily extended from year to year since it was first enacted in 1986. Because of its substantial bipartisan popularity, it has repeatedly been held hostage in previous Congresses to other, typically very unpopular causes like the tax increases in 1990 and 1993, as well as the Clinton health care plan last year. Again, restoring the 25 percent deduction and moving toward 100 percent would shatter a status quo in which the self-employed are used as a political football.

Self-Employed Health Insurance Deduction: A History

1986-1989:	The self-employed were first given 25 percent deductibility as part of the Tax Reform Act of 1986.
1989:	The Omnibus Budget Reconciliation Act of 1989 extended the deduction for nine months (for taxable years beginning before October 1, 1990.)
1990:	25 percent deductibility was extended through 1991.
1991:	25 percent deductibility was extended through June 30, 1992.
1992:	On June 30, 1992, 25 percent deductibility expired.
1993:	25 percent deductibility was included in Omnibus Budget Reconciliation Act of 1993 and applied retroactively from July 1, 1992, to December 31, 1993. (The deduction was limited if the individual or his or her spouse was eligible to participate in an employer-paid health plan.)
1994:	Self-employed deductibility no longer exists.

(5) **Health care reform: The first step.** The health care debate of the 103rd Congress ended in acrimony and gridlock. The deductibility issue gives the new Congress an opportunity to swiftly set a new tone for the health care debate: taking incremental steps on which most people agree to improve the system. The deduction for the self-employed is a great place to start: a reform with wide bipartisan support that would reduce the number of uninsured and deliver some much needed relief and fairness to others struggling to stay insured.

Conclusion

Again, NFIB urges you to do the following:

(1) Restore the 25 percent deduction retroactively for 1994 and increase it to 50 percent as a signal to every self-employed business owner that the status quo on this issue will no longer be tolerated.

(2) Move toward a permanent 100 percent deduction for the self-employed as soon as fiscally possible.

NFIB hopes that the Subcommittee on Health will take these steps on behalf of the self-employed. Mr. Chairman, we would like to express our appreciation for your leadership on this important issue. Self-employed business owners are calling out for fairness and stand ready to help you and your colleagues achieve it in 1995.

Thank you.

Chairman THOMAS. Thank you very much, Mr. Faris.
Mr. Dressler.

STATEMENT OF DON DRESSLER, PRESIDENT, INSURANCE SERVICES, WESTERN GROWERS ASSOCIATION, NEWPORT, CALIF.

Mr. DRESSLER. I am Don Dressler with the Western Growers Association. We are an association of fruit and vegetable growers based in California and Arizona.

Our members collectively produce half of the fruits and vegetables produced in the United States. A number of our members are self-employed individual farmers, many of which do their work themselves or have a few employees and especially new businesses and new farming operations started on a self-employed basis.

In addition to the equity argument, we think there are several other things that also should be considered when you look at this deductibility issue.

It was interesting in a recent report I saw just preparing for this trip, in the Health Affairs Journal there was a study that was done by a number of different people, including the University of Alabama, indicating among small employers, the prevalence of health insurance is twice as high in corporations as those who are unincorporated. That seems to me to be a pretty significant indicator of the power of the deductibility item because, if you are talking about similar sized businesses and some are incorporated and others aren't, then this has to be a critical factor.

We all know that probably the most important factor in decisions on purchasing health insurance is price. Another interesting thing I thought the study indicated is that price of health insurance is fairly elastic, meaning a small impact can be magnified and have a dramatic effect on purchasing decisions.

Well, first of all, we agree, it should be equal for everyone. But clearly the more deductibility, the more impact it has on encouraging health care. You are reversing it in a sense. In fact, there are some indications a reduction in price by 5 percent would increase purchases by 15 percent. So if you can get that kind of leverage, clearly the more that you can invest in the process, the more important it will be.

I would say secondary to price is the issue of reliability. One of the most important reasons why many people have not purchased health insurance is they are not sure that it is not going to be there and they are not sure they can count on it. Part of that, of course, has to do with if you are an employer with a employee, you don't want to purchase benefits for an employee if you don't have them for yourself.

The second thing is, you don't want to purchase them for your employee and have to take them away because then you have a really unhappy, demotivated employee.

Make this decision once and for all and be fixed and permanent. That will also help us with the knowledge and awareness of the issue because, once it is there and established, it is much easier to start educating people about it and they can make business decisions based upon it.

So kind of in sum, this is a really critical issue. It is very important to us in agriculture. I think it is important to all the business community. You can make a major difference in the affordability of health care by this decision. We would hope that you do it on a permanent basis so we can rely upon it in the future.

I want to thank you very much for your interest in this subject. I want to thank you for your support of our industry, and we very much appreciate the chance to be here.

[The prepared statement follows:]

STATEMENT OF DON DRESSLER

PRESIDENT - INSURANCE SERVICES

WESTERN GROWERS ASSOCIATION

HOUSE COMMITTEE ON WAYS & MEANS

SUBCOMMITTEE ON HEALTH

JANUARY 27, 1995

Mr. Chairman and distinguished members of the Committee, I greatly appreciate this opportunity to present the views of the Western Growers Association concerning the tax-deductibility of health insurance for self-employed individuals. Western Growers Association represents 2,400 members who grow, pack, and ship fresh fruits, vegetables, and nuts in Arizona and California. Our members ship approximately half of America's supply of fresh fruits and vegetables.

Western Growers Association has been providing health insurance to its members and their employees, including seasonal agricultural workers, for over 50 years. WGA currently provides affordable health benefits to over 50,000 individuals in California and Arizona, including members of Western Growers Association and their employees and dependents.

On December 31, 1993, the 25 percent tax deduction for health insurance premiums for self-employed individuals expired. Western Growers cannot overemphasize the importance of restoring this tax deduction. Furthermore, we urge that the deduction for self-employed individuals be gradually increased to 100 percent of health insurance costs and made permanent. Full deductibility of medical coverage costs is the amount corporations are allowed to deduct for the cost of providing medical coverage for their employees. It is simply unjust to expect independent farmers and producers to shoulder the enormous burden of health insurance costs, while corporations can deduct the entire amount of their health insurance costs, and also while individuals who work for corporations receive their medical coverage tax-free.

With much of last year's Congressional debate focused on health care costs and the importance of making health insurance as affordable as possible, we cannot understand why anyone would choose to deter independent farmers from obtaining adequate health coverage. Essentially, this is what will happen if the 25 percent tax deduction is not reinstated and augmented to 100 percent.

It is important to note that farmers work in what insurance companies consider to be a "high risk" or "hazardous" occupation. In addition, as self-employed individuals, they are generally not covered by workers' compensation. Both of these factors result in insurance companies charging farmers higher than average premiums: too high for most farmers to afford, even if they are allowed a tax deduction of 25 percent. In fact, health coverage is only affordable for many of our members and their employees because we have been able to bring down costs through the use of self-insurance.

Even with the lower rates obtained through the use of self-insurance, many farmers will have great difficulty in affording coverage unless they are able to deduct the full cost of health insurance. Thus, the number of the nation's uninsured individuals will increase even further.

Western Growers is disturbed that the issue of health insurance deductibility was allowed to go unresolved during the recent health care debate. Moreover, we are astonished that the 25 percent deductibility for self-insured individuals' health care costs--an amount which was enacted in 1986 and has been extended or reinstated retroactively ever since--was not continued. Independent farmers and producers do not have the luxury of waiting out the political storms in Washington, D.C. They must soon fill out their tax returns for 1994, and if the 25 percent deductibility is not restored before their returns are due, many farmers may be forced to discontinue the insurance policies that they are already hard pressed to afford.

It should be remembered that if sole proprietors and partnerships were able to fully deduct the cost of health insurance they buy for themselves and their families, more of them would be able to afford to offer insurance to their employees. A study performed recently by the Center for Health Policy at the University of Alabama found that 90% of small businesses listed premium cost as the major factor preventing them from providing insurance to their employees. Moreover, this study found that the health insurance purchase decisions among small employers were very elastic, which means any reduction in the cost would greatly increase the likelihood that the employer would provide insurance to the employee. In quantifiable terms, the study found that a 5% decrease in the cost of insurance increased the utility of the insurance by 15%.

Given this situation, by allowing a tax deduction for health premiums for self-employed individuals, you are attacking the primary reason for why people are uninsured today - that reason is high cost. Another statistic which illustrates the disparity between corporations and non-incorporated businesses is that, while 62% of small firms (50 employees or less) which were incorporated provide health insurance for their employees, only 33% of those which were not incorporated did so.

Clearly, other steps are necessary, beyond extending tax deductibility, in order to expand the availability of affordable health care. We have seen in California that basic insurance reforms for small business group insurance can contribute significantly towards this goal. Currently, only 17% of small employers get their health coverage through group plans. Insurance reform such as that enacted recently in California would certainly increase this number, thus increasing the availability of affordable insurance. Given this experience, Western Growers Association supports reforms such as guaranteed renewability, limitations on experience rating, and limitations on pre-existing conditions, and we encourage Congress to take action in this regard.

Thus, tax deductibility of health insurance costs benefits more than just self-employed individuals. It is one step that Congress can take right now towards increasing the number of Americans with health insurance without enacting problematic, full-fledged reform of the nation's health care system. We urge Congress to reinstate the 25 percent tax deduction for self-employed individuals and highly recommend that the deduction be increased to 100 percent and made permanent.

Chairman THOMAS. Thank you very much.

During the question period, given the type of people you represent, I would like to pursue some of the questions that we had asked earlier. But first let's hear from Ms. Sprague.

STATEMENT OF LISA M. SPRAGUE, MANAGER, EMPLOYEE BENEFITS POLICY, U.S. CHAMBER OF COMMERCE

Ms. SPRAGUE. Thank you, Mr. Chairman.

As you know, the U.S. Chamber of Commerce counts among its members 215,000 businesses, 96 percent with fewer than 100 employees, 71 percent with fewer than 10. I appreciate the opportunity to appear today to speak on behalf of all those businesses on the issue of health insurance deductibility for the self-employed.

Few issues are as clear cut and convincing. Restoration of the 25-percent deduction is a top priority for the chamber. Further, we regard full deductibility as an indispensable element of future reform efforts.

The chamber's membership is diverse, which at times can result in varying priorities within a given legislative issue, particularly one as complex as health care. But we have yet to hear from a single membership constituency, or indeed a single member, any suggestion that equity in the deductibility of health insurance should not be a top priority for the chamber as a whole.

You and others have noted that from 1986, a 25-percent deduction for self-employed persons was granted and repeatedly extended until Congress failed to renew it in 1994. Ironically, then, the one measurable result of the health care reform debate that dominated the year was that the most vulnerable of those who provide health insurance were left in worse straits than before. They do, as others have said, feel this deeply.

The chamber calls on Congress to restore the 25-percent deduction for 1994 and to act quickly enough in order that self-employed filers may reflect it in their 1994 tax filings. In this connection, we welcome and support your bill, Mr. Chairman.

To be sure restoration of the 25-percent deduction is no more than a quarter of a loaf, I join with my fellow panelists in stating that what is really needed is legislation to permit a 100-percent deduction of health insurance costs. The chamber urges this subcommittee to work to enact deductibility in 1995. Recognizing that the major obstacle to such action is its cost in tax revenues, the chamber is willing to consider a phased-in approach to get to 100 percent. But what we cannot accept is that the smallest businesses, frequently new and often struggling, should be denied a measure of security granted to larger businesses.

The chamber wants to commend the subcommittee for examining an issue that has been a thorn in the side of the Nation's smallest businesses for many years. We look forward to working with you to remove that thorn and to enroll the self-employed as full partners in our common effort to make private sector health insurance more available and more affordable.

Thank you.

[The prepared statement follows:]

STATEMENT
on
HEALTH INSURANCE DEDUCTION
before the
SUBCOMMITTEE ON HEALTH
of the
HOUSE COMMITTEE ON WAYS AND MEANS
for the
U.S. CHAMBER OF COMMERCE
by
Lisa M. Sprague
January 27, 1995

Chairman Thomas and members of the Subcommittee, I am Lisa Sprague, Manager of Employee Benefits Policy for the U.S. Chamber of Commerce. The Chamber is the world's largest business federation, representing 215,000 businesses (96 percent with fewer than 100 employees and 71 percent with fewer than ten), 3,000 state and local chambers of commerce, 1,200 trade and professional associations, and 72 American Chambers of Commerce abroad. We appreciate the opportunity to appear before this Subcommittee to comment on the issue of health insurance deductibility for the self-employed.

Few issues are as clear-cut and convincing. In fact, restoration of the 25 percent health insurance deduction is a top legislative priority for the Chamber. Further, we regard full deductibility as an indispensable element of a successful reform agenda, and one that should top the list of incremental improvements to be considered by this Subcommittee.

The business community, in its role as benefit-plan sponsor, has been the driving force in pushing reforms to our health care delivery systems and slowing the rate of increase in health care expenses. Today, we know that employers provides health insurance for the majority of those Americans who are insured. As the engine of the U.S. economy, small businesses -- including the self-employed -- have played a key role in the innovations and economies that have been realized. Yet the self-employed continue to be isolated and denied in terms of health insurance deductibility. That is why your hearing today is so important: to focus attention on and open the way to quick action in rectifying an injustice.

The Chamber's membership is greatly diverse, and at times this can result in its having to choose among varying priorities within a given legislative issue, particularly one as complex as health care. But we have yet to hear from a single membership constituency, or indeed a single member, a suggestion that equity in the deductibility of health insurance should not be a top priority for the Chamber as a whole.

Since 1986, self-employed persons have been permitted to deduct 25 percent of amounts paid for health insurance for the individual, his or her spouse, and dependents of employees. This provision was never written permanently into the tax code, but was repeatedly extended -- until December 31, 1993, when it was allowed to lapse. Congress failed to renew it in 1994. Ironically, then, the one measurable result of the health reform debate that dominated the year was that the most vulnerable of those who provide health insurance were left in worse straits than before fervent discussion of expanding coverage began. The Chamber calls on Congress to restore the 25 percent deduction for 1994, and to act quickly enough that self-employed filers may reflect it in their 1994 tax filings.

To be sure, restoration of the 25 percent deduction is no more than a quarter of a loaf. What is really needed is legislation to permit 100 percent deduction of health

insurance costs. Sound tax policy dictates full deductibility of premium or self-insurance costs as ordinary and necessary business expenses. There is no valid tax policy reason for treating the smallest businesses any differently. The Chamber urges this Subcommittee to work to enact full deductibility in 1995. Recognizing that the major obstacle to such action is its cost in tax revenues, the Chamber is willing to consider a phased-in approach to 100 percent deductibility. What the Chamber cannot accept is that the smallest businesses, frequently new and often struggling, should be denied a measure of security granted to larger businesses.

The Chamber wishes to commend you and the Subcommittee for holding a hearing on an issue that has been a thorn in the side of the nation's smallest businesses for many years: their inability to deduct the full cost of their health insurance, and the inequity inherent in being denied an advantage granted to their incorporated fellows. The Chamber looks forward to working with the Subcommittee to remove that thorn and to enroll the self-employed as full partners in our common effort to make health insurance more available and affordable in the private sector.

Chairman THOMAS. Thank you very much.
Ms. Whitt.

STATEMENT OF BENNIE L. THAYER, PRESIDENT, NATIONAL ASSOCIATION FOR THE SELF-EMPLOYED, AS PRESENTED BY JULIA WHITT, DIRECTOR, GOVERNMENT RELATIONS, NATIONAL ASSOCIATION FOR THE SELF-EMPLOYED

Ms. WHITT. Good afternoon. My name is Julia Whitt and I am the director of Government Relations for the NASE, National Association for the Self-Employed. I am pleased to have the opportunity to present our membership views on this issue in place of our president Bennie Thayer.

The NASE represents more than 320,000 small businesspersons nationwide. Over 85 percent of our members are businessowners with five or fewer employees and more than half are the smallest of small business, independent sole proprietors.

The issue of 100 percent deductibility of health insurance premiums is a paramount concern of our membership. The NASE views this hearing today as part of the Ways and Means Committee's commitment to resolve a significant problem for the small business community.

It is NASE's strong recommendation to the Ways and Means Committee and other Members of Congress to take immediate action to reinstate the 25-percent health insurance deduction for the self-employed. Reinstatement would be a positive step for several reasons.

First, early subcommittee action in 1995 will go a long way toward easing the administrative and compliance burdens for both the Internal Revenue Service and for the small businessowners in terms of processing 1994 tax returns.

Second, prompt reinstatement should help remove the pending tax increase self-employed persons will face in the absence of the deduction.

Third, quick passage of the 25-percent deduction would smooth the way for the health insurance deduction issue to be included in the Ways and Means Committee's deliberations on a tax component in the Contract With America.

Fourth, action also needs to be taken immediately to reinstate the deduction to help the self-employed maintain their current health insurance policies.

The NASE commissioned a study by Dr. Bruce Kirchoff which has been referred to earlier in testimony regarding the number of persons affected by elimination of this deduction. I would be willing to supply a copy of this study to remain part of the record. But according to that study, a total of 412,000 persons would join the ranks of the uninsured based on the loss of the deduction; 117,000 of these people would be children.

As indicated by the Employee Benefits Research Institute, in January 1994 there were already 2.8 million self-employed persons without insurance. One of the major goals of achieving meaningful, cost-effective health care reform was to reduce the number of Americans without health insurance. Obviously, loss of the deduction is health care in reverse for the self-employed.

As indicated by the NASE study, prompt reinstatement of the 25-percent deduction for the 1994 tax year will help mitigate the likelihood of a significant increase in the number of uninsured persons. We also believe that if Congress wants to increase the number of self-employed persons with health insurance, a 100-percent tax deduction is the most effective way to do this.

It wasn't until 1986 that Congress attempted to rectify to any degree the disparity in the tax treatment of health care premiums between unincorporated businesses and corporations by allowing the self-employed to deduct 25 percent of their health care costs. However, even with the 25-percent deduction, a self-employed individual incurs a higher effective cost when purchasing a health insurance policy because the self-employed must purchase their health insurance with primarily after-tax dollars while employees of large corporations have their policies paid with pretax dollars.

To purchase the same $4,000 policy, an employee of a large corporation might receive it tax free, a self-employed individual who makes $35,000 in adjusted gross income, receives a 25-percent health insurance deduction, and must earn $7,075 in pretax dollars. Now with no deduction, that same self-employed person purchasing that same policy will end up paying $8,214 in pretax dollars, a 16-percent increase.

It is obvious this is another example of a group who needs help the most gets the least. More than 12 million Americans are self-employed, and the figures that we used are the people who actually filed returns and claimed a self-employment tax deduction. Nearly 17 percent of these people earned adjusted gross incomes of less than $50,000.

Our figures show, based upon the IRS statistics, that only 22.7 percent of the self-employed actually claimed a health insurance deduction in 1992. Nearly 40 percent of those claiming the deduction had adjusted gross incomes of less than $25,000, and 67 percent had less than $50,000.

The issue of 100 percent deductibility is obviously a middle-class issue. Therefore, we urge Congress to consider it along with other initiatives focused on this needy group. Tax season is upon us and I believe that many of the self-employed are going to be surprised to find out they have no deduction for 1994. Therefore, on behalf of our more than 320,000 members, I urge the Ways and Means Committee to, No. 1, take immediate action to reinstate the deduction; and No. 2, raise the deduction level to 100 percent.

I thank you very much for allowing me to express our viewpoint and good luck.

[The prepared statement and attachment follow:]

STATEMENT OF BENNIE L. THAYER, PRESIDENT
NATIONAL ASSOCIATION FOR THE SELF-EMPLOYED

Chairman Bill Thomas, Ranking Member Pete Stark, and members of the House Ways and Means Subcommittee on Health, thank you for the opportunity to testify today. My name is Bennie L. Thayer, and I am testifying today as President of the National Association for the Self-Employed on the issue of the health insurance deduction for the self-employed.

The NASE represents over 320,000 small business persons throughout the United States. Over 85 percent of the NASE members are business owners with 5 or fewer employees. The membership is involved with a very wide range of businesses, notably in the consulting and retail fields. Our members strongly support 100-percent deductibility of health insurance premiums for the self-employed. This is an issue of paramount importance to the NASE membership. We wholeheartedly endorse Committee Chairman Bill Archer's recent call for a prompt reinstatement of the 25-percent health insurance deduction for the self-employed.

The NASE views this hearing today as part of Chairman Archer's commitment to this effort, as well as an important signal by the members of the Subcommittee on Health that they want to resolve a significant problem for the small business community.

The Need for a Quick Committee Markup

It the NASE's strong recommendation to the House Ways and Means Committee and the other members of Congress to pass a bill before February 15 to reinstate the 25-percent health insurance deduction for the self-employed -- which otherwise expired on December 31, 1993. Early committee action in 1995 will go a long way towards easing administrative and compliance burdens for the Internal Revenue Service in terms of processing 1994 tax returns. Also, prompt reinstatement of the 25-percent deduction should help remove the pending tax increase self-employed persons face in the absence of reinstatement.

Quick passage of the 25-percent deduction legislation would then smooth the way for the Ways and Means Committee's important deliberations involving the tax component of the Contract of America. As part of the committee's markup of Contract With America over the next two months, the NASE strongly urges the committee to go the next step with respect to the self-employed's health insurance deduction. We recommend that you include a provision to increase the deduction to 100 percent for 1995 and all tax years thereafter.

The Number of Self-Employed Persons Who Will Drop Insurance Coverage

Dr. Bruce Kirchhoff of the New Jersey Institute of Technology completed a study for the NASE in 1993 regarding the number of persons affected by elimination of the 25-percent health insurance deduction for the self-employed. According to this study, 295,000 self-employed persons would stop purchasing health insurance due to the loss of the deduction. Because some of these self-employed individuals have dependents, the study suggests that a total of 412,000-persons would join the ranks of the uninsured based on the loss of the deduction. As indicated by an Employee Benefits Research Institute study, there are already 2.8 million self-employed persons without insurance.

One of the major parameters of achieving meaningful, cost effective health care reform is to reduce the number of uninsured Americans. As indicated by the NASE study, prompt reinstatement of the 25-percent deduction for the 1994 tax year will help mitigate the likelihood of a significant increase in the number of uninsured persons.

Tax Equity

Current inequities in the federal tax law make it more difficult for the self-employed to be able to afford health insurance. It has been a long-standing practice under the tax law that corporations have been permitted to deduct all of the health insurance premiums paid on behalf of their employees.

However, it wasn't until 1986 that Congress attempted to rectify to any degree the disparity in the tax treatment of health care premiums between unincorporated businesses and corporations.

Beginning in 1986 and continuing through the end of 1993, self-employed persons had been permitted to deduct 25-percent of their health insurance premium costs from their taxes. However, even with the 25-percent deduction, a self-employed individual incurs a higher effective cost when purchasing a health insurance policy because he or she primarily pays for the insurance with after-tax dollars. This is in contrast to employees of large corporations who generally have their policies paid for by the company with pre-tax dollars.

As I stated previously, the health insurance deduction for the self-employed expired at the end of 1993. I am fully aware that Congress did attempt to address the issue last year within the context of health care reform.

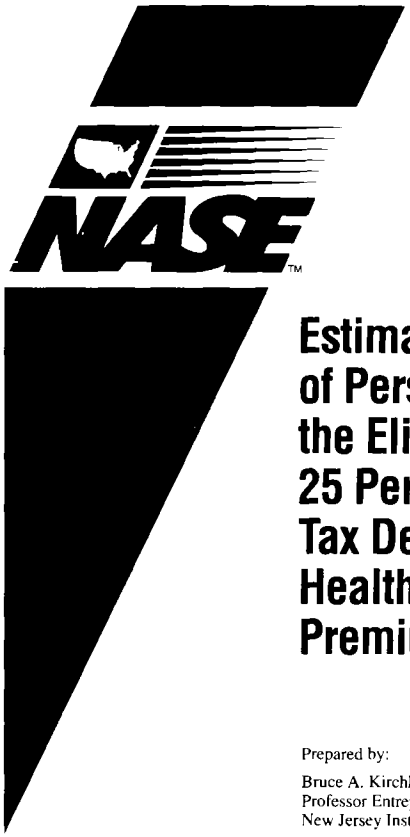
Throughout the initial discussions on reforming our health care system, the self-employed were promised that their quest for a 100-percent health insurance deduction would be answered affirmatively through the passage of final health care legislation by Congress. The NASE had every reason to believe this -- the 100-percent deduction had been a common theme in every major health care bill introduced in Congress in 1993 and 1994, including President Clinton's Health Security Act. Last year, everyone assumed that the deduction would be re-instated to at least the 25-percent level. Most of the major legislation addressed the issue retroactively and raised the deduction to 80 or 100 percent over a period of time. However, when health care reform died, so did the deduction.

Several bills have been introduced this Congress that would reinstate the 25-percent deduction for 1994 and raise it to 100 percent from 1995 on. The NASE and I support those pieces of legislation.

Unfortunately, we have found the road towards 100-percent deductibility to be one with many promises and little delivery. Even retention of a 25-percent deduction since 1986 has been fraught with much frustration. Every year the self-employed community would be promised a permanent, full deduction of their health insurance premiums, only to find themselves held hostage to federal revenue and budgetary concerns. In this way, self-employed persons have found their partial health insurance deduction subject to continual renewal on a year-to-year basis.

I urge the Ways and Means Committee to: (1) take immediate action to ensure re-enactment of the 25-percent deduction for 1994 and (2) raise the level to 100 percent for 1995 and beyond so that the self-employed can buy quality health care coverage for themselves and their families.

[Dr. Kirchoff's study was subsequently received:]



Estimating the Number of Persons Affected by the Elimination of the 25 Percent Income Tax Deduction for Health Insurance Premiums

Prepared by:

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January 27, 1993

July 13, 1993

Much has been written about the millions of Americans without health insurance, but little is noted about one of the biggest reasons: unfair federal tax policy.

Since January 1, 1993, self-employed Americans have not been able to deduct any portion of their health insurance premiums from their federal income taxes. Loss of this deduction represents a minuscule savings to the federal budget, but financially affects thousands of hard-working Americans.

That's why the National Association for the Self-Employed — representing more than 300,000 such Americans — commissioned a noted economist to determine how the loss of this deduction impacts self-employed Americans who pay for their own health insurance.

The study's conclusion: 400,000 Americans will no longer be able to afford their health insurance because federal tax policy makes it more expensive.

Thousands of Americans are suffering because Congress has failed to fulfill a promise it repeatedly made to self-employed Americans — fair and equal tax treatment.

Self-employed Americans create jobs. Many large businesses started in a garage or a basement. These same self-employed preserve jobs — laid-off workers of big companies often re-enter the work force as an entrepreneur.

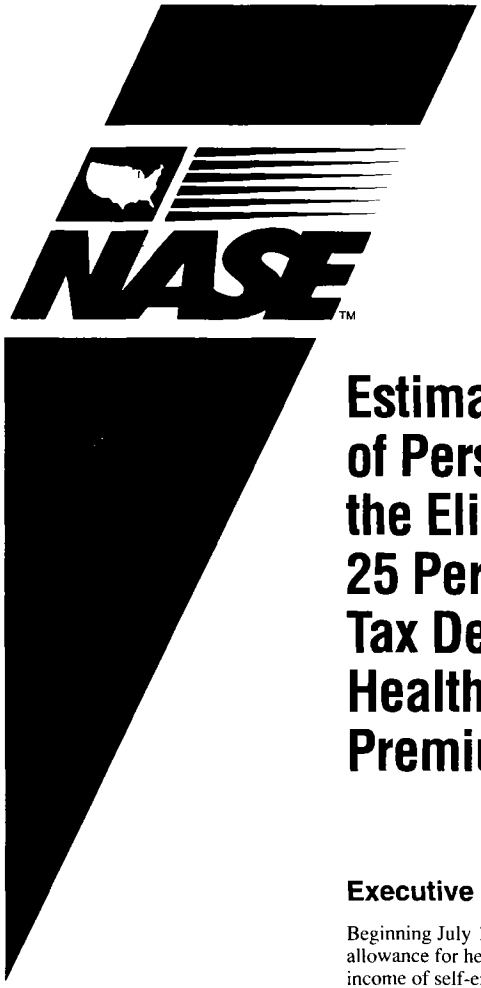
Yet, these are the very people whom our elected officials say no longer deserve a tax break when buying health insurance. While it is true that Congress and the President have indicated they plan to restore a partial deduction for the self-employed, this tax break would only be effective until December 31, 1993.

Next year, the financial pain begins anew. We challenge any group to tell us why self-employed Americans should not receive permanent, equal tax treatment when paying for health insurance premiums.

As you read this report, I'm sure you'll reach the same conclusion we did: the time to talk about tax fairness is over, the time act it is NOW.

Sincerely yours,

Bennie L. Thayer
Chairman, National Association for the Self-Employed

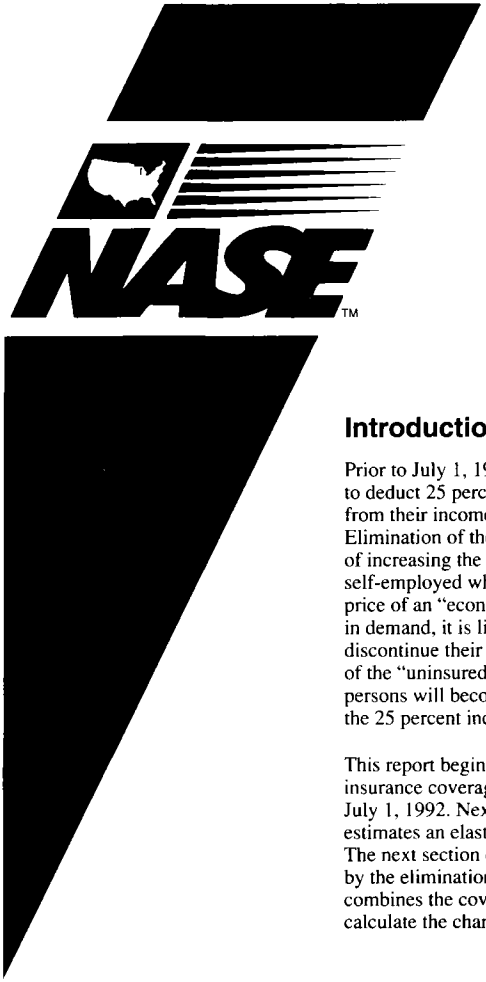


Estimating the Number of Persons Affected by the Elimination of the 25 Percent Income Tax Deduction for Health Insurance Premiums

Executive Summary

Beginning July 1, 1992, the 25 percent deduction allowance for health insurance premiums from the income of self-employed persons came to an end. This raises the question: "How many persons will become uninsured because of the elimination of this 25 percent income tax deduction?"

The answer, based on estimates drawn from analysis of statistics from the ***1991 Current Population Survey***, and published economic research, is 295,000 self-employed persons will stop purchasing health insurance. Because some of these have dependents, a total of 412,000 persons, including 117,000 children under 18, will join the ranks of the uninsured.



Introduction

Prior to July 1, 1992, self-employed persons were allowed to deduct 25 percent of their health insurance premiums from their income before calculating their income tax. Elimination of the deduction on July 1, 1992, has the effect of increasing the after-tax price of health insurance for the self-employed who subscribe. Since an increase in average price of an "economic good" typically results in a decline in demand, it is likely that some of the self-employed will discontinue their health insurance thereby entering the ranks of the "uninsured". The question of importance is, "How many persons will become uninsured because of the elimination of the 25 percent income tax deduction?"

This report begins with an estimate of the self-employed health insurance coverage prior to the change in the tax law on July 1, 1992. Next, it reviews the price elasticity research and estimates an elasticity for computing the change in coverage. The next section determines the effective change in price caused by the elimination of the 25 percent credit. Finally, the report combines the coverage, price elasticity and price change to calculate the change in number of insured citizens.

Previous Health Insurance Coverage

The 25 percent income tax deduction was available only to those persons who were self-employed (sole proprietorship, partnership, or "S" corporation).

Thus, the change in the tax law will affect only that portion of the population that is self-employed and has health insurance coverage.

We begin by defining the number of self-employed workers with health insurance and then extend that to the number of persons having coverage through self-employed workers.

Analysis of the ***1991 Current Population Survey***[1] reveals that there were 12.6 million self-employed workers of whom 9.6 million (76.7 percent) had private health insurance. Of these, 6.2 million (49.1 percent) have employer provided coverage.

Further analysis of the ***1991 Current Population Survey***[2] shows that there were 17.6 million self-employed workers and dependents with health insurance. These dependents are almost entirely children under 18[3]. Since there were 12.6 million self-employed, this equals 1.4 persons per self-employed worker with health insurance.

Price Elasticity of Demand for Health Insurance

Economists use the term "price elasticity" to denote the change in purchases that accompany a change in prices. Not surprisingly, price elasticities are negative, i.e., as prices increase, purchases decline.

The range of price elasticities for health insurance as published in economic research journals varies widely from a low of -0.06 to a high of -0.67[4]. Selecting a specific elasticity from among this wide range is made somewhat easier by Holmer's research. Holmer demonstrates that the elasticities calculated prior to his work were too large because of methodological errors. He reports smaller elasticities than previous research. His price elasticities are calculated for different income groups; -0.39 for families with annual incomes below $15,000; -0.14 for families with incomes from $15,000 to $25,000; -0.08 for families with $25,000 to $40,000; and lastly, -0.06 for families with over $40,000 annual income. The overall weighted (weighted for income distribution) price elasticity is calculated to be -0.16[5].

Given the wide variation in elasticities among income groups, calculation of the appropriate elasticity for the self-employed who purchase health insurance requires an estimate of self-employed income. Statistics from the ***1991 Current Population Survey*** show that employer-provided health insurance coverage is related to family income. The greater a family's income, the more likely it is to have employer-provided private health insurance. Families with incomes under $6,000 have coverage of 5.4 percent; $5,000-9,999, 12.6 percent; $10,000-14,999, 32.7 percent; $15,000-19,999, 43.4 percent; $20,000 to $29,999, 65.4 percent; etc.[6]

The employer-provided coverage of the self-employed (49.1 percent) is essentially equal to that of families with annual incomes of $14,000 to 19,999.

Thus, one can assume that this income level represents the average income of the self-employed. This income level is approximately $10,000 below the median for all American families. Thus, Homer's weighted average price elasticity understates the elasticity for the self-employed and needs to be adjusted.

We can adjust Homer's weighted price elasticity by changing the weights, or distribution of families, among income classes based upon the assumed lower average income for the self-employed. Essentially, this increases the percentage of self-employed families at lower income levels and reduces the percentage at higher income levels. Adjusting the income distribution of the self-employed so as to reduce the average income $10,000 results in an increase in the weighted average price elasticity from -0.16 to -0.19.

Change in Effective Price of Health Insurance

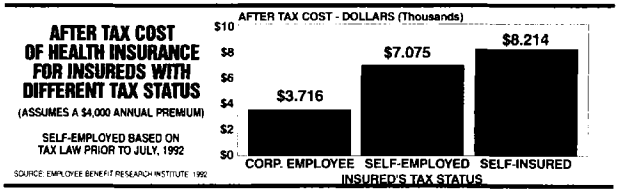
Tax policy affects the effective cost of health insurance premiums because some premiums are paid with tax deductible dollars and some are paid with after-tax dollars.

The law allows three different forms of health insurance premium payments. First, corporations that purchase health insurance for their employees are allowed to deduct the total cost from their income before paying taxes. This tax deduction effectively decreases the after-tax price of health insurance for those so insured. Second, self-employed persons could (prior to July 1, 1992) deduct only 25 percent of their health insurance premiums from their income before paying taxes. Thus, tax policy causes the after-tax prices of self-employed health insurance premiums to be greater than those paid by corporate employers. Third, individuals cannot deduct any health insurance premiums from their income tax so they have the greatest after-tax premium prices.

Thus, for any one health insurance premium amount, there are three different "after-tax", or effective, premium price groups: (1) 100 percent tax-free payments by the employer; (2) 25 percent tax deductible purchases by self-employed; and (3) zero percent tax deductible purchases by individuals. Assuming a premium of $4,000, and taking into account state and federal taxes, including income, social security, and Medicare taxes as paid by the average middle class family, these payments have been estimated as $3,716, $7,075, and $8,214 respectively[7].

From this, we can calculate the increase in effective premium prices beginning July 1, 1992. With the removal of the 25 percent tax deduction, the self-employed became members of the zero tax deductible group.

Thus, the self-employed's health insurance price rose from $7,075 to $8,214. This is a increase of $1,139, or 16.1 percent.

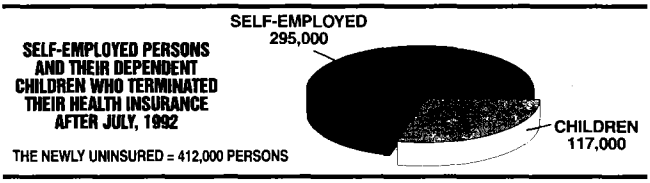


Estimating the Number of New Uninsured

The increase in price will cause some self-employed to terminate health insurance.

Multiplying this 16.1 percent price increase by the price elasticity of demand (-0.19) yields an estimate of the change in demand, at -3.1 percent. The number of privately insured self-employed workers prior to the tax change (9.5 million) times the -3.1 percent change in demand equals -295,000 self-employed. This multiplied by the number of persons per self-employed (1.4) equals -412,000 persons in total who will fall outside the health insurance system because of this change in the tax law[8]. This 412,000 persons includes 117,0000 children under 18 who will no longer have health insurance coverage.

Thus, 412,000 persons, 295,000 self-employed and 117,000 dependent children, will enter the ranks of the uninsured because of the elimination of the 25 percent tax deduction allowed prior to July 1, 1992.



[1] The 1991 Current Population Survey reports the results of a survey carried out in March of 1991. The questions about health insurance asked respondents to describe their health insurance status during the year 1990. Thus, the analysis reported here is relevant to health insurance experience in 1990.

[2] The statistics reported here are taken from: Employee Benefit Research Institute, An EBRI Special Report: Sources of Health Insurance and Characteristics of the Uninsured, Analysis of the March, 1991 Current Population Survey, (Arlington, VA: EBRI) February, 1992.

[3] This is taken from the EBRI report, Table 18, page 40.

[4] EBRI Report, Table 34, page G3.

[5] It is important to note that the negative sign denotes the direction of the relationship (increased price causes decreased demand) so that -0.67 describes a greater demand effect per unit price change than -0.06. Thus, an elasticity of -0.67 is referred to as "greater than" -0.06.

[6] Holmer, Martin, "Tax Policy and the Demand for Health Insurance." Journal of Health Economics, Vol. 3, (1984), pp. 203-221.

[7] EBRI report, Table 11, page 27.

[8] This calculation is taken from an analysis found in: Federal Tax Policy and the Uninsured; How U.S. Tax Laws Deny 10 Million Americans Access to Health Insurance, published by Health Care Solutions for America, Washington, D.C., January, 1992.

About the Author

Bruce A. Kirchhoff, Ph.D., prepared this analysis for the National Association for the Self-Employed. He is Professor of Entrepreneurship at New Jersey Institute of Technology. His prior credentials include service as Chief Economist for the U.S. Small Business Administration and as Assistant Director of the Minority Business Development Agency in the U.S. Department of Commerce.

Dr. Kirchhoff has published over 150 articles and papers on entrepreneurship, economic development, and business strategy in a wide variety of academic journals, books, trade and popular media. His book, *Entrepreneurship And Dynamic Capitalism* (to be published by Praeger in 1994), describes his research on the economics of small firm formation and growth. He has conducted research among large and small businesses and has received international acclaim for his work on formation, growth and survival of small firms.

Chairman THOMAS. Thank you very much.

The gentleman from Nebraska.

Mr. CHRISTENSEN. Thank you, panel. I really appreciate your testimony. Ms. Whitt, you just stated that your figures reflect 12 million self-employed individuals.

Ms. WHITT. That is based upon the people who on their tax returns actually made money and paid a self-employment tax, so it is a little lower than some of the figures that were discussed earlier by the SBA because their figures also included those people that had a loss.

Mr. CHRISTENSEN. I missed the SBA. What was the number they stated? Do you know, Mr. Chairman?

Chairman THOMAS. No.

Mr. CHRISTENSEN. The reason I asked is the Treasury states that almost 3.2 million self-employed individuals would claim a 25-percent deduction on their 1994 tax returns if it were made available to them.

I wanted to know if that is a figure that is low compared to the 12 million. Do you have any——

Ms. WHITT. Actually, I just asked our tax consultant prior to coming up here because I was wondering myself if a person claimed a loss on their tax return, if they would be able to still take the deduction. We can turn around and ask him.

Mr. CHRISTENSEN. Mr. Faris, do you have any idea on the number?

Mr. FARIS. The 12 million is a very close number. Again, it goes back to those who filed tax returns. When it comes to tax deductibility, the ones who file tax returns are the ones we are most interested in right now, so we think that is a good number.

Mr. CHRISTENSEN. I agree with you, Mr. Faris. Earlier you stated that it is a slap in the face to every small businessman or woman out there that we are only looking at the 25 percent. We want to do what is right, I know.

I have a lot of small businessowners in my district. We shouldn't treat small business differently than large corporations. Nearly every large corporation was once a self-employed business that grew. That is not always the case, but this country was founded on entrepreneurial spirit and to punish success is just not right.

I know we are talking about the revenue shortfall and trying to be careful with the budget, but if there is ever a time that we should restore some common sense to the Tax Code, it would be at this time where we could make a large step instead of just a small step toward that balance.

Do you have the numbers that reflect the number of people that would be reinstated with the 25 percent? Do you know how many this past year, Mr. Faris?

Mr. FARIS. Well, right now, we are talking in terms of specific numbers. I will have to get those to you to have a part of the record. I think the specific number in having those back on the roll, it goes back again to what you said, what we are telling the small business community in the numbers. It is very easy inside the beltway to focus on where we have shortfall and where we make it up, but all the people on Main Street hear is that the result is you are

going to give General Motors 100 percent and you are going to give me 25 percent and I have to ask for it every year.

There is just—it is just a hard place. I think for us, we see an immediate step, if you go to 25 percent and lock it in and say for sure you are going to have one-fourth, you still have the crumbs. We won't let you have the cake yet but the crumbs can still be yours.

Mr. CHRISTENSEN. I absolutely agree.

Mr. FARIS. I think small business is tired of hearing it. On November 8 they said it. They said it with the health care mandate, employer mandate.

Again, we get in this whole issue that I know the chairman and I have discussed a number of times, is that this is all a part of the whole health care issue. We have people in the highest places of our government go on record as saying these small business entrepreneurs who don't furnish insurance for their employees are just lower than dirt, and these same people don't even have 25 percent deductibility for themselves. They have 100 percent. The numbers are going to be—back again, do we look at the 25 percent, everyone that has been getting it will go back on the board again if 100 percent of the number is realized.

Mr. CHRISTENSEN. Mr. Faris, have you conducted any studies with the FIB to see what the number of people that would join the ranks of the insured would be if we were to restore 100 percent deductibility to the self-employed?

Mr. FARIS. We have tried that survey. We found it is in three tiers. We ask someone, do you think you would like to buy the product? They say yes. Second, here is the price of that product, then yes. The third is, could I have your check.

Well, that is kind of how it goes when you talk about insurance. You say if you could have full, 100 percent deductibility, would you then offer insurance? Well, sure, sure we would. Then you say, OK, now here is how much the insurance costs for you and for everyone else with 100 percent deductibility and here is what that means to you. Then that number drops. Then, third, is they have to write a check and then the number drops considerably. We assume that would be true here, but we don't know. We will see.

We would love to have everyone take advantage of this because they would be purchasing health insurance, but we all know that is just not going to happen. So therefore, I think we can look and see if we move to 100 percent, I don't think the numbers we are using today will be real hard numbers, because I don't think we will have that many people purchase into the system.

Mr. CHRISTENSEN. Thank you, Mr. Chairman.

Chairman THOMAS. In pursuit of that point, to what extent Mr. Faris, Mr. Dressler, or anyone can give us any indication of the fact that setting aside the 25, 50, or 100 percent that if in fact people, based upon the 25 percent, had offered health insurance, given its more critical role now in terms of the sensitivity of people about health insurance and its component in attempting to hire and keep labor, that you may not be able to be a free agent in making the decision of not having it or it would be a major impact on the company in terms of its employees or trying to replace employees.

Is there any feedback from your people along those lines?

Mr. FARIS. That is happening right now and it has been happening for some time.

One of our frustrations about the whole health care issue is that all the issues that impact the small business disproportionately—this is on the top of the list as we have discussed for the last 6 years. It goes into administrative costs. It runs over 30 percent compared to General Motors of 8 to 9 percent. It goes to cancellation when you have one claim. It goes to not being able to reissue or even to cancel because you have had minor problems, haven't even had a major claim. Or they just decide to drop you. So there is a credibility problem with small businessowners as it relates to health insurance and how it is provided in the first place. What this is is a rifle shot, a single focus that we have the power to do, can do, should do. It is immediate. It is a no-brainer.

Now, getting to 100 percent and the fairness and inequity and how much that would trigger the incentive to purchase, no matter what poll you see or research you see on that, no one knows. We will not know until we put it into effect. What I am saying is that if we put it into effect and we see how it impacts the budget, if we all need to drop to 97 percent coverage or 96 percent coverage, if it is fair for the goose, it is fair for the gander and we feel our goose is being cooked.

Chairman THOMAS. We have talked a lot about dynamic scoring in the budget area, and obviously if we made some reasonable reforms in the broader health care area, combined with changes in the percentage, you would see behavior modified in many ways. You indicated, Mr. Faris, you didn't really want the crumbs. At this stage you would take the crumbs.

Mr. FARIS. That is right.

Chairman THOMAS. Because you don't have them, and you are complaining because the other people have cake.

My concern is that I would kind of like to move into the bread category for everyone. Before I took on the awesome responsibilities of chairing this subcommittee, I would have been inclined to ask, Ms. Sprague, about your idea in terms of balancing between corporations who now have it and those who don't.

I do think, though, that we as a subcommittee have talked about in the last Congress, and obviously will continue to talk about, refocusing on the history of how corporations wound up with an open-ended, 100-percent deductibility and that perhaps that needs to be focused on in terms of a reasonableness. I wouldn't want to have this hearing focusing on the self-employed and on reinstating a percentage lead us into that discussion. But I just want everyone to know that I think that has to be part of the ongoing discussion.

I would say that Ms. Whitt or Mr. Faris or anyone else, if you have any studies that shed light on this, we would love to have them as part of the record because I found that there tends to be a dearth of any kind of solid statistics, which I know are difficult to obtain but would give us some guideline on the phasing in.

This is almost a self-answering question, but obviously if we can do the 25 percent on a retroactive basis and you are asking for 100 percent, can you give me any indication that might help us, what might be, from your point of view, a reasonable progression or a willingness to accept our exploration of a parity along the lines

from the gentleman from Maryland of an 80-percent rate or a suggested phase-in, as was indicated earlier by Mr. Neal—25, 50, 100 percent?

How critical do you want to make it to us in terms of willingness to work to not make it 100 percent immediately on a prospective basis, notwithstanding the unfairness? Any help for us in terms of what would be meaningful in making a behavioral change in keeping people with their health insurance or getting people into the market that are not now in the market at 25 percent?

Mr. DRESSLER. Mr. Chairman, I think working with young farmers and farm families, and from my own perspective, rather than talk about a percentage of deductibility, think about the real dollar cost. Because a young family has significant health care needs and they are less expensive to insure. But if they are in the childbearing years, we know how important prenatal care, newborn care is. I would urge you to think about some kind of 100 percent deductibility, up to a certain dollar amount, that would get them into the game of having access to health care.

Also, among our membership as people get older, we tend to take more catastrophic care, higher deductibles. In California, in our Bakersfield area, for example, it is not uncommon to have a $1,000 deductible plan. The person can handle the minor expenses. What he is afraid of is the major costs that unfortunately increase as we get older. He is trying to buy less expensive care because of the cost. So you might want to think about instead of just a percentage phase-in, 100 percent up to a certain amount of expenditure.

I know that was the subject of discussion last year when we were looking at comprehensive reform and deductibility of so-called "open-ender" or "golden" health care plans. It really comes to play in my membership because I know we are struggling to hold the costs down in every phase of life, but the needs are different at different stages of their life.

Chairman THOMAS. Does the gentleman from Maryland have a question?

Mr. CARDIN. Thank you, Mr. Chairman.

Just very quickly, Mr. Dressler. I appreciate that because I do think, I agree with the chairman; I am glad we are having these hearings to try to figure out what the appropriate amount should be. I put 80 percent in. Let me explain the reason why I think 80 percent is the appropriate level. You may not have been here at the opening of the hearing.

For a corporation, there are other considerations in the health care plan. The corporation is concerned about the cost of the plan and would be looking at cost-saving measures, including the employees' participation in the cost of the plan. For a self-employed person, that may not hold true, because a self-employed person can calculate how much money they will spend on health care and then if 100 percent of the premium is deductible, try to develop a plan that comes as close as possible to their out-of-pocket costs in order to maximize the tax advantage. So I think there is an argument against the 100 percent of any premium in an effort to try to provide parity between corporations and self-employed companies. That should be one consideration.

The chairman has raised a second consideration which is a very valid one: What percentage or what amount would maximize the number of people who would be insured? That is a second consideration. On the parity issue, it seems to me that allowing a 100-percent deduction would give self-employed individuals an advantage over companies.

Jack, you disagree?

Mr. FARIS. I really missed the first part of that.

Mr. CARDIN. Well, since the self-employed can calculate the total amount that they anticipate spending for health care and make sure that equals the premium amount by buying an insurance plan that covers that, they can shelter their entire medical cost. Most companies require employees to participate by paying part of the premium. Therefore, on average, today corporations are paying, and deducting, 80 percent of the premium costs and individuals are paying 20 percent.

Mr. DRESSLER. If I could just respond to that. A critical part of that, the large companies have access to what we call section 125 or cafeteria benefit plans, and they can actually allow the employee to pay part of the premium pretax through—I am not sure of the exact phrase, but basically a pretax deduction to pay the employee share of the cost plus the access to medical spending or flexible reimbursement accounts which therefore also lets them pay their so-called deductibles and other costs out of pretax dollars. This, of course, takes a fairly large business and a lot of access to tax incentives.

Mr. CARDIN. Absolutely right. Congress is going to have to take a look at the cafeteria plans. We can't allow that to continue uncapped in the future.

Chairman THOMAS. Might it be possible that if you included that with a "must offer" in terms of the employer to his employees, that that would temper the attempt to match on both sides?

Mr. CARDIN. It may.

Chairman THOMAS. That would be kind of a tempering effect.

Mr. FARIS. Just as I missed the first part of your statement, you have missed the first part of mine, so I would like to restate that briefly. And that——

Chairman THOMAS. We have 7 minutes left to go in a vote.

Mr. FARIS. To basically—real quickly. One is the economics of it all. The economics of the problem to get parity, real parity and that is the entrepreneurs of America are not just—saying they are important and the backbone but not try to break that backbone at every chance we get. Let's let everybody pay the same amount. The $45.6 billion is now being paid, and we are going to have to have $2 billion more to get to 100 percent, then let's all go to 95 or 96 percent. If we can move that up to 100 percent at some time, fine. But what is fair for Main Street ought to be fair for Wall Street.

The second part about this is the political issue of how people feel who have their house on the line who every time they turn around, I am from the government and I am here to tell you, that means you have got a short stick. In fact, you have to refile your taxes now. You will enjoy paying that money to the CPA. So I think the thing to do now is move quickly to the heart of it and let's get the 25 percent, but we need to move to 100 percent.

Mr. CARDIN. We are close.

Mr. FARIS. We are close.

Chairman THOMAS. We have to move quickly to a vote. But we appreciate the evidence.

It is clear we really would like to have a better research grounding so when we make a decision and we make it permanent, that it is a good, responsive one. The ultimate solution could be along your lines, Jack. You need to talk with the other people on the panel about that and I would love to hear the discussion. For now, though—and I appreciate all of your attendance, the subcommittee is adjourned.

[Whereupon, at 2:18 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

STATEMENT OF
LESLIE B. SAMUELS
ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON HEALTH
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

Mr. Chairman and Members of the Subcommittee:

I am pleased to present the views of the Administration on the 25 percent deduction for certain health insurance premiums paid by the self-employed. Under Internal Revenue Code section 162(l), certain sole proprietors, partners and more than two-percent shareholders of Subchapter S corporations are permitted to deduct 25 percent of the amount paid during the year for insurance that constitutes medical care for the taxpayer and the taxpayer's spouse and dependents. The deduction is not available, however, for taxable years beginning after December 31, 1993. Consequently, unless the Congress acts, self-employed individuals will not be able to claim any deductions for health insurance premiums on their 1994 income tax returns.

As the members of this Subcommittee know, the Clinton Administration proposed the extension of the 25 percent deduction, followed by an increase in the deduction to 100 percent of health insurance premiums in the Administration's health reform bill of last year. We continue to believe that allowing a deduction for self-employed individuals more closely conforms their tax treatment to the treatment of other employers with employees. This would recognize that these taxpayers share many attributes with both employers and employees. We also believe that the deduction for the self-employed will help to make health insurance more affordable for this segment of the population and will therefore contribute to expanded insurance coverage.

On behalf of the Treasury Department, I appreciate the opportunity to state for the record that the 25 percent deduction

issue needs to be dealt with expeditiously. If Congress does not act before 1994 tax returns are filed, substantial new administrative burdens could result for taxpayers and the Internal Revenue Service.

The Treasury Department estimates that almost 3.2 million self-employed individuals would claim the 25 percent deduction on their 1994 tax returns if it were made available to them. Those tax returns are due on April 15, 1995, although these taxpayers could request an automatic extension through August 15, 1995. If the Congress fails to act to extend the 25 percent deduction prior to the due date for income tax returns, millions of taxpayers will be forced to decide whether to incur the costs of filing amended income tax returns. Any such amended returns will also impose additional administrative burdens and costs on both the Internal Revenue Service and State and local governments.

As members of this Subcommittee may know, the Department of the Treasury has already taken steps to make it easier for taxpayers to claim the deduction if timely Congressional action occurs on this matter. The 1994 Form 1040 includes a line for claiming the self-employed health deduction, with a caution that taxpayers cannot claim the deduction unless the law is changed. But only swift Congressional action can minimize taxpayer uncertainty, compliance costs and administrative burdens.

As the President emphasized in his State of the Union message earlier this week, we should work together to assist self-employed individuals and others in buying more affordable health insurance. The extension and expansion of the self-employed health insurance deduction should be an integral part of that effort. We look forward to working with the members of this Subcommittee and others in the Congress to find a way to restore this deduction without increasing the Federal budget deficit.

STATEMENT OF THE AMERICAN FARM BUREAU FEDERATION
TO THE HOUSE WAYS AND MEANS COMMITTEE
SUBCOMMITTEE ON HEALTH
ON THE TAX DEDUCTION FOR HEALTH INSURANCE PREMIUMS
PAID BY THE SELF-EMPLOYED

January 27, 1995

Farm Bureau is the nation's largest general farm organization with a membership of 4.4 million families in 50 states and Puerto Rico. Farm Bureau members produce virtually every commodity grown commercially in this country. Our policy is developed by producer members at the county, state and national levels of our organization. Farm Bureau appreciates the opportunity to comment on the tax deduction for health insurance premiums paid by the self-employed.

The 25 percent tax deduction for health insurance premiums of self-employed sole proprietors expired on December 31, 1993. Farm Bureau must stress the urgency of reinstating the 25 percent deduction for health insurance premiums paid by the self-employed before farmers file their 1994 tax returns. In addition, Farm Bureau supports a permanent 100 percent deduction for health insurance premiums paid by self-employed individuals.

High health insurance costs are particularly troublesome in farming and ranching because it is a hazardous occupation. High risk translates into high insurance premiums, and many farmers are reducing their coverage or dropping it entirely because they cannot afford it. A tax deduction for the cost of insurance premiums will go a long way toward helping farmers and ranchers provide for their own insurance needs.

Providing self-employed persons the ability to deduct 100 percent cost of their health insurance premiums is also a matter of fairness. Corporations, including farms that are incorporated, are able to deduct the entire costs of their employees' health insurance. It is only fair that all farmers, regardless of how their businesses are organized, be able to deduct their entire health insurance costs.

During last year's health care reform debate, the provision to make health insurance premiums deductible was part of virtually every proposal. Now it is time to translate that support that into action. Farm Bureau urges quick action to reinstate the 25 percent deduction for 1994 and put into place a permanent 100 percent deduction for health insurance premiums paid by the self-employed.

Tax policies that are fair and equitable promote both the economic well-being for farmers and our nation's food supply. Thank you for the opportunity to present the views of the American Farm Bureau Federation about this matter of importance to all self-employed people.

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS
TAX DIVISION

The American Institute of Certified Public Accountants (AICPA) is the national, professional organization of CPAs comprised of more than 320,000 members who advise clients on federal, state and international tax matters as well as prepare income and other tax returns for millions of Americans. Our members provide services to individuals, not-for-profit organizations, small and medium-size businesses, as well as America's major businesses, including multi-national corporations. Many serve businesses as employees. It is from this base of experience that we offer our comments on the tax treatment of health insurance costs of self-employed individuals.

The decision in 1994 to postpone consideration of health care reform legislation has resulted, among other things, in the loss of a deduction by self-employed individuals for <u>any</u> health insurance premiums they have paid in that year. As part of the 1993 Omnibus Budget Reconciliation Act, when a number of other "expired provisions" were retroactively re-enacted (targeted jobs tax credit, low-income housing credit, employer-provided education and training expenses, etc.) and allowed to remain in the law past the end of 1993, the deduction for 25 percent of self-employed insurance premiums was terminated at the end of the calendar 1993. The committee reports noted that this provision should be considered in conjunction with forthcoming health care reform (as indeed it was, in virtually all the health care bills proposed during 1994).

Since, however, there were no health care changes in 1994, there was also no extension of the deduction for self-employed health insurance. This is a highly unfortunate result, and puts a significant penalty on the health costs of those who operate as proprietors, partners, or S corporation shareholder/employees, vis-a-vis those who are employees of C corporations.

Pending whatever changes are made to health care legislation in the future, we think it critical that Congress re-establish the right of self-employed persons to receive even that limited deductibility for health insurance costs that they enjoyed before 1994. We do recognize that this provision, on a stand-alone basis, is a revenue loser for the government. Nonetheless, there remains a major issue of fairness for a significant part of the business community, and we would urge your attention to this matter.

As an organization that values simpler approaches to tax legislation, we would greatly prefer to see action taken immediately, before the bulk of 1994 returns have been filed, rather than the added complexity of amended 1994 returns and refund claims that even a minor delay will cause. Still, we believe the self-employed business person has now – even with the best of congressional intentions – been further disadvantaged with respect to the cost of health care, and is entitled to a restoration of the deduction for the current year.

We appreciate your consideration of our views.

RICHARD J. DURBIN
20TH DISTRICT, ILLINOIS

AT-LARGE WHIP

COMMITTEE ON APPROPRIATIONS
SUBCOMMITTEE ON AGRICULTURE AND RURAL DEVELOPMENT
SUBCOMMITTEE ON TRANSPORTATION
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January 27, 1995

The Honorable Bill Thomas
Chairman
Ways and Means Subcommittee on Health
U.S. House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

I am writing in support of the legislation introduced by Representative Pomeroy to retroactively reinstate the tax deduction for 25% of health insurance premiums for the self-employed for 1994 and permanently increase the deduction to 100% of premiums for 1995 and beyond.

This legislation provides equity for self-employed taxpayers, who are currently at a disadvantage relative to incorporated business entities when they provide health insurance to themselves and their employees. The corporations they often compete with can take an income tax deduction for the full cost of the health insurance premiums they incur. The self-employed are not eligible for such a deduction today and could only deduct 25% of their premium costs before the provision expired at the end of 1993.

Farmers, ranchers, and small business owners who conduct their businesses as sole proprietors deserve the same treatment on this important matter as the corporations they often compete with.

Because of the high cost of health insurance -- especially insurance purchased by individuals -- the tax deduction is of critical importance to people who hope to provide themselves and their families with basic protection against catastrophic health care bills. A 100% deduction for health insurance premiums can reduce the net cost of health insurance for a farm family by as much as $500 to $1,000. This savings can make the difference between whether health insurance is affordable or unaffordable.

I am pleased to learn that you are holding a hearing on this subject. I would appreciate it if you would include this letter in the record for that hearing.

I urge your committee to act on Representative Pomeroy's legislation so that farmers and other self-employed people can receive equal treatment in the deduction of health insurance premiums.

Thank you for your consideration of my views.

Sincerely,

Richard J. Durbin
Member of Congress

RJD:tf

STATEMENT OF

HOME OFFICE ASSOCIATION OF AMERICA
SUBMITTED TO
HOUSE COMMITTEE ON WAYS AND MEANS

RELATING TO THE SAVINGS AND INVESTMENT HEARINGS

February 2, 1995

Chairman Archer, Representative Gibbons, and Members of the Committee on Ways and Means, my name is Richard Ekstract. I am Chairman of the Home Office Association of America ("HOAA"), an organization dedicated to serving the needs of individuals whose offices are in their homes. I appreciate the opportunity to submit testimony on two issues of vital importance to HOAA: the home office expense deduction and the self-employed health insurance deduction.

Background on Home Office Expense Deduction Issue

Up until enactment of the 1976 Tax Reform Act, taxpayers were able to take liberal advantage of home office deductions for most types of work conducted at their personal residences, either as an ordinary and necessary business expense under tax code section 162 or as an expense for the production of income under section 212. In response to perceived abuses of the deduction, Congress enacted section 280A, which sets forth rules and limits on the deductibility of expenses attributable to the business use of homes for individuals and S Corporations.

These rules and limitations no longer reflect the realities of how individuals work in today's world. Section 280A states that no home office deductions are allowed unless the deduction meets specific, and in our view overly complex, statutory requirements. It is virtually impossible for a large number of home office workers to qualify under these rules, and those that qualify cannot be sure that they do.

The rules state that the portion of the home that is used for business must be used exclusively on a regular basis,1/ and in only one of the three following ways: (1) as the principal place of business for any trade or business;2/ as a place normally used by clients, patients, or customers;3/ or in connection with the taxpayer's trade or business if the taxpayer is using a separate structure unattached to the personal residence.4/ Of these additional requirements, we have found that defining a taxpayer's

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1/ See § 280A(c)(1).

2/ § 280A(c)(1)(A).

3/ § 280A(c)(1)(B).

4/ § 280A(c)(1)(c). Two additional exceptions are provided in the statute which do not require exclusive use of a portion of a residence. A taxpayer in the business of selling products at retail or wholesale may take deductions allocable to space within the residence which is used on a regular basis as a storage unit for inventory of the business. This exception is only available if the residence is the sole fixed location of the business. See § 280A(C)(2). A taxpayer regularly using the residence to provide day care for children, adults over age 65, or mentally or physically disabled persons may qualify for deductions allocable to the day care business. See § 280A(c)(4). Deductions under § 280A are limited to the excess of (1) gross income from the use of the dwelling unit over (2) the deductions allocable to the unit which are allowable without regard to business use. See § 280A(c)(5).

"principal place of business" is the most difficult, and the various tests which have been formulated by the courts cannot achieve equitable results.

Supreme Court Restrictions Are Not Reasonable

In *Soliman v. Commissioner*,5/ the Supreme Court exacerbated the statute's already confusing scheme. In that case, the Court attempted to address the appropriate factors a taxpayer must use in determining whether a home office is his or her "principal place of business." The taxpayer in *Soliman* was an anesthesiologist who was employed by three hospitals, but who maintained a home office as a principal place of business used exclusively two to three hours a day for contacting patients and surgeons, and for performing related activities.

Even though the hospitals provided no office space to the taxpayer in *Soliman*, the Supreme Court reversed the lower court decisions which had allowed the deduction.6/ The Court's effort significantly narrowed the scope of the home office deduction by setting up a comparative test for determining whether an individual's home office is that person's principal place of business.7/

The comparative test does not work. The Court's two primary factors -- (1) the relative importance of the activities performed at each business location, and (2) the amount of time the taxpayer spends at each place of business -- are too vague.8/

The IRS' subsequent explanation of how it will apply the "relative importance" and "time" tests highlights the complex problems that the normal, unsophisticated home office worker must now confront.9/ Under this ruling, the Service said it will first apply the "relative importance" test, and if this test yields no definitive answer, it will look to the "time" test.10/ There is no way for a home office worker to achieve any level of comfort with these rules without expending considerable funds in lawyer or accountant fees.

5/ 113 S. Ct. 701 (1993).

6/ 113 S. Ct. at 708.

7/ Id. at 706. The Court rejected both the "focal point" test formerly favored by the Tax Court and the facts and circumstances test subsequently adopted by the Tax Court, which had won approval of the U.S. Court of Appeals for the Fourth Circuit.

8/ Id. In denying the home office deduction, the Supreme Court determined that the taxpayer's treatment of patients at the three hospitals was the "essence of a professional service" and the "most significant event in the professional transaction." The home office activities were regarded as less important to the taxpayer's business than his work at the hospitals. Id. at 708.

9/ Rev. Rul. 94-24, 1994-15 I.R.B. 5. The IRS had previously announced that it will not challenge home office deductions taken for 1991 and earlier tax years if the taxpayer reasonably fell within the scope of previous guidance issued by the IRS. See Notice 93-12, 1993-8 I.R.B. 1. The Service has also withdrawn a portion of proposed regulations under § 280A (issued in 1983) to reflect the *Soliman* decision. See IA-23-93, 59 Fed. Reg. 26466 (May 20, 1994).

10/ Rev. Rul. 94-24, 1994-15 I.R.B. 5.

Responses to *Soliman*

We applaud Congress' response to the *Soliman* decision, as numerous bills were introduced in the 103rd Congress. In particular, we strongly supported the Home Office Deduction Act of 1994, introduced in the House by former Representative Hoagland (D-NE) (H.R. 3407) and in the Senate by Senator Hatch (R-UT) (S. 1924).11/ The bill would have provided that a home office can qualify as a principal place of business if "the office is the location where the taxpayer's essential administrative or management activities are conducted on a regular and systematic (and not incidental) basis by the taxpayer," and the office is necessary because the taxpayer has no other location for the performance of such activities. The bill also contained a provision allowing for the deduction of business expenses attributable to home storage space for product samples. Currently, tax code section 280A(c)(2) allows a deduction for storage space for inventory only.

We were extremely pleased to see that Chairman Archer included the provisions of the Home Office Deduction Act in sections 12003 and 12004 of the Job Creation and Wage Enhancement Act of 1995 (H.R. 9), introduced on January 4. We urge their inclusion in the first tax bill which the Congress sends to the President this year.

Clarifying Home Office Expense Deduction Makes Sense for the 1990s and Beyond

The *Soliman* decision is not in step with commercial practice and economic reality. Home-based businesses have been growing in number and will likely continue to do so for the indefinite future.12/ These businesses create opportunity and jobs.

Many individuals affected by corporate downsizing have responded by creating small businesses operated out of the home. With the advent of fax machines, personal computers, and other telecommunications advances, these entrepreneurs have been able to run businesses out of the home that traditionally required an office setting. The success of many of these businesses has depended on whether or not they could be started up as home-based enterprises. The existence of a tax deduction for home office expenses can make an important difference for these fledgling companies.

Clarifying the home office expense deduction also makes sense from a family perspective. Home-based businesses have become an attractive option for parents who choose to work at home to spend more time with their children or elderly parents. Taxpayers should not be penalized for making such a choice.

Background on Self-Employed Health Insurance Tax Deduction

We also strongly support enactment of legislation allowing self-employed individuals to deduct their health insurance costs.

11/ H.R. 3407 had 83 cosponsors (37 Democrats/46 Republicans), including 13 Members of the Ways and Means Committee. S. 1924 had 15 cosponsors (7 Democrats/8 Republicans), including 3 Members of the Finance Committee.

12/ One 1992 news article reported that approximately 30 million Americans work out of the home. See G. Hall, Home Based Businesses Create Local Controversies, Gannett News Service (Nov. 10, 1992); see also New Publishers Serve At-Home Workers, L.A. Times, Feb. 14, 1993, at D10. The number of publications serving the growing number of at-home workers has risen dramatically. At present, there are approximately 50 publications. See id.

Prior to January 1, 1994, a self-employed individual generally could deduct 25 percent of the amount paid for health insurance for the taxable year on behalf of the individual and his or her spouse and dependents.13/ Congress' purpose in establishing this deduction in 1986 still exists today. At that time, lawmakers expressed concern about the disparity in tax treatment of health benefits between self-employed individuals and owners/employees of incorporated businesses.14/ The 25 percent deduction that self-employed individuals received for their health insurance premiums was designed to provide at least some portion of the favorable treatment for health insurance afforded employees covered under an employer-provided plan.15/

Restoring Self-Employed Deduction Would Represent Strong Step Toward Providing Equitable Treatment to Home Office Businesses

Mr. Chairman, a sense of excitement exists when entrepreneurs start up their home office businesses. Many express relief to be free from headaches like commuting, endless meetings, and office politics. They feel that they will be as free to go as far as their abilities will take them. Then, reality sets in. They realize that they often have to pay more for everything. For starters, they realize that they have to buy their own health insurance coverage at outrageous costs, and that the Federal Government, by providing disparate treatment with respect to health care expenses, caters to big business, not to them.

HOAA believes it is unfair and unjustified to premise the availability of a tax benefit on whether a taxpayer works for a Fortune 500, Subchapter C corporation or for himself or herself in an unincorporated business. Such treatment is simply one example of the ways home office businesses operated by self-employed individuals are treated as second-class businesses. Retroactively restoring the 25 percent deduction for self employed persons would represent a strong first step toward providing more equitable treatment to home office businesses. We urge you to do so prior to the April 15 filing deadline for individual tax returns. We also hope that lawmakers will ultimately enact legislation providing a 100 percent deduction for the health care costs of self-employed individuals, as has been proposed by numerous lawmakers and the Clinton Administration.

Conclusion

To conclude, I appreciate the opportunity to submit testimony on the importance to HOAA of preserving the home office expense deduction and reinstating the health insurance tax deduction for

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13/ This provision expired on December 31, 1993. See § 162(l). Sole proprietors, working partners in a partnership, and S corporation employees who own more than two percent of the corporation's stock could take advantage of the deduction. See Senate Committee on the Budget, Tax Expenditures: Compendium of Background Materials on Individual Provisions, S. Prt. 101, 103rd Cong., 2d Sess. 425 (1994) ["Tax Expenditures"].

14/ Tax Expenditures, supra note 13, at 428. An employer's contribution to a plan providing accident or health coverage to an employee and the employee's spouse and dependents is excludable from an employee's income. Further, businesses can generally deduct as an employee compensation expense the full cost of health insurance coverage provided to employees. See Joint Committee on Taxation, Summary of Revenue Provisions in the President's Budget Proposal for Fiscal Year 1993, JCS-3-92 46 (Feb. 6, 1992).

15/ Tax Expenditures, supra note 13, at 428.

self-employed workers. The *Soliman* decision is ill-suited to the modern economy. Clarification of the home office expense deduction rules makes sense from both a business and family perspective. Further, extending the health insurance tax deduction for self-employed workers will at least begin the process of equalizing the treatment of self-employed workers and those who work for Subchapter C corporations.

NATIONAL ASSOCIATION FOR THE ADVANCEMENT OF ORTHOTICS AND PROSTHETICS

INTRODUCTION

The National Association for the Advancement of Orthotics and Prosthetics (NAAOP) is a national, non-profit organization comprised of orthotic and prosthetic health care practitioners (orthotists and prosthetists) who clinically and technically design, fit, and fabricate orthopedic braces and artificial limbs (orthotics and prosthetics) for this nation's two million amputees and other people with physical disabilities requiring orthotic and prosthetic care. Quality orthotic and prosthetic care can be extremely cost-effective by enabling people with disabilities to achieve high levels of independence and function in the workplace, in the home, and in all aspects of community life. Appropriate orthotic and prosthetic care also helps prevent secondary disabilities and decreases long term health and welfare costs to society.

Orthotic and prosthetic services are reimbursed under Part B of the Medicare program through a fee schedule known as the "L-codes." Although the four recently-created Durable Medical Equipment Regional Carriers (DMERCs) currently administer reimbursements for orthotics and prosthetics under the Medicare program, there is a major distinction between durable medical equipment (DME) and orthotic and prosthetic (O&P) services that justifies separate consideration and treatment when regulating these sectors of the health care field.

ENSURING QUALITY ORTHOTIC AND PROSTHETIC CARE

Practitioner Education

A critical distinction between the provision of durable medical equipment and the provision of orthotic and prosthetic services entails the level of education and training necessary to provide comprehensive O&P services. Comprehensive orthotic and prosthetic care requires highly specialized and trained practitioners in order to design, fit and fabricate a customized artificial limb or orthopedic brace for the particular needs of each patient. These highly specialized services combine the disciplines of medicine and engineering like almost no other area of health care. The successful custom replication and restoration of functional human body parts, which are in a multitude of shapes, sizes and complex contours, is fundamentally different from most types of durable medical equipment which tend to be more generic, pre-fabricated, and less clinically intensive to provide.

In addition, significant variation exists in the delivery of quality orthotic and prosthetic services, primarily due to the range of physical disabilities orthotic and prosthetic care can benefit and the explosion of technology over the past decade. To keep abreast of clinical and technological developments, individual practitioners participate in continuing education, research, and the frequent exchange of information among professionals. The orthotic and prosthetic profession has a defined body of clinical and technical knowledge and a core of over 3,000 specially credentialed practitioners with formalized education provided by well-established baccalaureate and post-baccalaureate education programs offered at eight major American universities.

Certification and Accreditation

Currently, the American Board for Certification in Orthotics and Prosthetics (ABC) offers the highest level of credentialing standards for orthotists and prosthetists and is the most widely recognized credentialing organization for orthotic and prosthetic services. ABC was founded in 1948 and conducts a comprehensive credentialing process for both orthotic and prosthetic practitioners as well as facilities in which they provide their clinical and technical services.

ABC-certified orthotists and prosthetists are the only orthotic and prosthetic practitioners recognized by the American Medical Association (AMA) as true orthotic and prosthetic allied health professionals. The education requirements for ABC certification are the only educational pathways recognized by the Commission on Accreditation of Allied Health Education Programs (CAAHEP) and the U.S. Department of Education.

The ABC awards practitioner accreditation in three categories, Certified Orthotist (C.O.), Certified Prosthetist (C.P.), and Certified Prosthetist/Orthotist (C.P.O.). The minimum entry level requirements for practitioner education and certification are:

(a) a bachelor of science degree in orthotics and prosthetics or a bachelor of science degree in a related allied health or engineering field along with successful completion of specific undergraduate courses in orthotics and prosthetics at accredited schools,

(b) one year of clinical residency in each discipline, and

(c) successful completion of a comprehensive written, oral, and clinical examination for practitioners administered by the American Board for Certification in Orthotics and Prosthetics.

These stringent standards help ensure that ABC-certified orthotic and prosthetic practitioners are competent to provide the full range of comprehensive O&P care to patients with a multitude of varying disabilities. This high level of education and training helps assure quality in the clinical service element inherent in the delivery of these highly technical customized devices.

The Service Element of Orthotic and Prosthetic Care

Quality orthotic and prosthetic care is as much a professional service as it is a device that results from this service. While there is a service component in the delivery of some types of durable medical equipment, such as the design of customized wheelchairs and the delivery of certain home health services, orthotic and prosthetic care is generally far more service-oriented and specialized to the needs of each patient. Yet, when Congress and the Health Care Financing Administration (HCFA) have regulated durable medical equipment in the past, through fraud and abuse and reimbursement reforms for instance, they have tended to blindly cast the same net over the very different fields of orthotics and prosthetics.

The lack of separate treatment between DME and O&P has resulted in widespread confusion and limited understanding of this small but critical component of rehabilitation in our health care delivery system. This failure to separately address DME and O&P often creates unintended consequences and unfairly punishes the orthotic and prosthetic fields for problems in other areas of the health care delivery system. Two recent examples of this is the inappropriate reclassification by HCFA of custom orthotic seating systems as "inexpensive/routinely purchased" DME and the fraud and abuse orthotic body jacket investigation conducted by the Office of Inspector General.

HCFA'S RECLASSIFICATION OF ORTHOTIC SEATING SYSTEMS AS DME

Custom orthotic seating systems are designed and fabricated to meet the unique needs of people with severe physical disabilities requiring seating support usually associated with long term wheelchair use. Custom orthotic seating systems are needed in this instance to avoid serious health complications--such as decubitus ulcers and spinal collapse--and to maintain functional activities of daily living. Depending upon the severity of the patient, these customized orthoses range in cost from a few hundred to several thousand dollars. Until recently, HCFA reimbursed these orthoses using an orthotic L-code and individually considered each device to determine a reasonable fee.

With the creation of Medicare's Durable Medical Equipment Regional Carriers, these custom seating orthoses were inappropriately reclassified as "inexpensive/routinely purchased" durable medical equipment and assigned three different "K-codes," obviously not part of the orthotic and prosthetic L-code system. Instead of individually considering the fee for each custom seating orthosis claim, HCFA and the DMERCs now reimburse claims for these devices at a fixed allowable fee, regardless of the level of complexity involved in designing and developing the individual orthosis. Despite the fact that the descriptions for these three new K-codes include the

words, "orthotic" and "custom fabricated,"--which clearly demonstrate the propriety of reimbursing these devices under the L-code system--they continue to be treated as "one size fits all" durable medical equipment.

The DMERCs have recently stated that this action was taken because these custom orthotic seating systems are merely permanent accessories to wheelchairs and are not transferable. While custom orthotic seating systems are often fabricated to mount onto a wheelchair, the DMERC's rationale fails to consider the frequent use of these devices, particularly among children, as transferable between wheelchairs, as car seats, and in a variety of other situations, including allowing one to sit independently supported at a table to eat a meal.

HCFA and the DMERCs have been fully informed of this problem throughout the past several months, but have failed to remedy the situation to date. As a result, some of the very specialized orthotists who fit and fabricate these orthoses have begun to deny these services to Medicare beneficiaries. We point to this situation as an example of the problem of not recognizing the separate treatment of DME from orthotics and prosthetics. We request this Subcommittee, HCFA, and the DMERCs to consider reincorporating these newly-created K-codes into the L-code system where custom orthotic seating systems truly belong and determining fees for these orthoses based on individual consideration of each claim.

THE OFFICE OF INSPECTOR GENERAL'S TESTIMONY

The Office of Inspector General (OIG) testified today on the issues of fraud and abuse in the area of durable medical equipment generally, and specifically as to the investigation of "orthotic body jackets." The OIG testified that "payments for [orthotic body jackets] went from $217,000 in 1990 to $18 million in 1992. We estimated that 95% of those payments were for devices more properly categorized as [prefabricated wheelchair] seat cushions, rather than body jackets." Seat cushions are items of durable medical equipment that cost Medicare $200 to $300 per unit. An "orthotic body jacket" is a thoracic-lumbar-sacral orthosis (TLSO) designed for the treatment of spine or trunk musculoskeletal disorders such as fractures, spinal cord injuries, post surgical stabilization, scoliosis, congenital deformities, etc. The custom design and fitting of a TLSO requires sufficient medical knowledge of these complex disorders for one to possess the clinical and technical skills necessary to provide this complex and comprehensive orthotic service.

This type of orthotic body jacket is identified as L-0430 in the Medicare O&P reimbursement system and has a reimbursement value of approximately $1,000 to $1,200. According to the OIG report, unscrupulous providers began submitting claims for simple seat cushions using the L-0430 reimbursement code in 1990. By the time HCFA identified this fraud and abuse, nearly $18 million in fraudulent claims had been reimbursed under this L-code in 1992 alone.

What the Inspector General did not mention was that the 5% of "orthotic body jackets" that were deemed by the OIG report to be "legitimate" claims were, in almost every instance, provided by certified orthotists "whose primary occupation is supplying orthotic and prosthetic devices to patients. The non-legitimate body jackets in our sample were supplied by Durable Medical Equipment (DME) suppliers that primarily supply DME equipment and supplies, not orthotics." OIG Report , p.4.

THE IMPORTANCE OF CONDITIONS OF COVERAGE

Recognition of provider credentials in the delivery of quality orthotic and prosthetic care is a critical point that we strongly request this Subcommittee consider when attempting to legislatively ferret out health care fraud and abuse in the Medicare program. NAAOP believes that an effective way to curb the type of fraud and abuse that occurred with orthotic body jackets would be to establish conditions of coverage for reimbursement under the orthotic and prosthetic L-codes. By limiting reimbursement of orthotic and prosthetic services to qualified orthotists and prosthetists who are certified to provide these services, HCFA could dramatically reduce the likelihood of this type of fraud and abuse in the future, as well as, the additional costs of adjudicating these fraudulent claims.

Currently, as a practical matter, any provider who obtains a Medicare billing number can submit a claim for orthotic and prosthetic reimbursement. Until 1992, HCFA's Medicare policy carriers manual on orthotic and prosthetic coverage restricted reimbursement to ABC-certified orthotists and prosthetists. HCFA changed its policy to allow O&P reimbursement to any provider credentialed by a membership organization of the National Organization for Competency Assurance (NOCA). NOCA is not a credentialing organization, but rather a membership organization open to all organizations interested in credentialing issues.

Realizing this error in recognizing the NOCA and instead of limiting reimbursement to practitioners qualified to provide comprehensive orthotic and prosthetic care, HCFA further expanded the range of providers eligible to provide O&P services reimbursable under the Medicare L-codes in September 1994. HCFA, therefore, currently has no substantive restrictions or apparent monitoring procedures as to who is qualified to submit orthotic and prosthetic claims under the Medicare program.

HCFA, has potentially exacerbated the likelihood foı the type of fraud and abuse that occurred with orthotic body jackets by recognizing and allowing "anyone credentialed by any certification organization in orthotics and prosthetics" to acquire an O&P provider specialty code and use the L-code designations in submitting orthotic and prosthetic reimbursement claims. This HCFA Medicare carriers manual policy change only increases the likelihood for fraud and abuse and provides virtually no control over the use of the O&P L-codes. Further, HCFA's relaxation of its conditions for orthotic and prosthetic coverage may lead to further proliferation of "new" orthotic and prosthetic credentialing organizations wishing to meet the relaxed requirements for orthotic and prosthetic reimbursements.

The creation of orthotic and prosthetic conditions of coverage under the Medicare program, therefore, would serve to promote quality control of orthotic and prosthetic health care services provided to Medicare beneficiaries and would lead to easy identification of fraudulent and abusive activities by unqualified providers. HCFA should consider reincorporating the ABC practitioner certification and facility accreditation standards into its conditions for O&P coverage. These certification and accreditation standards include physical facility requirements and the prerequisite that an ABC-certified practitioner be employed full-time in an O&P facility.

CONCLUSION

NAAOP welcomes the opportunity to work with this Subcommittee, the Health Care Financing Administration, and the Durable Medical Equipment Regional Carriers to eliminate fraud and abuse in the Medicare program, to appropriately regulate orthotics and prosthetics separately from durable medical equipment, and to ensure the provision of the highest quality orthotic and prosthetic care to Medicare beneficiaries. Thank you.

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