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There is More to Deducting Health Insurance than Meets the Eye

Article Highlights:

- Itemized Deduction
- AGI Limitations
- What Insurance is Deductible
- Above-the-Line Deduction for the Self-Employed
- Income Limitation
- Subsidized Limitation

Health insurance premiums, especially in the wake of the Affordable Care Act, have risen dramatically and are one of the greatest expenses that most individuals pay. Although the cost of health insurance is allowed as part of an individual's medical deductions when itemizing deductions, only the amount of total medical expenses that exceeds 7.5% of the taxpayer's adjusted gross income (AGI) is deductible. The 7.5% limitation is increased to 10% for years after 2020.

The purpose of this article is twofold: first, to remind you what insurance can be included as a medical deduction; and second, to inform you of an alternate means of deducting health insurance for certain self-employed individuals—a means that avoids the AGI limitation and allows for deduction without itemizing.

Let's start by looking at what is treated as deductible health insurance. It includes the premiums you pay for coverage for yourself, your dependents, and your spouse, if applicable, for the following types of plans:

- Health care and hospitalization insurance
- Long-term care insurance (limited based on age)
- Medicare A in some circumstances*
- Medicare B
- Medicare C (aka Medicare Advantage plans)
- Medicare D
- Dental insurance
- Vision insurance
- Premiums paid through a healthcare marketplace net of the Premium Tax Credit

*Most workers, and any government employees who pay Medicare tax, have a portion of their wages deducted for contributions to Medicare A. This payroll tax isn't a deductible medical expense. However, those not covered under Social Security, and government employees who didn't pay Medicare tax, can voluntarily enroll in Medicare A. In that case, the Medicare A premiums are a medical expense.

Premiums paid on your or your family's behalf by your employer aren't deductible because their cost is not included in your wage income. Or, if you pay premiums for coverage under your employer's insurance plan through a "cafeteria" plan, those premiums aren't deductible either because they are paid with pre-tax dollars.

Special Rule for Self-Employed Taxpayers

If you are a self-employed individual, you can deduct 100% (no AGI reduction) of the premiums paid on behalf of yourself, your spouse, your dependents, and your children who were under age 27 at the end of the year without itemizing your deductions. This above-the-line deduction is limited to your net profits from self-employment, less the deductible part of your SE tax and contributions to SEP, SIMPLE and qualified retirement plans.

No above-the-line deduction is permitted for any month when the self-employed individual is eligible to participate in a subsidized health plan maintained by an employer of the taxpayer, the taxpayer's spouse, any dependent, or any child of the taxpayer who has not attained age 27 as of the end of the tax year. The plan is considered to be subsidized when 50% or more of the premium is paid by the employer. This rule is applied separately to plans that provide coverage for long-term care services. Thus, if you are a self-employed individual eligible for employer-subsidized health insurance, you may still be able to deduct long-term care insurance premiums as long as you aren't eligible for employer-subsidized long-term care insurance.

If you are a partner who performs services in the capacity of a partner and the partnership pays health insurance premiums on your behalf, those premiums are treated as guaranteed payments that are deductible by the partnership and are includible in your gross income. In turn, you may deduct the cost of the premiums as an above-the-line deduction under the rules discussed in this article.

This above-the-line deduction is also available to more-than-2% S corporation shareholders. For purposes of income limitation, the shareholder's wages from the S corporation are treated as his or her earned income.

If you have any questions related to deducting health insurance premiums, whether as an itemized deduction or an above-the-line deduction for self-employed individuals, please give this office a call.