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**Coverage of Uninsured Workers in Small Firms:
The Significance of Self-Employment among Firm
Owners**

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The Institute for Health Policy Solutions is an independent, non-profit organization established to identify, analyze and develop creative and workable solutions to health care financing and coverage problems. IHPS concentrates on policy approaches that incorporate complementary roles for the public and private sectors in expanding coverage of the uninsured. Based in Washington, D.C., the Institute also maintains a California office, directed by Liane Wong.

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Coverage of Uninsured Workers in Small Firms: The Significance of Self-Employment among Firm Owners

It is widely understood that both small firm workers and self-employed individuals constitute a disproportionate share of the uninsured. It is somewhat surprising, however, that little information or analysis is available on the substantial overlap between these populations as it pertains to health insurance coverage.

This is an important area for investigation because “self-employed” businesses are very numerous and employ many small firm workers. Self-employed businesses, as defined by the Internal Revenue Code, are comprised of firms organized as sole proprietorships, partnerships, and S-corporations.¹ Firms headed by sole proprietors and partners are of particular interest because workers in these unincorporated businesses are less likely to have employment-based coverage and more likely to be uninsured than workers in an incorporated firm of the same size.²

In this overview, we assess the impact of tax policies and market rules on insurance coverage rates and examine the implications for health insurance coverage expansion programs for these workers. As appropriate, we refer the reader to more detailed appendices in the later sections of this report.

The Number of Self-Employed Businesses and Their Workers Is Significant

There were over 22 million businesses in the United States in 2001, about 90 percent of which were owned by self-employed individuals.³ Seventy-three percent of all businesses were organized as sole proprietorships, 6 percent as partnerships, and 10 percent as S-corporations. Among firms with employees (beyond the owner), the percentage of businesses owned by the self-employed falls to 65 percent primarily because a large proportion of sole proprietorships do not have workers.

Surprising to many, about a third of all U.S. workers are employed by the self-employed. These self-employed business employers are typically small—sole proprietorships employ on average 4 employees, partnerships 11.5, and S-corporations 14. Given the

¹ Within S-corporations, only shareholders who own more than 2 percent of the S-corporation are considered self-employed (henceforth referred to as “2 percent shareholders”). The more modern forms of partnerships including limited liability company (LLCs) and limited liability partnerships (LLPs) are generally treated like partnerships for tax purposes. The other major category of business organization is the C-corporation. See Appendix A for more detail.

² S-corporations are a form of business ownership that is considered to be both self-employed and incorporated but these firms have a larger average size, different tax treatment and higher rates of insurance coverage. Based on our research, they appear to face incentives to insure that are more similar to C-corporations than to unincorporated businesses.

³ SBA, 2002. See Appendix B for more detail.

preponderance of sole proprietorships among self-employed businesses, approximately 90 percent of all self-employed firms with employees have fewer than 10 workers.

Among all firms with fewer than 10 workers, unincorporated businesses (i.e. sole proprietorships and partnerships) employ 31 percent of all private sector workers employed by firms of that size.⁴ Among firms with 10 to 24 workers, these businesses employ 14 percent of workers.

*Approximately Half of the Uninsured Working for Small Firms
(with Fewer than 10 Employees) Are Employed by Self-
Employed Businesses*

Small, unincorporated firms (sole proprietorships and partnerships) are less likely to offer health insurance to their workers than incorporated firms of the same size.⁵ For instance, among firms with between one and nine employees, only 29 percent of unincorporated firms offered coverage compared to 46 percent of incorporated ones. As a result, workers in unincorporated firms have employment-based coverage in their own name at a rate that is about 30 percent lower than among workers in incorporated ones (28 percent in unincorporated firms versus 39 percent in incorporated ones).⁶

Although a lower rate of employment-based coverage among unincorporated firm workers does not necessarily mean that these employees are more likely to be uninsured than workers in incorporated ones, previous research found that 37 and 25.5 percent of employees working for sole proprietorships and partnerships were uninsured, respectively, compared to 11.6 percent in C-corporations.⁷ Furthermore, this difference in uninsurance rates was largely attributable to lower rates of employment-sponsored insurance in the name of the employee among sole proprietorships (27.4 percent) and partnerships (48.3 percent) compared to C-corporations (69.9 percent).⁸

Based on these data, we estimate that almost half (or, at least 2.3 million) of uninsured employees working for firms with between 1 and 9 employees are employed by self-employed businesses.⁹ This rate may even be higher if only low-wage, uninsured small firm workers are examined. Moreover, the number of uninsured associated with self-employed businesses is augmented by potentially 300,000 to 400,000 uninsured owners of these small firms.

⁴ The data do not permit S-corporation employers to be separated from C-corporation employers by firm size.

⁵ For additional detail, see Appendix C.

⁶ The percentage difference between unincorporated and incorporated firms narrows to about 20 percent if only full-time workers are analyzed.

⁷ Monheit and Harvey (1993).

⁸ Employees in sole proprietorships and partnerships had higher rates of employment-sponsored coverage as a dependent—26.9 and 23.7 percent, respectively—compared to C-corporations—15.8 percent.

⁹ See Appendix C.

Incidence of Health Insurance Coverage among the Self-Employed Varies by Incorporation Status and Existence of Employees

About a quarter of self-employed individuals—sole proprietors, partners, and 2-percent S-corporation shareholders—are uninsured.¹⁰ This rate of uninsurance is higher than that for all classes of wage and salary workers (16.4 percent). Since the vast majority of the self-employed are either unaffiliated individuals or own firms with fewer than 10 employees, it may be instructive to compare their sources of coverage with employees associated with firms of that size. Because a third of small firm employees are uninsured, the self-employed appear to fare much better, with the difference in uninsurance rates largely due to a higher incidence of individual coverage among the self-employed.

Important coverage differences exist among self-employed individuals—coverage is higher if they own an incorporated firm and/or have employees. For instance, 26 percent of the *unincorporated* (i.e., sole proprietors and partners) self-employed *without* employees are uninsured. Among *incorporated* (i.e., S-corporations) self-employed firms *without* employees and *unincorporated* firms *with* employees, 19 and 18 percent of the self-employed are uninsured, respectively. Coverage is highest among self-employed individuals who own an *incorporated* business *with* employees as only 7 percent are uninsured. The decline in uninsurance rates among these different categories of self-employed is largely due to an increase in the incidence of employer-sponsored coverage—either in their own name or as a dependent.

Tax Treatment of Self-Employed Health Insurance Premiums Is Less Advantageous than that of Regular Employees

A key difference between self-employed businesses and other businesses is the tax treatment of health insurance for the business owner.¹¹ These differences are a function of the firm's legal form of business (see Appendix A). The owners of C-corporations who draw a salary as an employee are considered "employees" by the IRS and thus benefit from the favorable tax treatment accorded employee benefits. Because the owners of unincorporated businesses are considered self-employed and *not* employees, the premiums they pay for their own health insurance are not deducted (as an employee benefit expense) for the purposes of determining taxable business income.^{12,13}

¹⁰ See Appendix C.

¹¹ See Appendix D.

¹² S-corporation business owners face unique treatment when it comes to company sponsored health insurance. The firm may pay all or part of the premium on their behalf and deduct it as a business expense. That amount, however, is reported to the IRS as income. It is not subject to FICA, however, and the shareholder-owner may take the self-employed health insurance deduction.

¹³ All forms of business, including the self-employed, can deduct health insurance expenses they pay on behalf of their *employees* from gross business income.

In the interests of tax equity, however, the Internal Revenue Code provides a personal deduction for health insurance that only the self-employed can take on their personal income tax return if:

- the deduction does not exceed their earned income from the business;
- the insurance plan is “established in the name of the business”; and
- the self-employed individual and his or her spouse are not eligible to participate in other (i.e. not the insurance plan sponsored by the self-employed individual) employer-subsidized insurance.

Over time, the percent of health premium costs the self-employed can deduct has increased from 25 percent in 1987 to 100 percent beginning in 2003 (see Exhibit 14 in Appendix D).

However, despite a deduction that will soon amount to 100 percent of the premium, *unincorporated* self-employed individuals (who constitute the bulk of self-employed individuals) who claim the deduction are still not on an equal tax footing with employees. The reason is that the income used to pay their premium is subject to self-employment tax (equivalent to FICA).¹⁴ For normal employees, the amount paid by the employer is not subject to such taxes, and even the amount the employee contributes may be sheltered from FICA (and federal, state, and local income taxes) if the premiums are paid under a (IRC) Section 125 plan.¹⁵ An exception to this limitation for *unincorporated* self-employed individuals is if they employ their spouse and are considered a dependent of their spouse’s policy with the employee-spouse’s premium contributions treated like those of any other employee.¹⁶

Utilization of the Deduction by Self-Employed Individuals Is Relatively Constant

Our analysis of statistics of income data from the IRS shows that the self-employed health insurance deduction is claimed by approximately 25 percent of those claiming the deduction for the payment of self-employment tax (see Exhibit 12 in Appendix D). This

¹⁴ FICA or payroll taxes are comprised of two taxes: 6.2 percent of salary for Social Security payable up to a maximum salary (\$87,000 in 2003) and 1.45 percent of salary for Medicare with no maximum salary amount specified.

¹⁵ Note, however, that the incidence of Section 125 plans is low among small employers with only 15 percent of California employers with 2-50 employees offering coverage making a Section 125 plan available (Mercer, 2002). Given this, it is conceivable that the self-employed proprietor might be better off from a tax point of view since many employees can not shield their premium contribution from federal, state and local taxes.

¹⁶ Note, however, that no other (non-family) employees need be present to qualify for this tax treatment. Note also that this strategy is not available to S-Corporation 2 percent shareholders. The IRC treats the spouse of a 2-percent shareholder as a shareholder as well and hence they cannot be considered an *employee*. However, because the portion of their premium paid by the firm is already exempt from FICA (see footnote 12), this prohibition only “costs” S-corporation spouses to the extent they face an “employee” contribution.

percentage has not changed between 1990 and 2000, even though the deductible percentage doubled from 25 percent to 50 percent. This may be because rapidly rising insurance premiums have more than offset the effective increases in the deductible percentage.¹⁷ Given that sources of coverage for the self-employed have remained somewhat constant over the past 10 years,¹⁸ the health insurance deduction for the self-employed—combined with premium increases—appears to have had very little impact on rates of coverage for these business owners.

*Unique Coverage Options Available to Self-Employed
Individuals May Influence Their Offer of and Participation in
Group Coverage*

As is the case for any adult individual, the self-employed have the option of obtaining insurance coverage through the individual market. Those who have employees, however, have the unique option of obtaining coverage through a group plan they make available to their workers. The self-employed have this option because under most, if not all, state small group laws, sole proprietors and partners of partnerships can be considered employees eligible for group coverage.¹⁹

As has been well-documented, depending on the state, there often are significant differences between the group and non-group markets in terms of administrative cost, coverage protections, and rating policies. However, the choice of insurance venue (non-group or group) makes no difference in the tax treatment of the premiums paid by the self-employed. In addition, the absence of an “employer” contribution and the small average size of self-employed groups reduce the normal financial incentive to choose group coverage over non-group coverage.

Under these circumstances, self-employed individuals have a varying array of incentives and counter-incentives to offer and participate in insurance they offer their employees. Indeed, there are no *personal tax incentives* for an unincorporated owner to offer coverage to their workers, outside of normal labor-market dynamics. Under these conditions, a self-employed individual’s self-assessed health risk is likely to weigh heavily in his or her choice of (and whether to offer) group or non-group coverage. If owners are high-risk, they are likely to seek group policies to benefit from any available

¹⁷ As shown in Appendix D, the doubling of the deductible percentage from 1990 to 2000 is more than offset by the increase in health insurance premiums during that period.

¹⁸ Rates of individually purchased insurance have declined rather significantly since 1991 but most of the decline occurred prior to 1995 – a time of minimal premium increases. See Exhibit 11 and Exhibit 13 in Appendix D and associated discussion.

¹⁹ These laws either explicitly require or administrative rules or market practices require that sole proprietors and partners work the minimum number of hours required to be considered employees eligible for coverage. State laws do not explicitly include S-corporation shareholders, but if these individuals work the requisite number of hours, insurers most likely include them either as partners or as employees. The ability of the self-employed, however, to opt freely for the coverage venue of their choice may also be limited depending on state regulations, insurer market practices, and the personal circumstances and preferences of the owner and his or her employees (see Appendix E for further discussion).

risk spreading and better market protections.²⁰ If they are low risk, they may purchase coverage in the non-group market if state rating (group and/or non-group) policies result in lower prices in that venue. And, even if they offer group coverage, market rules and insurer practices suggest that in many states they have the flexibility to “opt out” of the group to purchase lower-cost coverage without affecting their group’s ability to qualify for coverage. This combination of tax policies and market rules and practices may induce self-employed business owners to select against the market and may contribute to the higher coverage costs observed for micro group health insurance policies.

Key Observations and Policy Considerations

A number of proposals to extend coverage to the uninsured target small-firm workers and their dependents. These strategies include small employer purchasing pools to negotiate with health plans or offer self-funded coverage;²¹ direct subsidies (or tax credits for) to small firms to induce them to offer and contribute toward coverage for their workers;²² and premium subsidies for low-income working families in small firms with majority low-wage workforces.²³

To the extent that policy makers are interested in devising policies specifically targeted to covering the working uninsured, particularly within small firms, the unique overlap between the self-employed and uninsured workers merits special consideration. For instance:

- Almost half of small firm (fewer than 10 employees), uninsured workers are estimated to work for an unincorporated business owner. This represents a significant portion of the uninsured.
- These low rates of coverage among workers in small, unincorporated firms reflects low rates of employer based coverage. Although offer rates are the lowest among small firms, they are even lower among small, unincorporated businesses.
- Almost 20 percent of the unincorporated business owners with employees are themselves uninsured, and thus they may be more receptive to policies that would allow them to receive coverage as well as their employees.

²⁰ Under state small group laws and the Health Insurance Portability and Accountability Act (or HIPAA), participating small group members are afforded issuance, renewal, rating, and continuation (as well as other) protections. HIPAA protections generally apply to groups consisting of two employees plus the owner(s). In most states, however, the firm with one employee (besides the owner) would qualify for state small group protections. See Appendix E.

²¹ For example, proposed federal “Association Health Plan” legislation would allow small employers to band together to negotiate with health plans or organize their own self-insured plan and would not require such plans to comply with state benefit mandates.

²² See, for example, the Health Insurance Association of America’s “InsureUSA” plan at www.insureusa.org.

²³ See, for example, Ed Neuschler and Rick Curtis (forthcoming).

- Contrary to conventional wisdom, small, self-employed firms with employees appear to be relatively stable and thus could provide an adequate platform for reaching uninsured workers.²⁴ Furthermore, new research has found that, despite their high rates of job turnover, low-income workers without employer-sponsored coverage had sufficient tenure that they would experience longer periods of continuous coverage with (subsidized) employer-sponsored coverage than they would experience in a public program.^{25, 26}

Clearly, important distinctions exist within the population of uninsured, small firm workers. The data in this report suggest that employer-based coverage expansion policies should take into consideration the unique attributes of self-employed firms and their workers. However, currently there is a lack of consistent, positive incentives for self-employed owners to offer coverage that thereby would undoubtedly hamper either the design and/or effectiveness of such policies. Thus, for coverage expansion policies to meet with more success, the following factors should be taken into account.

- Common sense suggests that self-employed business owners would be more likely to offer coverage to their workers if they themselves benefit from that coverage. Federal tax policies and insurance market rules and practices currently divorce the personal coverage decision for unincorporated, self-employed business from the decision of whether to offer health insurance to their workers. Strategies that more closely link these two decisions are likely to be more effective in increasing offer rates, and thus expanding coverage, among these firms.²⁷
- Even if public policy provides an incentive for self-employed owners to offer coverage to their workers:
 - under current law, these owners face incentives and disincentives to participate in that coverage.²⁸ Although not universally true, common sense would indicate that business owners would be more interested in the type of coverage they provide their employees if they too enroll in the group plan. In addition, as previously discussed, current coverage rules and practices permit some business owners to select against the group market. To succeed, coverage programs may need to be cognizant of both issues and create incentives for the former and incorporate provisions to guard against the latter.

²⁴ See Appendix F for more detail.

²⁵ A cause-and-effect relationship between the lack of employer-sponsored coverage and turnover among low-income workers is unclear. Research on employee turnover indicates that non-offering small businesses may have higher employee turnover. On the other hand, research also indicates job-based health insurance may contribute to the stability of the workforce. See Appendix F.

²⁶ Marquis and Kapur (forthcoming).

²⁷ While supporting data is not readily available to the authors, they speculate that the owners who employ their spouse, or whose firm is organized as an S-corporation (two business structures where owner coverage is more fundamentally linked to that of their employees) offer coverage at a higher rate than other forms of small business.

²⁸ See Appendix E.

- under current tax law, the *post-tax* price paid by unincorporated owners is typically higher than that faced by their employees for the same coverage. This occurs, not only because the employee benefits from the employer's contribution, but also because the owner typically faces a higher tax rate on the money used to pay the premium.²⁹ To be as effective as possible, programs designed to induce self-employed firms to offer coverage to their workers may need to address this issue.
- The proportion of self-employed individuals utilizing the health insurance income tax deduction suggests that insubstantial premium subsidies may have little effect on coverage rates for self-employed owners.³⁰ While the deduction for health insurance premiums for the self-employed may have merit from the perspective of tax equity, much larger, and possibly more direct, subsidies may be needed to cover those small firms owners and workers who are uninsured.³¹
- Anecdotal evidence from other subsidized coverage programs suggests that determining the true economic status of the self-employed is complicated given the unique nature of their businesses and tax filings. To effectively target limited subsidy dollars, it may be prudent for expansion programs to devote additional resources to determine the real income eligibility for these families and avoid spending these scarce funds on non-qualifying small firms owners.
- Finally, surveys of small business owners indicate that they often do not understand basic aspects of the complex set of current tax and market rules concerning offering health insurance.³² Unless tax and/or market policy changes intended to improve the rate at which self-employed individuals offer group coverage are as clear and consistent as possible, it seems doubtful that they will have a significant effect on coverage offer rates among self-employed firms.

The unique characteristics of the self-employed may have ancillary, and unanticipated, effects for other types of coverage expansions as well. For example, the proposed enactment of tax credits for low-income individuals to obtain non-group coverage could

²⁹ While the self-employed do not pay income tax on the income used to pay the premium, if they are unincorporated they are subject to self-employment tax of about 14% (.9235% of self-employment income is subject to SE/FICA rate of 15.3%). The employee only pays FICA and income taxes on the share of the premium they paid out-of-pocket which typically results in a lower tax burden. See Appendix D for more details.

³⁰ For instance, even with the self-employed health insurance deduction increasing to 100 percent in 2003, a self-employed family of four earning \$40,000 facing a marginal tax rate of 15 percent would receive a reduction in their federal tax liability of only \$900 for a policy costing \$6,000.

³¹ See Lyke (2001) for a discussion of tax equity considerations.

³² For example, in one survey of small businesses (SEHBS, 2000), about three-quarters of respondents who did not offer coverage did not realize that health insurance for their employees is a deductible business expense. About half of non-offering respondents did not realize that employees pay no taxes on the share of premiums paid by their employer. About six in ten responding small employers (offering and non-offering) were not aware that insurers cannot deny group coverage to small employers even though the health status of a worker may be poor. This survey of firms with 2 to 50 workers had 955 respondents, 47 percent of which did not offer insurance. Another survey of small California employers found that only 57% of health plan sponsors had heard of Section 125 plans (Mercer (2002)).

be more valuable to many self-employed individuals than the current deduction they can take for their insurance.³³ This could be true for self-employed proprietors with substantial resources who qualify for a large credit because they take substantial deductions, for example for depreciation. For those self-employed who were participating in group coverage with their employees, such a tax credit initiative may result in self-employed business owners dropping coverage (if they cannot easily opt of their group plan) in order to reap these tax benefits.³⁴ (Although the presence of a significant employer contribution would rarely cause a wage and salary worker to drop group coverage if offered a credit for non-group coverage, this would not be the case for the owner.)

In summary, a uniquely complex set of tax and market considerations affect health insurance options and costs for the self-employed. This can make it challenging for policy makers to influence the demand for insurance coverage among these business owners and their uninsured workers. However, it is important to note the significant number of uninsured workers and their families associated with these firms. These data indicate that small-employer-based coverage expansion proposals will have greater efficacy if such programs are designed to constructively address the unique tax and market incentives affecting the self-employed.

³³ The proposed tax credit for a family of four earning \$40,000 would be \$1,741 for a family policy costing \$3,333 or more. This family would probably face a marginal tax rate of just 15%, making the self-employed health insurance deduction worth only \$500 for a policy costing \$3,333. In order to realize a deduction worth \$1,741, they would have to spend \$11,606 on the premium. (The proposed credit as specified in Department of the Treasury, 2002)

³⁴ Obviously, self-employed businesses will not drop group coverage if it creates major disruptions among their employees or otherwise negatively influences their labor force. For a further discussion of the potential effect of individual tax credits on small group coverage, see Curtis and Neuschler, "Tax Credits for Individual Health Insurance: Effects on Employer Coverage and Refinements to Improve Overall Coverage Rates," accessible at <http://www.esresearch.org/Documents/curtis.pdf>.

Appendix A Defining the Self-Employed

Self-employed businesses, as defined by the Internal Revenue Code, are comprised of firms organized as sole proprietorships, partnerships, and S-corporations (Exhibit 1). Within S-corporations, only shareholders who own 2 percent or more of the S-corporation are considered self-employed. The more modern forms of partnerships including limited liability company (LLCs) and limited liability partnerships (LLPs) are generally treated like partnerships for tax purposes.³⁵

The other major category of business organization is the C-corporation. While rare, a person who considers himself or herself self-employed might organize his or her business as a C-corporation. They would not be viewed as “self-employed” by the IRS but they may identify themselves as self-employed on household surveys and in other venues.

Exhibit 1 How Legal Form of Business Relates to Self-Employment and Incorporation

Self-Employment Status	Incorporation Status	Legal Form of Business	Distinguishing Features
Self-Employed	Unincorporated	Sole Proprietorship	Owned by one individual. Personally liable for the debts of the business. Business income and profits reported on schedule C of personal tax return.
		Partnership (includes LLC and LLP)	Two or more people in a relationship to carry on a trade or business. A partnership is not a taxable entity. Each partner includes his/her share of the partnership’s profit or loss on his/her personal tax return. Each partner is personally liable for the partnership’s debts and legal liabilities.
	Incorporated	S-Corporation	An entity that can avoid the double taxation faced by C-corporations. The S-corporation itself is generally exempt from federal income tax. Its shareholders include on their tax returns their share of the S-corporations income and loss. The S-corporation is treated much like a partnership and a 2 percent or more shareholder is treated much like a partner.
Not Self-Employed		Regular or C-Corporation	A corporation is an independent entity. The profit of the corporation is taxed to both the corporation and to its shareholders when it is received in the form of dividends. Shareholders cannot deduct any loss of the corporation, nor are they liable for its debts (unless it can be demonstrated that they had controlling interest of the corporation).

Source: IRS

³⁵ A limited liability company (LLC) and limited liability partnership (LLP) are entities formed under state law by filing articles of organization as an LLC or LLP. Unless they specify otherwise, they are generally treated like partnerships for tax purposes, although they can legally operate as a sole-proprietor, a

Note that a sole proprietorship is not a separate legal entity, like a partnership or a corporation. No legal formalities are necessary to create a sole proprietorship other than appropriate licensing to conduct business and registration of a business name if it differs from that of the sole proprietor. Because a sole proprietorship is not a separate legal entity, it is not itself a taxable entity.

Because the appendices in this report contain some historical data, it is also worth noting that S-corporations have become an increasingly popular form of business organization over the past 20 years. With the passage of the Tax Reform Act of 1986, for the first time since 1916, the maximum personal tax rate was lower than the maximum corporate tax rate, thereby putting a premium on the ability of a business entity to pass through its income to its shareholders without the imposition of tax. Although it is our understanding that individual rates once again exceed corporate rates, S-corporations continue to be a popular form of business organization. Based on IRS tax returns, this growth in S-corporation businesses appears to come at the expense of the C-corporation form of business organization, with sole proprietorships and partnerships maintaining a fairly steady share of total businesses.

partnership, or a corporation. Unless organized as a C-corporation (rarely advantageous for a small business), the partners of a LLC or LLP are considered self-employed.

Appendix B Prevalence of Self-Employment among Firms and Workers

As shown in Exhibit 2, the self-employed (sole proprietors, partnerships, and S-corporations) are very numerous and, in fact, head up 89 percent of the businesses in the U.S. A large number of these, especially among those organized as sole proprietors, have no employees.

Among businesses *who employ others*, the self-employed represent 65 percent of employers. These self-employed businesses tend to be small. Sole proprietors, for example, have an average of only 4 employees and employ less than 6 percent of all wage and salary workers. In contrast, 69 percent of wage and salary workers are employed in C-corporations.

Exhibit 2 Distribution of Firms & Employees by Legal Form of Organization, 1997

	All Forms*	Self-Employed				Not Self-Employed
		Unincorporated		Incorporated		
		Sole Proprietor	Partnership	S-corporation	C-corporation	
	<i>Number (000)</i>	<i>Percent Distribution</i>				
Firms	20,822	73	6	10	11	
Firms with Employees	5,295	28	6	29	35	
Employees	103,360	6	4	21	69	
	<i>Number</i>					
Average Employees per Firm	19.5	3.9	11.5	14.1	38.0	

* includes a small amount of "other" firms: cooperatives, estates, etc.

Source: US. Bureau of Census, 1997 Economic Census.

Significant for this analysis however, is the fact that among small employers, self-employed small firms employ a significant share of workers. Among firms with fewer than 10 workers, unincorporated businesses employ 31 percent of private sector workers employed by firms of that size (see Exhibit 3).³⁶ Among firms with 10 to 24 workers,

³⁶ In contrast to the treatment by the Bureau of the Census, it is the intention of the MEPS to include the proprietors and partners of unincorporated businesses in their employee counts and firm size designations.

these businesses employ 14 percent of workers. (The data do not allow us to break out S-corporation employers from other incorporated employers by firm size. Thus, the percent of employees working for self-employed firms would be greater than that shown in Exhibit 3.) These small, unincorporated firms are of interest because they are the least likely to offer health insurance and, as later data will show, sole proprietors and partnerships are even less likely to offer health insurance than incorporated small firms.

Exhibit 3 Percent of Employees Working for Unincorporated Firms, by Firm Size, 2000

Firm Size	Percent of Employees in Unincorporated Firms
<10 Employees	31
10-24 Employees	14
All Firm Sizes	9

Source: MEPS, 2000

As shown in Exhibit 4, unincorporated firms with employees number around 2 million (again, the data do not allow us to break out S-corporation employers from other incorporated employers by firm size).³⁷ Almost half of the unincorporated employers have only 1 or 2 employees and almost all have fewer than 10 employees.³⁸

The small size of unincorporated businesses has significant implications for their health insurance market options (discussed in more detail in Appendix C). As a result, the small group market in which they purchase health insurance will be almost exclusively influenced by state law, with the Health Insurance Portability and Accountability Act being the significant exception (HIPAA, P.L. 104-191).³⁹ Their small size also results in most of these businesses being exempt from many of the federal laws affecting the employer-employee relationship and the provision of employee benefits. For example, many of these firms are so small that they are exempt from Federal anti-discrimination

It is believed, however, that respondents do not always include themselves in their response to the question on the number of employees.

³⁷ Note that the number of unincorporated self-employed implied in Exhibit 2, 1.8 million (34 percent times 5,295,000) is lower than that of Exhibit 3. The former is derived from the Economic Census of 1997 (with counts of very small firms derived primarily from tax records) and the latter is based on a household survey from 2001.

³⁸ Similar to Economic Census, these Current Population Survey (CPS) firm size designations *exclude* the owner from employee counts. Hence, with the CPS an unincorporated firm with one employee may have two *workers*, the employee and the self-employed owner. An unincorporated partnership with two (or more) partners and one employee could actually have three (or more) workers.

³⁹ The very low instance of self-insurance among small firms means most of them are not exempt from state regulation under the Employee Retirement Income Security Act of 1974 (ERISA). MEPS data indicate that only 10 percent of firms under 50 employees, that offer health insurance, self-insure.

laws that would have required them to provide equal benefits for all employees.⁴⁰ They may be subject to state anti-discrimination laws, however.

Exhibit 4 Unincorporated Self-Employed Firms, by Firm Size, 2001

Number of Employees	Thousands	Percent Distribution
1 Employee	626	30.7
2 Employees	467	22.9
3 to 5 Employees	474	23.2
6 to 9 Employees	161	7.9
10 or More Employees	186	9.1
Don't Know or Refused	129	6.3
Total with Employees	2,042	100.0

Source: February 2001 CPS

⁴⁰ A number of federal anti-discrimination laws exempt small employers from their requirements. For instance, firms with less than 15 employees are exempt from Title VII of the Civil Rights Act (which incorporates the Pregnancy Discrimination Act) and the Americans with Disabilities Act; firms with less than 20 employees are exempt from the Age Discrimination in Employment Act; and firms with less than 50 employees are exempt from the Family Medical Leave Act.

Appendix C Insurance Coverage Rates for Self-Employed Owners and Their Workers

Although the reasons may differ between the two groups, it has been well documented that workers and owners in very small firms find it difficult to access and afford health insurance. The available evidence also suggests that, after controlling for firm size, owners and workers in unincorporated businesses are less likely to have coverage than those in incorporated firms.

Incidence of Coverage Among Self-Employed is Low but Varies by Incorporation Status and Existence of Employees

Among all classes of wage and salary workers, the self-employed are the most likely to be uninsured. Twenty-four percent of the self-employed are uninsured compared to 16 percent of all wage and salary workers (see Exhibit 5).

Compared to all wage and salary workers, the self-employed face the substantial obstacles of small group size, no employer contribution, and less favorable tax treatment of health insurance when it comes to obtaining coverage (see Appendix D). Reflecting these considerations, less than half of the self-employed have employer-based coverage in their own name compared to all wage and salary workers. Conversely, their coverage as a dependent with employer coverage or from individually purchased policies is much greater than that of all wage and salary workers.

Exhibit 5 Sources of Health Insurance Coverage for Workers, Ages 18-64, 2001

	Self-Employed (incorporated and unincorporated; with and without employees)	All Wage & Salary Workers	Wage & Salary Workers in Private Firms with Fewer than 10 Employees
Employer Coverage, Own Name	27.1%	59.2%	27.7%
Employer Coverage, Dependent	26.7	16.3	23.7
Individually Purchased	18.9	4.5	9.5
Public	5.1	6.0	7.4
Uninsured	24.0	16.4	33.6
All Sources	102%	102%	102%

Note: Details add to approximately 102 percent because some respondents report insurance from more than one source.

Source: EBRI analysis of the March 2002 CPS supplement (as published in their December 2002 *Issue Brief*)

The rate of employer-based coverage among the self-employed aligns more closely with that of wage earners in firms with less than 10 employees. Compared to these workers,

however, the self-employed are more likely to be insured overall with the difference attributable to a much higher rate of individually purchased insurance.

Segregating self-employed business-owners by type of firm reveals some large differences in coverage rates. As shown in Exhibit 6, the percentage of self-employed individuals who have health insurance increases if their firms are incorporated and/or have employees.⁴¹

Exhibit 6 Sources of Health Insurance Coverage for Self-Employed Owners by firm characteristics, 2001

	Total Self-Employed (all ages; incorporated and unincorporated)	With Employees		Without Employees	
		Incorporated	Unincorporated	Incorporated	Unincorporated
Number of Proprietors (000)	12,712	2,364	1,965	1,415	6,968
<i>Distribution by Source of Insurance Coverage</i>					
Employer Coverage, Own Name	22%	52%	27%	25%	10%
Employer Coverage, Dependent	28	17	23	25	34
Individually Purchased	20	17	24	22	19
Other Source/Do Not Know	9	7	8	9	10
Uninsured	21	7	18	19	26
All Sources	100%	100%	100%	100%	100%

Note: Exhibit excludes those whose “health insurance coverage” and/or “presence of paid employees” was “unknown/refused to answer”. It includes the self-employed 65 years old and older.

Source: February 2001 CPS analysis supplied by the BLS.

The overall rate of coverage for unincorporated owners with employees is similar to that of all wage and salary workers. However, the unincorporated business owner with employees is much more likely to have employer coverage as a dependent or individually purchased insurance. Their rate of employer coverage in their own name is roughly half that of all wage and salary workers.

The self-employed who are unincorporated and do not employ others—the majority of the self-employed—have a very different coverage profile. Among all the self-employed, these individuals are more likely to be uninsured (26 percent) and are much less likely to have employer coverage in their own name (10 percent).

⁴¹ Furthermore, Monheit and Harvey (1993) found that employment based coverage for the self-employed in their own name went up significantly as the number of employees increased from fewer than 5 (28% have employer coverage in own name) to 9 or more (47% have employer coverage in own name).

Employees Working for Self-Employed Firms Less Likely to Have Employer-Sponsored Coverage and More Likely to Be Uninsured

After controlling for firm size and full-time status of workforce, unincorporated firms are less likely to offer coverage than incorporated ones. As shown in Exhibit 7, 29 percent of unincorporated firms with between 1 and 9 employees offered health insurance.⁴² In contrast, 46 percent of similarly sized incorporated firms offered health insurance. Because the percentage of firms offering health insurance increases with firm size (even among firms with fewer than 10 workers), more employees in this firm size category work for offering employers than the firm counts would indicate. Regardless of incorporation status, employees tend to enroll in their employer’s health insurance approximately 66 percent of the time if the firm offers.⁴³ Hence, the lower instance of unincorporated firms offering coverage results in a rate of employer health insurance coverage among employees that is about 30 percent lower in unincorporated firms than incorporated ones.

Exhibit 7 Health Insurance Coverage in Firms with Fewer than 10 Employees, 2000

	Unincorporated Firms	Incorporated Firms
Percent of Firms Offering	29%	46%
Percent of Employees in Offering Firms	42%	59%
Percent of Employees Enrolling in Employer-Sponsored Insurance <i>(includes those in offering and non-offering firms)</i>	28%	39%

Source: MEPS, 2000

If only full-time workers are analyzed, the difference between incorporated and unincorporated firms narrows but is not eliminated. The net result is rates of employer health insurance coverage among full-time employees that is 20 percent lower in unincorporated firms than incorporated ones.

⁴² Medical Expenditure Panel Survey-Insurance Component (MEPS-IC) covers *establishments* with at least one employee that were in business during the last quarter of the year (i.e., self-employed persons with no employees and no other locations are excluded). An establishment is a particular workplace or location. A *firm* is a company or business. A firm can have many establishments or only one. To make matters more complex, in MEPS, establishments and employees are tabulated by *firm size*—the number of employees at all locations of the business nationwide, as reported by the survey respondent. When analyzing firms under size 10, the average firm has only one establishment. Hence, in this analysis, the term “firm” is used throughout to avoid confusion.

⁴³ This statistic is a combination of the percentage eligible for coverage (approximately 82 percent among employees in offering firms—regardless of incorporation status) and the percentage of those eligible who accept coverage (approximately 80 percent of those eligible for coverage—regardless of incorporation status).

While the lower rate of employer-coverage in their own name has bearing on our analysis, it does not directly indicate whether employees who work for unincorporated firms are more likely to be uninsured than workers in incorporated firms. However, as shown in Exhibit 8, previous research found that employees of unincorporated firms were much more likely to be uninsured than those in C-corporations and less likely to have employer coverage in their own name.

Exhibit 8 Health Care Coverage of Employees by Legal Form of Business, 1987

	Employer-Sponsored Insurance – Policy Holder	Employer-Sponsored Insurance – Dependent	Uninsured
Sole Proprietorship	27.4%	26.9%	37.0%
Partnership	48.3%	23.7%	25.5%
S-corporation	51.7%	25%	18.5%
C-corporation	69.9%	15.8%	11.6%

Note: “Other” insurance coverage (the residual, not shown) was associated with high standard errors for the category S-corporation.

Source: 1987 National Medical Expenditure Survey – Health Insurance Plan Survey (Monheit, 1993)

While old, the analysis by Monheit and Harvey is useful because they used logistic regression to remove the effect of firm size, income and other variables, and to isolate the effect of form of business ownership on health care coverage.⁴⁴ Using this technique, they found that wage earners employed by sole proprietors were 22 percentage points less likely to hold employment-related coverage compared to those employed by C-corporations. The effect held true for partnerships and S-corporations but was weaker, 9 and 8 percentage points respectively.

Self-Employed Businesses Employ Almost Half of Uninsured Employees Working for Firms with Fewer than 10 Employees

CPS identifies 16 million workers in firms with fewer than 10 employees, 34 percent, or 5.4 million, of whom were identified as being uninsured. Within firms of this size, the rate of unincorporated firms offering coverage is about 30 percent lower than that of incorporated firms (see Exhibit 7). Supplementing this finding, older research suggests that the percent of employees without health insurance is higher among workers in unincorporated firms (see Exhibit 8).⁴⁵ By combining these statistics, it seems likely that 40 to 50 percent of the 5 million employees who work for unincorporated small firms are uninsured (see Appendix B). As a result, at least *40% of the 5.4 uninsured small firm*

⁴⁴ See Appendix D (and its particular Exhibit 14) for a discussion of the tax environment in 1987.

⁴⁵ This study was conducted by Monheit and Harvey analyzing the 1987 National Medical Expenditure Survey. Because MEPS and CPS do not identify the incorporation status of the worker’s firm in their household surveys, these newer data sources cannot be used to examine other sources of coverage for workers by the incorporation status of their firm.

employees work for a self-employed firm.⁴⁶ Moreover, the number of uninsured associated with self-employed businesses is augmented by potentially 300,000 to 400,000 uninsured owners of these small firms.⁴⁷

Exhibit 9 Estimated Health Coverage of Employees, Ages 18-64, in Firms with 1-9 Employees, by Incorporation Status, 2001

	Total Workers (millions)	Percent of Workers Uninsured	Total Uninsured (millions)
Unincorporated Firms	5	45	2.3
Incorporated Firms	11	29	3.1
All Firms	16	34	5.4

Notes: Data for “All Firms” from EBRI analysis of March 2002 CPS; split by incorporation status from MEPS, 2000. Exact number of uninsured by incorporation status is not known but the rate of uninsurance for the unincorporated is certainly higher than the overall rate. The uninsured percentages above reflect a 16 percentage point difference between unincorporated firm workers and incorporated firm workers.

Source: IHPS

⁴⁶ This may be higher if only low-wage, uninsured small firm workers were examined. Furthermore, if those employees working for an S-corporation are included, a clear majority of the uninsured working for firms with fewer than 10 employees work for a self-employed business. As discussed in Appendix D, however, the tax incentives faced by S-corporation owners differ from the tax incentives faced by unincorporated firms as they relate to health insurance coverage.

⁴⁷ CPS estimates that 18 percent of the owners of unincorporated businesses are uninsured.

Appendix D Tax Treatment of Health Insurance Coverage for the Self-Employed

A key difference between self-employed small businesses and other small businesses is the tax treatment of health insurance for the business owners. These differences are a function of the firm's *legal form of business*.⁴⁸ The owners of regular or C-corporations who draw a salary are considered "employees" by the IRS and are able to benefit from the same favorable tax treatment accorded employee benefits.⁴⁹ In contrast, owners of sole-proprietorships and partnerships are considered by the IRS to be self-employed, not employees. While the self-employed business owners may participate in any group insurance sponsored by their firm (see Appendix E), any premiums paid on their behalf are generally not a deductible employee benefit expense and they cannot be excluded from the taxable gross income of the business.⁵⁰ Owners of S-corporations who are more than 2-percent shareholders are considered self-employed by the IRS but are able to deduct their own health insurance as a business expense.

In the interests of tax equity (*vis-à-vis* employees) the Internal Revenue Code (IRC) provides a personal deduction for health insurance that is available only to the self-employed and is separate from their statement of business profit or loss. Self-employed business owners may take this deduction for health insurance on their personal income tax return if:

- the deduction does not exceed their earned income from the business;
- the insurance plan is "established in the name of the business"; and
- the self-employed individual *and spouse* are not *eligible* to participate in other (i.e., not the insurance sponsored by the self-employed individual) employer-subsidized insurance.

(In practice, it does not appear that the latter two requirements are audited or enforced.) If they meet the criteria above, self-employed owners can deduct 70 percent of the

⁴⁸ See Appendix A.

⁴⁹ Any form of business organization can deduct the health insurance expenses paid on behalf of *employees* from gross business income. Furthermore, this benefit is not treated as taxable compensation to the employee and is not subject to income tax or FICA. This tax treatment has led to widespread employer sponsorship and subsidization of health insurance in the United States.

⁵⁰ In the case of a partnership, if the health insurance premiums are characterized as "guaranteed payments to partners" (in other words, made without regard to the income of the partnership) they are permitted to deduct the premiums as a business expense. (This is similar to the treatment of premiums for S-corporation owners.) If the payments take the form of a reduction in the distribution to the partner, they are considered part of the partner's distributive share of income and no business expense deduction is permitted. (This is similar to the treatment of premiums by sole proprietors.)

premium for insuring themselves and their families in 2002 and 100 percent in subsequent years.⁵¹

It is important to note that even when the deduction for health insurance rises to 100 percent, the *unincorporated* business owner will still not be on an equal footing with the employee. Even though their full health insurance premium will be exempt from federal income tax, for those claiming the deduction, the premium they pay will be subject to self-employment tax (equivalent to FICA). For employees, only the employee-paid portion of the premium is subject to FICA and federal, state and local income tax.⁵² Even this portion may be sheltered from these taxes if the premiums are paid under a Section 125 plan.⁵³ Additionally, if the employer offers a health care flexible spending account, unreimbursed medical expenses may also be sheltered from federal and state income tax as well as FICA. Self-employed business owners can only shelter these out-of-pocket costs if they itemize their deductions and these expenses total to more than 7.5 percent of their adjusted gross income.⁵⁴

A special situation exists when unincorporated business owners employ their spouse.⁵⁵ Under these circumstances, the owner can benefit as a dependent from the employer coverage of their *spouse if their business is organized as a sole-proprietor or a partnership*. Since the policyholder is now an employee (and not an owner), this strategy allows the “employer contribution” to the premium to be deducted as a business expense as would be the case with any other employee and shelters the employer contribution from FICA, state and federal income taxes.⁵⁶ The amount the spouse-employee must

⁵¹ It is not necessary to itemize to receive this deduction as it is included as a subtraction from income used to arrive at Adjusted Gross Income or AGI (like the IRA deduction). Because AGI is usually the starting point for the calculation of state income tax liability, the self-employed health insurance deduction typically flows through to reduce state income tax liability. At least nine states have also adopted a small additional deduction for self-employed health insurance. In these cases, the filer is typically permitted to deduct any premium payments which weren't already deducted on form 1040 or schedule A (i.e., for 2002 this would be the 30 percent of the premium not claimed as a deduction on the federal return). When the federal deduction rises to 100 percent this type of state deduction will cease to have an impact. State Coverage Initiatives. www.statecoverage.net/tax.htm [Accessed Jan 23, 2003]

⁵² S-corporation shareholders are a special case. Like employees, these owners do not need to pay FICA on the part of their compensation from the firm representing health insurance premiums. Furthermore, an S-corporation may actually deduct the premiums for health insurance provided to its owner-employees but the premiums paid must be included in the gross wages of the owner-employee (and reported as taxable wages on his or her Form W-2). The owner-employee may then take the self-employed health insurance deduction on his/her individual tax return assuming they meet the criteria previously cited.

⁵³ Because they are not considered employees, sole proprietors and partners also do not qualify for any Section 125 plans (e.g., POP plans, flexible spending accounts, or cafeteria plans) they may have set up on behalf of their employees. These plans are not very common among small employers, however. According to a 2000 California small employer survey, only 15 percent of small California employers (2-50 employees) that sponsor insurance have a section 125 plan in place (Mercer, 2002).

⁵⁴ Another option for paying these expenses with pre-tax income is the Archer MSA but the rules governing its use are complex and take-up has been very limited.

⁵⁵ To qualify for this tax treatment, the spouse must be a “bona fide” employee. A W-4 must be filed for the spouse and payroll taxes are due on his or her earnings.

⁵⁶ It is estimated that in 1987 only 3.4 percent of the self-employed were dependents of family members that were employed by their business (Monheit and Harvey, 1993). Due to the IRS ruling bestowing

contribute would still be subject to FICA, state and federal income taxes unless sheltered under a Section 125 plan. (If no other employees are present, it is likely that the family would maximize the tax advantage by paying having the “firm” pay 100% of the premium.) S-corporations owners may not avail themselves of this strategy.⁵⁷

A summary of the tax treatment of health insurance premiums for self-employed individuals and for regular wage and salary workers is shown in Exhibit 10.

Exhibit 10 Summary of the Tax Treatment of Health Insurance Premiums for the Self-Employed and Regular Wage and Salary Employees

	Wage and Salary Employees (Including Unincorporated Business Owners with an Employee-Spouse through which Coverage Is Received)	Unincorporated Business Owner without an Employee-Spouse	S-Corporation 2 Percent Shareholders
<i>Treatment of “Employer Contribution” for Health Insurance</i>			
Deductible as a business expense?	Yes	<i>There is no employer/employee contribution, see below for tax treatment</i>	Yes
Subject to FICA/SE tax?	No		No
Subject to Federal Income Tax?	No		No
Subject to state/local income taxes?	No		No. (Reported as taxable wages but deductible on form 1040 if criteria met.)
<i>Treatment of “Employee Contribution” for Health Insurance</i>			
Deductible as a business expense?	No	Generally, no ⁵⁸	No
Subject to FICA/SE tax?	Yes (unless under a Section 125 plan)	Yes	Yes
Subject to Federal Income Tax?	Yes (unless under a Section 125 plan)	No (100% deductible in 2003 if criteria met)	No (100% deductible in 2003 if criteria met)
Subject to state/local income taxes?	Yes (unless under a Section 125 plan)	No	No

Source: IRS

legitimacy on this arrangement in 1994, instances of spousal coverage of the proprietor in their own business may have increased since that time.

⁵⁷ Unlike the partnership or sole-proprietorship, the IRC treats the spouse as a shareholder in the S-corporation. However, because the portion of their premium paid by the firm is already exempt from FICA, this prohibition only “costs” S-corporation spouses to the extent they face an “employee” contribution.

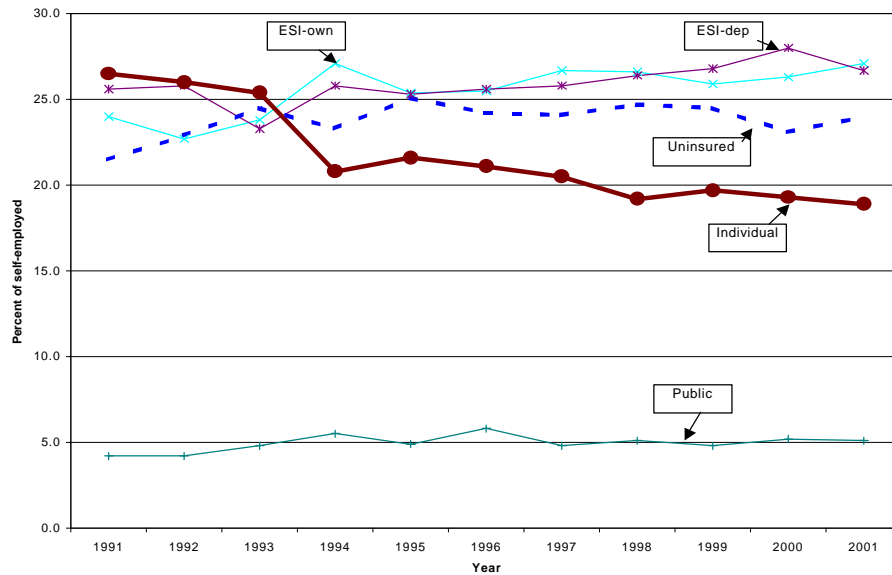
⁵⁸ In the case of partnerships where the premium payment can be characterized as a “guaranteed payment” the business expense deduction is permitted. See footnote 50.

Assessing the Impact of the Tax Treatment of Health Insurance for the Self-Employed

The impact of the differential tax treatment between self-employed business owners and C-corporation owners is difficult to assess. As Monheit and Harvey observed (see Appendix C), owners of unincorporated firms are less likely to be insured than incorporated firms after controlling for firm size and income. However, the self-employed purchase non-group insurance at twice the rate of all salary and wage earners in small firms. Is this due to the tax preference available to them that is not available to other purchasers of non-group insurance?

Exhibit 11 shows that sources of coverage for all the self-employed (both incorporated and unincorporated business owners) have remained relatively constant over the past eleven years (this is more definitely the case since 1994). The most significant trend is the decline in individually purchased insurance and a several percent increase in the uninsured and those with employment-sponsored insurance in their own name.⁵⁹

Exhibit 11 Sources of Health Insurance for Self-Employed Workers, 1991-2001



Source: EBRI *Sources of Health Insurance and Characteristics of the Uninsured, Issue Brief*, various years.

⁵⁹ In 1995 and later years, CPS data actually indicate fewer self-employed persons with individual insurance than the IRS identifies as claiming the deduction. The difference may lie in the number of self-employed claiming employer coverage in their own name. Some of this is likely to be group policies taken out in association with their business. For others, however, it may be coverage from a previous employer. While not shown in Appendix C discussion of coverage among the self-employed, the February 2001 CPS data indicate that 16 percent of self-employed workers with “employer-coverage in own name” were policies where the coverage was from a previous employer or other (current) employer.

During this period, the “take up” rate of the self-employed health insurance deduction (as a percentage of filers claiming a deduction for self-employment tax) has also remained constant.⁶⁰ As shown in Exhibit 12, the percentage of self-employed filers claiming the deduction has not changed between 1990 and 2000—a time period during which the deductible percentage doubled (from 25 to 50 percent).⁶¹ During this time, however, premium levels also increased (see Exhibit 13).

Exhibit 12 Prevalence of the Self-Employed Health Insurance Deduction among Filers Who Pay Self-Employment Tax, 1990-2000

Tax Year	Allowed SE Health Insurance Deduction (Percent of Premium)	Returns with SE HI Deduction as a Percent of Returns with SE Tax Deduction*	Average SE HI Deduction Claimed	Implied Average Premium per Return**
1990	25%	25%	\$ 591	\$ 2,364
1991	25%	26%	\$ 625	\$ 2,502
1992	25%	23%	\$ 484	\$ 1,935
1993	25%	24%	\$ 714	\$ 2,854
1994***	25%	12%	\$ 798	\$ 3,192
1995	30%	23%	\$ 864	\$ 2,879
1996	30%	24%	\$ 885	\$ 2,950
1997	40%	24%	\$ 1,178	\$ 2,945
1998	45%	25%	\$ 1,388	\$ 3,085
1999	45%	25%	\$ 1,935	\$ 4,299
2000p	50%	24%	\$ 2,085	\$ 4,171

* Certain S-corporation filers could claim the SE Health Insurance Deduction without paying any self-employment tax. Overall, S-corporation returns represent about 12 percent of total returns by sole-proprietors, partnerships and S-corporations.

** The Average SE HI Deduction Claimed divided by the Allowed SE Health Insurance Deduction.

*** The original legislation expired December of 1993. It was restored retroactively to January 1, 1994 but not announced until April 11, 1995. In order to claim the deduction, most filers needed to file an amended return.

P = preliminary

Source: IRS Statistics of Income, “Individual Income Tax Returns: Selected Income and Tax Items,” various years.

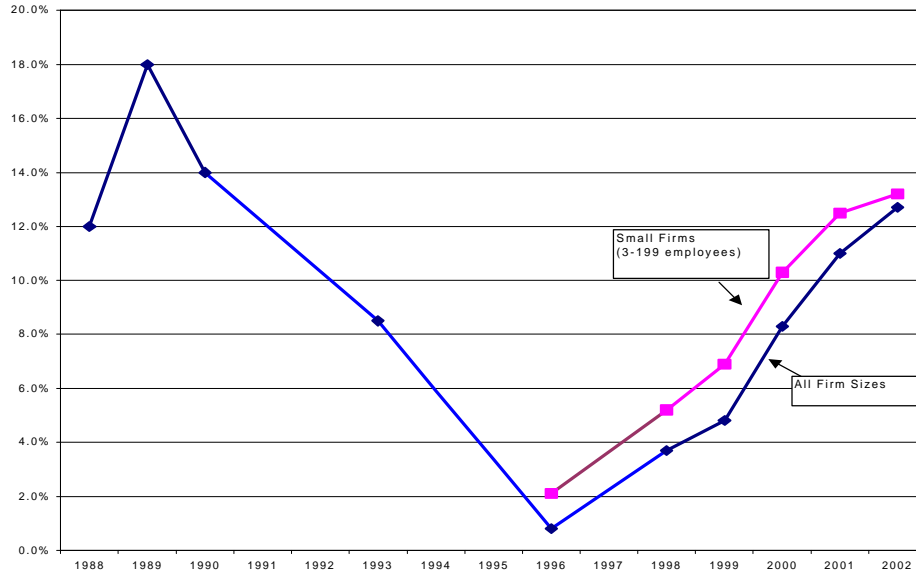
The net impact of the increasing deductible percentage and increasing premiums was a substantial increase in the post-tax price of privately purchased insurance for the self-employed. (It is certain that premium increases outstripped the impact of the rising deduction on the post-tax price of insurance during this 1990-2000 period. To illustrate, if premiums had been constant, for someone in the 28 percent tax bracket, the post-tax

⁶⁰ Due to differences in data sources, the time periods used in Exhibit 11, Exhibit 12 and Exhibit 13 are not identical. Exhibit 14 shows the deductible percentage for years earlier and later than those in Exhibit 12.

⁶¹ The self-employed are required to pay “self-employment tax” (analogous to FICA) on any income over \$400. They are permitted to deduct 50 percent of this expense from their calculation of adjusted gross income. By comparing returns with this deduction to those claiming the self-employed health insurance deduction we eliminate the numerous filers who reported a net loss from their business and hence were ineligible for the health insurance deduction. Note that the deduction for self-employment tax was effective beginning in 1990. Prior to that, a system of credits was used.

price of insurance would have declined just 7.5 percent during this time.⁶² If premiums increased during this time by even 1 percent per year, however, this reduction in post-tax price is eliminated. As shown in Exhibit 13, premium increases during this time certainly exceeded 1 percent per year.)

Exhibit 13 Annual Premium Increases for Employment-Based Health Insurance, 1988-2002



Source: Kaiser/HRET Survey of Employer-Sponsored Health Benefits, 1999 and 2002.

Given this large increase in post-tax price of health insurance, one might expect a reduction in the percentage of filers purchasing health insurance and seeking a deduction. But, as shown in Exhibit 12, this has not been the case either.

From these data, one could conclude that the tax deduction for health insurance premiums for the self-employed have merit from the perspective of tax equity (vis-a-vis wage and salary workers) but have not had much of an effect on the rates of coverage among the self-employed.⁶³ (Note that these trends only reflect the take-up rate associated with a 50 percent deduction. When the health insurance deduction increases to 100 percent in 2003 higher take-up rates are possible.)

⁶² The post tax price of insurance changed from $[\text{Premium} \cdot (1 - (25 \cdot .28))]$ to $[\text{Premium} \cdot (1 - (.5 \cdot .28))]$ or from $[\text{premium} \cdot .93]$ to $[\text{premium} \cdot .86]$. This change is $(.93 - .86) / .93$ or 7.5 percent.

⁶³ Research studies that have analyzed the consumption of health insurance by the self-employed are mixed in their reviews. While one study predicted that changes in the post-tax price of insurance would generate fairly large changes in the consumption of insurance, another study estimated that 90-95 percent of those claiming the self-employed health insurance deduction would have purchased insurance anyway. Gruber and Poterba (1994) estimated that a 1 percent increase in the post-tax cost of insurance would decrease the probability of insurance coverage among the self-employed by 1.8 percentage points. Glied (1999) looked at the same data and estimated that 90-95 percent of those taking the deduction would have brought insurance in the absence of the deduction.

Significant for our purposes, the self-employed health insurance deduction also does not encourage the provision of coverage for employees. The original version of the law (the Tax Reform Act of 1986) included a requirement that the owner offer coverage to their employees. This provision was dropped in 1989. As currently specified, the tax preference is neutral with respect to coverage of employees.

Exhibit 14 Percent of Premium Allowed as a Deduction for the Self-Employed, 1987-2003

Authorizing Legislation:	1986 Tax Reform Act	1995 Self-Employed Health Insurance Act	1996 The Health Insurance Portability And Accountability Act	1997 Taxpayer Relief Act	1998 Omnibus Consolidated And Emergency Supplemental Appropriations Act
Tax Year for Deduction: ▼					
1987	25%				
1988	25%				
1989	25%				
1990	25%				
1991	25%				
1992	25%				
1993	25%				
1994		25%			
1995		30%			
1996		30%			
1997		30%	40%		
1998		30%	45%		
1999		30%	45%	45%	
2000		30%	45%	50%	
2001		30%	45%	50%	60%
2002		30%	45%	60%	70%
2003		30%	50%	80%	100%
2004		30%	60%	80%	100%
2005		30%	70%	80%	100%
2006		30%	80%	90%	100%
2007		30%	80%	100%	100%

Note: Prior to 1987, premiums paid for employment related health insurance by unincorporated business owners were not deductible unless they exceeded 5 percent of the owner’s taxable income. The Tax Reform Act of 1986 introduced a 25 percent tax deduction for health insurance premiums for the self-employed (and raised the amount of medical expense needed to take an itemized deduction to 7.5 percent of adjusted gross income.)

Source: IHPS Compilation

Appendix E Insurance Options for Unincorporated Business Owners

In addition to facing unique tax treatment of health insurance, the self-employed also face a unique set of insurance market options. As is the case for any adult individual, the self-employed have the option of obtaining insurance coverage through the individual market. Those who employ others also have some unique options with respect to participating in group coverage with their workers.⁶⁴ These market options may influence the health insurance purchasing decision of the self-employed business owner even more than the health insurance tax deduction.

This section discusses coverage options for the self-employed in the group market, and specifically focuses on coverage in the small group market. It is based on an analysis of the state statutes and regulations and insurer market conduct in California, Connecticut, Kansas, Montana, Oregon, and Wisconsin.⁶⁵ Although the findings presented are representative of this research, the context should be kept in mind. More expansive and exhaustive research would be required to assure that rules and practices found in these states are typical of the range of such rules and practices nationwide.

Small Groups Laws Typically Include the Self-Employed

All of the state small group statutes we examined extended provisions concerning small group coverage to self-employed individuals heading up a firm that meets the minimum number of workers (usually two) required for group coverage. These laws accomplished this by including sole proprietors and partners of partnerships within the definition of “eligible employees.”⁶⁶

State laws typically define “eligible employees” as those employees eligible for coverage under the group plan who work on average a specified minimum number of hours as defined either in statute or by the employer within a statutorily defined range. These statutes also include sole proprietors and partners of partnerships in the definition of

⁶⁴ While not the focus of this paper, in several states, such as Connecticut, the self-employed *without* workers are also eligible to participate in the small group market as a group of one.

⁶⁵ We selected these states because they represent an array of small group reforms and are states where we have working relationships with state insurance departments and some insurers. We examined state statutes and available state regulations that were available on the internet through web sites maintained by each state. When possible, we spoke with state regulators and representatives of various state and national carriers to determine their perspective on the laws and administrative rules, prevalent market conduct, and, when relevant, their own operating procedures within each state.

⁶⁶ No state law referenced two-percent shareholders of S-corporations. The regulators indicated that, when their state’s small group statutes were developed, significant consideration was not given to the tax treatment of self-employed individuals. For this reason, two-percent S-corporation shareholders are not included in the statutes. Although a full review of the history of the state small group laws is beyond the scope of this paper, because small group statutes include corporations as an entity qualifying as a small employer, the drafters of small group legislation most likely already considered two-percent shareholders—to the extent they were active employees of the corporation—to be eligible for coverage like any other active employee of a corporation. Or, they may be considered eligible as partners of a partnership.

“eligible employees” if they “are included as an employee under a health benefit plan of a small employer.”

Note that these state laws grant sole proprietors and partners, as well as other eligible employees, the right to opt out of the group plan if they so desire. These laws permit eligible employees with other qualifying coverage—typically other group coverage—to waive coverage under the group plan. In addition, eligible employees may decline to participate in the group plan regardless of the existence of other qualifying coverage. In both cases, depending upon the size of the firm, the amount the employer contributes, and the state in which it is located, insurers may elect not to cover a group depending on the number or percentage of eligible employees who waive and/or decline coverage.⁶⁷

It is also important to note that not all state statutes specify whether sole proprietors must work the minimum number of hours that apply to other eligible employees. Some states, for instance California, prescriptively state that sole proprietors and partners must work full time (as defined in statute) to be included as employees under a health benefit plan.⁶⁸ Other state statutes do not explicitly state this, but either these states have required this through administrative rules or prevailing market practices require it.

Most Regulators Want the Self-Employed to Be Eligible for Small Group Coverage Protections

The state regulators with whom we spoke indicated that, when their legislation was written, the primary reason sole proprietors and partners were included within the definition of “eligible employee” was so these individuals could qualify for group coverage. They thought this necessary because state small group laws afforded significant protections to the participants of such groups that are typically not found in the individual market.⁶⁹ These protections include guaranteed issue, guaranteed renewal, and limitations on the application of pre-existing condition exclusions. In addition, state small group reforms limit the premiums insurers can charge based on the health status and claims experience of the group’s employees, and in the case of two states we reviewed (Connecticut and Oregon), market rules prohibit its use altogether. Inclusion within group coverage, particularly for older and/or less healthy sole proprietors and

⁶⁷ To reduce the potential for adverse selection and for greater administrative economies, insurers typically require a certain percentage of a small group’s eligible employees to participate in the group plan. This percentage may vary based on the size of the group, but typically is around 70-75 percent. Typically, employees with other employer-sponsored coverage—for instance, through a spouse—are not included in such calculations.

⁶⁸ Section 10700(f) of the Insurance Code of the California Codes.

⁶⁹ All the state statutes we analyzed had been enacted in some form prior to the passage of the Health Insurance Portability and Accountability Act (P.L. 104-191), commonly referred to as HIPAA. HIPAA afforded many of the protections contained within these state statutes on a national level to small employers—most specifically, guaranteed issue of all insurance products (prior to HIPAA, some states only provided guaranteed issue of specific products); guaranteed renewal; guaranteed acceptance of all eligible employees; no variation in premiums within a group based on health status, claims experience, etc.; and 12 month pre-existing condition exclusions with a six-month look-back period. HIPAA also extended other protections that are beyond the scope of this paper. It is important to note, though, that HIPAA did not contain significant provisions restricting the premiums insurers could charge to small employers.

partners, can permit these individuals to obtain coverage, possibly much more cheaply, than they could obtain on their own.

That the intent of the framers of small group legislation was to extend the protections of such legislation to sole proprietors and partners is reinforced by the other individuals who were included in the definition of eligible employee. Typically, state statutes include independent contractors along with sole proprietors and partners of partnerships. Some states have gone further. For instance, Wisconsin statutes permit business owners, including the owner of a farm business, and members of a limited liability company to be included as an employee of a health benefit plan.⁷⁰

Regulators Differ on Flexibility of Self-Employed to Participate in Group

The predominant statutory language regarding inclusion of self-employed individuals in small group coverage would seem to indicate that such individuals have the option to choose whether or not to participate in a group plan that they offer their employees. By choosing to not participate, self-employed individuals would not be waiving or declining coverage but instead would be treated as though they were ineligible employees. Thus, they would not be included at all in any participation calculation an insurer might perform and would not preclude the “employee group” from obtaining employer group coverage.

The potential for this flexibility is based on the interpretation of the use of “if” within the typical statutory language. For instance, “The term (eligible employee) includes a sole proprietor, a partner of a partnership, and an independent contractor **if** (emphasis added) the sole proprietor, partner, or independent contractor is included as an employee under a health benefit plan of a small employer.”⁷¹ Of course, such an interpretation depends upon *who* is making such a decision—the sponsor of the employer plan, which under the Employee Retirement Income Security Act of 1974⁷² (ERISA, assuming the plan is subject to Title I of ERISA), is typically the sole proprietor or partner, or the insurer writing the coverage.

The state regulators interviewed expressed a range of opinions regarding whether this flexibility indeed exists. All regulators expressed reservations about stating a definitive interpretation in the absence of consultation with legal and other experts within the department and without experiencing a practical problem (which none had faced to date) that would provide the facts and circumstances on which such a decision could be based.

Given these reservations, a few regulators thought a case could be made for interpreting the statutes either way. Several, however, thought a stronger case could be made for permitting sole proprietors and partners the flexibility to determine whether they would be included as an employee under their group plan. In fact, one regulator thought that his/her state’s small group guaranteed issue provisions would be violated if such

⁷⁰ Other states may already include members of a limited liability company under the broader definition of partners of a partnership.

⁷¹ Section 33-22-1803 (12) of the Montana Code Annotated.

⁷² 29 U.S.C. 1002(6).

flexibility were not granted. Another thought that, since the legislation provides similar protections to sole proprietors and partners as to other employees with regard to participation in the group plan, and because any employee has the option not to participate in a group plan, this discretion should exist for sole proprietors and partners as well. Another regulator thought such flexibility was already granted to sole proprietors and partners under general group insurance statutes.

Those regulators who thought such flexibility existed expressed the belief that such a decision should apply equally to all partners within an employer group. Thus, if the partners of a firm deemed that the partners would not be included within the group plan, this decision had to extend to all firm partners.

A few regulators, on the other hand, thought that such flexibility did not exist. Their attitude was that the defining issue was the number of hours a sole proprietor or partner worked. If such individuals worked the number of hours necessary to be considered an eligible employee, they thought it appropriate for a carrier to consider them eligible employees and thus include them in any participation calculation they might employ.

These differences in opinion generally disappeared, though, in consideration of whether sole proprietors or partners would be determined “new entrants” or “late enrollees” to their group plan. Under state and federal law, employees eligible to participate in a group plan who decline such coverage (but not those who waive it due to the existence of other qualifying coverage such as employer-sponsored coverage) are considered “late enrollees” if they later attempt to enroll in the plan.⁷³ State laws and market practices vary, but typically such employees must either wait a period of time before they can enroll or, if they can enroll immediately, may be subject to an 18-month pre-existing condition exclusion period. Regardless of their perception of proprietor/partner flexibility, all regulators thought that insurers would (or would have the right to) investigate, if a sole proprietor or partner claimed he or she was a new entrant, the proprietor or partner’s relationship with the firm.⁷⁴ If the insurer determined that the sole proprietor or partner had not newly joined the firm (or had not recently begun to work sufficient hours, relocated, etc., to qualify for group coverage), the insurer could deem that the proprietor or partner was not a “new entrant” to the firm and thus should be

⁷³ These individuals may not be considered late enrollees if they qualify for a special enrollment period under HIPAA which permits them to enroll without penalty (although a 12-month pre-existing condition exclusion may still be applied depending on any previous coverage they might have had). Such special enrollment periods include the addition of a dependent through marriage, birth, or adoption and permit the employee and affected dependent to enroll.

⁷⁴ The issue of whether sole proprietors or partners should be considered late enrollees is a technical one that apparently has not arisen and, if it were to arise, may only be resolved through the courts or clarifying legislative language. Although a full analysis is beyond the scope of this paper, it is possible to argue that sole proprietors or partners who opted not to be eligible for their group plan and who later seek to enroll should not be considered late enrollees because these individuals were never *eligible* for the group plan in the first place. Such lack of eligibility could be demonstrated by the fact that the sole proprietor or partner did not provide a declination of coverage or waiver of coverage to the writing insurer. On the other hand, carriers could claim that individuals who are not considered late entrants are only those who were recently hired by the firm or met state- and HIPAA-specific qualifying events (such as special enrollment periods as permitted under HIPAA). In those instances when these criteria did not apply to sole proprietors and partners seeking coverage after initial plan enrollment, these individuals could be considered late entrants.

treated as a late enrollee. The regulators thought that insurers should be permitted to do this to protect themselves from adverse selection they might otherwise incur from the proprietor or partner.

Insurer Market Practices Affect Self-Employed Group Coverage Options

Regardless of potentially varying unofficial interpretations from state regulators, the ability of self-employed individuals (sole proprietors and partners) to elect to participate (without having to waive or decline coverage) in a group plan they offer their employees largely depends upon the practical application of market rules and insurer practices within their state. In particular, this flexibility largely hinges on three factors: 1) the participation requirements utilized by insurers (either as dictated by law or as prevailing market practice), 2) the underwriting diligence employed by insurers, and 3) the types of coverage insurers count (or must count) as other qualifying coverage.

Before discussing these components, it should be noted that sole proprietorships or partnerships with a larger number of employees (those with 10-20 or more employees) have a greater degree of flexibility than smaller firms with regard to their participation. This is the case in part because insurers typically subject larger small firms to less stringent participation requirements. But even the same 75-percent participation requirement would have a different effect on a three-employee group than a twelve-employee group. In a three-employee group, all workers would have to participate (or have other qualifying coverage) for the group to qualify, while in the twelve employee group, up to three workers could simply decline to participate without affecting the group's ability to obtain coverage. So, in a larger small group, even if the insurer included the proprietor or partner in the participation calculation, the proprietor or partner would have a greater ability to opt out of the group plan (by declining rather than waiving coverage) with no repercussions on their group's ability to get coverage.

Participation Requirements: The degree of specificity in state laws regarding carrier participation requirements vary. Most state laws require that participation requirements be applied uniformly to small firms with the same number of eligible employees. Some states permit insurers to vary participation requirements for firms that contribute 100 percent of the premium (e.g., California). Other states permit insurers to require 100 percent participation among all eligible employees, regardless of the existence of other employer coverage, for firms below a certain size (e.g., Montana permits insurers to require this for firms with three or fewer employees). Moreover, other states specifically prescribe the number or percentage of employees an insurer can require to participate based on the number of eligible employees (e.g., Wisconsin).

The ability of a sole proprietor or partner (who is deemed an employee for participation purposes) to elect not to participate (and to not waive coverage) in the health plan they offer their employees depends upon the size and location of the firm and the amount contributed. For example, a full-time sole proprietor with three eligible employees could effectively elect not to participate in his or her group plan by declining coverage in Wisconsin (where, for a firm of that size, insurers can only require two employees to participate), while a similarly situated sole proprietor in Oregon may be required to participate in order for the group to get coverage (some insurers require 100 percent

participation of all eligible employees who do not waive insurance due to other qualifying coverage).

While self-employed individuals may have an option whether or not to be part of the “group,” insurers typically are not overly concerned about sole proprietors or partners who do not initially enroll with their group due to their latitude to treat them as late enrollees. Although insurers may suffer some small adverse selection due to these individuals not initially enrolling, the insurers we interviewed typically are more concerned about providing coverage to proprietors or partners who do not have a bona fide attachment to the firm or who are not actually working the required minimum number of hours. Of even greater concern to insurers, particularly those operating in states with modified community rating reforms in the small group market and little or no reforms in the individual market, is providing coverage to very small firms—whether sole proprietors, partnerships, etc.—that are not legitimate small groups. In this case, the problem insurers are experiencing is individuals such as independent contractors who attempt to form “fictitious” small groups⁷⁵ in order to qualify for group coverage to obtain more favorably priced insurance than they could get through the individual market.

This issue of very small, or “micro,” groups is further complicated by the intersection of HIPAA and state small group law. HIPAA applies to small employers with 2 to 50 employees with the definition of employee referencing section 3(6) of ERISA.⁷⁶ For example, a full-time sole proprietor with two part-time employees (who work less than the minimum number of hours required by state law to be considered eligible employees) would qualify under HIPAA but not under state law. As such, the plan participants would be entitled to guaranteed issuance (as required by HIPAA) but would not benefit from any rating constraints the state might require.

Underwriting Diligence: Regardless of the participation rules insurers utilize, proprietors and partners could attempt to not participate in their group plan by “slipping through the cracks” and thus avoiding inclusion in any participation calculation. The effort and sophistication with which insurers determine the employees eligible for coverage under the group plan may significantly affect the ability of self-employed individuals to do so.

To prevent adverse selection, it is in the interest of insurers to determine the full extent of employees potentially eligible to participate in the group plan. If insurers do not do this, they could expose themselves to adverse selection by potentially allowing healthier employees to avoid coverage under the group plan (who could then obtain lower-cost coverage in the individual market), leaving primarily higher risks in the group.

⁷⁵ Many states prohibit insurers from selling coverage to groups that are formed solely to purchase insurance and have no other major reason for their existence. Such groups are called “fictitious groups.” See Hall (2000) for a discussion of these fraudulent groups.

⁷⁶ HCFA (now CMS) has stated that a state law definition of “small employer” cannot be more restrictive than HIPAA’s definition but it can be more expansive and a few states include a larger range of firm sizes. HIPAA does not prevent a health insurer from establishing group participation rules that are otherwise permissible under state law (e.g., requiring an employer to have 75 percent employee participation).

Based on our research, it appears most insurers employ several mechanisms to determine the number and identity of employees eligible for coverage within a group applying for coverage. It appears that the basic mechanism all insurers employ is to collect from the group copies of some form of wage and tax statement which employers must submit to state government on a quarterly basis for unemployment insurance or other purposes.⁷⁷ A limitation to this form, though, is that sole proprietors or partners are typically not listed and thus they may “slip through the cracks” if they so desire.

Given this, it is possible that a number of insurers typically only learn of the existence of a sole proprietor or partner when such individuals apply for coverage.⁷⁸ This can often occur after the group has already received coverage and the sole proprietor or partner loses coverage through their spouse and thus seeks coverage through the plan. Representatives of such insurers acknowledged that it was quite possible for sole proprietors or partners to “slip through the cracks” and avoid being included in any participation calculations or getting coverage through the group.

Other insurers utilized more sophisticated means to learn about the existence of sole proprietors or partners. One insurer required applying groups to submit a roster of employees along with a quarterly wage and tax statement. Although more thorough, this process could still potentially permit self-employed individuals to slip through if they so desired.

A very sophisticated insurer, though, employed several checks to ensure that it determined the existence of sole proprietors or partners. A check thought to be very effective was to request information about the type of firm seeking coverage. Depending upon the response—that is, whether the firm is a sole proprietorship, partnership, corporation, or some other entity—the insurer could then request relevant supplemental information. For instance, the insurer would request a Schedule C from a firm that indicates it is a sole proprietorship or Schedules K-1 or the relevant partnership agreement from a firm indicating that it is a partnership. As an additional check, the insurer requires the employer application to be signed by an officer of the firm. Thus, although some individuals may fall through the cracks, this insurer is much more likely to detect the existence of all self-employed individuals associated with the firm and hence to include them in its participation calculation if warranted. This does not mean that a sole proprietor or partner could not opt out of a plan offered to his or her employees, but rather that they would only be able to do so if the firm could otherwise meet participation calculations.

Other Qualifying Coverage: Typically, a significant disincentive for a sole proprietor or partner to decline coverage (versus waiving coverage) is that, if he or she does decide to

⁷⁷ Since such statements are filed quarterly, some insurers require employers to submit W-4 forms for newly hired employees.

⁷⁸ For some of these insurers, undoubtedly some circumstances may prompt further information requests. For example, a firm that is named after the principal or principals where such names do not appear on an application, waiver, or declination form; or a situation where the name of the individual signing the employer application does not appear elsewhere. In those instances where a sole proprietor or partner actively seeks coverage, some insurers require them to complete a form certifying that they are actively engaged with the firm and work the requisite number of hours.

later join his or her plan, the insurer can and most likely will treat them like a late enrollee. As such, the proprietor or partner must wait until their group's next open enrollment, or if they can join immediately, may be subject to a 18-month pre-existing condition exclusion. It is possible that in some states, though, eligible employees may be able to utilize many different types of coverage—rather than just other employer coverage—to justify waiving coverage, thereby giving self-employed individuals much greater latitude regarding participation in their group plan.

For example, in Wisconsin, it appears that eligible employees can waive coverage if they have other qualifying coverage, which the department of insurance reportedly interprets as including an individual policy. (All the other states we reviewed did not count individual coverage as “qualifying” coverage.) Thus, sole proprietors or partners in Wisconsin who have individual coverage (or coverage other than other employer-sponsored coverage) have much greater discretion to decide whether to participate in their group plan, assuming the group qualifies for coverage based on the remaining eligible employees, than similarly situated proprietors or partners in other states.

Although this situation arose in only one of the states we investigated, it could significantly influence whether self-employed individuals in that state elect to decline coverage in the group plan they offer their employees as discussed above.

Business Owners Face Incentives and Disincentives to Participation in Their Group Plan

Although there are no personal tax incentives for a self-employed individual to offer coverage to the workers in his or her firm, there can be incentives for a self-employed individual to participate in a group plan he or she offers his/her employees.⁷⁹ These incentives vary, depending upon the state market rules and insurer practices existing in the self-employed person's individual and small group markets, his or her own personal circumstances, and the circumstances of his or her employees.

Although there are undoubtedly myriad scenarios that might exist, assuming a self-employed individual decided to offer coverage to his or her employees, some of the key incentives or disincentives for self-employed participation in a group plan are listed in Exhibit 16.

In sum, health insurance market rules and practices convey a varying array of incentives and counter-incentives for proprietors to participate in health insurance with their small employee group. The myriad rules across states reflect state concerns about selection “games” across the group and non-group markets that could cause deterioration of the small-employer-group risk pool. On the other hand, states want proprietors and partners to have appropriate access to group coverage because it might be difficult for a number of them to obtain affordable major medical coverage in the individual market given the fewer protections typically afforded there. It seems obvious that proprietors are more

⁷⁹ Health benefits remain a tax advantaged form of employee compensation (see Exhibit 10 in Appendix D) but the provision of health coverage to employees does not materially affect the tax treatment of the owner's premium payment.

likely to extend coverage to their workers if they themselves would benefit from the availability of and participation in that coverage. But, as with federal tax policy, there are not consistent, positive incentives in that direction.

Exhibit 15 Incentives and Disincentives for Business Owners to Participate in Coverage they Sponsor for their Employees

Incentives to Participate in Group	Disincentives to Participate in Group
<ul style="list-style-type: none"> ● The owner was planning to offer group coverage anyway and, by participating, the owner enabled the group to meet insurer participation standards. ● The owner was planning to offer group coverage anyway, and the cost of coverage for owner would be lower through the group versus what they could obtain in the individual market. (This scenario would be most likely to occur among owners who are older and/or have health conditions. This would also be most likely the case in states where small group market premiums are compressed through some form of community rating while individual market premiums are largely unregulated.) ● The other possible source of comparably priced coverage was “non-qualifying” and was known to be unstable or uncertain.* 	<ul style="list-style-type: none"> ● The owner has a highly stable source of “non-qualifying,” lower-priced coverage.* ● Barriers to later entry into the group are low. (For example, with Wisconsin’s generous definition of “other qualifying coverage,” an owner could maintain an individual policy for him or herself that is more comprehensive and/or less costly than what he or she provides through the group plan with the reassurance that they could change their mind and enroll in the group coverage without penalty at a later date.) ● The owner(s) wanted better insurance coverage (that is, more comprehensive, broader provider networks, etc.) for themselves than what they would be able or willing to purchase for their employees. (Some states permit or insurer practices allow employers to establish separate classes of employees with different types of coverage and employer contribution amounts.)

* If the owner waives coverage in order to take non-qualified coverage, and later loses that coverage, they will have to request participation in the group as a late entrant and may experience disruptions or limitations on that group coverage.

Source: IHPS

Appendix F Stability of Small Firms and Employment of Low-Income Workers

In order to design effective programs to extend health insurance to workers in self-employed small firms, policy makers should take into consideration the stability of the business itself as well as employee tenure. Employment stability has important implications both for premium assistance programs⁸⁰ and for programs that subsidize transitional insurance for workers between jobs.

Self-Employed Small Firms Are Relatively Stable

Despite their small size, self-employed businesses are relatively stable. Approximately 90 percent of firms with one to nine employees are in existence after 4 years (Exhibit 16).⁸¹ This rate is comparable to self-employed firms with 100 or more employees. Perhaps not surprising, self-employed firms with *no employees* have the lowest survival rate, but even 72 percent of these firms are in existence after four years. (Conventional wisdom widely credits small firms with having high rates of discontinuance but this appears to be concentrated among marginal firms with extremely low revenues and no employees.⁸²)

Exhibit 16 Firm Survival, by Size, 1992-1996

Type of Firm	Percent of 1992 Firms Still in Business in 1996
All Firms with a Self-Employed Owner (including firms with no employees)	75.5
No Employees	72.4
With 1-4 Employees	89.6
With 5-9 Employees	91.5
With 100+ Employees	91.3

Note: These data include firms formed as S-corporations but excludes those organized as C-corporations.

Source: Small Business Administration, *Characteristics of Small Business Employees and Owners*, 1997.

⁸⁰ Premium assistance programs are programs where public subsidies are used to help pay some or all of the premium contribution an employee must make towards employment-sponsored coverage.

⁸¹ Although the percentage that remain in business for at least four years is similar to larger firms, the amount of time the other 10 percent remained in business is unknown. For example, commonsense would indicate that, if formed at the same time, a smaller self-employed businesses would have gone out of business sooner than a larger one.

⁸² See also Nucci and Bates (1990).

Worker Tenure Is Unstable Among Low-Income Workers But the Availability of Health Insurance May Reduce Employee Turnover

Employee turnover is an important factor influencing the stability of health insurance coverage and can reduce the effectiveness of programs that seek to expand employment-based coverage to low-income, uninsured workers. Unfortunately there are no data that measure turnover differences between unincorporated and incorporated firms. However, available data indicate that firms with poorer benefits and lower wages (conditions that characterize these small firms) experience higher rates of turnover.⁸³

Independent of firm characteristics⁸⁴, low-income workers—those below 200 percent of the federal poverty level (FPL)—are also likely to have relatively unstable work relationships as it is often the combination of low wages *and less than full-time, full-year work* that keeps many families near poverty.⁸⁵

However, the availability of job-based health insurance may contribute to the stability of employment. According to a recent literature review, the issue of adequate health insurance matters substantially when individuals are deciding whether they should change jobs or retire.⁸⁶ Older research found that employer-sponsored health insurance reduces voluntary turnover by 25 percent.⁸⁷

Programs that target non-offering small businesses, especially low-wage small businesses, may attract firms with high turnover among their low-wage or low-income workers. Nonetheless, owners and workers seeking to reduce turnover may self-select into such a program, thereby mitigating this concern and increasing the target effectiveness of the program.

Regardless of whether the availability of health insurance would substantially reduce employee turnover among low-income workers, Marquis and Kapur (forthcoming) found that, despite their high rates of job turnover, low-income workers without employer-sponsored coverage had sufficient tenure that they would experience longer periods of continuous coverage with (subsidized) employer-sponsored coverage than they would experience on their own in a public program.

⁸³ Lane (1999).

⁸⁴ Marquis and Kapur (forthcoming) find that employee turnover does not appear to be strongly correlated with firm size after controlling for other factors.

⁸⁵ Lane (1999).

⁸⁶ Gruber and Madrian (2002).

⁸⁷ Madrian (1994).

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