CTJ Citizens for Tax Justice

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Medicare Tax Reform in Health "Corrections" Bill Unlikely to Have Any Noticeable Impact on Small Businesses and Jobs

The health care bill before the U.S. Senate this week (which makes a number of improvements to the main health reform bill that President Obama signed into law today) includes a reform of the Medicare tax. The Medicare tax is the one existing tax that is devoted to paying for health care. As structured currently, it is a flat-rate tax that completely exempts income from investments. The Medicare tax reforms in the pending health bill address this lack of progressivity.

The Medicare tax is currently a flat tax of 2.9 percent on earnings. Technically, half is paid by workers and half is paid by employers, but it is generally agreed that workers also pay the employer portion through reduced wages.

This legislation would make this a two-rate tax, so that all earnings below $200,000 (or $250,000 for married couples) would be taxed at 2.9 percent and earnings above this threshold would be taxed at 3.8 percent. (The share of the tax paid by employers, 1.45 percent, would not change, and self-employed people would continue to pay the entire Medicare tax, as they do now.)

In addition, for the first time, the Medicare tax would apply to investment income, at a rate of 3.8 percent, to the extent that adjusted gross income (AGI) exceeds $200,000 (or $250,000 for a married couple).[1]

These changes are unlikely to have any noticeable adverse impact on small businesses.

The Medicare tax on investment income would have no impact on small businesses.

The Medicare tax on investment income does not affect small business owners at all. It applies only to "passive" income, i.e. dividends, royalties, interest, capital gains, and investment income from businesses that taxpayers are not involved in running. Small business income is generally thought of as "active" income, i.e., income from businesses that taxpayers are involved in running.[2]

The higher Medicare tax rate on earnings would have no effect on 95 percent of small business owners, and would have no impact on hiring and investment decisions for the other 5 percent.

The increased Medicare tax rate on large amounts of earned income would have no significant impact on small businesses, for several reasons.

First, the Medicare tax paid by employers on behalf of their workers would not change. It would remain at 1.45 percent of the employees' earnings. The increase in Medicare taxes on earned

[1] In other words, the Medicare tax on investment income would equal the lesser of the taxpayer's investment income or the amount by which AGI exceeds $200,000 (or $250,000 for a married couple).

[2] Active business income that Subchapter S corporation owners are allowed to treat as unearned income is (sadly) exempted from the new Medicare tax on investment income.

income will be paid entirely by the employee.

Second, active business income from small businesses organized as sole proprietorships and partnerships is already subject to the Medicare tax on earnings. Therefore, those earnings will be subject to the increased rate if taxpayers' total earnings exceed the $200,000/$250,000 threshold. But only a small percentage of small business people earn that much.

We define active small business owners as those who receive more than half of their adjusted gross income from small businesses that they are involved in operating. We calculate that just 4.7 percent of active small business owners will have total earned income (including wages in some cases) in excess of the $200,000/$250,000 threshold in 2011, and will therefore pay increased Medicare taxes on a portion of their earnings.[3]

Third, taxes on the income of small business owners have nothing to do with their ability to hire workers and create or retain jobs. Employers are *not* taxed on the money that they pay to employees. And they're not taxed if their businesses are unprofitable. They are taxed only on profits, i.e., what, if anything, is left over to take home after they've paid their employees and paid their other expenses.

Fourth, this tax has little, if anything, to do with business owners' ability to save and invest. Some opponents of taxes make a somewhat sophisticated argument that small business people have to save their after-tax income to invest in new machinery or equipment or whatever capital expenditures they need before they can hire more people to expand operations, and any tax on their income will reduce their ability to do that.

But most small business people probably borrow to make capital expenditures. It would be unusual for a person to pay out of their own bank account to build a factory, or buy an expensive machine, or buy trucks to deliver goods. And even if they did pay cash for capital expenditures, if they are truly operating a small business then they can take advantage of the small business expensing under Section 179. This means they won't pay taxes on income they use for this purpose (up to $250,000 this year, and this limit will probably be extended).

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[3]We define small business income to include the sum of active partnership income, active Subchapter S corporation income, sole-proprietorship income (schedule C) and farm income (schedule F). Losses are not counted. (As pointed out in note 2, active Subchapter S income is exempt from both the Medicare tax on earned income and the new Medicare tax on investment income.)