Citizens for Tax Justice

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Health Care Reform Financing Options:

President's Medicare Tax Reform Would Affect about 2% of Taxpayers and End the Exemption for Wealthy Investors

The health care plan recently put forward by President Obama would make the Medicare tax more progressive, by increasing the tax rate on high earners and scaling back the current Medicare tax exemption for investment income.[1] These reforms would affect only 2.3 percent of taxpayers in 2014.

Reasons to Reform the Medicare Tax: It Exempts Those Who Live Off Investments and It Isn't Progressive

The Medicare payroll tax is the one important tax we already have that is dedicated to funding health care. But currently it is a regressive tax, for two reasons. First, it completely exempts wealthy investors whose income takes the form of capital gains, stock dividends, interest, rents, royalties, and many other types of investment income. Second, it has a single, flat rate.

The Medicare payroll tax (also called the Hospital Insurance tax, or HI tax) is levied at a flat rate of 2.9 percent on all wages and salaries. 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.

Impact of Medicare Tax Reform in President Obama's Health Care Proposal in 2014

Income Group	Average Income	Percent with Tax Increase	Average Tax Increase	Tax Increase as % of Income	Share of Tax Increase
Lowest 20%	$ 14,900	—	$ —	—	—
Second 20%	30,200	—	—	—	—
Middle 20%	48,600	—	—	—	—
Fourth 20%	80,600	—	—	—	—
Next 10%	123,300	—	—	—	—
Next 5%	174,000	0.4%	+4	0.0%	0.1%
Next 4%	306,100	35.4%	+718	0.2%	15.8%
Top 1%	1,734,600	90.6%	+15,264	0.9%	84.0%
ALL	**$ 84,200**	**2.3%**	**$ +179**	**0.2%**	**100.0%**

Source: ITEP Microsimulation Model, March 2010

[1] The President's proposal to apply the Medicare tax to investment income is similar in concept to a proposal described in a previous CTJ report. (See Citizens for Tax Justice, "Health Care Reform Financing Options: Make the Medicare Tax a More Progressive Tax that Wealthy Investors Pay Just Like Everyone Else," July 7, 2009, http://www.ctj.org/payingforhealthcare/medicaretaxproposal.pdf.) The proposal described in the previous report would raise more revenue because it was designed to be the main tax measure to finance health care reform. The President's proposal would raise less revenue because it is designed only to supplement the other revenue provisions that Congressional leaders have settled on.

How President Obama Would Make the Medicare Tax Fairer

The President's proposal would make two changes to the Medicare tax, starting in 2013.[2] First, the proposal would apply the 2.9 percent Medicare tax to investment income for taxpayers with adjusted gross income (AGI) above $200,000 for unmarried taxpayers and above $250,000 for married couples. (This Medicare tax on investment income would be phased in so that taxpayers would not pay the full tax rate until their AGI is $40,000 above the $200,000/$250,000 threshold.)

Second, the proposal would increase the Medicare tax rate on wages and self-employment income by 0.9 percent on earnings in excess of $200,000 for unmarried workers and $250,000 for married workers (combined). (This higher tax rate would not apply to investment income.)

The AGI thresholds and earnings thresholds of $200,000/$250,000 would be indexed for inflation.

The Medicare Tax Reforms Would Raise $184 Billion from 2013 through 2019 without Affecting Low- or Middle-Income Taxpayers

The Congressional Joint Committee on Taxation has concluded that the President's proposed reform of the Medicare tax would raise $183.6 billion from 2013 (the first year it would be in effect) through 2019.

The table on the previous page illustrates our estimates of how the President's Medicare tax proposal would impact taxpayers in different income groups in 2014. (The year 2014 is chosen because the effects of the current recession will be less pronounced, making it more representative of future years.)

We find that this provision would only affect 2.3 percent of taxpayers in 2014. The richest one percent would pay 84 percent of the resulting tax increase, and the richest five percent would pay virtually all of the tax increase.

President Would Preserve One Significant Loophole

Unfortunately, the President's proposal would *not* put an end to a scheme used by some wealthy business owners to avoid the Medicare tax. The scheme involves people who own and work for "S corporations" (corporations whose profits are not subject to the corporate income tax, but are instead included in the income of their owners). These individuals are allowed to tell the IRS how much of the income they receive from the company is compensation for their work (wages or salary, which are subject to the

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[2] The President's plan would "include an additional 0.9 percentage point Hospital Insurance tax for households with incomes exceeding $200,000 for singles and $250,000 for married couples filing jointly. In addition, it would add a 2.9 percent tax for such high-income households to unearned income including interest, dividends, annuities, royalties and rents (excluding income from active participation in S corporations)." Capital gains is not explicitly mentioned in the summary but is understood by administration officials and Congressional staff to be included in the types of income that would be newly subject to the 2.9 percent tax. See "Summaries of Key Elements of the President's Proposal," Title IX. http://www.whitehouse.gov/health-care-meeting/proposal/titleix/targeted-healthcare-tax

Medicare tax) and how much is "dividends" from the company (which are not subject to the Medicare tax).

Naturally, some individuals attempt to disguise their compensation as non-compensation income to avoid the Medicare tax. Former Senator John Edwards famously told the IRS that his name was an asset owned by his law firm (an S corporation), and that almost all of his multi-million-dollar legal fees reflected income from that asset, rather than the compensation for his legal services (which it obviously was).

Unfortunately, the President's proposal would not apply the Medicare tax to non-compensation income from S corporations (except for "passive" income, meaning income from a business that the owner is not actively involved in). This means that the "John Edwards Loophole" would remain in place.

Some lawmakers demanded that the loophole be preserved in the mistaken belief that this would protect "small businesses." Based on the most recent IRS data, we calculate that only 2.7 percent of small business owners would be affected by extending the Medicare tax to active S corporation income for those with AGI above the $200,000/$250,000 threshold. (We define small business taxpayers as the ones who receive more than half of their AGI from active small-business income.)[3]

The President's Medicare Tax Reform Is Preferable to Relying More on the Excise Tax on High-Cost Health Insurance Plans

Despite retaining the "John Edwards Loophole," the President's Medicare tax reform makes the President's overall plan significantly more progressive than the health bill approved by the Senate on Christmas Eve. That bill relies more on an excise tax on high-cost employer-provided health insurance benefits, which would be passed on to some middle-income families. A previous study from Citizens for Tax Justice concluded that the Senate's excise tax would make the tax code less progressive than it is today.[4]

The Senate amended its excise tax on health insurance before it approved its bill, and the lost revenue was offset by increasing the Medicare tax on upper-income people's wages. The President's plan scales back the health-insurance tax much further, so that it affects fewer people, and further expands the Medicare tax so that many kinds of investment income will be subject to the Medicare tax as well.

These reforms would make the Medicare tax much fairer than it is today, while raising significant revenue to help fund health care reform.

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[3] We define small business income to include the sum of non-passive partnership income, non-passive Subchapter S corporation income, sole-proprietorship income (schedule C) and farm income (schedule F). Losses are not counted.

[4] Citizens for Tax Justice, "Would the Senate Democrats' Proposed Excise Tax on 'High-Cost' Employer-Paid Health Insurance Benefits Be Progressive?" December 11, 2009. http://www.ctj.org/pdf/healthexcisetax20091211.pdf