Health Reform's Tax on Investment Income: Facts and Myths

By Donald B. Marron

To help pay for expanded health insurance coverage, the health reform legislation enacted in 2010 imposed several new taxes. The largest is the ''Unearned Income Medicare Contribution,'' a 3.8 percent tax on the net investment income of high-income taxpayers. When it begins in 2013, the tax will apply to taxpayers with adjusted gross income exceeding $200,000 ($250,000 for joint filers), with no indexing for inflation. The Joint Committee on Taxation estimates that it will raise $123 billion from 2013 through 2019.

This new levy is often overlooked in discussions of capital income taxation. The top rate on long-term capital gains and qualified dividends is scheduled to increase from 15 to 20 percent on gains and 39.6 percent on dividends (the top rate on ordinary income) at year-end, when the 2001 and 2003 tax cuts expire. Those rates rise to 21.2 and 40.8 percent, respectively, when the effect of the ''Pease'' provision that limits the value of itemized deductions is included.

But those figures do not include the new tax. In fact, high-income taxpayers will face a top rate of 25 percent on gains and 44.6 percent on dividends if the tax cuts expire. If Congress extends the tax cuts again, the top rate on capital gains and dividends will rise to 18.8 percent.

Almost all the burden will be borne by taxpayers with extremely high incomes: More than half of the burden falls on taxpayers in the top 0.1 percent of the income distribution and more than 86 percent on the top 1 percent.

Despite receiving little attention, the new Medicare contribution tax has already spawned at least two myths.

First, the name of the tax suggests that its revenues are earmarked for Medicare. In fact, the revenues will go into general revenue, just like other income taxes. (Another health reform tax, a 0.9 percent increase in the hospital insurance tax on earned income for high earners, will go to Medicare.)

Second, some observers have asserted that the 3.8 percent tax would apply to all home sales. In reality, the tax applies to capital gains, not sale proceeds. And the current exclusion of gains on home sales — up to $500,000 (joint) or $250,000 (single) on a primary residence — would still apply; thus, the vast majority of home sellers will face no new burden from this tax.

Distribution of Tax Increases From Health Reform's Tax on Net Investment Income, 2015

Cash Income Percentile	Units With a Tax Increase			Share of Tax Change (percent)
	Affected Units (percent)	Average Change in After-Tax Income (percent)	Average Tax Change (dollars)	
Bottom 80%	0	0	0	0
80-90	0.3	-0.1	153	0
90-95	3.1	-0.3	335	0.2
95-99	66.8	-0.4	1,226	13.5
Top 1 Percent	89.4	-1.7	23,053	86.3
Top 0.1 Percent	96.1	-2.3	129,424	53.5

Source: Urban-Brookings Tax Policy Center Microsimulation Model (version 0411-3). These figures assume the extension of all expiring tax cuts except temporary business investment incentives and the payroll tax cut.

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Who Benefits From Tax Expenditures?

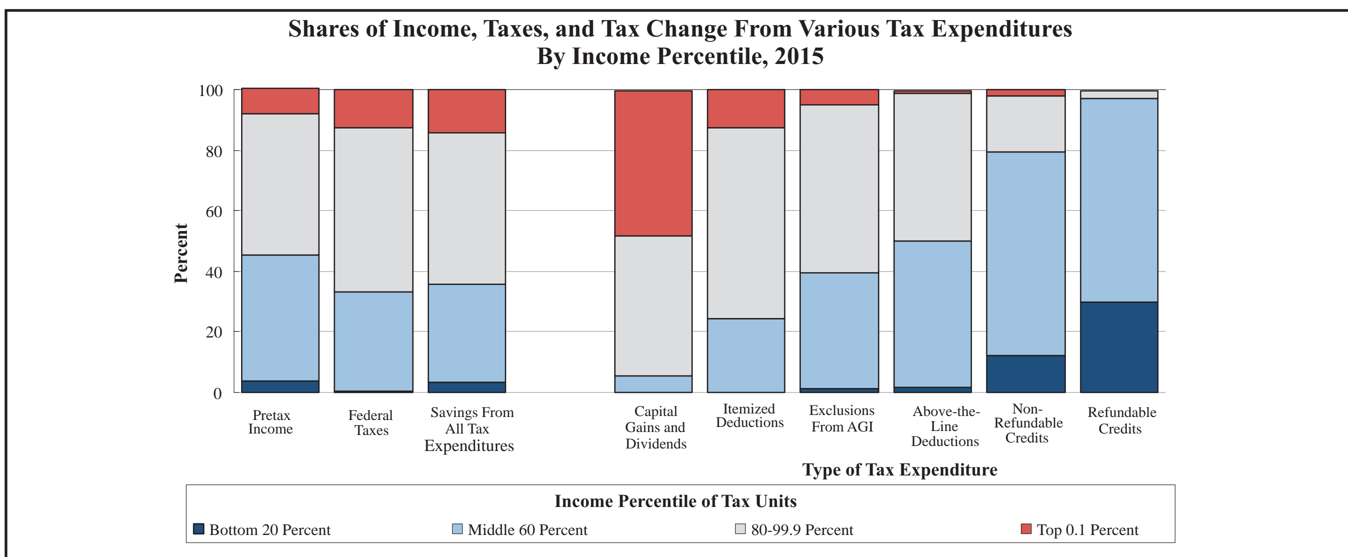
By Roberton Williams

The federal income tax is replete with tax expenditures, provisions that grant special benefits to selected taxpayers or for selected activities. Exclusions and deductions reduce taxable income, preferential rates cut the tax on specific types of income, and tax credits are subtracted directly from tax liability.

The various kinds of tax expenditures reduce taxpayers' individual income tax liability differently throughout the income distribution (see graph). More than 90 percent of the tax savings from preferential tax rates on long-term capital gains and qualified dividends go to taxpayers in the top quintile (or fifth) of the income distribution, and nearly half the benefits go to people in the top one-tenth of 1 percent. The top quintile gets about three-fourths of the savings from itemized deductions and more than 60 percent of the benefits of exclusions of selected sources of income such as employer health insurance contributions. High-income households receive relatively larger benefits from special rates, deductions, and exclusions, because they have relatively more income from certain tax-favored sources (capital gains, dividends, tax-exempt interest) and because under our graduated income tax, exclusions and deductions are worth more to taxpayers in higher rate brackets.

In sharp contrast, most of the value of tax credits goes to households in the bottom four quintiles. Nearly 80 percent of nonrefundable credits and more than 95 percent of refundable credits benefit those households. Many credits phase out for high-income taxpayers, limiting their value, but they are a major reason why nearly half of all tax units pay no federal income tax. Nearly one-third of all refundable credits go to the poorest one-fifth of all households and often result in net payments from the government.

Overall, tax expenditures give more benefits to high-income households relative to income but are roughly proportional to tax liabilities. The top quintile collects 55 percent of all income, pays 67 percent of all taxes, and gets nearly 65 percent of the value of tax expenditures. Middle-income households earn slightly more than 40 percent of all income, pay one-third of taxes, and get one-third of tax benefits. The poorest quintile of households receives slightly less than 4 percent of both income and benefits from tax expenditures but pays only 0.5 percent of federal taxes, largely because refundable credits offset almost all their tax liabilities.



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