

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.



Tax Policy Center
Urban Institute and Brookings Institution

The Tax Policy Center, a joint venture of the Urban Institute and the Brookings Institution, provides independent, timely, and accessible analysis of current and emerging tax policy issues for the public, journalists, policymakers, and academic researchers. For more tax facts, see <http://www.taxpolicycenter.org/taxfacts>.