CribSheet 12-15 3/15/13

Beginning in 2013, the Patient Protection and Affordable Care Act (PPACA) will impose two enormous new surtaxes, one on certain wage/salary income and the other on certain investment income. The latter tax has been erroneously portrayed as a "sales tax on home sales." Both taxes discourage small business growth and employment.

PPACA: Medicare Wage/Salary and Investment Taxes

There has long been a Medicare payroll tax.

PPACA adds two new taxes on top of an existing payroll tax. Medicare has long been funded primarily by a 1.45% payroll tax on wage/salary income. PPACA adds a new surtax on some wage/salary income and another on certain investment income.

The taxes won't fund Medicare.

Unlike the longstanding 1.45% payroll tax, the two new taxes will not actually fund Medicare. Rather, they will fund the coverage expansion of PPACA itself.

There is a new tax on wages.

Now, PPACA will apply an extra 0.9% tax on wage/salary income above a threshold of $200K for single filers and $250K for joint filers.

Another tax falls on investment income.

In addition, single filers earning over $200K and joint filers earning over $250K will experience a 3.8% tax on a portion of their investment income, including capital gains, interest, dividends, rents, and royalties – minus some exclusions.

These taxes will discourage small business growth.

These taxes are especially onerous for small business. These taxes will be especially detrimental to small business. Most small businesses are pass-throughs that report their income on their household IRS Form 1040s. So, for example, business earnings that the owner saves for future business expansion will be taxed immediately.

These taxes are huge.

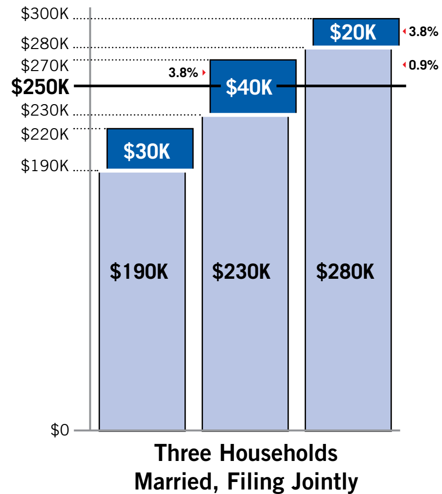
Taken together, these two provisions will increase Americans' taxes by $318 billion over 2013-2022. Taken together they comprise the largest revenue increase in PPACA – nearly as large as all the other PPACA tax increases combined.

Here's the basic tax math.

The adjacent graph and descriptions below give an idea about how the taxes are structured. The adjacent graph gives an idea of how the two taxes are calculated. The three households in this graph are all married, filing jointly. For that category, calculations begin with a $250K threshold. If these were single filers, the threshold would be $200K.

Of course, you need a professional accountant to capture all the nuances of an actual tax return.

In the graph, the lower bars represent wage/salary income and the upper bars represent investment income.



Household #1 pays neither tax.

Household #1 has $190K in wage income and $30K in investment income. Wage income does not exceed the $250K threshold, so they do not owe the 0.9% wage tax. Modified adjusted gross income (MAGI) is $220K and does not exceed the threshold, so they do not owe the 3.8% investment tax.

Household #2 pays the 3.8% tax.

Household #2 has $230K in wage income and $40K in investment income. Wage income does not exceed the $250K threshold, so they do not owe the 0.9% wage tax. MAGI ($270K) does exceed the threshold, so they owe the 3.8% investment tax on that part of investment income above the threshold. Their tax is 3.8% x ($270K - $250K) = $760.

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Household #3 pays both the 0.9% and the 3.8% taxes.

Household #3 has $280K in wage income and $20K in investment income. Wage income does exceed the $250K threshold, so they do owe the 0.9% wage tax on that part of wage income above the threshold. All of the investment income is above the threshold, so they owe the 3.8% investment tax on all of investment income. Their taxes are 0.9% x ($280K - $250K) = $270 and 3.8% x $20K = $760, for a total of $1,030.

All three pay the longstanding 1.45% tax.

All three households also pay the traditional 1.45% Medicare payroll tax on wage income. For these three households, those taxes are, respectively 1.45% x $190K = $2,755, 1.45% x $230K = $3,335, and 1.45% x $280K = $4,060.

Together, the taxes yield perverse results.

The interactions between the two new taxes produce some perverse results. In the graph, Household #2 faces a 3.8% marginal income rate on wage income, which is higher than the 0.9% marginal rate that the higher-income Household #3 faces. See the 1/6/11 entry **here** for a fuller explanation.

The Medicare Investment Tax adds great complexity to the U.S. Tax Code.

The Medicare investment tax adds an enormous degree of complexity to the already-complicated U.S. Tax Code. One expert argued in recent **Congressional testimony** that that this new tax essentially creates a third parallel income tax system alongside the standard income tax and the Alternative Minimum Tax (AMT).

Semi-hoax: a 3.8% "sales tax" on home sales.

The investment tax has been a source of confusion with respect to home sales.

In 2010, an error-filled viral email made its way around the web, opening with, *"Did you know that if you sell your house after 2012 you will pay a 3.8% sales tax on it? … That's $3,800 on a $100,000 home etc. … When did this happen? It's in the healthcare bill. Just thought you should know."* Contrary to the message of this email, the 3.8% investment can fall on part of the proceeds of a home sale, but is in no way a "sales tax." The email missed two crucial points.

Correction #1: The tax only hits capital gains.

The first error in the email was confusing a capital gains tax with a sales tax. Suppose you purchase a rental property (not your primary residence) for $550K and sell it later for $600K. The 3.8% tax on investment income would only fall on the $50K profit, not on the $600K sale price. The tax would be $1,900, not $22,800.

Correction #2: There's a primary residence exclusion.

Another error in the email was failing to consider the fact that if the property is your primary residence, the Tax Code grants a large exclusion from taxation – $250K for single filers and $500K for joint filers. If a married couple purchased their home for $300K and sell it now for $850K, the capital gain is $550K, and the post-exclusion taxable portion is $50K. They would pay a tax of $1,900 (3.8% of $50K) – and NOT 3.8% of the $850K sale price or 3.8% of the $550K profit.

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