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New Taxes on the Wealthy Are Bad News for Everyone

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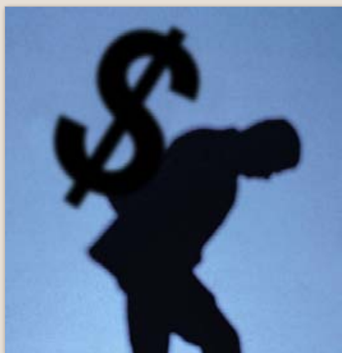
The new health care law will substantially increase the tax burden of high-income workers and small businesses over the next few years. Those tax increases could be piled on top of other tax increases on the labor and investment income of high-income earners. The tax hikes will reduce the capital stock and discourage small business job creation — the opposite of what is needed to grow the economy.



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Adding to the Tax Burden of Small Businesses. Taxing the wealthy is politically popular since it is assumed that few people will be affected. However, many people who are deemed wealthy are actually small business owners or self-employed professionals whose business income is taxed at personal income tax rates. Indeed, 93 percent of businesses are taxed through the individual income tax system. These businesses employ a majority of American workers and create a majority of jobs. High marginal tax rates reduce their incomes and stifle job creation.

Increasing Federal Income Tax Rates on High-Income Earners. The 2001 Bush tax cuts reduced the lowest marginal income tax rate from 15 percent to 10 percent and the highest from 39.6 percent to 35 percent. Unless Congress acts, the tax cuts will expire at the end of 2010 and rates will return to their pre-2001 levels. President Obama supports extending current tax rates for lower- and middle-income earners, but has proposed increasing income, dividends and capital gains tax rates on couples with adjusted gross incomes (AGI) of at least $250,000 and singles with AGIs of at least $200,000. Thus, for example:

- A married couple filing jointly whose current federal income tax rate is 33 percent will see their rate rise to 36 percent if their AGI in 2011 is between $232,950 and $375,700.
- If their tax rate is 35 percent, it will rise to 39.6 percent (AGI over $375,700).

New Medicare Taxes. Beginning in 2013, the new health care reform law will impose an additional 0.9 percent Medicare tax on wage income for individuals earning more than $200,000 a year and couples earning more than $250,000. This will be added to the existing 2.9 percent Medicare tax split between employees and employers. In addition, the new law imposes a 3.8 percent Medicare tax on unearned income, such as rent, royalties, dividends and capital gains for the same high-income earners.

Higher Taxes on Capital Gains and Dividends. Capital gains are the amount by which an asset's selling price exceeds its purchase price. Under current law, capital gains on assets held more than a year are taxed at a flat 15 percent rate for most taxpayers. The capital gains of taxpayers in the 10 percent and 15 percent federal income tax brackets are not taxed at all. Capital gains on assets held less than a year are taxed at an individual's ordinary income tax rate. If the Bush tax cuts were

Taxes on $50,000 Initial Investment After One Year
(assuming 8 percent capital gain and 3 percent dividend)

Married Filing Jointly (top tax bracket)	Dividend Rate	Capital Gains Rate	Taxes Paid (in dollars)	After-Tax Rate of Return	Effective Tax Rate
Extend Lower Tax Rate on Qualified Dividends*	15.0%	15.0%	$825	9.35%	15.00%
Obama Tax Proposal for Qualified Dividends	20.0%	20.0%	$1,100	8.80%	20.00%
Obama Proposal + 3.8 Percent Medicare Tax on Unearned Income	23.8%	23.8%	$1,309	8.38%	23.80%
Obama Tax on Ordinary (nonqualified) Dividends +3.8 Percent Medicare Tax	43.4%	23.8%	$1,603	7.79%	29.15%

* Qualified dividends are taxed at a lower rate than ordinary income as a result of the Bush tax cuts. They must be paid from a domestic company or qualified foreign company and the assets must be held at least 60 days. Ordinary (nonqualified) dividends are taxed at an individual's income tax rate.
Source: Author's calculations.

extended, these rates would remain in place. However, the Obama administration has proposed to increase long-term capital gains tax rates from 15 percent this year to 20 percent in 2011 for the two highest tax brackets, affecting nearly 4.5 million taxpayers.

Qualified dividends — paid by American companies or qualified foreign companies on stock that has been held for at least 60 days — are currently taxed at 15 percent for high-income earners, whereas ordinary (nonqualified) dividends and interest are taxed at regular income tax rates. The Obama administration has proposed raising the qualified dividends rate to 20 percent, while ordinary dividends would be taxed at the higher marginal rates of 35 percent and 39.6 percent for those earning $200,000 a year or more.

Consider the following scenarios for the above income groups. Suppose an individual owns $50,000 worth of stock that has accumulated an 8 percent capital gain and 3 percent dividend after one year. The tax on the $4,000 gain (sold after one year) would be as much as $1,451, compared to $825 if the current tax cuts are extended. As the table shows:

- With the current capital gains tax rate of 15 percent, the tax on the sale of $50,000 in stock would be $825, and the after-tax rate of return would be 9.35 percent (first row of table).
- If President Obama's proposed capital gains and dividends rates of 20 percent go into effect, along with the new Medicare taxes, the tax bill rises to $1,309 and the after-tax rate of return falls to 8.38 percent.
- For ordinary dividends, a higher marginal tax rate and the new Medicare taxes could nearly double the individual's effective (average) tax rate from 15 percent to more than 29 percent (last row of table).

Thus, for high earners the after-tax rate of return on this type of investment would fall by more than 10 percent, or nearly one percentage point.

Increasing the capital gains tax could lower government tax revenues, because people will hold on to assets in order to avoid the tax. This lock-in effect has been noted when capital gains tax rates increased in the past. Moreover, the lower rate of return resulting from higher taxes may discourage people from investing in certain capital assets in the first place.

Better Idea. It would be better to simplify the tax code by implementing a flat capital gains rate of, say, 10 percent, for all income groups and investments. And forget about the additional Medicare taxes: In today's struggling economy, we can ill-afford to impose additional taxes on productive workers and small businesses, or reduce the rate of return on capital investment.

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