



FACT SHEET

How Closing a Tax Loophole That Benefits the Rich Would Strengthen Medicare

By Jean Ross and Seth Hanlon July 14, 2022

Senate Democrats have reportedly agreed to close the Medicare tax loophole in the reconciliation bill.¹ This reform is crucially important because it would:

- Close a tax loophole exploited by high-income business owners to avoid paying into Medicare.
- Raise more than \$200 billion in revenue over 10 years. These funds would strengthen Medicare by extending the solvency of its trust fund.
- Level the playing field between wage earners and small-business owners who currently pay Medicare taxes, and those who have been able to dodge them.

Background on the Medicare tax loophole

Under current law, a 2.9 percent tax split between employees and employers supports the Medicare hospital insurance (HI) trust fund. To support expanded health coverage, the Affordable Care Act (ACA) imposed an additional rate of 0.9 percent for high-income earners, bringing the top Medicare tax rate to 3.8 percent. Prior to the ACA, the HI tax applied to wages and self-employment income such as the income of a sole proprietor but not to unearned income. The ACA addressed this disparity by applying a 3.8 percent parallel tax, the net investment income tax (NIIT), to unearned income such as capital gains, interest, dividends, and business income that is earned passively by high-income households.²

Thus, since the passage of the ACA, almost everyone pays either Medicare taxes or the NIIT. But certain business owners—those who receive income through an S corporation, limited liability company, or limited partnership and are considered an active participant in the business—fall through the cracks and avoid both taxes. High-income business owners often structure their businesses deliberately to take advantage of this Medicare tax loophole. The loophole drains revenue and creates inequities between the workers and business owners who pay either Medicare tax or NIIT, and the business owners who pay neither.

How would closing the Medicare loophole improve the fairness of the tax code?

The reconciliation bill would reportedly close the Medicare tax loophole for individuals making more than \$400,000 and couples earning more than \$500,000. That would make the tax code more fair:

- According to an unpublished analysis by the Institute on Taxation and Economic Policy, 97 percent of the additional tax from closing the loophole would be paid by the wealthiest 1 percent of households, those with incomes higher than \$680,000.³
- No one making less than \$400,000, or \$500,000 for couples, would pay a single cent more.
- The Medicare loophole is exploited mainly by the wealthy, who receive the lion's share of business income. Households in the top 1 percent of the earnings distribution receive approximately two-thirds of partnership and S corporation income.⁴ The majority of partnership income—58 percent—is accounted for by the finance sector.⁵ Professional services account for 15 percent and real estate for 6 percent.
- The vast majority of small businesses are sole proprietorships whose owners already pay the Medicare self-employment tax. Closing the Medicare loophole helps to level the playing field between them and the high-income business owners—including wealthy investment fund managers, doctors, lawyers, entertainers, and others—who exploit the existing loophole. As an article by two tax lawyers advises: “Avoiding both the NIIT and self-employment tax on ... management fees should be fairly straightforward for a private equity fund.”⁶
- Pass-through business income has skyrocketed in recent decades and is highly concentrated at the top. From 1979 to 2018, total business income received by the top 1 percent of households rose by 600 percent; in contrast, labor income increased by 247 percent, and that from capital gains and other capital income—which accounts for the largest fraction of income received by the top 1 percent—rose by 164 percent.⁷ Researchers note that a substantial fraction of the rise in business incomes occurred because “pass-through owner-managers pay themselves less in wages and more in profits for tax purposes.”⁸ The ability to avoid Medicare tax is one reason why wealthy individuals create pass-through business entities and route their income through them.

Who would and would not pay the new tax?

- A CEO of an S corporation earning \$10 million per year who games the current system by reducing their salary by \$5 million and the profits they receive by an equal amount would pay an additional \$190,000.

- A celebrity with a total income of \$5 million per year who funnels \$1 million of appearance fees through an S corporation, rather than treating them as wages or Schedule C self-employment income, would pay an additional \$38,000.
- A mom and pop business operating as a sole proprietorship with a net income of \$75,000 per year is unaffected for two reasons: 1) They already pay Medicare self-employment tax on all of their income, and 2) the reform only applies to business owners currently paying neither Medicare tax nor the NIIT with incomes higher than \$400,000, and \$500,000 for couples. Ninety percent of sole proprietors reported profits of less than \$100,000 in 2016, the most recent year for which data are available.

Conclusion

Senate Democrats are reportedly devoting the revenue from closing the loophole to the Medicare trust fund. That is crucially important because the Medicare trust fund is expected to become depleted by 2028, according to the Medicare trustees.⁹ With the new revenue from closing the loophole, the trust fund would not be depleted until 2031.

Endnotes

- 1 Emily Cochrane, Margot Sanger-Katz and Jim Tankersley, "Democrats Propose Raising Taxes on Some High Earners to Bolster Medicare," *The New York Times*, July 7, 2022, available at <https://www.nytimes.com/2022/07/07/us/politics/medicare-solvency-taxes.html>.
- 2 IRS, "Questions and Answers on the Net Investment Income Tax," available at <https://www.irs.gov/newsroom/questions-and-answers-on-the-net-investment-income-tax> (last accessed July 2022).
- 3 Institute on Taxation and Economic Policy, unpublished data, on file with authors.
- 4 Michael Cooper and others, "Business in the United States: Who Owns It, and How Much Tax Do They Pay?," *Tax Policy and the Economy* 30 (1) (2016), available at <https://www.journals.uchicago.edu/doi/10.1086/685594>.
- 5 IRS, "SOI Tax Stats - Partnership Statistics by Sector or Industry," available at <https://www.irs.gov/statistics/soi-tax-stats-partnership-statistics-by-sector-or-industry> (last accessed July 2022).
- 6 Michael Kosnitzky and Michael Grisolia, "Net Investment Income Tax Regulations Affecting S Corporations," *Taxes - The Tax Magazine*, April 2013, available at <https://www.bsfilp.com/images/content/1/4/v2/1443/Kosnitzky-Grisolia-MAG-04-13.pdf>.
- 7 Bilal Habib and Ellen Steele, "The Distribution of Household Income, 2018" (Washington: Congressional Budget Office, 2021), available at <https://www.cbo.gov/system/files?file=2021-08/57061-Distribution-Household-Income.pdf> <https://www.cbo.gov/publication/57061>.
- 8 Matthew Smith and others, "The Rise of Pass-Throughs and the Decline of the Labor Share" (Cambridge, MA: National Bureau of Economic Research, 2021), available at https://scholar.princeton.edu/sites/default/files/passthrough_laborshare_resubmitted.pdf.
- 9 Social Security Administration, "A Summary of the 2022 Annual Reports: Social Security and Medicare Boards of Trustees," available at <https://www.ssa.gov/oact/TRSUM/> (last accessed July 2022).