

# WebMemo



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## Pelosi Health Care Plan: Who Pays the Surtax?

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The House legislation to enact Speaker Nancy Pelosi's (D-CA) health care plan relies on a large surtax to pay for it. The surtax is 5.4 percent on personal income of single filers with over \$500,000 and joint filers with over \$1 million in modified adjusted income. This surtax hammers successful small business owners who file as individuals and will gradually encompass all American taxpayers, much like the dreaded Alternative Minimum Tax (AMT) does.

**Not Indexed for Inflation.** The threshold of the surtax is not indexed for inflation, which means that more and more taxpayers will be affected as incomes rise. This is the latest form of bracket creep: paying higher taxes on income over time because a tax does not account for inflation. This means that if a taxpayer's income only keeps up with inflation, he or she will be poorer despite having the same level of purchasing power every year.

To illustrate how dangerous this can be, consider the current debacle with the AMT: It was originally conceived in 1969 as a tax to affect only approximately 1 percent of taxpayers who were seen as avoiding some tax payments. However, since it was not indexed to inflation, more and more middle-class taxpayers have been in the AMT bracket. As a result, Congress must enact legislation year after year to "patch" the inflation to make sure millions of tax filers are not suddenly forced to pay the AMT. Without the patch, tax filers with taxable income as low as \$75,000 would be forced to pay the AMT.

The original thresholds for the AMT in 1969 were \$500,000 for individuals filing as singles and \$1 million for joint filers. But because incomes rise with inflation while the thresholds remain the same, 40 years from now—the same time period as the AMT's existence (and assuming 2 percent inflation)—single filers who make \$222,000 today would be affected this surtax. In 2020, joint filers who make a combined \$804,000 would be affected by the surtax. This means that the threshold of the surtax has dropped by almost a fifth (again, assuming 2 percent inflation). If inflation exceeds 2 percent, then the values would be even lower, such as \$722,000 for joint filers in 2020 with 3 percent inflation. The enactment of the surtax without inflation means that future Congresses will have to continually to pass legislation to patch the surtax just like they do with the AMT.

**Who Is Affected by the Surtax?** Proponents of the 5.4 percent surtax on high-income individuals argue that it will only affect the very rich, who can afford to pay a higher rate in order to ensure that the poor have access to health care. If only it were this simple.

Raising taxes on the highest earners can never affect only those individuals. The money that is

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## Taxpayers Affected by the Proposed Income Tax Surcharge

Taxpayer Group	Total Filers in Group	All Filers with Business Income		Filers with over 25% of Income from Business		Filers with over 50% of Income from Business	
Joint filers reporting \$1 million+ in income	322,590	287,152	89%	184,731	57%	89,223	28%
Single filers reporting \$500,000+ in income	301,456	152,534	51%	86,492	29%	57,005	19%

Source: Heritage Center for Data Analysis Individual Income Tax Model

Table 1 • WM 2687  heritage.org

taxed would otherwise have been invested, which would create jobs at those companies, or spent creating jobs through consumption.<sup>1</sup>

However, the surtax as currently proposed would have an even more direct affect on jobs—because it would be a direct surtax on hundreds of thousands of small businesses. These small businesses are the engine of new job creation in the economy. Right when the U.S. needs this job creation the most, the surtax would force successful small businesses to make cutbacks and layoffs.

Out of the approximately 300,000 joint tax filers earning over \$1 million, about 90 percent have small business income. Thirty percent earn more than half their income from their small business. These small business tax filers would face a sudden increase in their tax burden. In addition, those businesses earning less would be less likely to expand because their risk-taking would be offset by a much lower reward. This surtax is a tax on the major jobs creation engine of the U.S. economy. There could not be a worse time to propose it.

**Another Tax on the Middle Class.** If the health care bill is passed, the surtax would affect hundreds of thousands of small business owners as early as next year. Since the surtax is not indexed for inflation, it would affect more and more people each year until it becomes a huge tax increase on the middle class. The surtax would reduce the return on income from goods like capital gains that should be indexed to inflation.

By increasing taxes on business, individuals, and capital, the surtax would slow economic growth at a period where the economy is struggling. Business owners would be discouraged from expanding and hiring new workers when the unemployment rate is 10.2 percent.

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1. Curtis S. Dubay, “Seven Myths about Taxing the Rich,” Heritage Foundation *Backgrounder* No. 2306, August 3, 2009, at <http://www.heritage.org/Research/Taxes/bg2306.cfm>.