Trump, Buffett, and how the wealthy are taxed

By Eugene Steuerle *Thu, Oct 20, 2016*

'At the end of the day, tweaks to the individual income tax system, including higher tax rates, are unlikely to increase dramatically the taxes paid by the very wealthy,' writes our guest columnist, in describing tax strategies that will survive the election.

The individual income tax has never taxed the very wealthy much. Donald Trump may have claimed huge losses starting in the early 1990s, but, like other rich investors, he wouldn't have paid much tax regardless. Despite paying some tax, Warren Buffett's release of his 2015 tax return affirms that conclusion.

There are two major reasons: first, paying individual income taxes on capital income is largely discretionary, since investors don't pay tax on their gains until they sell an asset. Second, taxpayers can easily leverage capital gains and other tax preferences by borrowing, deducting expenses, and taking losses at higher ordinary rates while their income is taxed at lower rates. Such tax arbitrage is, in part, what Trump did.

To be fair, some, like Buffett, live modestly relative to their means and still contribute most of what they earn to society through charity. Some pay hefty property and estate taxes and bear high regulatory burdens. And salaried professionals and others with high incomes from work, whether wealthy or not, may pay fairly high tax rates on their labor income. Still, there are many ways for the wealthy to avoid reporting high net income produced by their wealth.

The phenomenon is not new. In studies over 30 years ago, I concluded that only about one-third of net income from wealth or capital was reported on individual tax returns. Taxpayers are much more likely to report (and deduct) their expenses than their positive income. In related studies, I and others found that rich taxpayers reported 3% or less of their wealth as taxable income each year.

But your favorite billionaire did not get that way by earning low single-digit returns to his wealth. Buffett's 2015 adjusted gross income (of $11.6 million) would be around one-fiftieth of one percent of his wealth, which in recent years has been estimated to be near to $65 billion. Yet, over the past five complete calendar years, Buffett's main investment, Berkshire Hathaway, has returned an average of over 10% annually.

The wealthy effectively avoid paying taxes on those high returns either by never selling assets and thus never recognizing capital gains, deferring income long enough that the effective tax rate is much lower, or by timing asset sales so they offset losses, as Trump likely has been doing to use up his losses from 1995.

When you die, the accrued but unrealized gains generated over your lifetime are passed to your heirs completely untaxed, though estate tax can be paid by those who, unlike Buffett, don't give most away to charity.

"Tax arbitrage," the second technique, is simple in concept though complex in practice. It allows an investor to leverage special tax subsidies just as she'd arbitrage up any investment—in this case, to yield multiple tax breaks. If you buy a $10 million building with $1 million of your own money and borrow the other $9 million, you'd get 10 times the tax breaks of a person who puts up $1 million but, because she doesn't borrow, buys only a $1 million building.

The law limits the extent to which most people can use deductions and losses from one investment to offset income from other efforts, but "active" investors are exempt from most of those restrictions. In real estate it is quite common for the active individual or partner to use the interest, depreciation, and other expenses from a new investment to generate net negative taxable income to offset positive income generated by other, often older, investments.

The main trick is simply to let enough income from all the investments accrue as capital gains. For example, take a set of properties that generate $1 million in rents and $500,000 in unrealized appreciation. If expenses are $1,200,000, net economic income would be $300,000 ($1,000,000 plus $500,000 minus $1,200,000); but net taxable income would be a negative $200,000 ($1,000,000 minus $1,200,000) since the unrealized appreciation is not taxable income.

Real estate owners enjoy other tax benefits as well. They can sell a property without declaring the capital gain by swapping the asset for another piece of real estate—a practice known as a "like-kind" exchange. Often, when a property exchanges hands it ends up being depreciated more than once.

At the end of the day, tweaks to the individual income tax system, including higher tax rates, are unlikely to increase dramatically the taxes paid by the very wealthy. Instead, policymakers need to think more broadly about how estate, property, corporate, and individual income taxes fit together and how to reduce the use of tax arbitrage to game the system.

The Government We Deserve *is a periodic column on public policy by Eugene Steuerle. A former deputy assistant secretary of the Treasury, he is an Institute fellow and the Richard B. Fisher Chair at the nonpartisan Urban Institute.*