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## **The Need for the “Buffett Rule”**

### **How Millionaire Investors Pay a Lower Rate than Middle-Class Workers**

In his September 19 speech outlining his deficit-reducing plans, President Barack Obama proposed what he called the “Buffett Rule.” It’s not yet a specific legislative proposal, but rather a “guiding principle” that the super wealthy should not pay a lower rate of federal tax than the middle class.

Warren Buffett has long criticized the loopholes in the tax code that allow him to pay an effective tax rate of 17.4 percent while his secretary who earns \$60,000 a year pays an effective tax rate around 30 percent.<sup>1</sup> The Buffett Rule is the idea that the tax rules should be changed to reduce or eliminate this unfairness.

This report shows why the Buffett Rule is sorely needed:

- The federal tax system taxes income from work at a much higher rate than income from wealth.
- Buffett’s effective tax rate of 17.4 percent is typical of taxpayers with \$10 million or more of investment income.
- Buffett’s claim that his secretary pays about 30 percent of her income in federal taxes is not only plausible, but very likely.
- News stories, reports, and blogs that focus only on the amount of federal *income* tax paid by high-income taxpayers are omitting the substantial amount of payroll taxes that workers pay.
- Critics of the Buffett Rule who cite data showing that the average effective tax rate for the wealthy is higher than the average effective rate for the middle class miss the point of the Buffett Rule.

#### **Taxing Work More than Wealth**

In fact, Buffett *does* pay a far lower rate than his secretary. And Buffett is certainly not alone. As the IRS reported in its latest data on the 400 highest-income taxpayers, their average effective rate (after deductions and credits) in 2008 was only 18.1%.<sup>2</sup>

Two features of our tax code primarily drive Buffett’s lower rates. The first is that most of Buffett’s income is investment income in the form of dividends and long-term capital gain that is taxed at a preferential low

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<sup>1</sup> Tom Bawden, “Buffet Blasts System that Lets Him Pay Less Taxes than Secretary,” The Sunday Times (London), June 28, 2007, <http://www.timesonline.co.uk/tol/money/tax/article1996735.ece>

<sup>2</sup> Citizens for Tax Justice, “400 Highest-Income Americans Paid an Effective Rate of 18.1% in 2008,” May 19, 2011, <http://www.ctj.org/pdf/irstop400may2011.pdf>. Adding payroll taxes would increase the rate to 18.4%.

rate of 15 percent, while income from work is taxed at ordinary income tax rates ranging from 10 to 35 percent. The second is that while probably all of his secretary's income is subject to payroll taxes, most of his income is not.<sup>3</sup>

Here are two examples that illustrate the way our tax code taxes income from wages at a much higher rate than income from investments.

- 1) A single person with \$60,000 of wages in 2011 who doesn't itemize deductions will pay federal income taxes of about \$8,750 and payroll taxes of \$9,180,<sup>4</sup> for an effective federal tax rate of **29.9%**.<sup>5</sup>
- 2) A single person with \$60,000 of income from capital gains and dividends will owe only \$2,400 in federal income taxes and zero payroll taxes, for an effective rate of **only 4%**.<sup>6</sup>

Now let's look at some guys doing a lot better, with \$20 million in income.

- 1) If that income is from wages, the federal income tax is about \$6,276,000<sup>7</sup> and the payroll taxes are \$591,100. The taxpayer has an effective federal tax rate of about **34%**.
- 2) A person with \$20 million in income from capital gains and dividends will pay \$2,695,200 in income tax and zero payroll taxes, for an effective federal tax rate of **13.5%**.

It makes no sense that someone who makes millions from work (like a corporate executive or a professional athlete) pays more in taxes than someone who makes millions from investments. But it's downright unfair when millionaire investors pay effective tax rates far lower than those of most middle-income people.

### **Buffett's Tax Rate Typical of Taxpayers with \$10 Million or More of Investment Income**

Taxpayers with \$10 million or more in investment income this year will pay an average 17.2 percent of their income in federal income taxes and payroll taxes, very close to the 17.4 percent Warren Buffett pays.<sup>8</sup>

Effective rates depend on many different factors, particularly the composition of income. The table below demonstrates that a taxpayer with \$10 million in wages will pay far more than a taxpayer with \$10 million

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<sup>3</sup> This will change to a limited degree under a provision of the healthcare reform law enacted in 2010. The 2.9 percent Medicare tax will be increased to 3.8 percent for high-income people and will, in effect, apply to most investment income as well as wages, starting in 2013. The bulk of the payroll tax, the 12.4 percent Social Security tax, will continue to apply only to the first \$106,800 of wages that an individual earns. (This cap rises annually with wage growth.)

<sup>4</sup> We include the employer share of payroll taxes which most economists agree are ultimately borne by employees in the form of lower wages and benefits.

<sup>5</sup> These calculations do not include the payroll tax reduction enacted under President Obama because it is temporary and not representative of the taxes that normally apply. Taking the temporary payroll tax reduction into consideration would lower the effective rate of the person with income of \$60,000 to 28 percent.

<sup>6</sup> This situation is unusual because far fewer low- and middle-income people live primarily on investment income than do high-income people. We include the example to illustrate the enormous disparity in rates between taxpayers with the same amount of income, based on the type of income they have. This occurs at every income level.

<sup>7</sup> Our calculation assumes the average amount of itemized deductions for a taxpayer with this income level as reported in the IRS Statistics on Income data.

<sup>8</sup> Warren E. Buffett, "Stop Coddling the Super Rich," The New York Times, August 14, 2011, [http://www.nytimes.com/2011/08/15/opinion/stop-coddling-the-super-rich.html?\\_r=1](http://www.nytimes.com/2011/08/15/opinion/stop-coddling-the-super-rich.html?_r=1).

in investment income because two key types of investment income – long-term capital gains and qualified stock dividends – are granted the special low 15 percent rate.<sup>9</sup>

Effective Tax Rates of the Very Rich Depend on Composition of Income							
Taxpayers with \$1 and \$10 Million+ in Wages vs. Taxpayers with \$1 and \$10 Million+ in Investment Income in 2011							
Taxpayers with...	# of taxpayers	average total reported income	% income that is "ordinary"	% income that is tax-preferred**	% income tax-exempt interest	fed income tax as % of income	fed income + payroll tax as % of income
\$1 million or more in earned income	108,500	\$ 3,598,000	87.6%	11.3%	1.2%	27.3%	30.2%
\$10 million or more in earned income	3,300	\$ 25,097,800	90.5%	8.5%	1.0%	29.2%	31.9%
\$1 million or more in investment income*	72,100	\$ 4,936,100	40.9%	54.2%	4.9%	20.1%	21.0%
\$10 million or more in investment income*	3,900	\$ 24,759,500	17.9%	79.0%	3.2%	16.7%	17.2%

\* Investment income includes short-term and long-term capital gains, qualified and unqualified dividends, taxable interest and tax-exempt interest.  
 \*\* Income taxed at preferential rates includes long-term capital gains and qualified dividends, both of which are currently subject to a top rate of 15 percent under the federal income tax. Other income is taxed as "ordinary" income at the ordinary income tax rates.

Source: ITEP tax model, September 2011

### Comparisons of Federal Tax Rates Must Include the Payroll Tax

Some of Buffett’s critics complain that millionaires, and the rich generally, pay federal income taxes at higher rates than others. But this ignores the many other types of taxes that have a much greater impact on low- and middle-income Americans. The federal government imposes many different taxes through different mechanisms and it is a household’s total tax obligation that is the most meaningful. It’s absolutely not true that some Americans “have no skin in the game.”<sup>10</sup>

Calculations of effective federal tax rates should at least include federal income taxes *and* payroll taxes. The fact is that many, many households pay more in federal payroll taxes than in federal income taxes<sup>11</sup> and that payroll taxes make up more than a third of total federal revenue. To analyze the relative contributions taxpayers make to federal coffers, one must include the substantial payroll taxes that most Americans pay.

<sup>9</sup> Some of Buffett’s critics claim that investment income is largely double-taxed because it represents profits that were subject to the corporate tax. See our fact sheet on the corporate tax system to understand why corporate profits are actually under-taxed. Citizens for Tax Justice, “Why Congress Can and Should Raise Revenue through Corporate Tax Reform,” September 20, 2011, <http://ctj.org/pdf/corporatefactsheet.pdf>.

<sup>10</sup> See Edward D. Kleinbard, “Rich Man Whining,” August 24, 2011, [http://www.huffingtonpost.com/edward-d-kleinbard/income-tax-cuts\\_b\\_934386.html?ref=fb&src=sp](http://www.huffingtonpost.com/edward-d-kleinbard/income-tax-cuts_b_934386.html?ref=fb&src=sp).

<sup>11</sup> Leonard E. Burman and Greg Lieserson, “Two-Thirds of Tax Units Pay More Payroll Tax Than Income Tax,” Tax Policy Center, April 9, 2007, [http://www.urban.org/UploadedPDF/1001065\\_Tax\\_Units.pdf](http://www.urban.org/UploadedPDF/1001065_Tax_Units.pdf).

## **Averages Don't Tell the Whole Story**

While averages across income distributions are sometimes useful, this is one debate in which averages are not all that helpful. As shown above, two taxpayers with exactly the same amount of income can pay wildly different effective tax rates depending on the source of their income, among many other things.

In the last few days, many stories have been written that try to debunk the so-called “myth” that millionaires pay a lower tax rate than the middle class. Endless statistics have been trotted out to show that the average federal tax income rate for the mega-rich is higher than the average federal income tax rate for the middle class and many commentators have pointed to the average income taxes paid by all millionaires as somehow disproving the need for the Buffett rule.<sup>12</sup> Those stories completely miss the point.

Neither Buffett nor the President ever claimed that millionaires across-the-board pay taxes at lower rates than middle-income people. The point is that these situations do occur and they are the most striking example of a tax system that is broken.

The examples above illustrate how even taxpayers at the same income level could have very different effective tax rates, which is something average effective tax rates would not make clear.<sup>13</sup> Compare the effective tax rate of the taxpayer with \$20 million in capital gains and dividends (13.5%) to that of the taxpayer making \$60,000 from wages (29.9%) and you can see where things have gone awry.<sup>14</sup>

## **The Rich Aren't Over-Taxed**

Despite the claims of the President's critics, the rich are not paying more than their fair share. Citizens for Tax Justice recently calculated that in 2010, the richest one percent of Americans (who had incomes above \$424,000 and average income of \$1,254,000) paid 21.5 percent of the total federal, state and local taxes paid, roughly proportional to the 20.3 percent of the country's total income that went to this group that year.<sup>15</sup>

The services provided by government — roads that facilitate commerce, schools that create a productive workforce, defense and protection of property that provide the stability needed for businesses to thrive — have benefited the wealthy families who own most businesses, corporate stocks and other assets more than anyone else. While the incomes of many Americans have stagnated, the affluent have seen their income skyrocket and it's reasonable to ask them to contribute more to support the society that allows them to make fortunes.

This widening income gap, coupled with the fact that our tax system overall is not over-burdening the rich, should lead lawmakers to adopt progressive tax increases. Of course, there's a lot wrong with our tax code, and it won't all be resolved by increasing taxes on millionaire investors, but the Buffett Rule is a major step in the right direction.

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<sup>12</sup> For example, see Stephen Ohlemacher, “Are the Rich Paying Less than Secretaries?” Associated Press, September 20, 2011. <http://news.yahoo.com/fact-check-rich-taxed-less-secretaries-070642868.html>

<sup>13</sup> The average rate paid by the \$20 million earners in our example is 25% compared to 16% for the guys making \$60,000.

<sup>14</sup> As former U.S. Labor Secretary Robert Reich once said, “Averages don't always reveal the most telling realities. You know, Shaquille O'Neal and I have an average height of 6 feet.” Reich is 4'10” and former basketball star O'Neal is 7'1.”

<sup>15</sup> Citizens for Tax Justice, “America's Tax System Is Not as Progressive as You Think,” April 15, 2011, <http://www.ctj.org/pdf/taxday2011.pdf>.