Mr. Buffett's Taxes

Jon Zagrodzky

At a big fundraiser for Hillary Clinton in June, Warren Buffett condemned our tax system for permitting the rich to pay income taxes at lower rates than the less well-off. According to the Washington Post, Mr. Buffett said he was taxed at 17.7 percent on his 2006 taxable income of more than $46 million, while his receptionist was taxed at 30 percent. "I don't have a tax shelter," he declared, emphasizing that he paid his taxes in compliance with current tax law.

To his credit, Mr. Buffett has long criticized the inequities of our tax system. "How can this be fair?" he asked of how little he pays relative to his employees in a 2006 interview with Ben Stein. "How can this be right?"

A major source of the unfairness he disdains is the tax code's complexity. The truly rich, who have skilled accounting and legal resources at their disposal, can take full advantage of this complexity. The result is that wealthy people like Mr. Buffett pay nowhere near the top marginal rate of 35 percent, while many less wealthy wage earners do. Raising tax rates, which some politicians claim is necessary to restore tax fairness, will not affect the tax bills of the truly rich.

But let's assume that we could somehow ensure that Mr. Buffett paid the top 35% rate on every dollar of his taxable income. Would the resulting tax bill be fair? From a rate perspective, the answer is yes – he would finally be paying a higher rate than his receptionist. Unfortunately, the tax code's complexity has another dimension that the rich can fully exploit, which is how taxable income is determined.

According to Mr. Buffett, his 2006 taxable income was $46 million, an enormous sum to be sure. But in the context of his even more enormous estate – some $35 billion before he started giving it away to the Gates Foundation – it's almost microscopic. If that amount represented the full earnings on his estate, the rate of return would be just over 0.1%, hardly believable considering the Oracle of Omaha's track record. So, what happened to the rest of his earnings? Wherever they ended up – in unrealized gains, tax-exempt organizations, offshore entities, tax-free bonds, foundations, trusts – they didn't end up as taxable income. The bottom line is that really rich people can use the tax code's complexity to structure their affairs in a way that avoids triggering taxable income, something mere W-2 wage earners have an increasingly hard time doing. Ask anyone who has been hit recently with the Alternative Minimum Tax.

We need tax reform that helps ensure that the really rich incur tax liabilities in line with the average taxpayer. First, it's important that the rich pay the top marginal tax rate on their taxable income. Mr. Buffett should never have to worry that he's paying a lower rate than his receptionist. Second, and more importantly, we need to ensure that the rich who manage to keep their taxable income low still contribute meaningfully to the overall tax burden.

We can accomplish this with an asset tax. A tax like this would need to be structured carefully and applied only to the very largest asset concentrations. But if Mr. Buffett had been required to pay an asset tax last year of, say, 1 percent of his estate, the resulting tax bill would have been $350 million.

This may seem like a lot of money, but let's keep things in perspective. Assume for a moment that Mr. Buffett had invested his entire $35 billion estate in taxable Treasury Bills earning 5 percent per year. His annual income would have been around $1.7 billion, and his income tax assuming the top marginal rate of 35 percent would have been more than $600 million, nearly twice what he would owe under the asset tax described above!

I don't mean to pick on Mr. Buffett. But I do think it would be helpful for him to stop complaining about the tax code and start proposing real reform that meaningfully increases his personal income tax bill. When that day comes, he will have real credibility on the subject of tax reform.

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