CTJ Citizens for Tax Justice

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How to Implement the Buffett Rule

A change in the Medicare tax that was enacted last year as part of health care reform will take an important but limited first step towards implementing President Obama's "Buffett Rule," the principle that tax laws should not allow millionaires to pay a smaller percentage of their income in federal taxes than do middle-class taxpayers. To further implement the Buffett Rule, Congress could end the existing income tax preference for capital gains and dividends or enact the type of surcharge for income exceeding $1 million that Senate Democrats recently proposed.

Background

The table below demonstrates two types of unfairness: taxpayers at the same income level with different effective tax rates, and taxpayers at a very high income level with a lower effective tax rate than taxpayers who have much less income. This second problem, which is highlighted by the circled figures and arrows, is what the Buffett Rule seeks to resolve. Both problems are caused by the fact that certain types of investment income are taxed less than other types of income.

The Buffett Rule is named for the super-successful investor Warren Buffett, who makes tens of millions of dollars each year but has said he pays a lower effective tax rate than his secretary, who makes about $60,000. The left side of the table below divides people like Mr. Buffett's secretary (people making between $60,000 and $65,000 annually) into three groups, depending on how much

Millionaires with Investment Income Pay Lower Tax Rates than Many Middle-Income Taxpayers

Share of Middle-Income Taxpayers and High-Income Taxpayers Relying on Investment Income for a Portion of Total Reported Income, and Effective Combined Federal Income and Payroll Tax Rates, in 2011

Total Reported Income	$60k-$65k		$10 million or more	
	Share of Taxpayers Making $60k-$65k	Average Effective Tax Rate** for Taxpayers Making $60k-$65k	Share of Taxpayers Making $10 million +	Average Effective Tax Rate** for Taxpayers Making $10 Million +
More than half of reported income is investment income.*	2.3%	7.1%	32.0%	15.3%
Between one tenth and half of reported income is investment income.*	7.3%	14.1%	20.0%	25.3%
Less than one tenth of reported income is investment income.*	90.4%	21.3%	48.0%	31.5%

Source: Institute on Taxation and Economic Policy tax model, October 2011

* Investment income includes short-term and long-term capital gains, qualified and unqualified dividends, taxable interest and tax-exempt interest. Under the federal personal income tax, long-term capital gains and qualified dividends are subject to a top rate of 15% while other income is taxed at "ordinary" rates (except for tax-exempt interest which is not taxed at all). None of these types of income are subject to federal payroll taxes.

** The effective tax rate is combined federal personal income and payroll taxes as a percentage of total reported income. Payroll taxes include those paid directly by the employee and those paid directly by the employer because economists agree that the employee ultimately bears even the employer side of the tax, in the form of reduced wages and benefits. These figures do not include the effect of the temporary payroll tax holiday, which is not a part of the permanent tax rules.

of their income they receive from investments. Over 90 percent of these taxpayers fall into the third group of taxpayers, who receive less than a tenth of their income from investments.

The right side of the table divides people like Mr. Buffett (people making over $10 million annually) into the same three groups depending on how much of their income they receive from investments. These taxpayers are far more likely to receive most of their income from investments. Almost a third of these taxpayers are in the first group, who receive over half of their income from investments — and, as a result, pay a smaller percentage of their income in federal income and payroll taxes, on average, than the 90 percent of taxpayers in the $60,000-$65,000 income range who receive less than a tenth of their income from investments.

Investment income is taxed less than other types of income in two ways. First, the personal income tax has special, low rates for two key types of investment income (long-term capital gains and qualified stock dividends), including a top rate of 15 percent. Second, the payroll taxes that apply to wages do not apply to investment income.[1]

Average effective tax rates are estimated here as federal personal income taxes and federal payroll taxes divided by reported income. The payroll taxes include the 12.4 percent Social Security tax that applies to the first $106,800 of wages earned and the 2.9 percent Medicare tax that applies to all wages. This includes both the half of payroll taxes paid directly by employees and the half paid directly by employers. (Economists agree that even the employer half of the tax is ultimately borne by employees in the form of reduced wages and benefits.)[2]

The effective tax rates for the groups of taxpayers are shown as averages and there is, of course, variation within those groups. For example, Mr. Buffett has said that his secretary, who made $60,000 annually, paid about 30 percent of his or her income in federal personal income and payroll taxes. The secretary would likely fall into the third group of taxpayers with less than one tenth of income coming from investments. The average effective tax rate for this group is 21.3 percent, but the secretary's rate is above the average, probably for several reasons. Married couples within this group will have lower effective rates, and the secretary may be single. Also, this group includes some recipients of Social Security benefits, most of which are not taxed.

Assuming the secretary is single and receives $60,000 of income entirely from wages in 2011 and does not itemize deductions, he or she would pay $8,750 in federal income taxes and $9,180 in federal payroll taxes, which combined are 29.9 percent of his or her income.[3]

Change in Payroll and Investment Taxes as Part of Health Care Reform

The health care reforms signed into law last year include a reform of the Medicare tax that is scheduled to go into effect in 2013 and which will partially implement the Buffett Rule. Under this provision, the Medicare tax will still be a 2.9 percent tax on wages for most people, but for high-income taxpayers it will include a 3.8 percent tax on wages and investment income above a certain level.

Under this provision, the 1.45 percent Medicare wage tax paid directly by workers would increase by 0.9 percent to 2.35 for wages in excess of $200,000 for unmarried taxpayers and $250,000 for married taxpayers. This means that the combined employer-paid and employee-paid Medicare taxes on wages will have two rates, 2.9 percent and 3.8 percent.

Even more importantly, a 3.8 percent tax will apply to investment income to the extent that it makes up whatever portion of adjusted gross income (AGI) exceeds $200,000 for unmarried taxpayers and $250,000 for married taxpayers.

As a result, even long-term capital gains and qualified stock dividends would be subject to a new 3.8 percent tax in addition to the personal income tax that already applies. The table below illustrates what would happen if the Medicare tax change came into effect in 2011 instead of 2013. The tax increase will raise the effective federal tax rates of taxpayers making over $10 million annually mostly from investments. The provision will cause a smaller increase for the taxpayers of this income level who rely less on investment income. (This is because the Medicare tax increase on earned income above $200,000/$250,000 is just 0.9 percent.)

Health Care Reform Will Partially Implement the Buffett Rule

Share of Middle-Income Taxpayers and High-Income Taxpayers Relying on Investment Income for a Portion of Total Reported Income, and Effective Combined Federal Income and Payroll Tax Rates, in 2011 —
if Health Care Reform Medicare Tax Increase Was in Effect in 2011

Total Reported Income	$60k-$65k		$10 million or more	
	Share of Taxpayers Making $60k-$65k	Average Effective Tax Rate** for Taxpayers Making $60k-$65k	Share of Taxpayers Making $10 million +	Average Effective Tax Rate** for Taxpayers Making $10 Million +
More than half of reported income is investment income.*	2.3%	7.1%	32.0%	18.7%
Between one tenth and half of reported income is investment income.*	7.3%	14.1%	20.0%	27.2%
Less than one tenth of reported income is investment income.*	90.4%	21.3%	48.0%	32.5%

Source: Institute on Taxation and Economic Policy tax model, October 2011
See table on page one for explanation of * and **.

The table demonstrates a little-noted fact about the health care reform legislation: It will take an important but limited first step towards implementing the Buffett Rule. Conversely, repealing health care reform would violate the Buffett Rule by increasing the ability of millionaires to pay lower effective tax rates than middle-income people.

Eliminate Personal Income Tax Preference for Capital Gains and Dividends

The most straightforward way to further implement the Buffett Rule would be to eliminate the special, low rates in the personal income tax that apply to long-term capital gains and qualified stock dividends. This would essentially mean that investment income is taxed just like any other income under the personal income tax.

Long-term capital gains and qualified stock dividends are subject to just two rates under the personal income tax: zero percent in the lowest two tax brackets and 15 percent in the rest of the tax brackets. (Most of this income is therefore taxed at 15 percent under the personal income tax.) These tax preferences are quite regressive. The majority of the benefits of the lower rate for dividends go to the richest five percent of taxpayers. About three-fourths of the benefits of the lower rate for capital gains go to the richest one percent of taxpayers.[4]

The table below demonstrates how eliminating these tax preferences would, to a large extent, address both of the types of unfairness described at the outset: taxpayers at the same income level paying different effective tax rates, and very high-income taxpayers paying a lower effective tax rate than someone with far less income.

Ending Tax Preference for Capital Gains and Dividends Would Further Implement Buffett Rule

Share of Middle-Income Taxpayers and High-Income Taxpayers Relying on Investment Income for a Portion of Total Reported Income, and Effective Combined Federal Income and Payroll Tax Rates, in 2011 —

if Health Reform Medicare Tax Increase in Effect in 2011 AND Capital Gains and Dividends Taxed at "Ordinary" Personal Income Tax Rates

Total Reported Income	$60k-$65k		$10 million or more	
	Share of Taxpayers Making $60k-$65k	Average Effective Tax Rate** for Taxpayers Making $60k-$65k	Share of Taxpayers Making $10 million +	Average Effective Tax Rate** for Taxpayers Making $10 Million +
More than half of reported income is investment income.*	2.3%	9.9%	32.0%	30.6%
Between one tenth and half of reported income is investment income.*	7.3%	15.1%	20.0%	30.3%
Less than one tenth of reported income is investment income.*	90.4%	21.3%	48.0%	32.9%

Source: Institute on Taxation and Economic Policy tax model, October 2011

See table on page one for explanation of * and **.

Millionaire Surcharge

The recent proposal by Senate Democrats to impose a surcharge on income over $1 million would not address the first type of unfairness described at the outset (taxpayers at the same income level paying different effective tax rates). However, it would, to a degree, address the second type of unfairness (very high-income taxpayers paying lower effective tax rates than people with far lower incomes), which is the goal of the Buffett Rule.

The surcharge proposed earlier this month by Senator Harry Reid would be a 5.6 percent tax on adjusted gross income (AGI) exceeding $1 million. (The threshold is $1 million for both married and unmarried taxpayers.)

Unlike the Medicare tax change enacted as part of health care reform, the surcharge would apply the same way to all types of income, meaning it would raise taxes for all extremely wealthy people regardless of how much of their income they receive from investments. It therefore does not directly address the different tax rates paid by very high-income taxpayers at the same income level depending on the source of their income, but it would nevertheless reduce the number of millionaires who are able to pay lower effective tax rates than middle-income taxpayers.

The table on the following page demonstrates that the very high-income taxpayers in each of the three groups would all see their effective federal tax rates increase by around 5 percentage points if the surcharge was in effect in 2011.

Millionaire Surcharge Would Partially Implement the Buffett Rule

Share of Middle-Income Taxpayers and High-Income Taxpayers Relying on Investment Income for a Portion of Total Reported Income, and Effective Combined Federal Income and Payroll Tax Rates, in 2011 —
if Both Health Reform Medicare Tax Increase AND 5.6% Surcharge on AGI above $1 Million Were in Effect in 2011

Total Reported Income	$60k-$65k		$10 million or more	
	Share of Taxpayers Making $60k-$65k	Average Effective Tax Rate** for Taxpayers Making $60k-$65k	Share of Taxpayers Making $10 million +	Average Effective Tax Rate** for Taxpayers Making $10 Million +
More than half of reported income is investment income.*	2.3%	7.1%	32.0%	23.9%
Between one tenth and half of reported income is investment income.*	7.3%	14.1%	20.0%	32.4%
Less than one tenth of reported income is investment income.*	90.4%	21.3%	48.0%	37.8%

Source: Institute on Taxation and Economic Policy tax model, October 2011
See table on page one for explanation of * and **.

The Warren Buffett/Secretary Problem Is Real, and Congress Has Options to Address It

Some commentators have suggested that, because people with incomes exceeding $1 million, *on average,* pay higher effective tax rates than middle-income people, the problem targeted by the Buffett Rule does not exist. The tables here demonstrate that the problem is not the effective tax rates of millionaires across the board but a *particular class* of millionaires whose income is mostly from investments.

This does not mean the problem arises only in rare cases. In fact, almost one third of taxpayers with income exceeding $10 million fall into this category (of taxpayers who rely on investment income for over half of their total income). Over 90 percent of the taxpayers in the $60,000-$65,000 income range fall into the group of taxpayers who rely on investment income for less than a tenth of their income — and pay a higher federal tax rate as a result.

Other commentators have argued that the federal tax system already disproportionately targets the very rich, but Citizens for Tax Justice has shown that this is not true if one accounts for all of the types of taxes that Americans actually pay. [5]

Any lawmakers who think millionaires should not be allowed to pay lower effective tax rates than middle-income Americans should take several steps. First, they must reject any effort to repeal health care reform. Repeal of the law would violate the Buffett Rule. Citizens for Tax Justice has explained elsewhere that the Medicare tax change included in that legislation makes the tax system fairer and will not have negative impacts on the economy.[6]

Second, lawmakers should reform the personal income tax so that it taxes income from investments the same way it taxes income from work. Far from being a radical proposal, this was a key component of the Tax Reform Act of 1986, which was signed into law by President Reagan. The undoing of this reform over the following decades was a mistake and should be reversed.

Third, if Congress is unable to immediately eliminate the income tax preferences for capital gains and dividends, then it could, for the time being, enact a surcharge on incomes exceeding one million dollars, as proposed by Senate Democrats. Citizens for Tax Justice has explained elsewhere that this surcharge would only affect one-fifth of one percent of taxpayers and that this percentage does not vary much by state.[7]

This option would leave in place the tax disparities between millionaires who live off their investments and millionaires who work. Perhaps the ire of the latter group of millionaires is what's required to catch the attention of lawmakers and prod them to enact real reform.

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[1] 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

[2] These figures do not include the impact of the temporary 2011 payroll tax holiday which is not a permanent part of the tax rules.

[3] Taking the temporary payroll tax reduction into consideration would lower the effective rate of the secretary with income of $60,000 in this example to 28 percent.

[4] Citizens for Tax Justice, "President Obama's Fiscal Year 2011 Budget: Federal Government Should Collect at Least as Much Revenue as Obama Proposes," February 10, 2010. http://www.ctj.org/pdf/obamabudgetfy2011.pdf

[5] 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

[6] Citizens for Tax Justice, "Medicare Tax Reform in Health "Corrections" Bill Unlikely to Have Any Noticeable Impact on Small Businesses and Jobs," March 23, 2010, p.18-19. http://www.ctj.org/pdf/medicaretax&smallbiz.pdf

[7] Citizens for Tax Justice, "State-by-State Figures on Proposed Millionaire Surcharge," October 6, 2011. http://www.ctj.org/pdf/reidsurcharge.pdf