Lifetime Wealth Taxation of the Very Rich

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How The Wealthy Differ from You and Me

- Higher economic returns (portfolio holdings, selection bias)
- Lower realized returns (ability to re-categorize and time income)
- Effective federal tax rate on economic income from capital <10%
- Overall taxes paid during life as percentage of wealth <3% with richest paying smallest fraction

Theory

- Yaari (1965), Feldstein (1995, 1999), many others – People make intertemporal choices in a world of
  - uncertain lifetimes,
  - unknown health status,
  - possible bequest motives,
  - different statutory tax treatment of different types of income

- Persons facing higher marginal tax rates have greater incentive to seek tax-preferred income and to avoid realization

- Medical condition, age, and other demographic traits can affect income realization and taxes paid during life

Data

Decedents from 2007 who filed estate tax return Form 706 (met filing threshold of $2 million in gross estate)

(total N=36,889; stratified sample N=12,296)

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Federal tax returns for 2002-2006 Forms 1040

- Total gross estate $229 billion
- Mean gross estate $6.2 million, mean net estate $6 million
- Median gross estate $3.2 million, median net estate $3.15 million

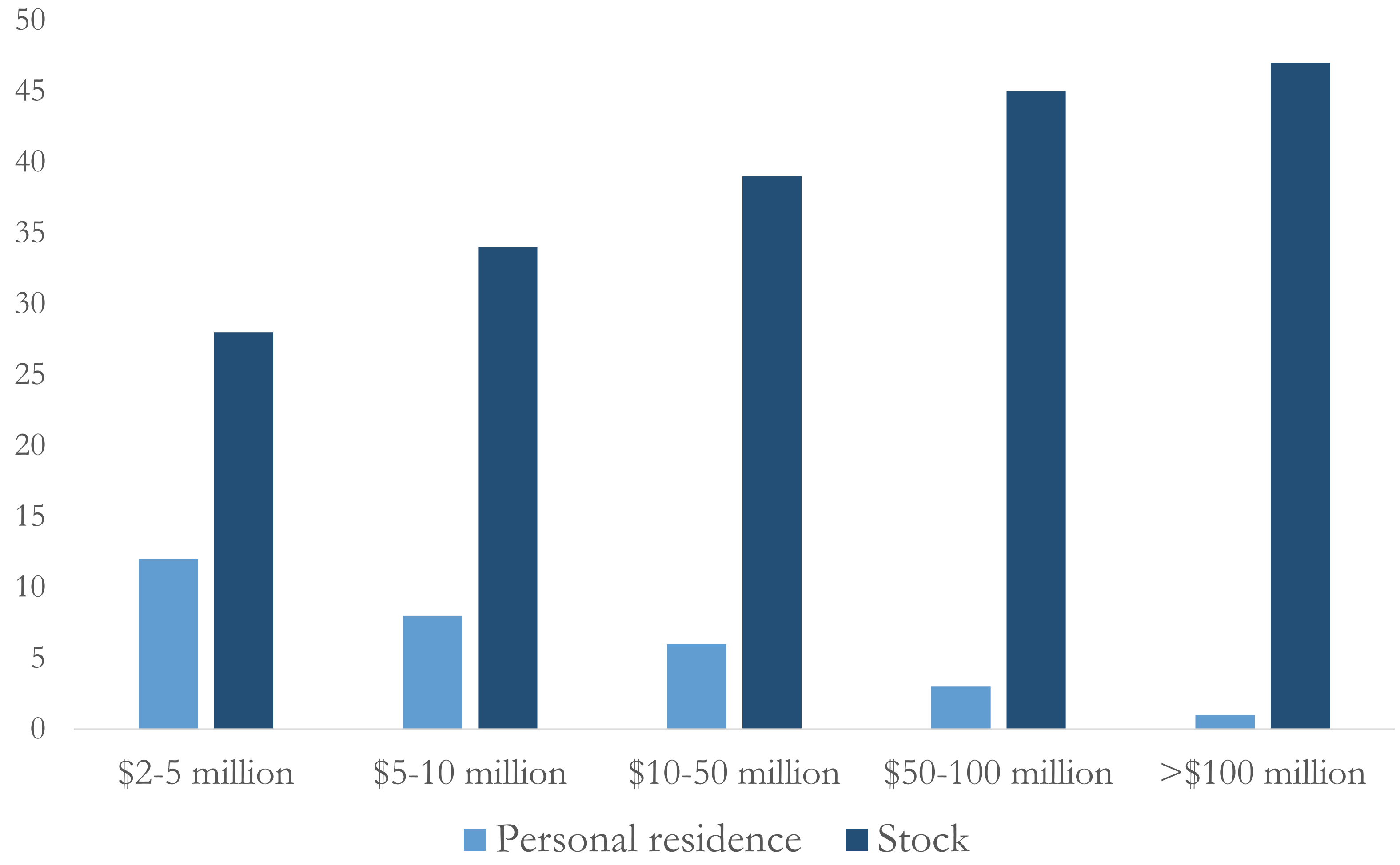
From Decedents to the Living Population

- Can gross up to living population with wealth of at least $2 million via multiplier method
- SOI staff created multipliers using national mortality rates by age and sex for holders of large-dollar-value annuity policies

Distribution Across Wealth Categories

Net estate category ($ million)	%
0--2	3.5
2--5	70.9
5--10	17.1
10--50	7.7
50--100	0.5
Over 100	0.3

Personal Residence and Stock as Percentages of Net Estate, by Wealth Category

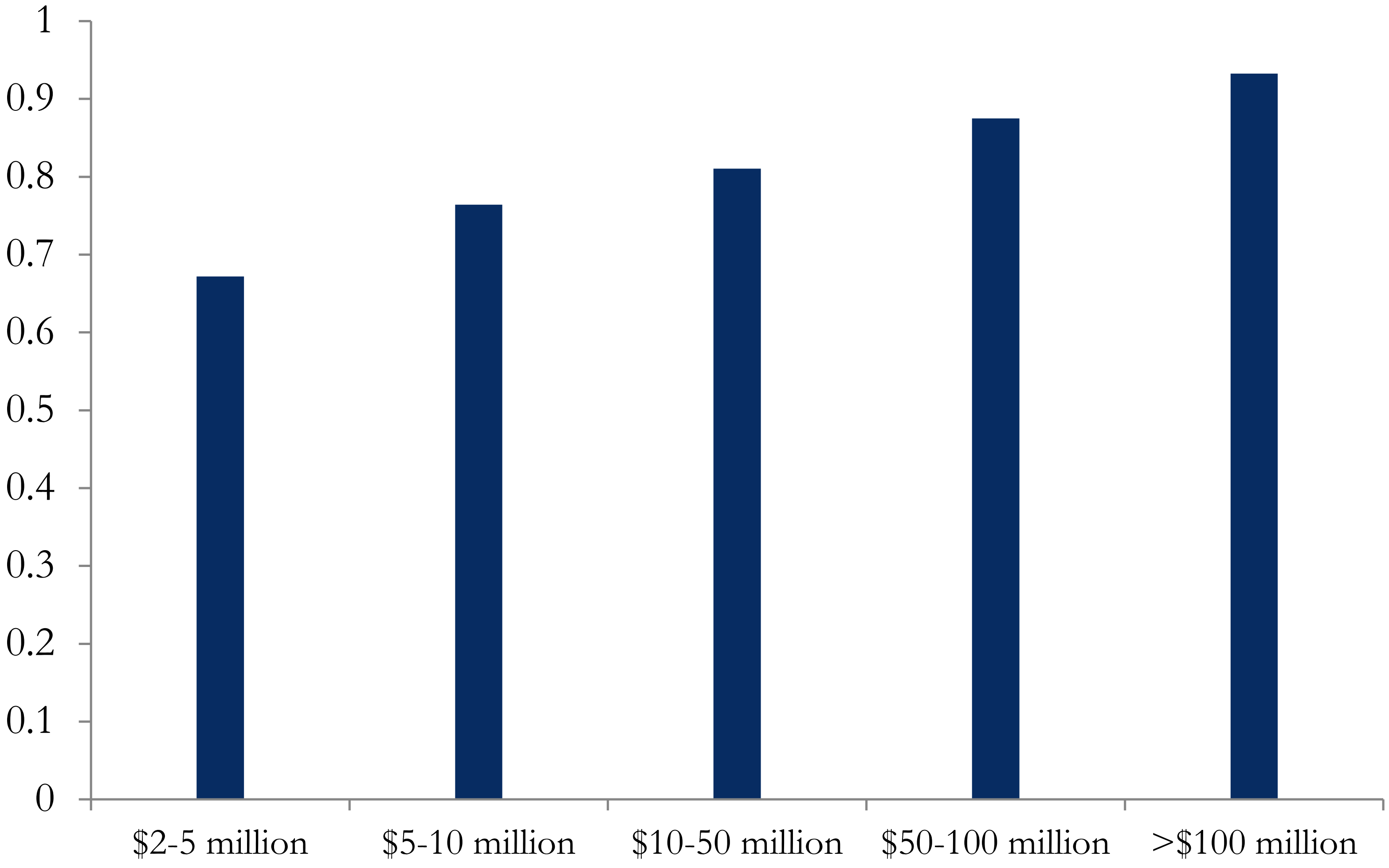


Two Measures of Capital Income

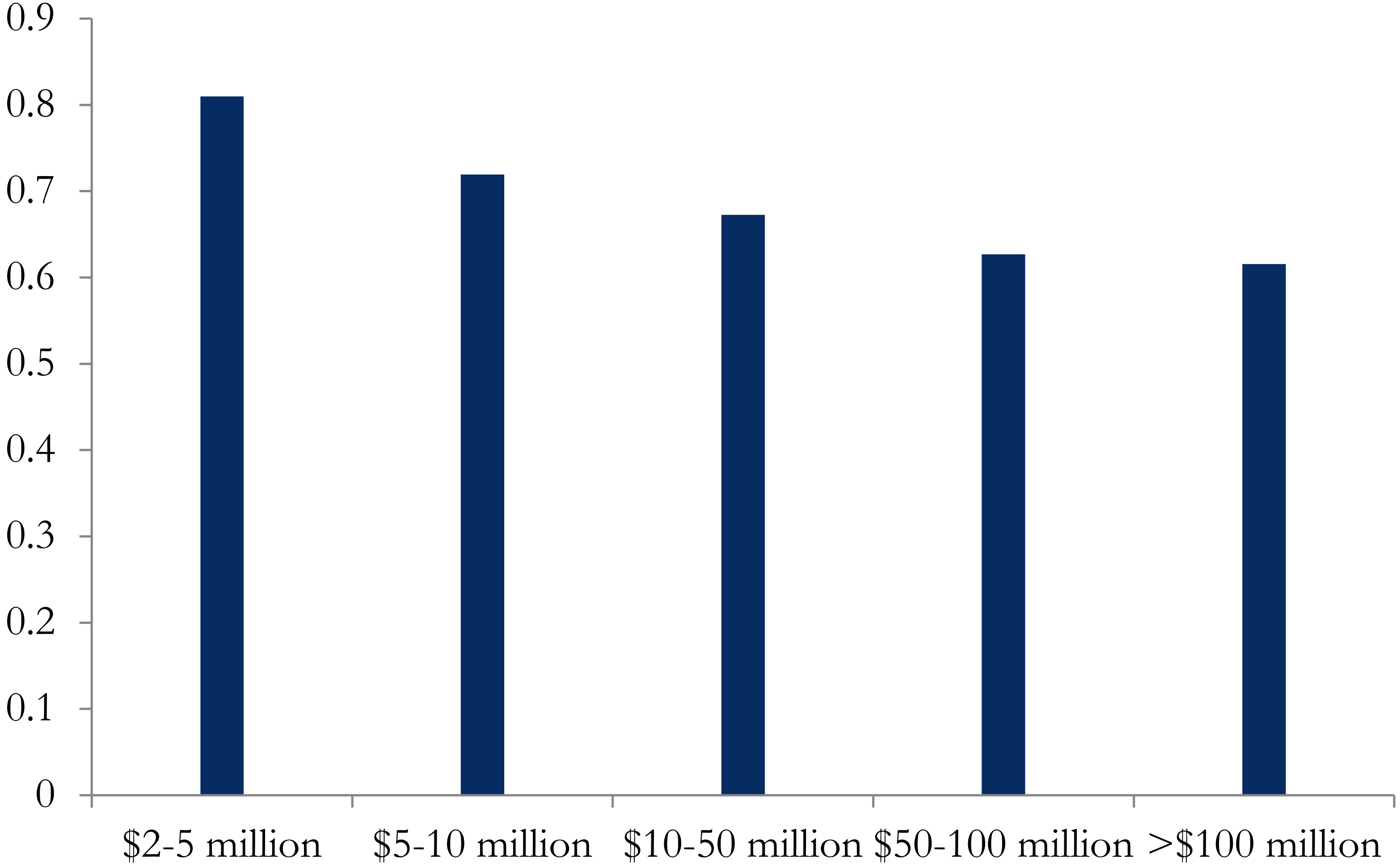
Net capital income	Net taxable capital income
Taxable interest	Taxable interest
+Tax-exempt interest	
+Capital gains	+Taxable capital gains [a]
+Dividends	+Dividends
+Gains from sale of business property	+Gains from sale of business property
+½ Schedule C	+½ Schedule C
+¾ Schedule E	+¾ Schedule E
+½ Schedule F	+½ Schedule F
+½ IRA distribution	+taxable portion of IRA distribution
+½ Pensions and annuities	+taxable portion of pensions and annuities
-Interest deduction	-Interest deduction

[a]Capital gains are taxed at a rate lower than income. "Taxable" capital income converts capital gains income to an amount equivalent to what it would have been had capital gains been taxed at the same rate as income. All income figures are in constant 2007 dollars; five-year averages are used.

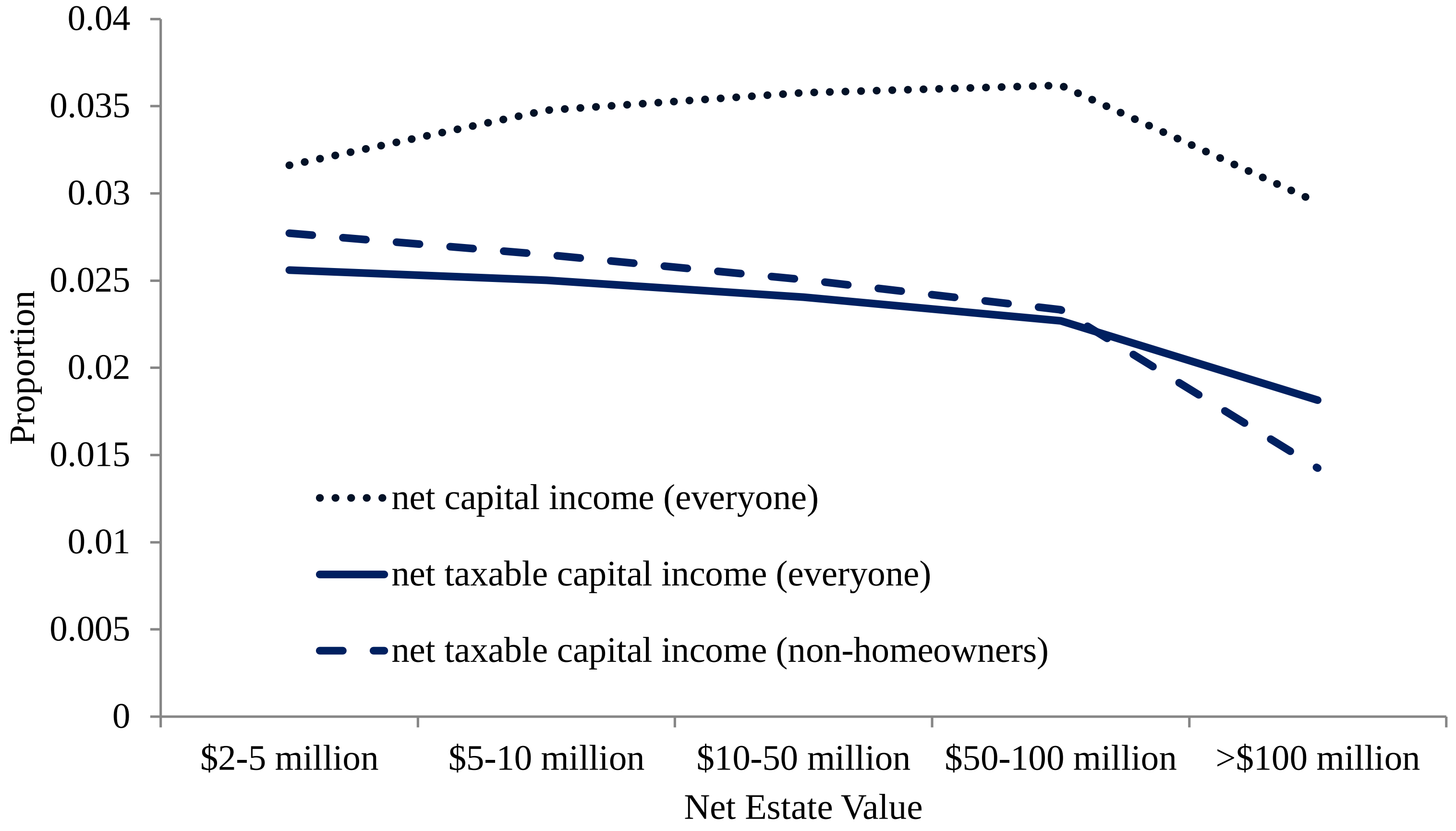
Net Capital Income as a Proportion of Total Income, by Wealth Category



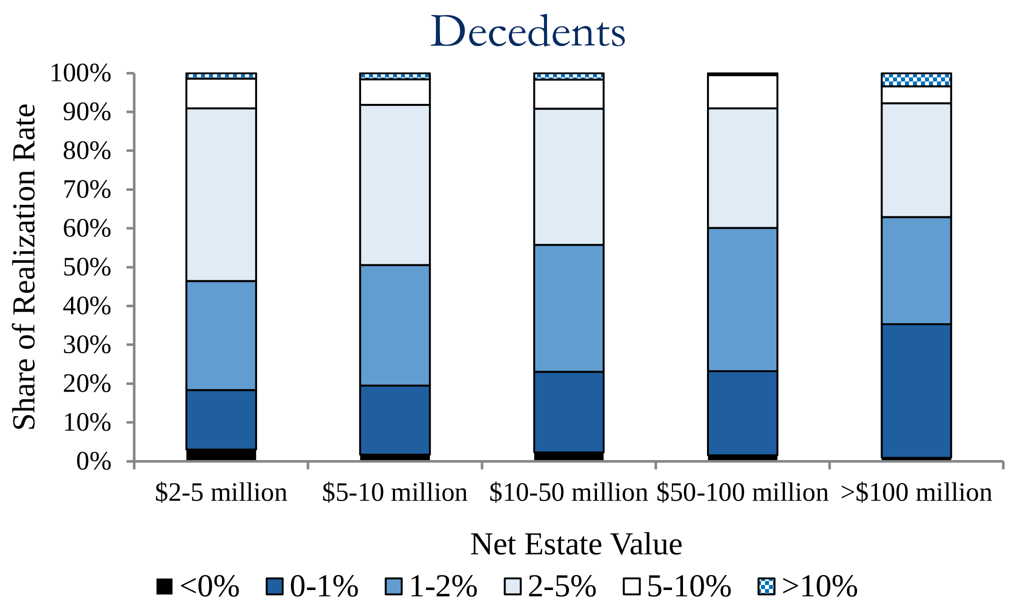
Net Taxable Capital Income as a Proportion of Net Capital Income, by Wealth Category

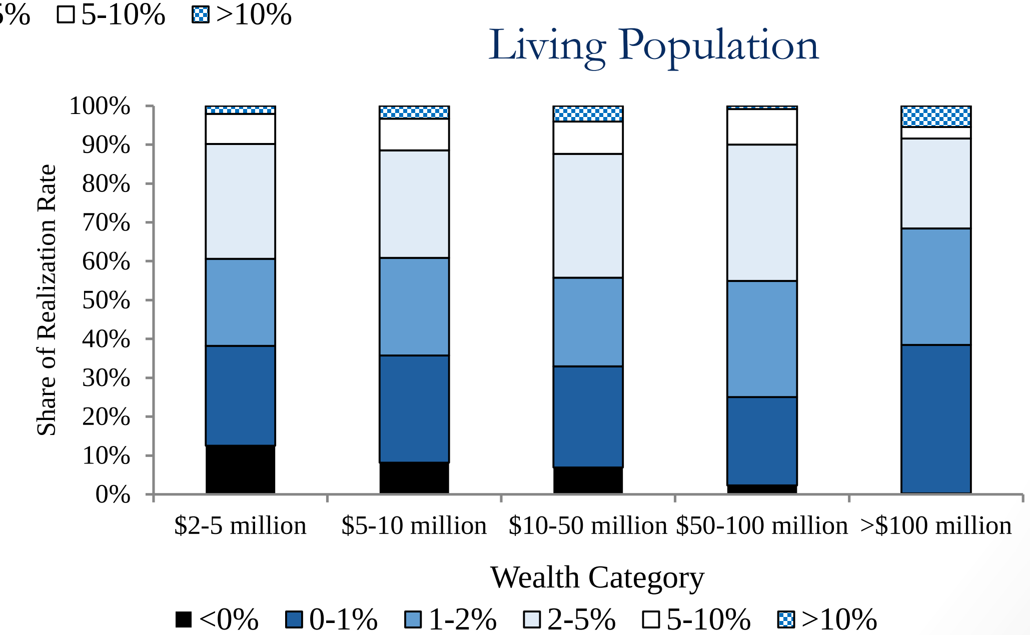


Net Capital and Net Taxable Capital Income as Proportion of Net Estate

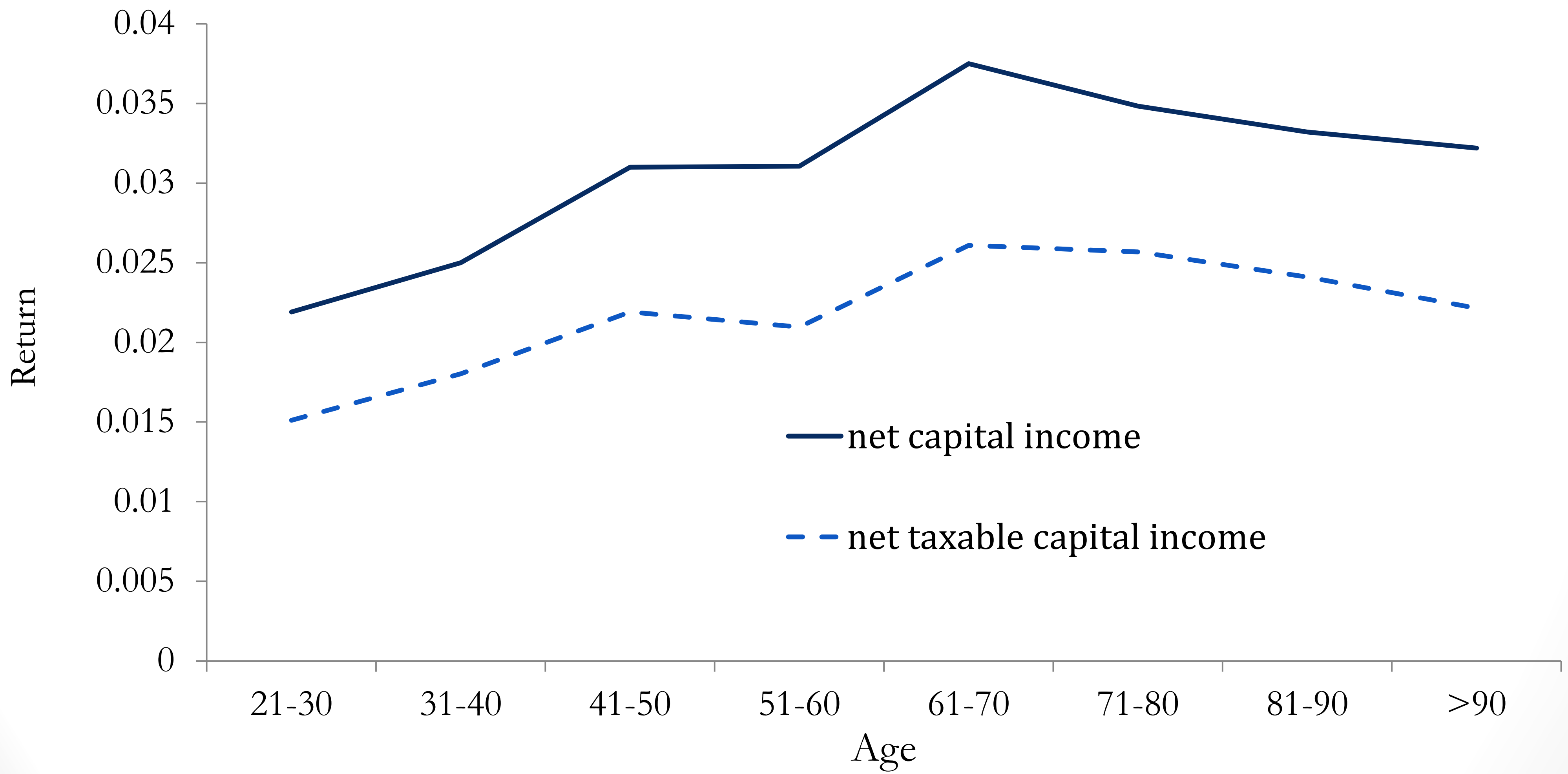


Percentages of Estates with Different Rates of Realization of Net Taxable Capital Income, by Wealth Category





Estimated Realized Return on Capital for the Living Population, by Age Group



Regression Analysis

ln net capital income (or ln net capital taxable income) =

f(ln net estate, age, age squared, dummies for age/gender/extraordinary medical expense, ln charitable contribution, home value as % of net estate)

$\hat{\beta}$ (elasticity of capital income with respect to net estate):

0.919 for net capital income
0.799 for net taxable capital income

Statutory vs. Effective Federal Income Tax Rates

- Long-term real return on stock ~ 7%
- Typical realized return by wealthy individual ~ 2%
- Top marginal federal income tax rate = 35%

- Effective marginal federal income tax rate = 10%

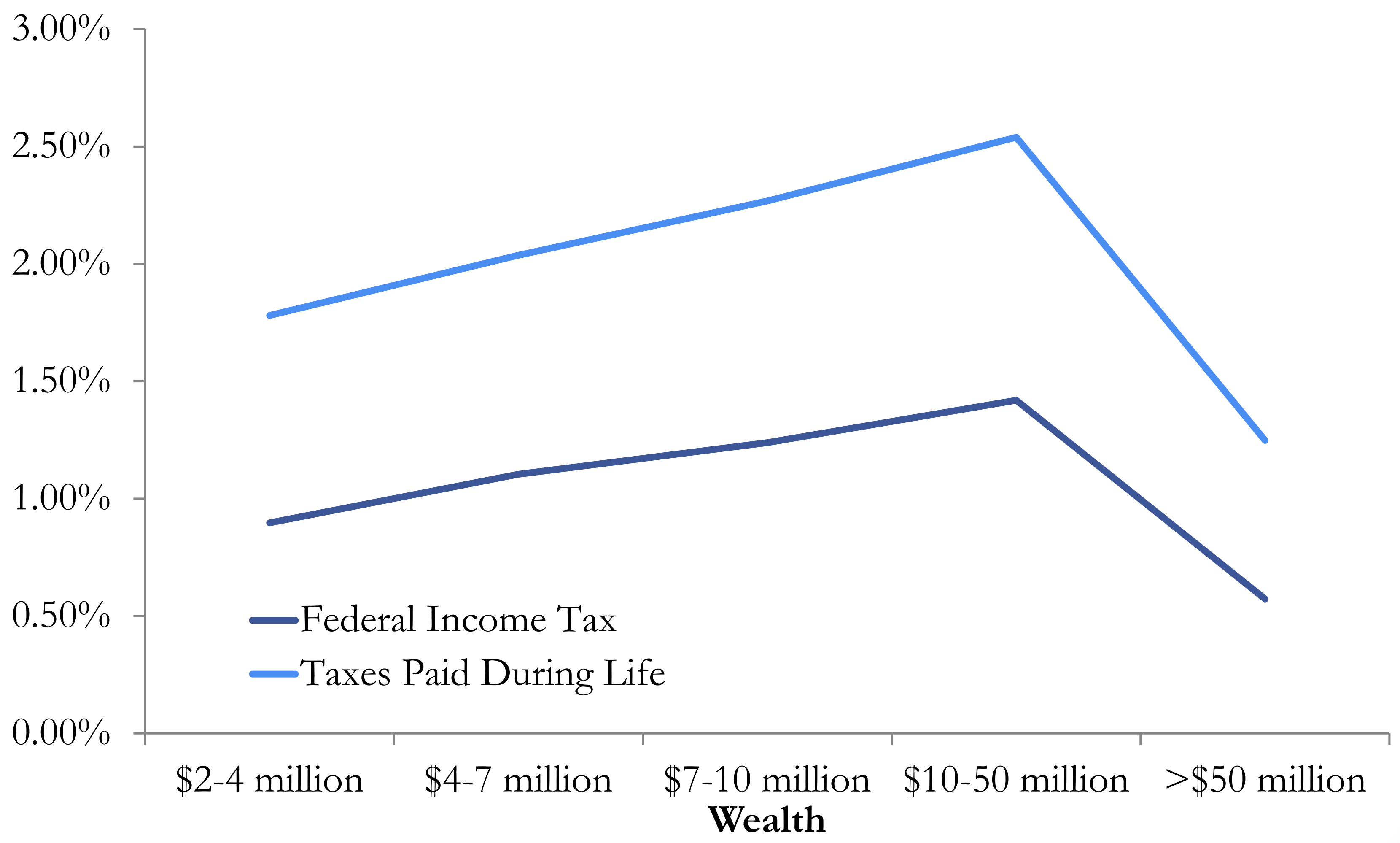
What About Other Taxes?

- State and local income tax
- Real estate and other property taxes
- Social Security and Medicare taxes
- Imputed corporate tax
- Estate and generation-skipping transfer taxes

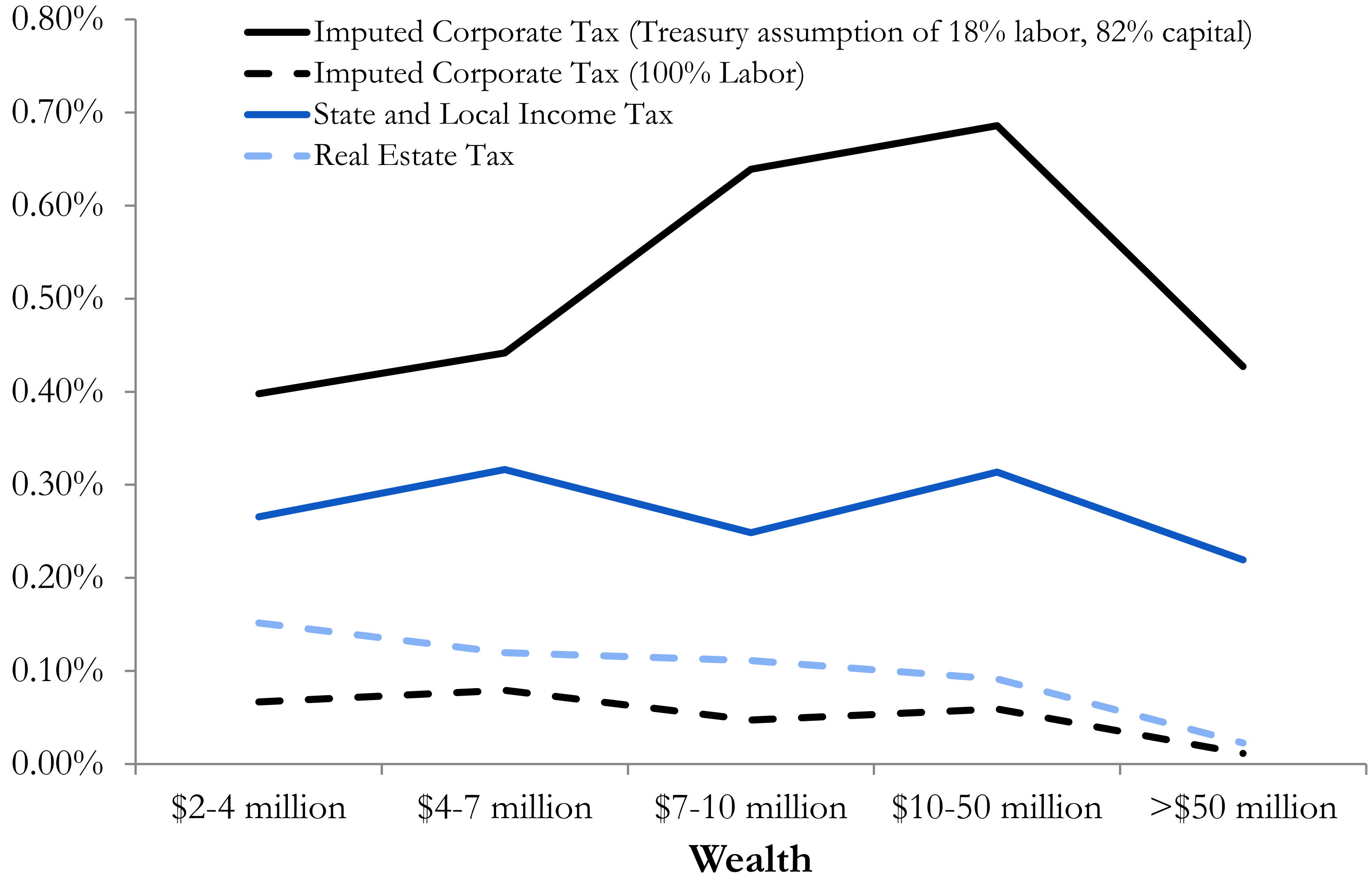
Data: Single Itemizers, Living Population

- 92-98% (depending on wealth category) itemized in at least one year between 2002 and 2006 – can obtain information about state and local income tax, real estate tax, other property tax
- Can also calculate Social Security/Medicare tax (assign both parts to employee) and can impute corporate tax via SOI information on overall corporate tax paid
- Use multiplier to estimate living population with assets of at least $2 million
- Focus on single persons to avoid marital deduction issue associated with estate tax and potential Social Security tax issue

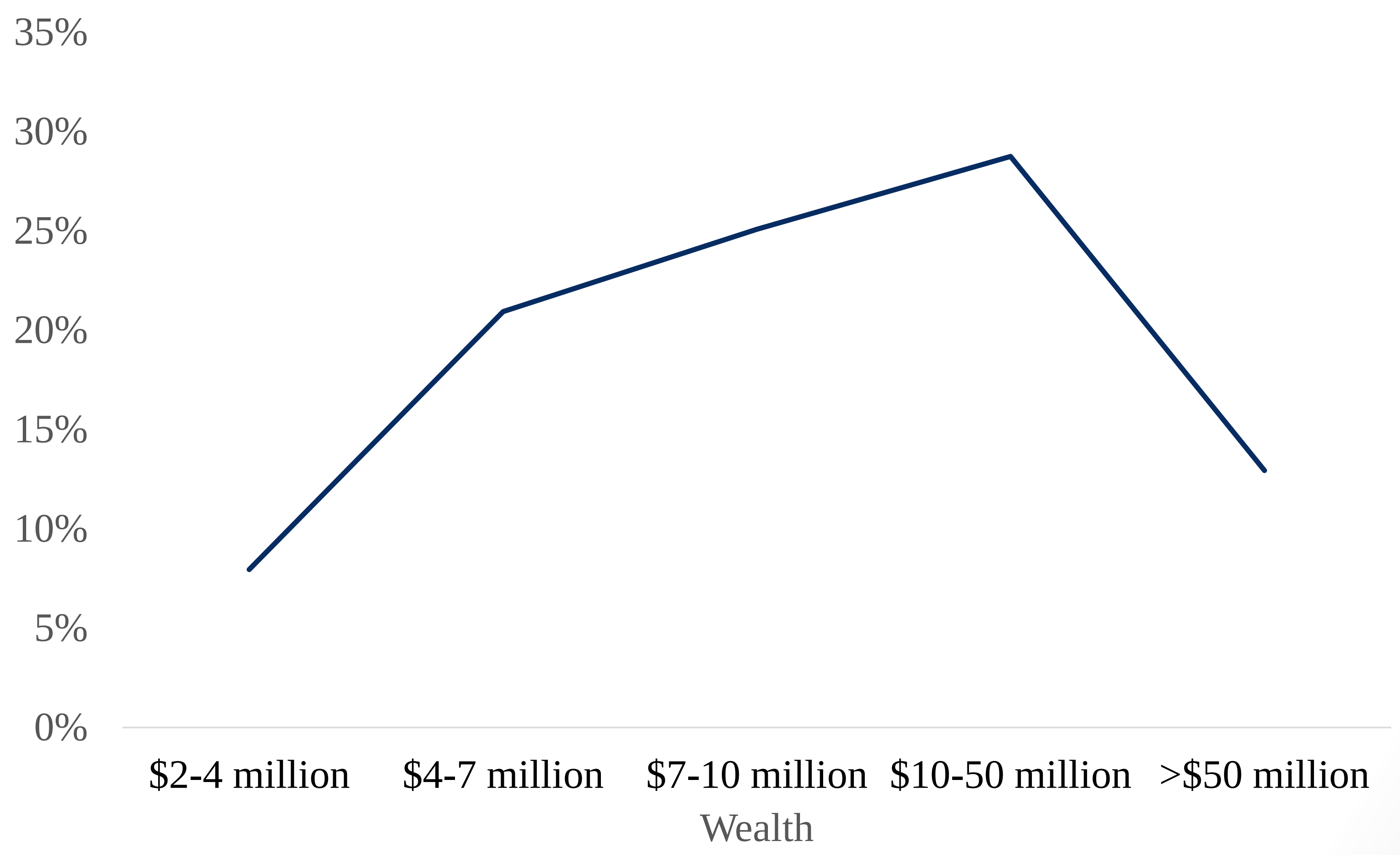
Annual Taxes Paid During Life and Annual Federal Income Tax as Percentages of Wealth, Single Wealthy Itemizers, by Wealth Category



Annual State/Local Income Tax, Real Estate Tax, and Imputed Corporate Tax as Percentages of Wealth, Single Wealthy Itemizers, by Wealth Category



Federal Estate Tax as a Percentage of Wealth, Single Wealthy Itemizing Decedents, by Wealth Category



The Wisdom of Warren Buffett

- "I still pay a lower tax rate than my secretary"
- Compares capital gains tax rate to rate on labor income
- Doesn't account for discretion in realization

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- Wealthy have higher economic returns and lower realized returns than non-wealthy
- Looking only at realized income overstates progressivity of tax system
- Inferring wealth distribution from realized capital income understates wealth inequality