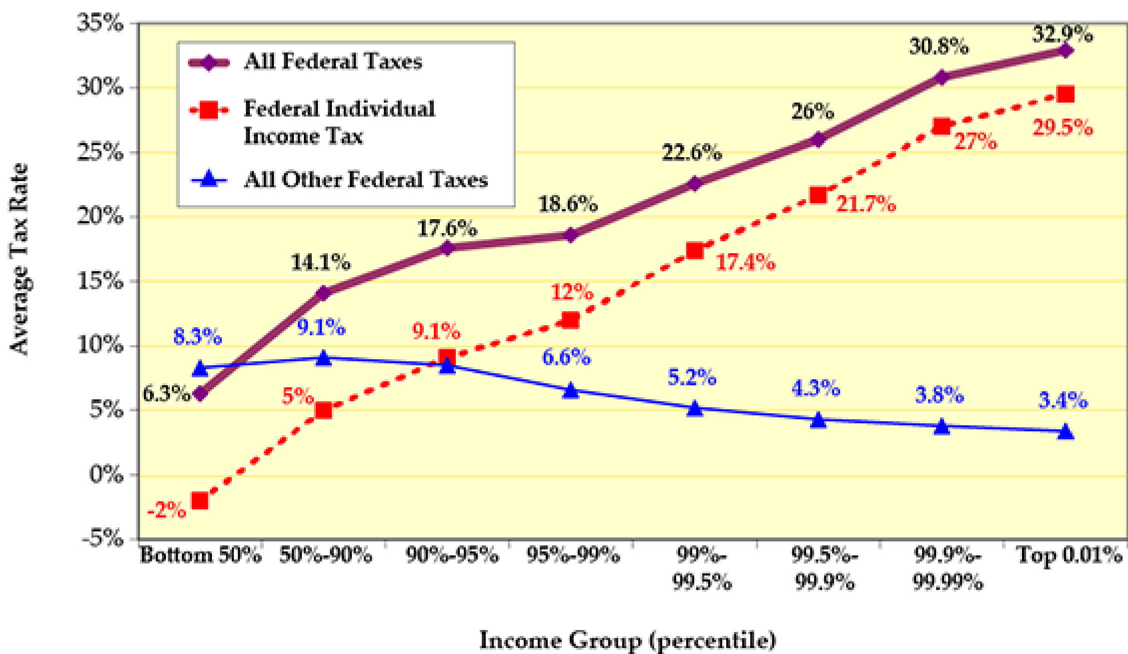
Do the Superrich Pay Tax at the Highest Rates?

By Martin A. Sullivan

For a May 12 hearing on "Reforming the Tax Code's Advantageous Treatment of the Wealthy," the Joint Committee on Taxation published (JCX-24-21) new estimates of average tax rates that do not indicate the wealthy are advantaged. The JCT estimates, reproduced in Figure 1, show tax rates steadily increasing as incomes increase. In Figure 1, the progressivity of the federal individual income tax offsets the net regressivity of all other federal taxes, leading the JCT to conclude that "the overall Federal tax system, on average, remains progressive."

There can be little doubt that at the low end, the U.S. federal income tax is progressive. This is attributable to a generous standard deduction, the progressive rate structure, and refundable child and earned income tax credits. But as we move to the very upper income levels, the tax environment changes dramatically. The aforementioned progressive features of the code matter much less. (The top individual tax rate for married couples filing jointly applies to all taxable income above $628,300.) Capital income is a much larger share of income for the rich than it is for the working class. So tax advantages for capital income significantly reduce high-income tax rates below those suggested by statutory tax rates.

Figure 1. JCT Estimates of Average Federal Tax Rates by Income Group, 2018



Source: JCT, "Present Law and Background on the Taxation of High-Income and High-Wealth Taxpayers," JCX-24-21, Table 4 (May 10, 2021). Tax units are ranked using tax-unit, size-adjusted pretax/after-transfer incomes. Other federal taxes include payroll taxes, corporate tax, estate and gift tax, excises taxes, and customs duties.

Preferential Treatment

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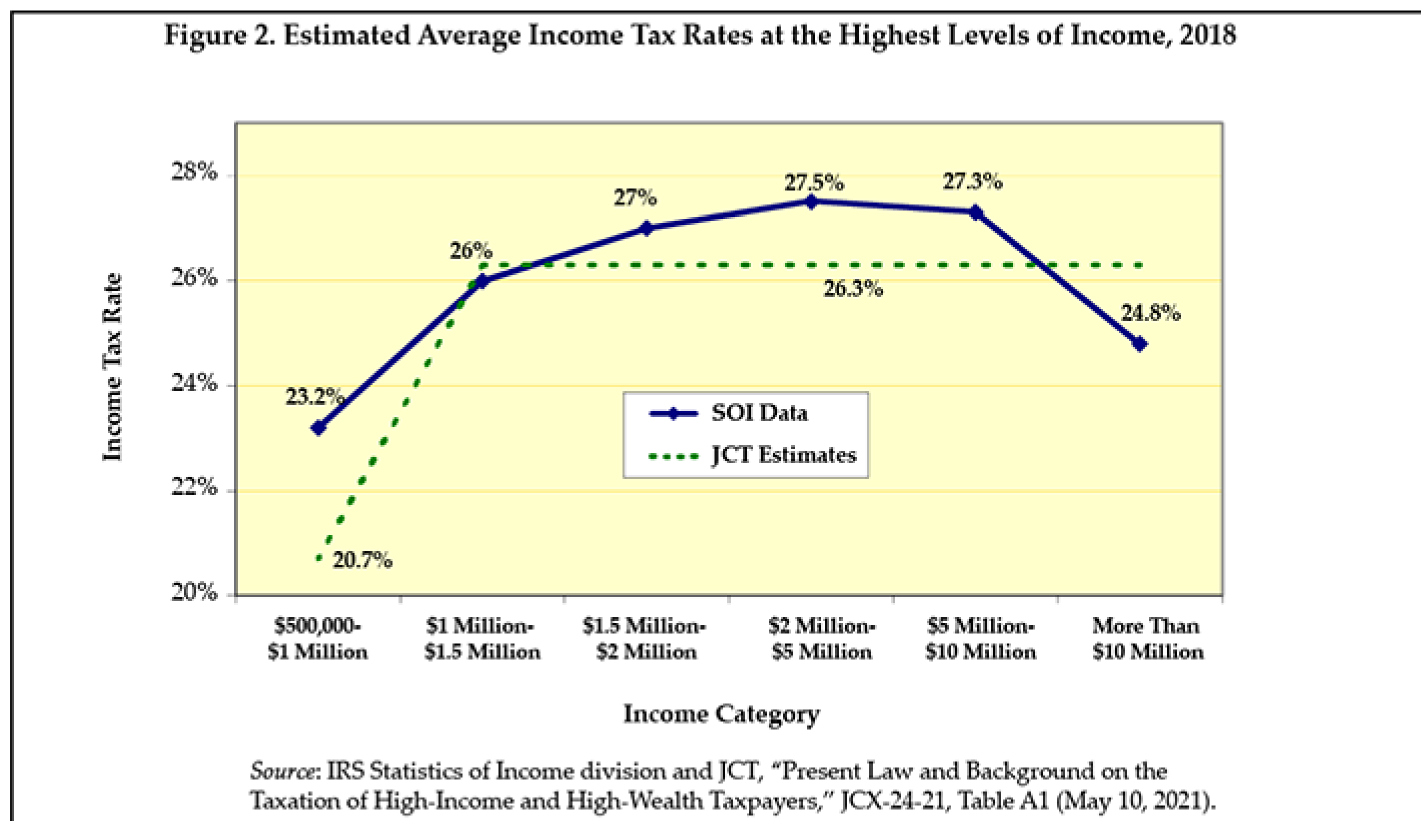
In this article we'll focus on two tax advantages of capital income that reduce the progressivity of the tax system at the high end. The first is the preferential rate on capital gains and qualified dividends. The effective rate on this income for high-income taxpayers is a 20 percent income tax rate plus a 3.8 percent net investment income tax. Although it's a massive oversimplification of reality, as a first approximation we might expect a taxpayer with $10 million of income divided evenly between wages and capital gains to pay a federal income tax equal to approximately 30.4 percent (the average of 23.8 percent and 37 percent).

In the solid line in Figure 2, we can see how the effects of preferential treatment of capital income are significant enough to overcome the progressive features of the income tax. For incomes above $5 million, average tax rates fall as income rises. This should come as no surprise. Some taxpayers at the high end may be receiving nearly all their taxable income in the form of capital gains and qualified dividends, in which case their effective tax rate would begin to approach 23.8 percent. These tax rates come directly from statistics compiled by the IRS Statistics of Income division. The numerator is taxes paid (less refunds). The denominator is adjusted gross income.

The dashed line in Figure 2 is a more sophisticated calculation of effective tax rates computed by the JCT. (The underlying JCT estimates for figures 1 and 2 are the same. The difference is the categorization — by percentiles in Figure 1, by dollar amounts of income in Figure 2.) The numerator is taxes paid (less refunds), and the denominator is income after transfers. Because high-income taxpayers don't receive large amounts of transfer payments (relative to their income), the difference in denominators between the SOI and JCT average tax rates is of no major consequence.



What is of consequence, however, is that the JCT aggregates all taxpayers with more than $1 million of income into a single category, which does not allow us to see if the JCT is estimating declining

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rates of tax for income — say, in excess of $5 million — as we observe in the SOI data. This would be confirmation that at the highest income levels, the preferential taxation of capital income begins to offset the progressive features of the tax code, and that the U.S. tax system, while for the most part progressive, is not progressive at the highest income levels.

More Than They Realize

The other advantage capital income enjoys over non-capital income is the deferral and eventual exemption of unrealized capital gains from tax. Under section 1014, heirs receiving assets do not carry over basis of the decedent but receive a basis stepped up to the value of assets at the time of death of the decedent, which means that income from appreciation of those assets, from the time of acquisition by the decedent to the time of death, will never be subject to income tax.

> *Capital income is a much larger share of income for the rich than it is for the working class. So tax advantages for capital income significantly reduce high-income tax rates below those suggested by statutory tax rates.*

Rich folks not only have more capital income than others, but they also have a greater ability to defer gains until death because they are less likely to need dividends or to sell assets to maintain their lifestyles. Because the advantages are so large, and the ability to avoid tax is relatively simple — that is, just don't sell assets — deferring capital gains until death is the big enchilada of income tax planning for the superrich.

Unfortunately, the JCT method doesn't take into account unrealized capital gains, nor is there any discussion in the report of the role that unrealized gains play in high-income tax planning. It is widely accepted in public finance economics that a good income tax strives to tax economic income. Economic income is in turn widely accepted to follow the Haig-Simons definition, equal to consumption plus changes in wealth. Unrealized gain is a change in wealth. Unrealized gain is economic income. Unrealized does not mean unreal. The wealthy can see it very clearly on their brokerage statements, even if the IRS will not see it on tax returns.

Because unrealized gains aren't reported on tax returns, they are difficult to estimate even for government economists with access to confidential IRS data. Nevertheless, in a 2018 article by Jenny Bourne, C. Eugene Steuerle, Brian Raub, Joseph Newcomb, and Ellen Steele, the authors estimated that for the very wealthy, only about half of capital income (including unrealized gains) was picked up on tax returns in 2006 ("More Than They Realize: The Income of the Wealthy," *Nat'l Tax J.* 335 (June 2018)). They also reported that on average, about 80 percent of income for the wealthy was capital income. Applying these same ratios and using current tax rates lead us to the back-of-the-envelope calculation in the table of an apparent effective tax rate (like those reported in Figure 2) and an effective tax rate on economic income.

In the first column of the table, a taxpayer with $100 million of taxable income is assumed to have $20 million of wage (non-capital) income and $80 million of realized capital income. Wage income is subject to income tax at 37 percent, and realized capital income is taxed at 23.8 percent. One-half of

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actual capital income is unrealized, so unrealized capital income equals realized capital income. Total tax is $26.44 million (equal to 37 percent of $20 million plus 23.8 percent of $80 million).

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If we ignore unrealized gains, the effective tax rate is 26.44 percent. But if we include unrealized income in the denominator (so we are measuring the effective tax rate on economic income), the effective tax rate is 14.69 percent (equal to $26.44/$180). Based on the facts and assumptions we have laid out, it's hard to see how a good assessment of taxation of the very rich can ignore unrealized gains. It would be like evaluating the Los Angeles Lakers offense without talking about LeBron James.

The second column of the table is a hypothetical calculation for taxpayers who have accumulated most of their wealth through appreciation of stock, with most of the appreciation unrealized until death. This might reflect the situation of the superrich on the *Forbes* 400. In this case, the effective tax rate on realized income is 24.06 percent, but the effective tax rate on economic income is 6.11 percent.

Looking Forward

Sometimes economists hear from non-economists that unrealized gain isn't really income. It is, they say, phantom income or paper profit. If these non-economists are correct, then the U.S. tax system looks like the solid line in Figure 2: a bit regressive at the upper end. If the economists are correct and unrealized gains are as large as Bourne et al. estimate, we have a system in which the superrich pay rates of tax lower than many middle-income families. If we are going to properly assess how the wealthy are now being taxed and how they should be taxed in the future, we in the tax policy community must fully flesh out the role of unrealized capital gains. As an economist, your author sides strongly with the point of view that unrealized gains are income. If this view is wrong, somebody better tell Jeff Bezos and Elon Musk that they aren't really wealthy.

Calculation of Hypothetical Effective Tax Rates on Realized Income and Economic Income

	Average Wealthy Person Using Bourne et al. Parameters	Superwealthy Individual
Realized capital income as percentage of total reported income	80%	98%
Unrealized gain as percentage of realized gain	100%	300%

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	Average Wealthy Person Using Bourne et al. Parameters	Superwealthy Individual
Total income reported on Form 1040	$100	$100
Wage income	$20	$2
Realized taxable income	$80	$98
Unrealized capital income	$80	$294
Income tax	$26.44	$24.06
Total income reported on Form 1040	$100	$100
Economic income	$180	$394
Effective tax rate on tax return income	26.44%	24.06%
Effective tax rate on economic income	14.69%	6.11%
Source: Author’s calculations.		

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