JVL Associates, LLC NEWSLETTER

March 2012

Did you just pay your "fair share"??

With another tax season behind us I thought it appropriate to take a deeper look into the issue of tax "fairness".

Our President has been touring the country promoting the "Buffet Rule" as a cure for the perceived "unfairness" in our tax system. The White House calls it "a simple principle of tax fairness that asks everyone to pay their fair share." So, the pertinent question of the day is – ***did you just pay your "fair share"?***

Let's begin by looking at the following chart which compares the distribution of income earned (Federal AGI) and the distribution of the actual Federal Income Taxes paid for 2009 (latest data available). [1]

Summary of Federal Individual Income Tax Data, 2009

Source: Internal Revenue Service

Category based on Federal AGI	AGI brackets	Number of Tax Returns with Positive AGI	(In Millions) Total Federal AGI	Percent of Total Federal AGI By Category	Percent of Total Federal AGI Cummulative	(In Millions) Federal Income Taxes Paid	Percent of Federal Income Taxes Paid By Category	Percent of Federal Income Taxes Paid Cummulative
Top 1%	$343,927 and up	1,379,822	$ 1,324,572	17%	17%	$ 318,043	37%	37%
Top 2 - 5%	$154,643 to $343,927	5,519,288	1,157,918	15%	32%	189,864	22%	59%
Top 6 - 10%	$112,124 to $154,643	6,899,110	897,241	11%	43%	102,249	12%	71%
Top 11 - 25%	$ 66,193 to $112,124	20,697,331	1,770,140	23%	66%	145,747	17%	88%
Top 26 - 50%	$ 32,396 to $ 66,193	34,495,551	1,620,303	21%	87%	90,449	10%	98%
Bottom 50%	under $32,396	68,991,102	1,055,215	13%	100%	19,511	2%	100%
All Taxpayers		137,982,204	$ 7,825,389	100%		$ 865,863	100%	

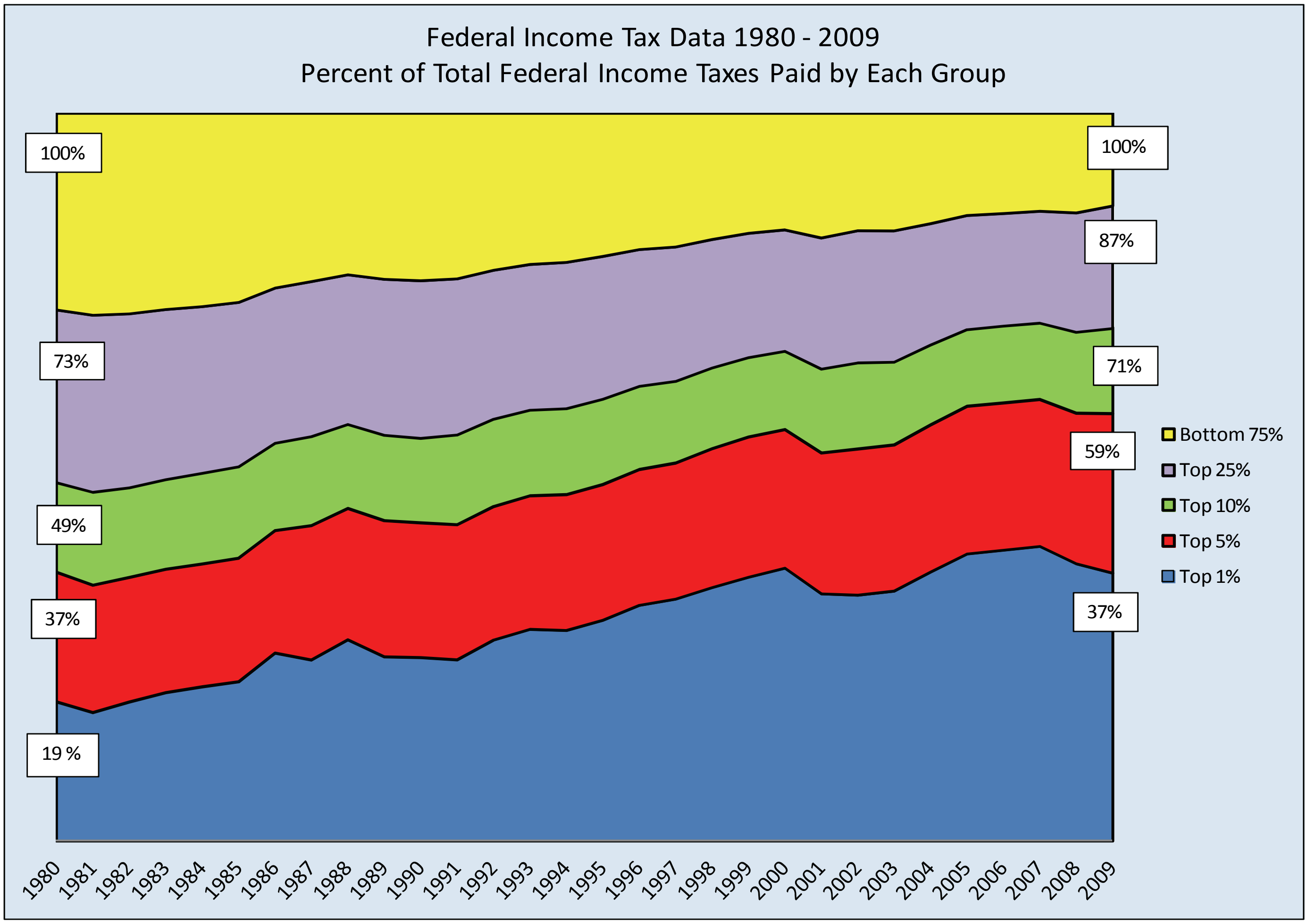
www.taxfoundation.org

As the chart shows the top 1% of all tax filers earned 17% of the income in the country and paid 37% of the federal income taxes. Add in the next 4% and we see that the top 5% of tax filers earned 32% of the income and paid 59% of the income taxes. Throw in the next 5% and we see that the top 10% of the tax filers earned 43% of the income and paid 71% of the income taxes. In each of these three categories (top 1%, top 5% and top 10%) their percentage of the total federal income taxes paid exceeded their respective percentage of the total income earned.

But, let's keep looking. Add the next category and we find that the top 25% of tax filers earned 66% of the income and paid 88% of the federal income taxes. Now throw the next 25% in the mix and we see that the top 50% of tax filers earned 87% of the Nation's income and paid 98% of the Nation's income taxes. That means the bottom 50% of all tax filers paid just 2% of the countries' federal income taxes while earning 13% of the total income.

Let's turn to history to see if this "unfairness" is new. The next chart shows the percentage of federal income taxes paid by each category. Looking back in history we see that the top 1% of tax filers have seen their share of the total federal income taxes paid grow from 19% in 1980 to 25% in 1990 to 30% in 1995 and remain above 35% since 2004. The top 5% have seen their share of the total taxes paid grow from 37% in 1980 to 59% in 2009. The top 10% have seen their percentage increase from 49% in 1980 to over 71% in 2009. During this same time the bottom 75% of tax filers have seen their share of the total federal income taxes paid decrease from 27% in 1980 to 13% in 2009.

[1]



But wait; there must be something to support the "unfairness" claim. So, let's look at the amount of taxes paid by the different categories as a percentage of their income earned. This next chart shows that, in total, the top 1% of tax filers pay 24% of their income earned in federal income taxes, the next 4% pay 16%, the next 5% pay 11%, the next 15% pay 8%, the next 25% pay 6% while the lowest 50% of all tax filers pay just 2% of their income in federal income taxes.

Looking at the totals, we see that the average rate of taxes paid as a percent of income earned was 11%. But only the top 10% of all tax filers paid that rate (or higher) while 90% of all tax filers paid less than the average! Ouch...that doesn't seem "unfair"….

Summary of Federal Individual Income Tax Data, 2009 [1]					
Source: Internal Revenue Service					
					Federal Income
		Number of	(In Millions)	(In Millions)	Taxes Paid
Category based		Tax Returns with	Total	Federal Income	as a % of
on Federal AGI	AGI brackets	Positive AGI	Federal AGI	Taxes Paid	Federal AGI
Top 1%	$343,927 and up	1,379,822	$ 1,324,572	$ 318,043	24%
Top 2 - 5%	$154,643 to $343,927	5,519,288	1,157,918	189,864	16%
Top 6 - 10%	$112,124 to $154,643	6,899,110	897,241	102,249	11%
Top 11 - 25%	$ 66,193 to $112,124	20,697,331	1,770,140	145,747	8%
Top 26 - 50%	$ 32,396 to $ 66,193	34,495,551	1,620,303	90,449	6%
Bottom 50%	under $32,396	68,991,102	1,055,215	19,511	2%
All Taxpayers		137,982,204	$ 7,825,389	$ 865,863	11%
www.taxfoundation.org					

Of the 140 million federal income tax returns filed for the 2009 tax year over 58 million resulted in a zero or negative federal income tax. Negative federal income tax means that the taxpayer received refundable credits (Making work pay credit, Earned income credit, Child tax credit, Educational credit, etc.) greater than the amount of their actual income taxes and the Government sent a check to the taxpayer – not a refund of withholding tax – a check direct from the U.S. Government. That means that 41% of all 2009 tax filers paid nothing in federal income taxes or received a check from Uncle Sam comprised 100% of someone else's money. That is up from 21% of tax filers in 1980 and 1990 and 25% in 2000. [1]

So, maybe we need to move our analysis down from the national totals and focus on one single person – that might help us find this "unfairness". And that one person just happens to be … the other candidate, Mitt Romney. So, let's compare the President's 2010 tax return with Mr. Romney's 2010 tax return. By placing the two returns side by side we see what the President is really talking about – he paid 24% of his income in federal income taxes and Mitt Romney only paid 14%. Now, it's starting to make some sense!

2010 Federal Income Taxes

Tax Return Details

		OBAMA		ROMNEY
Salaries & Wages	$	395,188	$	-
Interest Income		8,066		3,295,727
Dividens Income		9,997		4,923,348
Business Income from Schedule C		1,382,889		593,996
Capital Gain (Loss) from Schedule D		(3,000)		12,573,249
Rents, Royalties, Pass Thru Income (Loss) from Schedule E		1,323		(279,884)
Other Income		1,151		554,908
TOTAL INCOME	**$**	**1,795,614**	**$**	**21,661,344**
One Half of Social Security Taxes Paid		18,518		14,576
Self-Employed Retirement Contribution		49,000		-
Domestic Production Activities Deduction		-		261
ADJUSTED GROSS INCOME (AGI)	**$**	**1,728,096**	**$**	**21,646,507**
Itemized Deductions:				
State & Local taxes		52,527		672,444
Real Estate Taxes		25,742		226,356
Other Taxes		-		146
Home Mortgage Interest		49,945		-
Investment Interest		-		51,444
Charitable Contributions		245,075		2,983,974
Other Investment Related Expenses		-		584,776
Exemptions		14,600		7,300
TAXABLE INCOME	**$**	**1,340,207**	**$**	**17,120,067**
Regular Tax	$	438,949	$	2,873,054
Alternative Minimum Tax		-		232,989
Foreign Tax Credit		(22,215)		(129,698)
Other Income Taxes		-		4,270
TOTAL INCOME TAXES	**$**	**416,734**	**$**	**2,980,615**
Total Income Taxes as a % of:				
Adjusted Gross Income		**24%**		**14%**

Source: Personal federal income tax returns released by candidates

But, how did Mitt get away with this? There must be some sort of "story" in this tax return, something sneaky or maybe even sinister. Well not exactly, Mr. Romney just happened to have his income in the form of dividends and capital gains which are taxed at 15% while his itemized deductions (including $900,000 paid in state, local and property taxes plus another almost $3 million in charitable contributions) were greater than his ordinary income sources. Thus, after reporting all of his income in accordance with federal income tax laws and applying the federal income tax rates that President Obama signed into law in 2010 Mr. Romney is now accused of not paying his "fair share"!

But, if we dig a little deeper we find that Mr. Romney has reported income called carried interest as long term capital gain and it is taxed at the 15% level. Remember that term, "carried interest", because you will be hearing about it a lot as the campaign heats up. Certainly, this must be a Republican give away to the rich. This just doesn't sound fair.

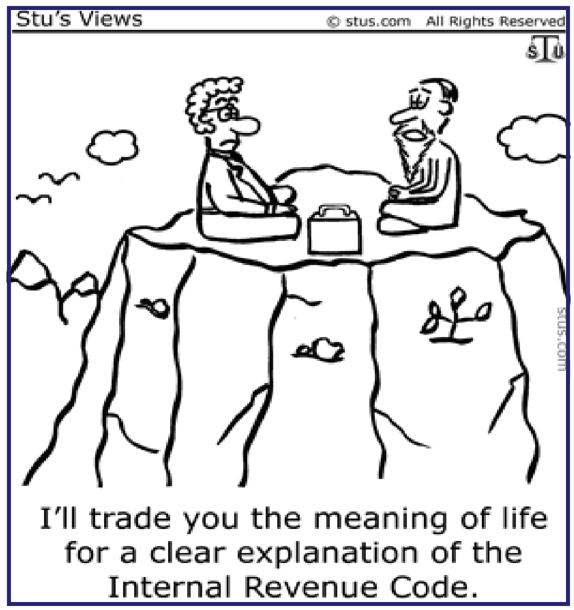
As it turns out, carried interest is the name given to the income earned from the sale of a business sold by a private equity firm, venture capital company or hedge fund that it has owned for over one year. The gain or loss on the sale is a long term transaction just like it is for the average investor who sold their Apple stock after one year. The difference is that carried interest refers to the portion of the gain (usually 20%) which is allocated to the fund managers as a reward for making the investment in the first place. Some people, including many members of Congress, would like to see carried interest treated as compensation to the manager and be treated as a bonus and therefore taxed as ordinary income.

So, why hasn't the taxation of carried interest been changed? The issue has been discussed for many years – this is not new. In 2007, in a bipartisan attempt to make tax law changes, Sen. Chuck Grassley (Republican- Iowa) and Sen. Max Baucus (Democrat – Montana) co-sponsored tax legislation that would change the tax rate on carried interest from capital gain rates to ordinary income rates. At the same time, House Democrats sponsored a bill doing the same thing. But, the bills didn't get very far. Sen. Charles

Schumer, a Democrat Senator from New York, killed the Senate bill. The New York Times reports that Sen. Schumer "raised more than $1 million from the booming private equity and hedge fund industries for the Democratic Senatorial Campaign, of which he is chairman. He has been reassuring them that he will resist an effort led by members of his own party to single out the industry with a plan that would more than double the taxes on the enormous profits reaped by executives. He said a tax increase on private equity and hedge fund executives could lead to an exodus of jobs and companies from New York, and even from the country. He said he worried that the industry was being unfairly singled out." [2] You give me money and I won't let the bill pass – how can that be "unfair"?

What is the Buffett Rule the President is promoting? In its simplest form the Rule, named after billionaire investor Warren Buffett, would apply a special rate to anyone making over $1 million. "People earning at least $1 million annually – whether in salary or investments – should pay at least 30 percent of their income in taxes." [3] Under the bill, the income they are referring to is Adjusted Gross Income (AGI) which comes before itemized deductions. Thus, the Buffett Rule takes away from those earning over a million dollars all of the deductions that are available to everyone else– and all in the name of achieving "fairness". Really, I'm not making this stuff up!

OK. Let's step back, put on our thinking caps and have a serious debate about the purpose of taxes. I pulled a copy of the very first Federal Income Tax Return from 1913 (now you know what's in those piles on my desk) and noted that the entire return was 3 pages long with 1 additional page of instructions. The tax rates ranged from 1% on the first $20,000 of income up to a maximum of 7% on income over $500,000. Another interesting item was that dividends received from corporations were excluded from taxable income.



Today the U.S. Tax Code is 3.8 million words long. [4] There have been 4,428 changes to the tax code over the last decade. [4] The IRS has 1,999 different publications, forms, and instruction sheets that you can download from the IRS website. [4] According to the Tax Foundation, the average American has to work until April 17th just to pay federal, state, and local taxes." [4] Is "fairness" really even an issue anymore.

For decades the tax code has been used to promote activity and incentivize behavior.

Let's look at dividends. Dividends are corporate profits that have already been taxed at the corporate level (up to 39%) and then are paid out to shareholders. Congress, realizing they had already received taxes on those profits and wanting to promote investment voted to reduce the tax burden on dividends at the individual level. So, currently dividends are taxed at a rate no higher than 15%. If one looks through both corporate and individual taxes the true tax rate on the corporate profits paid out in dividends can be up to 54% (39% plus 15%) which is higher than any other tax rate. Under the Buffett Rule the combined tax rate on dividends would be 69% (39% plus 30%).

And what about long term capital gains? The tax code incentivizes people to invest for the long term by rewarding those holding an investment for over one year with a reduced tax on the gain. Currently that rate is 15% but is scheduled to go up to 20% on January 1, 2013. With stock market volatility at historically high levels are we really at a point in the stock market recovery to take away the incentive to hold stocks for the long term?

What about itemized deductions. Funding charitable organizations has historically been allowed as a reduction in the computation of taxable income (comes after Adjusted Gross Income). This incentivizes people to make charitable contributions which support religious, charitable, scientific, or educational purposes which society believes is for the greater good. Under the proposed Buffett Rule anyone making more than $1 million dollars would not be allowed this deduction. Has anyone asked if taking away the incentive of the tax deduction would reduce the amount of charitable contributions made by those affected by this rule.

While I could go on about this subject, let's wrap up by quantifying this idea. Congress' Joint Committee on Taxation estimated that if enacted, legislation reflecting Obama's proposal would collect $47 billion through 2022 – a trickle compared with the $7 trillion in federal budget deficits projected during that period." [3] That computes to less than 1% of the problem.

If Warren Buffett is seriously concerned that his taxes are not high enough then he has the ability to send a gift to Uncle Sam anytime he wants. The Federal Treasury would be pleased to take his money. Promoting tax gimmicks that ignore massive problems is not helpful.

If anyone really thinks the President is being serious consider that the Washington Post recently quoted the President as saying: "There are others who are saying: Well this is just a gimmick. Just taxing millionaires and billionaires, just imposing the Buffett Rule, won't do enough to close the deficit, well I agree." The Post went on to report, " And if that's not enough evidence of gimmickry, after his speech Obama's reelection campaign unveiled an online tax calculator to see how your tax rate stacks up against Mitt Romney's and see what the Buffett Rule would do." [5]

While this farce is going on we are rapidly approaching January 1, 2013 when all tax rates are scheduled to go up. The temporary tax rate reductions are set to expire at the end of 2012. The highest individual income tax rate will increase from 35% to 39.6%. The rate on capital gains will increase from 15% to 20%. The preferential treatment of dividends ends and dividends will be taxed as ordinary income. In addition, the tax hikes in the 2010 health care reform legislation kick in. That adds an additional 0.9% tax rate for wages over $250,000 as well as an additional 3.8% tax rate on all non-earned income over $250,000(includes interest, dividend and capital gain income). The additional tax increases are expected to be a substantial drag on the economy still recovering from the last recession.

Our nation is in need of a serious debate on the purpose of taxes, the type of taxes, who pays those taxes and how much we pay in taxes. Unfortunately, that isn't going to happen this election year.

What really is your "fair share"? Is your fair share based on population – we all pay an equal amount? Is it based on number of tax returns filed – every return pays equally?

Should it be based on tax laws – promoting activities or incentivizing behavior – thus a deduction is a deduction no matter how much you earn? Do we need to adjust the tax rates so our tax burden is more progressive than it already is? Maybe the more important question is – who gets to decide what your "fair share" is?

The next time you hear someone (including the President) talk about tax fairness – be aware that it is all politics – all campaigning. Rather than making a serious effort to fix the problem, use smoke and mirrors and get people to look elsewhere. Why tackle the real problem – leave that for the next guy.

So, pull a copy of your tax return, take a look at the amount of income taxes you paid, compare it to your AGI and then ask yourself – *did you just pay your "fair share"?*

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References

[1] Information obtained from the following source: www.taxfoundation.org

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[3] The Grand Rapids Press, *"Obama Urging Congress to pass 'Buffett Rule' tax"*, by Jim Kuhnhenn, April 1, 2012

[4] The Economic Collapse Blog, *"24 Outrageous Facts About Taxes In The United States that Will Blow Your Mind"*, April 12, 2012

[5] The Washington Post, "*Rebuffing Obama's gimmicky 'Buffett Rule'"*, By Dana Milbank, April 11, 2012