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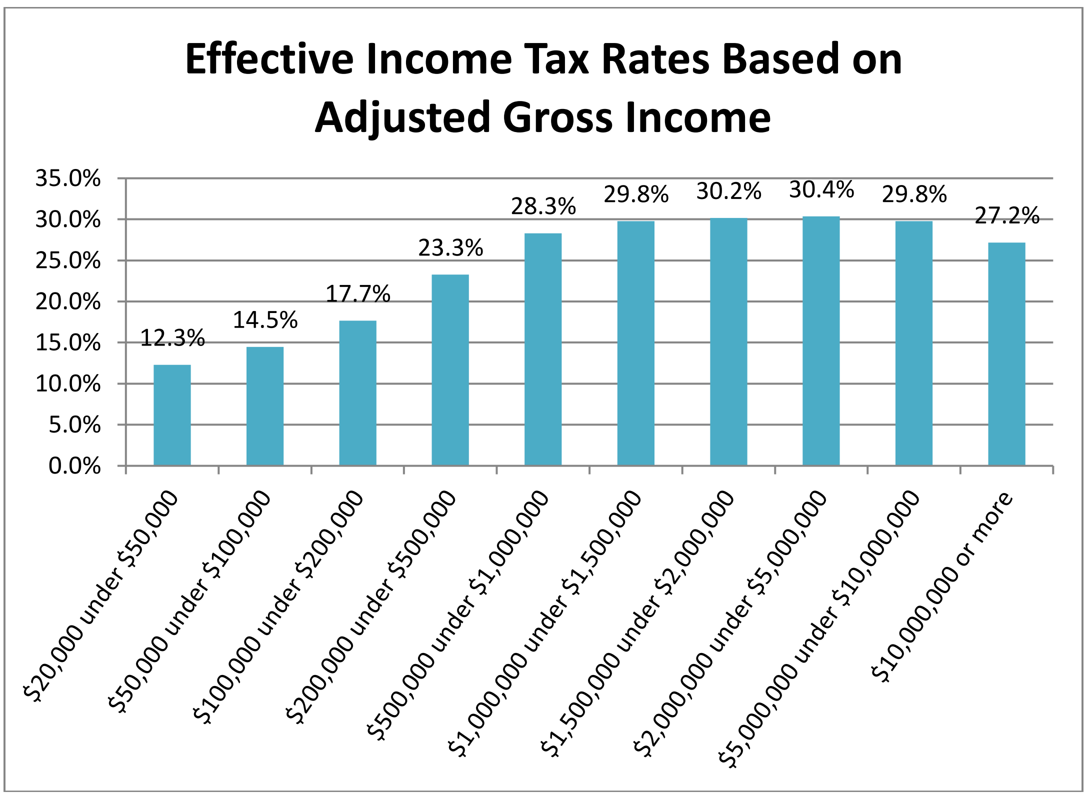
Are We Really Coddling the Super-Rich?

In August of 2011 legendary investor Warren Buffett wrote an editorial in the New York Times entitled, "Stop Coddling the Super-Rich." In the editorial Buffett argued that the rich have not been asked to pay their fair share and should have their taxes increased. What really resonated with many was Buffett's argument that he should not be paying a lower tax rate than his secretary. President Obama quickly adopted the phrase and used it in support of his position of increasing taxes on the upper class.

In the editorial Buffett asserts that he paid a 17.4% tax rate in 2010 while others in his office averaged a 36% rate. Instead of shock and/or anger, the numbers triggered a red flag for me. The U.S. has a progressive taxation system - rates progress higher as your income increases. Buffett's rate was unusually low. The average effective income tax rate for a person making over $10,000,000 in 2009 was 27% (see chart below). I also knew that a 36% average effective rate seemed unusually high. Something was amiss.



2009 Figures. Source - http://www.irs.gov/taxstats/indtaxstats/article/0,,id=133521,00.html

One of the first things we must do when we read any statistical argument, such as the one Mr. Buffett is making, is to carefully note how things are measured. In his editorial, Buffett calculates total tax bill, comprised of income taxes plus both the employer and employee portion of payroll taxes, and divides that against "taxable income." It is vital that we look at both of those numbers. Let's start with taxable income.

Someone reading Mr. Buffett's article is very likely to equate the term "taxable income" with total income, which would be incorrect. Mr. Buffett has chosen to use "taxable income" which is gross income less your standard, or itemized, deduction and personal exemptions (line 43 of your Form 1040). This is an important choice that skews the percentages higher for middle class wage earners.

For example, let's assume a secretary in his office earns $100,000, is married with one child, has a mortgage and gives 10% of his/her income to a local church or charity, resulting in $25,000 in itemized deductions. Instead of using $100,000 for the denominator, Mr. Buffett would have used $64,050. Buffett's choice of "taxable income" instead of salary changes the result (in this example) from a total tax rate of 26% to a rate of 41%. By using a smaller denominator the income tax rate goes from 10.9% to 17.0% and the payroll tax rate goes from 15.3% to 23.9%.

Before we look at the numerator in Mr. Buffett's calculations, I would also make one other point. Mr. Buffett, whether intentional or not, clearly chose only the tax impacts that increased the tax rate for his staff. For instance, in the U.S. health insurance benefits are not taxed, which means they are not included in income reportable to the IRS yet are clearly an economic benefit to the employee. If Mr. Buffett had included health benefits as compensation, the denominator would have increased significantly more for his secretary and very little for himself, thus lowering his secretary's rate.

As we noted above, the primary reason Buffett's secretary appeared at first glance to be paying more in taxes was due to the impact of payroll taxes (Buffett's effective income tax rate of 17% was significantly higher than the hypothetical secretary's 11% income tax rate). The higher payroll tax rate is due to how our Social Security system is financed. It is purposefully designed to be fair to all payors. In other words, payroll taxes are capped at earnings of $106,800 because the benefits are capped at that wage. Therefore someone making up to $106,800 is going to pay a higher percentage of their income in payroll taxes.

What Buffett also fails to note is that he is taking a snap shot at a certain point in time. Right now Buffett is already past retirement age and collecting Social Security. His staff is still paying in. The secretary with a hypothetical $100,000 salary will eventually retire and collect nearly $28,000 per year until death. In other words, the Social Security taxes paid in will, if the person lives to normal life expectancy, be fully returned and then some. Thus one could reasonably argue that a proper analysis of the lifelong tax burden would remove payroll taxes from the calculation entirely.

There is one remaining calculation adjustment that Buffett used in his calculation of payroll taxes. He attributed the portion paid by the employer to the employee. Obviously he could argue that if there were no payroll taxes the employee would likely receive it as income, and that may be true, but it doesn't offset two important points. The first, albeit minor, point is that if he was going to include the employer paid portion of the tax he should have also added that amount to income since it was not previously included. Secondly, if you didn't agree that the payroll tax portion should be completely excluded from the analysis, a strong argument can be made that the company (and therefore its owners, which includes Mr. Buffett) actually paid the employers portion of the payroll tax. Thus half of the payroll tax attributed to the employee would drop off, and Mr. Buffett's taxes would increase exponentially since Berkshire Hathaway has over 100,000 employees.

In Berkshire Hathaway's early annual letters, Buffett would regularly use the concept of "look-through" earnings to give the shareholder a greater picture of the true earnings power of Berkshire Hathaway. Berkshire's income statement only captured the dividend income from Berkshire's large stock holdings whereas Buffett correctly understood that a more accurate picture of Berkshire's earnings would have included all the after-tax earnings of its stock portfolio.

I think Buffett should have used the same thought process in regards to his own dividend income and taxes. If he had, his dividend income would have gone from a 15% tax rate to 45%, after adjusting for the impact of corporate taxes. Buffett's long term capital gains are essentially capturing the change in the present value of the future cash flows of the stocks he sold. In other words, while he held them, the companies retained some of their after-tax earnings and reinvested them back into their business and thereby grew the value of the company during his time of ownership. Since Buffett typically buys stable profitable franchises it is highly likely that while he owned those stocks they were paying corporate taxes of 35%. Thus even his 15% capital gains rate is ignoring the substantial corporate taxes that were paid on his behalf as an owner.

Interestingly Mr. Buffett comes to the conclusion that his income tax should be raised when it is actually the payroll tax that is causing the apparent disparity. Why did Buffett not call for a change in how payroll taxes are collected?

Upon analysis it seems clear that Buffett used a non-representative example of the super-rich, himself, and, to make matters worse, cherry picked facts and used a faulty analysis in order to arrive at his conclusion. If looked at objectively, it is clear that the U.S. has a progressive taxation system and it is not coddling the super-rich any more than any other group.

Tim Eriksen is the founder and president of Eriksen Capital Management. He has managed a private fund that focuses primarily on small and micro cap stocks since 2006. The editorial is an excerpt from the fund's 2011 year end letter. Tim can be reached at tim@eriksencapital.com