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Buffett Rule Has Big Exemption

BY KEN HOOVER

President Obama touted the Buffett Rule this week as part of his re-election campaign, but legislation to enact it has a major exemption that would reduce likely tax revenue and discourage productive investment.

If passed by Congress -- highly unlikely -- the Buffett Rule would require everyone with an income of $1 million or more to pay a 30% minimum federal income tax. It's named after billionaire Warren Buffett, who famously said his secretary paid taxes at a higher rate than he did.

Obama on Tuesday renewed his call for the rule. Hours earlier, the White House issued a report arguing that rich people weren't paying enough taxes.

But a Buffett Rule bill by Sen. Sheldon Whitehouse, D-R.I., has a glaring omission. It exempts a favorite tax shelter of the wealthy: municipal bonds.

The legislation determines if a taxpayer has a million-dollar income by looking at adjusted gross income. That excludes tax-exempt interest payments.

"That does undermine the logic put forward for the rule," said Alan Viard, senior fellow at the conservative American Enterprise Institute. "I'm surprised more people haven't picked up on that. Municipal bonds are held disproportionately by high-income taxpayers, and they get the highest tax break."

State and local governments issue municipal bonds to finance capital projects like schools, roads and high-speed trains. Because they are tax exempt, interest rates -- and financing costs for local governments -- are lower.

Take the example of ketchup heiress Teresa Heinz Kerry, wife of 2004 Democratic presidential nominee Sen. John Kerry.

When she released her 2003 tax returns during the campaign, slightly more than half her income came from tax-exempt bonds. She paid $628,401 in federal taxes on $5.1 million in income. That was at a 27.4% rate of her adjusted gross income, but only 12.3% of her total income.

Another example might be a client of financial adviser Mark Martiak, who, he said, was worried about the Buffett Rule over lunch earlier this week.

A New York City resident, she has $70 million in municipal bonds. High earners living in the Big Apple can face a combined federal, state and city tax bite of 43.8%, says Martiak, Current muni yields are 4.5% to 5%. A 5% coupon translates to the equivalent of 8.5% taxable return, Martiak said.

"It's worth noting the Buffett Rule is a backdoor way to crack down on one tax provision, to capture long-term capital gains," Viard said.

Long-term capital gains, taxed at 15%, are why many rich people pay tax rates below what Obama deems fair. Buffett reportedly pays an effective rate of just 11%.

That compares to the top rate of 39.6% on wages, profits, rents and royalties.

The favorable tax treatment for long-term capital gains was enacted in 2003 for the stated purpose of stimulating investment.

Raising it could have the opposite effect of driving investors out of productive activities, like the private economy, into government debt.

"What will happen is that investors will move money into municipal bonds. . . . It would have a bad effect on the economy," said Dan Mitchell of the free-market **Cato Institute.**

Analysts have given it no chance of passing the Senate, where Democrats lack the 60-vote majority necessary to block a GOP filibuster. And Republicans control the House.

"The purpose of President Obama pushing the Buffett Rule is to distract the American people from his failure to get the economy moving and to reduce the deficit," said Curtis Dubay, who analyzes tax policy at the conservative Heritage Foundation. "It would slow the economy and fall on job creators."

An aide to Whitehouse said the senator has worked on the bill for months, well before Obama brought up the Buffett Rule. It has 13 Democratic co-sponsors.