How rich get richer: all the rest pay more

IRS scrutinizes wage earners but takes investors at their word under separate, unequal system

By David Cay Johnston

Get a raise last year, or a bigger job, or make some extra money working overtime? You'll pay the tax man.

Too bad you did not get a job as a hedge fund manager. If you had, you would not owe any taxes come April 15 on your share of the hedge fund's profits.

Hedge funds are unregulated investment pools open only to rich individuals and big institutions. They operate offshore. And for their managers, some of whom earned a half-billion dollars last year, taxes are deferred as long as they keep the hedge fund open and the profits offshore, while you get taxes deducted from your paycheck. And, thanks to our government, their tax avoidance is perfectly legal.

The favored treatment afforded hedge fund managers, several of whom are in their 30s and have untaxed, multibillion-dollar fortunes, is just the tip of a very costly iceberg. Vast amounts of untaxed income, collecting unseen beneath the surface of the news, helps explain why the administration proposes less spending on education, health care, basic scientific research and veterans. Even as our government borrows more than $50 billion each month, it lets many of the richest Americans defer and sometimes completely avoid taxes.

What few of us realize is that the United States has two income tax systems, separate and unequal.

One system is for wage earners. Congress requires that your employer report your pay so Internal Revenue Service computers can check up on your tax return. Banks report interest. Brokerages report dividends. You must provide a Social Security number for each child you claim as a dependent. Congress does not trust you.

Middle class subsidizes the rich under separate, unequal tax system

▶ TAXES
From Page C1

The other system is for business owners, landlords and investors. Congress does not require such independent reporting, saying that would be a burden.

These people do not escape all independent reporting. Anyone who sells stock, for example, has the gross proceeds reported to the IRS. But the investor is trusted to say how much the stock cost and, thus, how much profit or loss was incurred.

Studies by the government show that investors understate their capital gains by close to $200 billion each year. The IRS has no mechanism — none — to check up on capital gains, according to two professors, Jay Soled, who teaches business at Rutgers in New Jersey, and Joseph Dodge, who teaches tax law at Florida State University. They estimate that capital gains tax cheating alone costs the government $29 billion annually.

But IRS auditors will catch people who cheat, right? Not really.

For more than a decade, Congress has steadily eroded the capacity of the IRS to enforce the tax laws, with one exception. Since 1997, Congress has approved more than $1 billion in extra funds to audit the working poor. In recent years, parents who work full time at the minimum wage have been as much as eight times more likely to be audited than millionaire investors in partnerships.

The wealthy who mine the tax system face little risk of getting caught. Only 1 partnership in 400 gets audited, and agents say many audits are superficial and closed quickly to make statistical reports create the appearance of toughening enforcement.

Last month, the IRS announced it expects to collect more than $3 billion from people who bought an abusive tax shelter called Son of Boss, a strategy for people with tons of stock options. The penalty for most of these cheats will be 20 percent or less. But penalties twice that size are being applied to the small-time chiselers who owe the government about $7,000 each in taxes because they got taken in a scam called the National Audit Defense Network.

> The IRS "picks on the little guy" over small sums while "largely overlooking an ocean of money hidden in business entities for which the owners, rather than the businesses themselves, were supposed to pay taxes."
>
> CHARLES ROSSOTTI
> *former IRS commissioner*

That it is official government policy on taxes to favor the rich and go after the little guy is an open secret in Washington.

Charles Rossotti, the wealthy businessman who was IRS commissioner for five years beginning in 1997, says so in his own new book, "Many Unhappy Returns." He wrote that the IRS is "like a police department that was giving out lots of parking tickets while organized crime was running rampant."

The IRS, he wrote, "picks on the little guy" over small sums while "largely overlooking an ocean of money hidden in business entities for which the owners, rather than the businesses themselves, were supposed to pay taxes."

In their first 15 years, more than a quarter of President Bush's tax cuts will go to the top half of 1 percent of the population, the nonpartisan Tax Policy Center estimates. The top tenth of 1 percent will pocket 15 percent of the income tax cuts, far more beyond their share of all income. And estate tax repeal will be worth even more to this thin and rich slice of Americans.

Under President Bill Clinton, who is widely known to have raised taxes on top wage earners, the effective tax rates paid by the 400 highest-income Americans fell sharply, from 30 percent in 1993 to 22 percent in 2000.

I calculated that had the Bush tax cuts been in effect in 2000, the top 400 would have paid a tax rate of 18 percent on incomes that averaged $174 million each that year. The government knows what the top 400 actually paid in 2001 and 2002, but the Bush administration refuses to release the data. One official who has seen the numbers said my 18 percent figure is wrong. "Your estimate was high," he said.

Bush says he wants a new tax system that will lower taxes on savings and investments and on "risk takers." He said a new system must be revenue neutral, meaning it will bring in the same amount as the old system.

If those with significant assets are going to pay less, there are only two ways to make up that revenue. One would be tremendous economic growth. The other would be to subtly shift more of the tax burden onto those Congress already watches closely: wage earners.

David Cay Johnston, a San Francisco native, is a Pulitzer Prize-winning reporter for the New York Times. This article was adapted from the new paperback edition of his book "Perfectly Legal," an expose of how middle-class taxpayers subsidize the rich. Contact us at insight@sfchronicle.com.