MORE THAN THEY REALIZE: THE INCOME OF THE WEALTHY

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Income reported on tax returns and surveys understates true economic income for the rich because most of their income comes from capital, and these individuals accrue rather than realize much of this capital income. As a consequence, studies based on realized income tend to underestimate income and wealth inequality and overestimate tax progressivity.

We use a new dataset — federal estate tax returns from 2007 linked to federal income tax returns from 2002 to 2006 — that captures wealth and income information for decedents with assets of at least $2 million. Not surprisingly, these individuals concentrated their wealth in assets that yielded the highest long-term returns, but they also sought opportunities to defer income recognition and to invest in tax-preferred assets. We find that the vast majority of these rich decedents realized returns to capital of less than 5 percent and typically less than 2 percent. At the same time, the stock market enjoyed long-run real returns of at least 7 percent. Taxable returns to capital were even lower in our data set, principally because capital gains are taxed at a rate lower than income. Strikingly, realized returns to capital — whether taxable or not — for the richest decedents were lower than those for less wealthy individuals.

Those who die are older on average than those who live. Information about age- and sex-specific mortality rates allows us to gross up our figures to obtain estimates of wealth and income for the living population in 2007 who held at least $2 million in assets. We find that realized returns for the living tended to be even lower than for decedents, likely reflecting a greater ability to consume out of wages for the young and a greater need to realize income to pay medical bills for the old.

The implications are clear. Rates of realization are low enough throughout life that much income is not merely deferred from individual income taxation but excluded forever. With continually higher levels of individual exclusion from the estate tax, an increasing share of wealthy individuals will escape tax on much of their capital income. Policy makers interested in assessing tax burden, estimating wealth via income capitalization, and calculating measures of economic inequality must therefore take care in using realized income or taxable income as measures of true economic income.