Tax-Free Living: How Some Wealthy Dodge the Top 400 Taxpayers List

By David Cay Johnston

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Johnston analyzes how the tax code lets some people live lavish lifestyles while legally paying no income tax and what Congress should do as it hunts for revenue.

The breakup of Frank and Jamie McCourt's marriage is making headlines because the couple, who own the Los Angeles Dodgers, lived an exceptionally lavish lifestyle. But what their divorce proceedings also reveal is how the official reports on incomes and tax burdens disguise reality.

In six years the McCourts spent $108.9 million without incurring any federal or California income taxes, her lawyers said in court papers. The only levies that may have been paid were payroll taxes on Mrs. McCourt's salary as the nominal head of the Dodgers, and even that is not clear from the court filings.

"The parties have not paid any federal or California income taxes since they moved to California in 2004," her lawyers wrote in a filing seeking nearly a million dollars a month of maintenance pending the completion of the divorce. (For the filings, see *Doc 2010-5054*.)

The family lived on a budget, the court papers show. The budget prepared for 2008 anticipated spending $43 million, of which $25 million was from new loans to fix two of their homes, and $18 million came from borrowing against Dodgers ticket revenues, which came with the added benefit of creating tax-deductible interest expenses.

The fact is that the McCourts are not unusual among people who have built up billion-dollar fortunes. Many Americans are spending millions, even tens of millions, each year while paying little or no income tax. And it's all perfectly legal, thanks to the generosity our Congress shows the richest among us.

How many tax dodgers like the McCourts are there?

The IRS Statistics of Income for 2007, at Table 1.4, shows that 959 taxpayers reported an adjusted gross income of $1 million or more but paid no income tax. That report significantly understates how many people had big incomes while living tax free. The McCourts, for example, would not be included.

The table includes only people who showed seven figures or more on the last line on the front of their Form 1040. The real story is people who, like the McCourts, show little to nothing on that line or, more commonly, negative numbers for AGI.

We simply do not know how many people show a tiny AGI but in reality live lavish lives because they have income that escapes taxation or because, like the McCourts, they borrow against their assets.

We simply do not know how much economic gain they achieve, because of the way the data are reported. And therefore we also do not know just how much they are costing the rest of us by forcing us to pick up more of the burden of maintaining the governments at all levels that enable and protect their riches. But you can be sure that includes people with annual three-comma incomes (that would be a billion dollars or more) that they defer.

Even the annual report the IRS issues on people who make $200,000 or more and pay no tax is misleading because, in terms of AGI, people like the McCourts do not make $200,000.

Just last month a Wisconsin developer who wants to become a U.S. senator revealed that he has not paid income taxes in years despite millions of dollars in annual income. Campaign disclosure forms show that in 2008 and the first 10 months of 2009, Terrence Wall had income of $3.5 to $14.2 million and incurred no federal or Wisconsin income taxes.

Asked whether it is fair to the middle class that they pay taxes and he lives tax free, Wall told the Milwaukee *Journal Sentinel* that "everyone should pay less in taxes."

The reality is that everyone else must pay more in taxes when Wall and the McCourts pay nothing.

Few Americans realize that you can make a huge income and live in a style beyond the imaginings of just a generation ago, all the while paying no income taxes. And part of the reason is the way that the government collects and distributes data. Congress appropriates funds to carefully track how much the elderly, the disabled, the orphaned, and the poor get from the government, but not the super-rich or the corporations on which it lavishes tax dollars and tax breaks. These rules force the rest of us to subsidize people like the McCourts and the would-be senator from Wisconsin.

It is an outrage that the economic gains of these artful tax dodgers at the apex of the economy are not found in the data on top incomes and on top taxpayers. Instead they show up in the data on people with little or no income and, often, negative income. That is an issue the SOI folks pointed out in one report, which I wrote about in an earlier column (*Tax Notes*, Aug. 4, 2008, p. 485, *Doc 2008-16746*, or *2008 TNT 151-40*.)

The latest IRS report on the top 400 taxpayers showed their average income was $344.8 million in 2008, up more than $80 million each from the year before, and their income tax rate was just 16.1 percent, down from nearly 30 percent in 1993.

If we had a report on the top 400 incomes, it would almost surely show even higher average income and much lower average tax rates. We need data on the top 400 nontaxpayers — indeed, on all nontaxpayers whose real incomes are not reflected by the AGI line of their tax returns.

Next year several million taxpayers who earn high incomes will see their marginal tax rates rise, but these changes will have no effect on the tax burdens of people like the McCourts, because they enjoy all the benefits of our society — including taxpayer-financed courts — without sharing in the burden. So Congress will squeeze a bit more from these people while ignoring people like the McCourts? This is equitable? This is reasonable? Does this even make sense?

Congress needs to investigate. It needs to lay the groundwork by asking questions, and then it needs to hold public hearings with witnesses under oath so the public can understand that the income tax system is a tight snare for those who toil for wages, but a tax-free lark for those who profit from being hedge fund managers, real estate developers, and other tax-favored industries.

Taxes will go up, as the brilliant piece of economic art on the cover of the March 1 issue of *Tax Notes* shows. (An enlarged and framed copy of that cover will soon hang on my wall of economic and political art.)

We have borrowed and spent, cut taxes and spent, and given away to those high in the economic order so much for so long that we have little choice now but to raise taxes. We could, of course, cut spending, but because the prime targets for that are education, healthcare, and the social safety net, that choice means an even poorer future, as we would fail to develop our most valuable asset (young brains), erode the value of our workforce through poor to no healthcare, and invite crime and violence by rending the tattered remains of our always thin safety net.

Currently a single working person who makes $500 weekly bears a total federal tax burden of 22 percent of her income. In federal income taxes alone she pays almost 9 percent of her wages to Washington. That is almost five weeks of gross pay each year for federal income taxes on a wage income just below the median of $509 a week. (See *Tax Notes*, Apr. 27, 2009, p. 479, *Doc 2009-8959*, or *2009 TNT 79-16*.)

The McCourts spent $26,000 every five and a half hours in 2008, but bore no federal income tax burden.

As Warren Buffett has said, class warfare is being waged, and his side is winning.

The McCourts' practice was to treat their actual income as distributions from their existing capital. Court papers show that, for example, the couple routinely borrowed against Dodgers ticket revenues, a neat tax trick that comes with an added bonus: One of their entities deducts the interest.

The court papers also suggest that finding tax cheating on the McCourts' Forms 1040 would be about as hard as finding snow on the ground in Rochester, or Washington this winter. One document, drawing on sworn testimony, says that all use of a private jet was treated as a Dodgers expense even though a third of it was for personally ferrying the McCourts.

Surely the owners of McDonald's franchises and small manufacturing firms who have been audited for charging personal expenses to their company books can appreciate that it is fundamentally unfair to hassle them over a few hundreds or thousands of dollars without giving similar attention to people with exponentially more opportunities to chisel and cheat.

Congress should start asking questions about how many people enjoy huge incomes and economic gains but pay little or no tax.

A good place to start would be asking the SOI division to issue reports on people with big numbers on the front of their Form 1040, but little, no, or negative amounts on the last line of that page.

Then Congress should ask its investigative arm, the Government Accountability Office, to compare the names of these rich nontaxpayers to the data on campaign contributions and lobbying by these individuals, their companies, and the trade associations and political action committees that they finance directly and indirectly.

You and I may not get the names, but there is no reason that government officials cannot examine the records and then write reports with statistical data. There is also no reason not to put data in single digits. The state of New York, for example, in its statistics of income data sometimes produces spreadsheet cells with three unnamed taxpayers — at the county level.

Next, Congress should ask the Joint Committee on Taxation for a report on the provisions of the tax code that make it possible for one to have big income from salary, rents, and other items, but to make it vanish before getting to the AGI line.

That report should include not just the usual technical explanation, but also one written in plain English and edited so that anyone with an eighth-grade education can understand it. Plain, simple, clear language is needed here so that the vast majority can easily grasp what is hidden behind the obscure words and concepts, backward sentences, and missing data.

We know about the McCourts because after they raised four sons, their marriage came apart. He says she was having romps with the chauffeur; she says he is cooking his books to make 80 percent of his net worth seem to vanish — and that his real fortune is nearly $2 billion more than his net worth statement shows.

Interestingly, her lawyers also argued that it appears that whatever the court orders Mr. McCourt to pay his estranged spouse, she would be free of any income tax obligation to him.

Her lawyers quote a Dodgers financial adviser as testifying in a deposition to the effect that "the complex organizational structure of the McCourt Enterprise was created principally to minimize any income tax liabilities for the parties. Among other things, he explained that such a structure enables intercompany transfers to be disregarded for tax purposes, and allows certain expenditures which might otherwise have to be capitalized to be instead expensed, resulting in more favorable tax treatment."

Mrs. McCourt wants — and under California law is entitled — to continue enjoying her share of about $800,000 per month in tax-free perquisites like a round-the-clock limo and the private jet, according to court papers.

And both the McCourts evidently want it all without paying a penny in federal or state income taxes.

A net worth statement prepared before the couple got into their legal fight set Mr. McCourt's net worth at $834.9 million as of September 30, 2008. However, her lawyers noted, that did not include the value of the regional sports network he can create in 2013 when Fox's contract to broadcast Dodgers games ends. The lawsuit puts the value of that future entity at $1.5 billion just for the English-language portion. Given the size of the Spanish-language audience in Southern California, the non-English-language portion's value would not be de minimis.

What is shocking here is not the accusations that Mr. McCourt is trying to pose as being in relative poverty. His lawyers put in the public record the specter that because the economy is in bad shape, Mr. McCourt might have to get by on a mere $5 million per year. Trying to hide income and assets from an estranged spouse is an old game, one that the California courts have become very skilled at flushing out because California is one of those states where each spouse is due half of the gain during the marriage, absent a prenuptial agreement.

IRS examiners take note: According to sworn testimony, there was the backdating of Mr. McCourt's personal net worth statement, or as one of his aides put it in an e-mail to a banker eight minutes later, a "scrubbing" of the document.

Curiously, as part of his effort to present himself to the judge as a newly pauperized victim of the economy, Mr. McCourt's net worth statements show more than $112 million in tax liabilities because some of his assets are worth more than their cost basis. But there have been no sales, just loans against those assets — loans that enable the tax-free living.

We simply cannot afford to subsidize the likes of the McCourts and Wall. The burden on the poor, the middle class, the affluent, and the rich who pay taxes is too great a price to pay, fiscally and politically. Whether we deal with either the fiscal or political issues, however, will depend on Congress. Is it up to the task? Or, considering the high cost of campaigning, will only members of Congress be up to the ask?

Your thoughts? E-mail me at *JohnstonsTake@tax.org*.