Wealth often fails to show up on tax returns

Billionaires use transactions to put income out the reach of IRS

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Bloomberg News

When billionaire Billy Joe "Red" McCombs, co-founder of Clear Channel Communications Inc., reported a $9.8 million loss on his tax return, he failed to include about $259 million from a lucrative stock transaction.

After an audit, the Internal Revenue Service ordered him to pay $44.7 million in back taxes. McCombs, who is worth an estimated $1.4 billion and is a former owner of the Minnesota Vikings, Denver Nuggets and San Antonio Spurs sports franchises, sued the IRS, settling the case in March for about half the disputed amount.

McCombs's fight with the IRS illustrates an overlooked facet in the debate over tax rates paid by the nation's wealthiest. Billionaires who derive the bulk of their wealth from stock appreciation are using strategies that reap hundreds of millions of dollars from those valuable shares in ways the IRS often doesn't classify as taxable income, securities filings and tax court records show.

"The 800-pound gorilla is unrealized appreciation," said Edward J. McCaffery, a professor of law, economics and political science at the University of southern California in Los Angeles.

While Warren Buffett has generated attention with his complaints that he and his fellow billionaires pay federal income taxes at a lower rate than his secretary — about 17% — the real figure is often smaller, said David S. Miller, former chair of the tax section of the New York State Bar Association and a partner at Cadwalader, Wickersham & Taft LLP in New York.

"The problem is not that people like Warren Buffett pay tax at a 17% rate, it's that they can use complex transactions not available to most Americans to get cash from their appreciated stock without paying any taxes at all," Miller said.

The rate at which the 400 U.S. taxpayers with the highest adjusted gross income actually paid federal income taxes — their so-called effective tax rate — fell to about 18% in 2008 from almost 30% in 1995, IRS data show. That's the tip of the iceberg, since much of their wealth never converts into income on a tax return, McCaffery said.

In the McCombs case, the billionaire entered into transactions known as variable prepaid forward contracts. He received about $259 million for lending an investment bank his Clear Channel shares with a promise to deliver the stock for good a few years later. The arrangement enabled McCombs to defer paying capital gains tax because he hadn't sold his shares, lawyers for the billionaire said. The IRS deemed the transaction a sale since the bank paid McCombs cash and got the use of his stock almost immediately.

Transactions like these may complicate plans by President Barack Obama to help close the federal deficit by increasing taxes on millionaires. Obama has said the tax code should contain a "Buffett Rule" to ensure that millionaires pay taxes at least at the same rate as middle-class Americans. Republicans have said they prefer lowering tax rates for businesses and the wealthy.

In the past two years, some of the wealthiest executives in the United States have used deals similar to McCombs's to reap returns while deferring the taxes without running afoul of IRS rules, securities filings show.