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Organization Trends

The Estate Tax

Charitable Giving and Private Profits
Who Wins, Who Loses?

By Palmer Schoening, M.P.P and William Beranek, Ph.D

Summary: The 2001 tax relief legislation provided for the phase out and termination of the federal estate tax in 2010. But Democrats in Congress revived it for 2011 and 2012. And if Congress fails to act before January 1, 2013, the Federal Estate Tax exemption will drop to $1 million and the rate will increase to 55%. Former Director of the Congressional Budget Office, Douglas Holtz-Eakin estimates that returning to a 55% death tax would cost an already jobs-thirsty America an additional 500,000 lost jobs. The most likely scenario this year is a one-year extension of the current tax (35% estate tax with a $5 million exemption) but Congress would be wise to repeal the tax completely. Repealing the tax will provide jobs, keep family businesses and farms intact, and increase charitable giving.

Death tax enthusiast Rep. Jan. Schakowsky (D-Ill.) at a rally last year.

Leftist politicians who resent some Americans having more money than others want to tax those they label "the rich." Rep. Jan Schakowsky (D-Ill.) is offended that "[i]n the United States today, the richest 1% owns 34% of our nation's wealth" which, she says, is "more than the entire bottom 90% combined." Unless the wealth of the rich is more heavily taxed, says Schakowsky, Americans will be forced to make one of two choices. "We can choose to cut education, job creation and health care, or we can choose to ask those who can contribute more to do so."

Another class warrior, AFL-CIO president Rich Trumka, also embraces this false dichotomy. "Across this country, schools are firing teachers, first responders are underfunded, and hard-working Americans are being denied basic services," says Trumka. "Yet, billion-dollar fortunes are exempt from paying their fair share of estate taxes. There is something wrong with this picture."

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Schakowsky wants to tax the rich so that Americans become more "equal"—and politicians have more power to redistribute wealth. But what about Trumka's emotional demand for an estate tax—or what opponents call "the death tax"—on inherited wealth?

Trumka's attack on "billion dollar fortunes" seeks to direct populist anger towards people with money. More importantly, however, his demand for an estate tax will lead to bad public policies about how to raise tax revenues and how to improve the lot of those less fortunate.

Those who today advocate stringent estate taxes think taxing the inheritances of the wealthy will generate enormous revenues for the federal government. They are wrong. They think estate taxes will eliminate the power of the wealthy ("plutocracy"). Wrong again. And they think estate taxes will give the rich an incentive to make charitable contributions while they are alive in order to claim tax deductions for their gifts. Three times wrong.

This paper points out that the revenue raised by the tax is insignificant—$20.4 billion which is only 0.76 percent of total federal revenue. Imposing an estate tax will not encourage charitable giving. Contrary to popular belief, eliminating the estate tax will instead *increase* charitable contributions by the wealthy.

The estate tax is costly for the IRS to administer and it has harmful social and economic effects. It hurts small business owners, farmers, and successful entrepreneurs who want to transfer family assets to their heirs. The estate tax forces them to spend time and money on elaborate exercises in the legalities of estate-tax counseling, planning and accounting. Alicia Munnell, a member of President Clinton's Council on Economic Advisors, found that the estate tax imposes compliance costs (tax planning, collection, etc) in excess of $26 billion. This compliance cost exceeds the estate tax's revenue yield.

The tax is unfair and economically destructive – it ought to be buried permanently.

Estate Tax Advocates and Profiteers

Why are liberal advocates for increased government taxes and spending so enthusiastic about the estate tax, which raises so little money? What motivates wealthy businessmen like Warren Buffett and Bill Gates Sr. to be such strong supporters of the tax?

The quick answer is that the estate tax doesn't affect them and in Warren Buffett's case, he directly profits from the estate tax through Berkshire Hathaway. Buffett has been open about his plans to give away most of his wealth. The website of Berkshire Hathaway, his fabulously wealthy holding company, reprints Buffett's letters to charities promising them large portions of his stock in the publicly owned company.

Buffett has announced that he will give most of his wealth to the Bill and Melinda Gates Foundation, which has a three-member board of trustees: Bill and Melinda Gates and Warren Buffett. Smaller amounts—a relative term in discussing Buffett's wealth—have gone or are destined for the Susan Thompson Buffett Foundation, named for his late wife, and for three foundations administered by his children, the Howard G. Buffett Foundation, Sherwood Foundation (formerly Susan A. Buffett Foundation), and the NoVo Foundation, operated by his son Peter Buffett.

These five foundations benefit greatly from donations by Buffett; in total, he plans to give them 85 percent of his stock in Berkshire Hathaway. The foundations could conceivably do many good things with this money and do them better than a government that relies on the estate tax. (For more background, see "Warren Buffett: A Wealthy Philanthropist with Some Bad Ideas," by Martin Morse Wooster, *Foundation Watch*, November 2011, and "Warren Buffett's Philanthropy: What About the Other $6 Billion?" by Jonathon McClellan and Robert Huberty, *Foundation Watch*, October 2006.)

Buffett doesn't believe his heirs should receive nothing. In a 1986 article Buffett said he planned to leave his children "enough money so that they would feel they could do anything, but not so much that they could do nothing."

The estate tax will have little impact on Warren Buffett's children, but it will affect the children of farmers and small business owners who are not 81 year old multi-billionaire investors. Very few of them will inherit so much that they can do *nothing*. But unlike Buffett's children, the estate tax will prevent many of them from inheriting enough to do *anything*.

It is important to note that Berkshire Hathaway owns seven insurance companies that offer "second to die" (or "survivorship") life insurance policies. These are policies that let wealthy people leave their heirs large sums by reducing the estate tax hit.

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In fact, life insurance is the life's blood of Buffett's own fortune. Insurance premiums, which don't have to be paid out to beneficiaries for years if not decades from now, provide the capital that has let Buffett expand Berkshire Hathaway. The value of these premiums is called the float, and the float of all Berkshire Hathaway-owned insurance companies totaled $66 billion in 2010. These funds are reinvested in stocks and bonds further increasing the value of Berkshire Hathaway stock and Buffett's personal wealth at the expense of the very clients his life insurance companies are claiming to help.

Insurance accounts for one-third of Berkshire Hathaway's operating profits. If the estate tax were repealed, it's likely the demand for life insurance policies would drop, and Buffett's float would sink.

Family businesses hit by the estate tax are not in the same category as Berkshire Hathaway. Nearly 70 percent of all family businesses do not survive to the second generation. When grieving families cannot afford to pay the estate tax, they are often forced to sell their businesses to publicly-owned companies like Berkshire Hathaway. These companies don't pay estate taxes.

Bill Gates Sr.

Those who benefit from the estate tax are least likely to want to end it.

Take estate tax booster Bill Gates Sr., father of Microsoft founder Bill Gates. Gates argues that the estate tax is the only tax on accumulated wealth in the U.S. Somehow he forgets about capital gains taxes. Gates claims the estate tax discourages the concentration of wealth, but it actually hurts those who are trying to accumulate wealth. When the estate tax takes assets from those who are only marginally wealthy, often from assets like land or machinery, not cash or stock investments, it may force them to sell assets to pay the tax. Often times these assets include family businesses, a sector of the national economy that accounts for 60 percent of employment and 78 percent of new employment. And when family businesses are forced to close or lay off employees, the unemployment rate increases.

Like Warren Buffett, Bill Gates's livelihood has benefited from the estate tax. As an estate planning attorney in Seattle, Bill Gates Sr. earned his living reducing the estate taxes owed by people less wealthy than his son.

Life Insurance Industry

There are other big supporters of the estate tax, most notably life insurance companies that quite possibly benefit most.

Even though eliminating the estate tax could save 1.5 million small-business jobs, as estimated by former Congressional Budget Office director Dr. Douglas Holtz-Eakin, life insurance companies lobby vigorously against repeal. That's because they provide "second-to-die" insurance for couples and other estate planning instruments to reduce the estate's tax burdens. According to the American Council of Life Insurers, in 2005 roughly 10 percent of the $124 billion in premiums collected by the life insurance industry were attributed to estate planning purposes – that is about $12 billion in premiums. In 2008, these premiums were $147.2 billion. This means the industry stands to forego nearly $15 billion in annual revenues if the estate tax is eliminated.

Life insurance companies have a huge stake in the status quo. Suppose, for example, a taxpayer has a potential $1 million estate tax. He can buy a policy on his life matching the estate tax liability, with the income tax-free insurance proceeds. This benefit persuades many people to purchase such insurance, thus swelling the premium income of the insurers.

Just recently the chief lobbyist for the Association for Advanced Life Underwriting (AALU) made it clear that the life insurance industry will continue to advocate for a strong estate tax. "We've invested significant time, energy and dollars into fighting off repeal of the estate tax and insuring sustainability in the estate tax arena," said Chris Morton, AALU vice president of legislative affairs.

But not all life insurance agents favor the estate tax. Independent agents who deal in property insurance tend to support its repeal because many are small-business owners whose families would be negatively affected by the estate tax. Their chief lobbyist Charles E. Symington Jr. has said the tax "disproportionately and negatively impacts small and family-owned businesses, which are crucial to our nation's economy. The reemergence of this tax could lead to more small-business failures and hinder the perpetuation of family-owned small businesses."

Leftist Nonprofits

In addition to support from insurers and the mega-rich there are nonprofit pro-tax, big government advocacy groups that openly embrace the estate tax. They include Citizens for Tax Justice, OMB Watch, Progressive States Network, and United for a Fair Economy. Organized labor is also solidly behind the tax. The AFL-CIO, American Federation of Government Employees (AFGE), American

Federation of State, County and Municipal Employees (AFSCME), Communications Workers of America (CWA), Service Employees International Union (SEIU), and the United Auto Workers (UAW) oppose efforts to repeal the estate tax.

Perhaps the most prominent activist group is Boston-based United for a Fair Economy (UFE), which is heavily funded by liberal foundations. They include George Soros's Foundation to Promote Open Society ($350,000 since 2009) and Open Society Institute ($200,000 since 2004), the Soros-funded Tides Foundation ($863,132 since 1999), Ford Foundation ($750,000 since 2003), Rockefeller Philanthropy Advisors Inc. ($180,000 since 2002), Susan Thompson Buffett Foundation ($50,000 since 2002), Ben & Jerry's Foundation ($100,000 since 2007), Public Welfare Foundation Inc. ($200,000 since 2004), and Funding Exchange Inc. ($81,500 since 2003). UFE is a coalition builder: It has created a network of 700 business leaders "in the top five percent of income and/or wealth" who favor "fair taxes." UFE also supports a grassroots organization of 28 state-level groups.

The Progressive States Network, a union-dominated version of the American Legislative Exchange Council (ALEC), cites studies arguing that cutting state estate taxes will force budget cuts or increases in other state taxes. It has received grants from the Ford Foundation ($700,000 since 2009), Foundation to Promote Open Society ($150,000 since 2010), Open Society Institute ($807,024 since 2009), Public Welfare Foundation Inc. ($850,000 since 2007), and Stephen M. Silberstein Foundation ($200,000 since 2006).

Why Do People Give?

Estate tax advocates, especially philanthropic institutions, have long argued that the tax provides an incentive for taxpayers to make charitable donations. The argument is that rather than have a tax be paid when they die, donors are more likely to make a tax-deductible contribution while they are living.

However common sense suggests that the motive for charitable giving is altruism coupled with capacity to pay, not tax deductibility. If a taxpayer's goal is to bequeath the maximum amount of his estate to his heirs, then that aim is not satisfied by making a charitable contribution to avoid the estate tax.

A definitive economic analysis, "Charitable Donations and the Estate Tax: A Tale of Two Hypotheses," published in the *American Journal of Economics and Sociology* (July 2010) by University of Georgia economists William Beranek (co-author of this article), David Kamerschen, and Richard Timberlake confirms this intuition.

The economists note that if obtaining a deduction were the main incentive for individuals seeking to protect their estates from taxation, then charitable giving would have to be a financial benefit to heirs. But charitable giving as a tool for estate planning does not accomplish this goal.

Let's do the math. A taxpayer has an estate of $2 and the estate tax rate is 40 percent. If the entire estate is left to heirs, they receive $1.20 and the government collects a tax of 80 cents. If the entire estate is donated to charity, heirs get nothing. If $1 goes to charity and the after-tax estate goes to heirs, then the heirs receive 60 cents on the dollar, which is half as much as what they receive by inheriting the full estate minus the estate tax. Clearly, to maximize the amount going to heirs it is better to bequeath them the full estate even though it is subject to estate taxes.

The Decision to Donate

How people allocate their estates between heirs and charities is no great mystery. The analysis by Beranek, et. al. demonstrates that individuals make charitable contributions after reaching a wealth threshold which permits them to provide for both charities and heirs. As wealth increases, so does charitable giving. This entirely rational explanation is confirmed by IRS data.

Altruism plays an important role: we want to aid charities even when our estates are small. But when estates are small the desire to recognize and care for loved ones takes precedence. Affection trumps altruism. With modest estates, heirs come first even though charitable donations are tax-deductible. Only when individual wealth grows to a point where the tension in giving to charities and heirs is resolved, does charitable giving increase.

On the margin, tax-deductibility may nudge a taxpayer to favor charitable donations over heirs. However, as wealth accumulates, the benefits from tax-deductibility diminish rapidly relative to the satisfaction received from making the donation. The notion that the estate tax is needed to provide incentives for donations is one of the biggest myths linked to the tax.

In fact, the estate tax limits the donor's capacity to make charitable contributions. Think it through: The more money you have, the more you can give. Yes, you will give more if your donations are tax-deductible. (That's why liberal foundations and charities are so op-

posed to the Obama administration's repeated attempts to cap the charitable deduction at 28 percent even for those whose income puts them in the 35 percent tax bracket.)

But if there were no tax at all, there would be even more money to give. That's what is sought by those of us who favor ending the estate tax. If our national policy were to maximize donations at death, then we should want to get rid of the estate tax, which reduces charitable giving rather than encouraging it as advocates claim.

Even Warren Buffett doesn't buy the argument that tax-deductibility spurs charitable giving. When he and Bill Gates Jr. were interviewed about their massive philanthropy Buffett denied that the tax deduction motivates the wealthy to give.

Conclusion: Charitable Giving Vs. Government Spending

The core arguments for retaining a death tax are weak. The death tax actually adds to the concentration of wealth, brings in little revenue, and is a coercive way to redistribute wealth. Charitable giving, by contrast, is voluntary redistribution. If the estate tax rate is reduced or the tax eliminated altogether, we can expect that voluntary redistribution of wealth will replace involuntary redistribution—and that's a good thing.

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Many thanks.

Terrence Scanlon
President

BrieflyNoted

George Soros is on the warpath again. The Left's favorite Wall Street billionaire and a cohort of his unidentified radical friends are expected to contribute as much as $100 million to help the Democratic Party win this November, reports the *New York Times*. Soros and other big Democratic donors are expected to give mainly to organizations focused on grassroots organizing. The donors are wary of competing directly with pro-Republican "super PACs," which are independent political action committees without contribution limits. The *Times* reports that Soros will give over $1 million to **America Votes**, which helps **ACORN**-like groups get out the vote, and $1 million to **American Bridge 21st Century**, a super PAC run by **David Brock**, head of the Soros-funded **Media Matters for America**.

"Spooky Dude," as **Glenn Beck** calls Soros, suffered a major setback in his quest to re-make America when the left-wing **Secretary of State Project** withered away after a disastrous 2010 election cycle. The Soros-funded "527" political committee was formed solely to help elect left-wing Democrats. In most states the secretary of state is the chief elections officer. The group aimed to elect "progressives" to this often-overlooked but critically important office to skew the electoral process. Perhaps the project is considered unnecessary because Attorney General **Eric Holder** is aggressively halting efforts to ensure ballot box integrity. The Justice Department has blocked several states' new voter ID laws and discourages investigations of voter fraud.

The **Obama** administration has enlisted the National Action Network to help defend the president's widely unpopular healthcare scheme. Health and Human Services Secretary **Kathleen Sebelius** appealed to the group, whose leader is Rev. **Al Sharpton**, at its recent convention in the nation's capital. "In our country what we know is healthcare inequality [has been] one of the most persistent forms of injustice but over the past three years, as Rev. Sharpton reminded us, we have begun to turn the tide," Sebelius said. "Now is not the time to turn back." She urged activists at the corporate-sponsored confab to fight for the misnamed Patient Protection and Affordable Care Act (a.k.a. Obamacare).

Left-wing Santa Monica College students angry about tuition increases were reportedly delighted that campus police pepper sprayed them during a recent demonstration. The students showed up in force at a college trustees' meeting to protest a planned 300 percent increase in tuition for core courses. As a student mob was forcibly ejected from the trustees' meeting one student can be heard saying in the video from the Santa Monica campus, "We won! We won! They pepper sprayed us!" The **Occupy Wall Street** movement promptly began using images from the confrontation as propaganda, ignoring protesters' provocative behavior and falsely claiming police brutality.