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## **A Compromise on the Estate Tax**

By Diana Aviv and Robert Greenstein

When the newly elected Congress gets down to business next year, among the issues it will consider is the fate of the estate tax. The tax is now scheduled to be phased out through 2009 and disappear completely in 2010, but then reappear a year later in 2011.

Congress is divided over whether to repeal the tax permanently or to retain it in a substantially scaled-back form. A critical question is whether elimination of the estate tax would harm charities -- and the people and causes they serve -- by discouraging wealthy people from making charitable donations.

That question has long divided experts and politicians, but now the facts involved in the debate have largely been settled. The widely respected Congressional Budget Office recently issued a major study that found that if the federal estate tax had not existed in 2000, charitable donations would have been reduced by a stunning \$13-billion to \$25-billion that year. That large potential loss in donations is more than the total amount that all corporations gave to charity in 2000, and almost as much as all foundations contribute to charitable causes annually.

It is now clear that the path Congress chooses regarding the estate tax will have profound implications for the nonprofit world. While previous studies by economists at the Treasury Department and the Brookings Institution produced similar findings, the Congressional Budget Office study is likely to play a key role in the debate over the estate tax because of the agency's high standing among Democrats and Republicans alike. The Congressional Budget Office's director, Douglas Holtz-Eakin, previously served as chief economist for President Bush's Council of Economic Advisers.

The Congressional Budget Office found that the estate tax leads affluent people to donate far more than they otherwise would, because such donations -- whether made during life or as bequests at death -- sharply reduce estate-tax liability. For example, if a potential donor's assets would be subject to the 48-percent estate-tax rate that currently applies to large estates, then a charitable bequest of \$1-million would reduce the tax liability of the estate by \$480,000. Repeal of the estate tax eliminates the tax savings from charitable donations and thus would reduce substantially the incentive to make such donations.

If the estate tax were retained in a smaller form, as some lawmakers have suggested, the Congressional Budget Office says the drop in charitable giving would be much smaller. If the first \$2-million to \$3.5-million of an individual's estate (and twice that amount for couples) were exempt from the tax, charitable giving would have declined by just \$1-billion

to \$6-billion in 2000, compared to a drop of up to \$25-billion if the tax were eliminated completely.

That approach -- exempting all but the biggest estates from the tax -- makes sense. If the first \$2-million to \$3.5-million of an individual's estate were exempt, charities would lose much less in donations than they would if the tax were eliminated altogether, and the federal government would lose much less in estate-tax revenue. Plus, by raising the value of the estate exempt from taxation, only the largest one-half of 1 percent of estates would face any estate tax; the other 99.5 percent of estates would be fully exempt.

Some supporters of estate-tax repeal say that eliminating the tax would increase charitable donations; their claim is that inheritors of large estates would donate more if they were inheriting the full value of the estate rather than the estate minus the amount taken in taxes. The Congressional Budget Office study shows that isn't the case. It found that elimination of the tax break for charitable donations would discourage giving much more powerfully than the elimination of the tax would encourage it. The result would be a large net drop in charitable giving.

The significant decline in charitable donations from wealthy Americans forecast by the Congressional Budget Office study would have damaging effects on the nonprofit world, and on American society. Donations from individuals make up 84 percent of all charitable giving, and they constitute one-sixth of the total budgets of nonprofit groups. Moreover, about two-thirds of all charitable contributions by individuals in 2000 were made by people with a net worth high enough to potentially face the estate tax. If nonprofit groups lost a substantial part of these donations, many of them would have to scale back their activities significantly.

Another argument made for eliminating the estate tax is that doing so would give a lift to the economy and add jobs.

Encouraging growth is surely a desirable goal, but no credible evidence backs up the idea that repealing the estate tax would do so. To the contrary, a growing array of studies have concluded that if the revenue losses from tax cuts like an estate-tax repeal are financed through higher budget deficits -- the policy course we are now on -- the net result is likely to be negative for the economy and job creation, due to the adverse economic effects of swollen deficits.

Opponents of the estate tax have also said that the tax constitutes "double taxation." The assets in an estate have already been taxed once as income, they argue, and should not be taxed again under the estate tax. In fact, a substantial part of the value of estates -- especially of the largest ones -- has never been taxed as income because it is in the form of unrealized capital gains (i.e., assets that appreciate in value but are not subject to capital-gains taxes because they are passed on to an heir rather than sold).

Thus, the estate tax serves as a valuable backstop to the income tax, providing a reasonable way to tax income that otherwise would escape taxation. That was one of the reasons the estate tax was established in the first place.

The estate tax also was created in recognition of the fact that, as President Theodore Roosevelt stated in 1906, "the man of great wealth owes a particular obligation to the State because he derives special advantages from the mere existence of government."

Like other Americans, the very wealthy benefit from government investments in areas such as defense, education, environmental protection, and infrastructure, and they rely on the government's protection of individual property rights. The existence of an estate tax clearly hasn't hindered the amassing of large fortunes in the United States. It seems fair that people who have prospered the most in this society help to preserve it for future generations through tax revenue that derives from their estates.

The most fundamental reason for the estate tax, or any tax, is to provide government with the resources it needs to meet important public priorities.

Over the past few years, the federal budget has swung from large surpluses to even larger deficits. Economists and forecasters across the political spectrum, as well as respected international bodies like the International Monetary Fund, agree that the nation faces devastating long-term fiscal problems as the baby boomers age and need increased health care. With federal revenue now at its lowest level as a share of the economy since 1959 and federal spending projected to rise to historically high levels when the baby boomers begin to retire, deficits are on course to reach economically unsustainable and dangerous magnitudes unless strong action is taken.

Permanently repealing the estate tax would dig the deficit hole even deeper. Congress, of course, could compensate for the loss of revenue by cutting programs heavily. But the long-term deficit problems are so serious that if lawmakers rely on budget cuts as the primary means to avert crushing deficits, deep cuts in federal programs vital to the nonprofit world -- including education, the arts, health care, and especially aid for poor and vulnerable people -- are likely to ensue.

Repeal of the estate tax also would harm state budgets. Most states have their own estate taxes. A majority of these taxes are linked to the federal estate tax, and repeal of the tax effectively would eliminate state estate taxes as well in these states, costing them billions of dollars. The loss of estate-tax revenue would probably force those states to cut programs or raise other taxes in response.

Given the enormous consequences for nonprofit groups, charities and foundations need to participate actively when debate over the future of the estate tax resumes in Congress. Organizations that have been reluctant to take a stand on this issue need to become more deeply grounded in what is at stake -- for themselves, the people they serve, and the nation as a whole -- and to revisit the matter with their boards.

Tax incentives are a basic part of the nation's charitable infrastructure, and the estate tax has for decades been one of the most important of these incentives. Retaining a smaller tax that applies to the estates of the wealthiest Americans would be a sensible way to preserve charitable gifts and protect federal and state budgets, while responding to the criticism the current estate tax has engendered.

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