

by Gene Steuerle

Estate Tax Reform — A Third Option

Several pressures are combining to force lawmakers to seek a more permanent resolution to the estate tax issue. This article suggests a possible compromise that would enhance the ability of wealthy individuals to avoid paying tax to government and still pass on significant assets to their heirs — but only if they make substantial contributions to charity. The compromise is not perfect, but it gives some heed to arguments on both sides of this debate — limiting the government's access to the assets of those who die with a great deal of wealth while still recognizing their simultaneous obligation to the society that made those accruals possible.

Although the estate tax is repealed in 2010 for one year only, it then gets reinstated in 2011 with even lower exemption levels than apply now. But repeal or reinstatement of the tax is not the only lurking issue. The 2001 legislation never specified adequately how the taxation of capital gains at death would proceed. For some taxpayers, taxes could be even higher after repeal than before, especially if their estate would have avoided tax but they are caught with capital gains. Even exemption of a substantial amount of gains could encourage all sorts of tax planning before death in how to use assets with different amounts of gain relative to value. Yet another issue is today's large deficit and the extraordinarily difficult budget situation the nation faces as early as 2008, once the baby boomers begin retiring and lowering the rate of growth of both the economy and government revenues. Another neglected issue is the significant increase in complexity created by the way that the estate tax credit for state estate taxes was repealed.

My own study of the estate tax (Eugene Steuerle, "Equity and the Taxation of Wealth Transfers," *Tax Notes*, September 8, 1980) implies that the tax was never meant primarily as a revenue raiser or even as an alternative to capital gains taxation at death. Why else would it have features such as exemption levels that exclude most estates and a marital tax deduction that effectively exempts transfers to those of the same generation as the decedent? These features imply that the tax is primarily addressed at the transmission of wealth to younger and succeeding generations and at reducing the ability of generation after generation of high-wealth-holding families to create an effective aristocracy of wealth.

In truth, there is no tax on the wealthy per se. Instead, there is a tax only on large estates that are passed on in concentrated form to individual heirs. A complete exemption is allowed for every dollar of the estate that is given to charity — something not even allowed in the income tax. If a person becomes rich through luck or hard work, and that person is willing to use the money to help the community or nation more broadly, no tax is as-

essed. Here the person making the transfers is allowed to designate what he or she believes is in the best public interest, without any vote by society and few limitations imposed by law. The unlimited charitable deduction reconfirms that the tax is intended less to raise money for the government and more to limit the creation of an aristocratic class.

But much more than money is at stake. Combining an estate tax with an unlimited charitable deduction sends strong signals about two characteristic American ethics: That hard work and success generally should be extolled; and that the successful have strong obligations back to the democratic society that made possible their success. Those are not contradictory but mutually reinforcing ethics. In terms of the social fabric of the nation, the signals set by the tax and charitable deduction in many ways affect behavior far more than the raw tax incentives themselves. Put another way, people often behave according to societal expectations, not just the potential for monetary gains or losses. The raw calculation that 50 cents of tax can be avoided by giving a dollar to charity may be less important than the societal signal that one should give out of one's abundance — one way or the other.

The recent contest among the wealthiest families in America — with well-known figures such as Bill Gates Sr. and Warren Buffett on one side and the Gallo and Mars families on the other — is not just over the estate tax. Gates Sr. and Buffett and many other richer members of society opposing estate tax repeal have also expressed strong interest in charitable giving out of wealth. Gates's son has established the largest foundation in the United States, and Buffett suggests that he will add to his current charitable habits by giving away most of his wealth at death. "Just like you, we or our families have made heaps of money," they seem to be saying to their fellow rich, "we should all be able to find enough meritorious charitable causes that none of us should have to pay that much in estate tax. They may also be saying that if society is going to have aristocratic classes, it's not clear to them why the likelihood of achieving that status should be inversely related to levels of generosity.

That brings me to my compromise proposal. As specified earlier, it's not perfect by any means. But, then, neither is the estate tax in its current form or various proposals to tax gains at death as a substitute.

- First, provide a higher exemption or credit level that would confine any tax on estates or heirs to the very rich and super rich rather than the merely rich.
- Second, unlike current law, which provides a deduction, allow donors a credit against tax for charitable contributions made. With the current deduction, a very rich individual must essentially give away

almost all wealth (or at least that wealth above the exemption amount) to avoid the estate tax altogether.

That's essentially it. A charitable credit set at a rate above the estate tax rate would allow wealthy individuals wanting to avoid any estate tax to still leave substantial assets to heirs without paying any tax.

Say, for instance, that the maximum tax rate were set at 50 percent for estates in excess of \$50 million and some lower rates for estates between \$10 million and \$50 million. The super rich would still face a tax rate of 50 percent on most of their estate. For instance, those with a \$1 billion taxable estate would essentially owe \$500 million in estate tax for passing their estates onto their children in this system. To leave even \$800 million of that \$1 billion to charity would still leave them with an estate tax of close to \$100 million (slightly less in this example because of lower rates and an exemption applying to different parts of the first \$50 million of estate). Suppose instead that we set a charitable credit rate that was higher than the related estate tax rate. For instance, the credit rate might be set at 1½ times the tax rate. In this case, the charitable credit rate would be set at 75 percent for that portion of the estate subject to the 50 percent rate, or it might be set at 75 percent of all charitable contributions. Then, roughly speaking, the billionaire in this case could give \$750 million to charity, leave \$250 million to heirs, and avoid paying an estate tax altogether. Or he could pay \$500 million in estate tax and leave \$500 million to heirs.

In many ways, this alternative system makes clearer the notion that the tax is less about revenue raising and more about obligations to society. The estate or inheritance tax could be avoided by those wanting to meet those obligations through charity, but a gift of almost the entire estate would not be necessary to avoid the tax altogether.

What are some related issues that would have to be faced or at least recognized? With an estate tax credit, it would be necessary also to give some estate tax credit for charitable donations before death — so as to avoid locking in giving until death. Congress should also consider converting the estate tax to an inheritance tax to make clear that the tax is meant only for large accruals of assets through inheritance in absence of charitable giving. It is also possible to give heirs — either in an inheritance or estate tax — greater flexibility than under

current law to avoid tax by giving to charity even when their predecessors have failed to do so. Congress may also want to consider the rules applying to disposition of a closely held business when the assets are given to charity, allowing the owners some time to manage the affairs of the business without losing the controlling interest. Some simplification of state tax law for inheritances or estates should also be restored, or else dying with residences in different states could become even more complex. Finally, while the proposal significantly raises the incentive for giving for the first dollars of estate, once the estate tax is effectively removed by the charitable credit, the incentive effect is reduced. My guess is that the stark reality of the charitable alternative would effectively increase giving, but there is no sure way of knowing. Certainly, it is likely to increase giving relative to a repealed estate tax.

CORRECTION

In Anthony Infanti's article on deconstructing Circular 230 (*Tax Notes*, June 20, 2005, p. 1575), the sentence immediately following footnote 22 was placed in the wrong paragraph. It should be removed from that paragraph and added to a paragraph that would read as follows:

The recent changes to Circular 230 exemplify the futility of searching for authorial intention and the one true meaning of a text. During the panel discussions that I attended at the ABA tax section meeting, the government seemed to be giving practitioners mixed signals about its intent. Whenever practitioners became upset about the potential impact of the new rules, the government representatives urged them to interpret the rules in a common sense fashion and not to worry about extreme interpretations of ambiguous language. Then minutes later, in answers to specific hypotheticals, the same government representatives espoused narrow interpretations of the exceptions and exclusions built into the recent changes to Circular 230 and broadly interpreted the scope of the new written advice rules. For example, they read the new "negative advice" exception so narrowly as to cause practitioners to interject that it would, in reality, provide them absolutely no relief from the new rules at all.

Tax Analysts regrets the error.