

## Will Estate Tax Repeal Hurt Charitable Giving?

Predictions are that charitable giving will suffer dramatically if estate taxes are reduced or eliminated. Experience proves otherwise. But advisors do need to prepare for a new age in philanthropy

By Robert F. Sharpe, Jr., president, Robert F. Sharpe & Company, Memphis, Tenn.

Immediately after the passage of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), there was speculation about how its planned elimination of the estate tax would affect charitable giving. The consensus seemed to be that charities would experience tremendous losses—and that it would happen just when they hoped to receive a portion of the “greatest wealth transfer” in our nation’s history. Some press reports predicted a decline in charitable giving of up to \$6 billion per year as a result of the elimination of the estate tax. That would be an enormous drop, considering how much charities received from estates each year. For example, estates required to file estate tax returns in 1999 (the most recent year publicly reported) donated \$14.6 billion. A \$6 billion decline would be a 41 percent reduction in bequests by the wealthy and a loss of over one-third of total bequests reported for that year.

The impact on specific charities could be considerable. Consider higher education. During the past 15 years, bequests to higher education have averaged just under 25 percent of gifts by individuals. The predicted decline in charitable bequests would mean a loss of up to 10 percent of funding from individuals’ gifts. The universities that make up the Ivy League would lose upwards of \$100 million a year—enough to pay more than 1,000 professors’ salaries or provide full scholarships to 4,000 students.

But gifts to charity are not made just because of tax laws. Americans have been giving more each year, both during their lifetime and on their death, despite the fact that even under the current tax regime such largesse substantially reduces the wealth they can enjoy or leave to heirs.

The reasons people make charitable gifts are complex and only

partially rooted in economics. For some, religious or philosophical beliefs lead to the conclusion that they are stewards of the wealth they inherit and/or accumulate during their lifetime. They invest a portion of their assets in ways they hope will make the world a better place. Charitable gifts also can assume great importance for testators who never married or had children. Such motivations are timeless and not subject to the whims of Congress.

Tax policies may, however, dictate the best timing for gifts, and the most advantageous properties and planning tools to use to complete the gift. Even with a much-reduced or eliminated estate tax, advisors will be kept busy counseling clients on how to maximize charitable gifts while helping to preserve financial security for themselves and their heirs. Some alternatives that will become more attractive under a regime that reduces or eliminates estate taxes include traditional split-interest gifts, gifts at death from retirement-plan assets and proceeds from insurance policies originally purchased to offset estate taxes.

## HISTORY

During the early years of the 20th century, Congress and the legislatures of many states decided that the involuntary redistribution of wealth in America through taxation of accumulated assets at death was desirable from both a fiscal and social policy standpoint. Over the years, there have been many changes to the structure of the estate- and gift-taxation system; at times, these taxes have assumed greater or lesser importance in estate and financial planning.

Between 1976 and 1981, Congress made major changes designed to exempt all but the largest estates from taxation. As tremendous increases in wealth occurred during the past two decades, however, the growth in the value of assets outstripped the growth in the threshold levels at which estate and gift taxes begin to apply. As a result, an increasing percentage of estates became subject to taxation. What is now derided as the “death tax” again became a major concern for more middle- and upper-

middle-income American households. This was particularly true in areas of the country where a relatively modest home and assets sufficient to maintain a middle-class lifestyle in retirement years were enough to trigger federal estate taxes of 37 percent to 55 percent, or more.

The 2001 Tax Act featured a combination of increases in threshold amounts and reductions in the maximum estate-tax rate—which were intended to quickly address bracket creep. In a move that, in retrospect, may seem like wishful thinking, Congress also included provisions designed to totally eliminate the estate tax over time. (See “Maximum Tax-Free Amount,” page 6.) Congress did decide to permanently maintain the gift tax, presumably to keep massive amounts of assets from being transferred during a person’s lifetime, thereby reducing its ability to reverse course in the future and reinstate the estate tax.

Whatever Congress may decide regarding the future of the estate tax, the immediate impact of the lawmakers’ actions is significant. More than half of the individuals who would have been subject to estate tax in 1998 would not owe the tax as of Jan. 1, 2002. If the increase in the exemption amount rises, as planned, to \$1.5 million on Jan. 1, 2004, 80 percent or more of estates that would have been taxed as recently as 1998 will be exempt. (See “Most Will Soon Be Free of the Estate Tax,” page 6.) As a result, planning for estate taxes already does not apply to 99 percent of Americans; there are no tax incentives for those people to leave funds to charity. In other words, if estate-tax law changes are going to affect charitable giving, the impact should be seen very soon.

## REASONS FOR GIVING

While some predict large declines in charitable gifts, others are more optimistic. Economic theory accounts for their different views.

Under the concept of “elasticity of demand,” as the price of certain “products” rises, the demand for them will fall. If the “demand” for charitable gifts via estates is believed to be “elastic,” then the number of gifts via estates should fall as the after-tax “price” rises as a result of the reduction or

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### MAXIMUM TAX-FREE AMOUNT

The Economic Growth and Tax Relief Reconciliation Act of 2001 raises the estate-tax threshold level until it eliminates the tax entirely

YEAR	ESTATE TAX	GIFT TAX	MAXIMUM RATE
2002	\$1,000,000	\$1,000,000	50%
2003	1,000,000	1,000,000	49
2004	1,500,000	1,000,000	48
2005	1,500,000	1,000,000	47
2006	2,000,000	1,000,000	46
2007	2,000,000	1,000,000	45
2008	2,000,000	1,000,000	45
2009	3,500,000	1,000,000	45
2010	NO TAX	1,000,000	35

Source: Internal Revenue Code

### MOST WILL SOON BE FREE OF THE ESTATE TAX

When the increase in the exemption amount rises to \$1.5 million on Jan. 1, 2004, 80 percent or more of estates that would have been taxed as recently as 1998 will be exempt

# OF ESTATES	VALUES OF THOSE ESTATES	CUMULATIVE EXEMPT	CUMULATIVE PERCENTAGE
49,705	\$650,000-1,000,000	\$49,705	50.79%
36,419	1,000,000-2,500,000	86,124	88.00
7,689	2,500,000-5,000,000	93,813	95.86
2,665	5,000,000-10,000,000	96,478	98.58
944	10,000,000-20,000,000	97,422	99.54
446	over 20,000,000	97,868	0.46
97,868		97,568	100%

Source: Internal Revenue Service

### ECONOMIC FORMULA

How to determine the cost of a charitable gift to those who would otherwise inherit that property

$$G - (G \times T) = \text{Cost of Estate Gift}$$

where *G* = Amount of Gift

and *T* = Estate Tax Rate

$$\$1.00 - (\$1.00 \times 49\%) = \$.51$$

When the estate tax rate is 49 percent,  
it costs a donor just \$0.51 to give one dollar.

Source: Robert F. Sharpe, Jr.

elimination of gift and estate taxes. (See "Economic Formula," this page.)

Since 2001, the "cost" of a charitable gift from estates subject to the highest tax rates has risen by 13 percent from \$.45 to \$.51 per dollar donated. Currently, the minimum cost for a gift via the estate where maximum federal estate taxes apply is \$.51 per dollar (\$1.00 - (49% X \$1.00)). With no estate tax, the cost would rise to \$1.00 per dollar, or 100 percent (\$1.00 - (0% X \$1.00)).

This analysis naturally leads one to the conclusion that gifts to charity from estates would fall dramatically with the elimination of the estate tax.

But price increases do not have as great an effect on demand for goods and services where demand is relatively inelastic (as in the case of gasoline or medical care).

Those who predict that charitable gifts from estates will not decline assume that the demand for charitable bequests is inelastic. There is some evidence that this is the case. Indeed, industry surveys reveal that only a minority of those planning charitable bequests say they will do so for the purpose of reducing estate taxes. A study released in 2000 by the National Committee on Planned Giving reported that the desire to support charities was the reason most respondents gave for why they planned to include charitable gifts in their estate plans. (See "Why People Give," page 7.) Hard facts as well as reported motivations lend further support to the contention that charitable bequests are inelastic. The amount of bequests from non-taxable estates has been rising in recent years, along with the amounts left from estates that are subject to tax. In fact, in recent years bequests from non-taxable estates actually grew at a higher average rate than those from taxable estates.

I have seen this phenomenon up close. One national charity will report \$64 million in bequest income for 2003, up from \$20 million in 1996.

This year's figure represents the receipt of bequests from 950 estates, averaging \$67,000 per bequest. The average annual gift per donor is in the range of \$20 with lifetime gifts averaging less than \$10 each for some 25 percent of the donors. The average size of the estate from which these bequests come is in the range of \$600,000, far below taxable thresholds. (See "One Charity's Experience," this page.)

A case can thus be made that charitable bequests and other testamentary transfers are completed for reasons other than estate- and gift- tax considerations. The tax system generously subsidizes these gifts, but in the final analysis, natural heirs are always deprived of wealth, and it therefore costs something to make the gift. No matter how one analyzes the situation, for each \$1 million left to charity from an estate subject to 49 percent estate-tax levels, it costs other heirs \$510,000 that they would have received had there been no charitable dispositions. This is undoubtedly one of the reasons some 83 percent of people who die with taxable estates each year choose not to make charitable gifts a part of their plans.

**IN MY EXPERIENCE**

I have observed that many motivators are at play when people plan to voluntarily redistribute assets for charitable use during lifetime and at death. These motivators tend to group into five categories: religious, social, political, emotional and economic. Each of these categories can be broken into many subcomponents, and they each interact in subtle and complex ways that differ from individual to individual.

Remember that tax savings and other economic motivators are neutral factors and are the same regardless of the charitable recipient. If, for example, a person is considering five proposals for charitable remainder trusts that would benefit five differ-

**WHY PEOPLE GIVE**

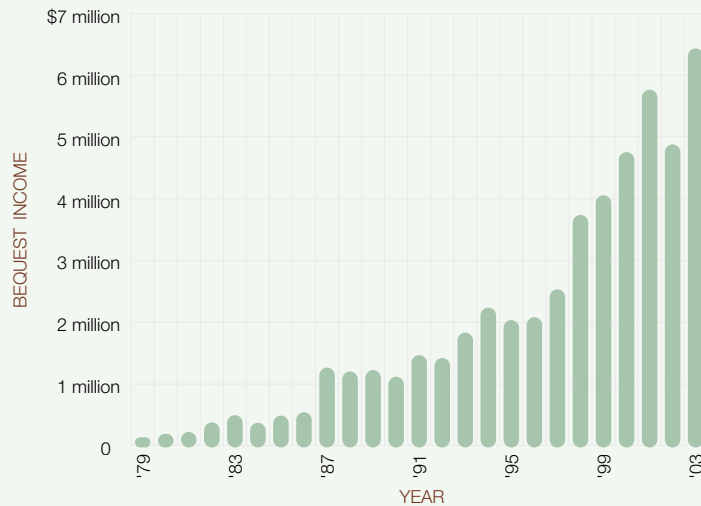
A desire to support charities was the number one reason given for including charitable gifts in estate plans

Desire to Support the Charity	97%
Ultimate Use of Gift by the Charity	82
Desire to Reduce Taxes (Income or Estate)	35
Long-Range Estate and Financial-Planning Issues	35
Create a Lasting Memorial for Self or Loved One	33
Relationship with a Representative of the Charity	21
Encouragement of Family or Friends	13
Encouragement of Legal or Financial Advisors	12

Source: National Committee on Planned Giving 2000 study

**ONE CHARITY'S EXPERIENCE**

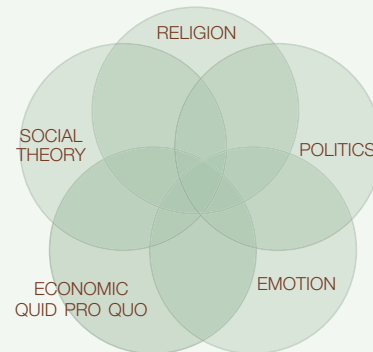
Bequest income during the past 25 years helps demonstrate that donors give for reasons other than taxes



Source: Robert F. Sharpe, Jr.

**THE VENN OF GIVING**

Motivators tend to group in five categories, which interact in subtle and complex ways that differ from person to person



Source: Robert F. Sharpe, Jr.

ent charitable entities, the entity that the donor ultimately selects will result from a combination of various non-tax-related motivators. (See “The Venn of Giving,” page 7.)

Understanding the nature of these motivators and how they come into play with different individuals is fascinating and challenging. In my experience, it is the key to helping clients plan gifts most effectively, regardless of tax incentives that may come and go over time.

Where other motivators are at work, it can be argued that charitable bequests may actually increase as a result of the reduction or repeal of estate taxes. Under the “supply side” arguments used to justify income tax reductions in past years, the reasoning was that Americans give from discretionary income and that as it goes up, so does their giving. The same argument can be used for the proposition that as estate taxes are reduced, there is more discretionary capital available to people who are charitably inclined.

Consider the case of an individual with an estate of \$10 million who made a \$1 million bequest commitment in 2001 as part of a campaign for endowment by his alma mater. As tax rates are lowered, the combined impact of estate taxes and the charitable gift falls while the net amount received by heirs rises. It is true that the after-cost of the gift to the family rises with reductions in tax rates, but the amount saved in taxes more than offsets the increased cost, resulting in the family receiving more than twice as much as would have been the case when the donor first provided for the gift. Under these circumstances, a rational donor would not reduce or eliminate the bequest and might even increase it if the goal were to provide a predetermined maximum amount to heirs, which is often the case with the very wealthy.

Thus, one might argue that under current tax law the glass is now half-

full rather than half-empty and that elimination of the estate tax would simply increase what is in the glass—actually stimulating demand for charitable gifts at death by lowering the cost of charitable bequests to non-charitable heirs.

This argument is buttressed by a study conducted in 2000 by the same team at Boston College team (led by Paul G. Schervish and John J. Havens)

## It can be argued that charitable bequests may actually increase as a result of the reduction or repeal of estate taxes.

that authored the report heralding the coming of an outsized wealth transfer to Baby Boomers. Commissioned by Bankers Trust Corporation, the study surveyed a number of wealthy Americans with a median net worth of over \$38 million.<sup>3</sup> The study revealed that if these people were given a choice, they would not leave all assets to family members and other loved ones, but instead would choose to split the 37 percent they expect to pay on average in estate taxes between loved ones, charities and taxes. Surprisingly, those surveyed believed that they should pay some 9 percent on average in estate taxes. (See “Preferences,” page 9.)

### THE FUTURE

For-profit promoters of charitable remainder trusts and similar tax-favored financial-planning tools started asserting in the mid-1990s that the nation’s tax laws encourage wealthy persons to be charitable. This belief was based on the conclusion that the rich are inevitably stewards of social

capital, whether they like it or not. Obviously, such thinking will need to be re-examined if estate and gift taxes are eliminated and charitable giving becomes fully voluntary. Then, in the area of gift planning, greater focus of necessity will be placed on the gift element while assuring that the plan chosen helps balance the donor’s multiple objectives and maximizes the amount devoted to charitable use.

For many years, for example, gifts of appreciated property have been a popular alternative, because it is possible to give more at less cost due to capital-gains tax savings. But donors always will enjoy greater wealth if they sell a property and pay the capital-gains tax. The same analysis also can be applied to gifts via the estate: It may be possible to give the same amount to charity at less cost, or more to charity at less total cost to heirs, than during the time when estate taxes applied.

For donors who wish to make significant gifts during their lifetime while enjoying tax savings, income, asset management and other benefits, traditional split-interest gifts, including charitable remainder trusts, gift annuities, lead trusts and other vehicles perhaps will hold greater appeal with the reduction and possible repeal of estate and gift taxes.

History supports this view. In the 19th and early-20th century—as long as 75 years before the introduction of income, gift and estate taxes in America—many religious and educational institutions had fully developed planned-giving efforts in place. For instance, the annual report of Texas Christian University published in 1908 stated, “One of the brightest hopes lies in the increasing number of able people who are remembering T.C.U. with large donations in the form of annuity gifts, named endowments, and bequests.” This report was pub-

lished some nine years before the inception of the estate tax and the availability of the charitable income tax deduction.

Charitable gift annuities were so widespread during this time that the American Council on Gift Annuities was founded in 1927 to suggest prudent rates. These rates were to assure that there'd be a significant gift left for charitable use and that charities would not overextend themselves in competition for gift annuity dollars.

If estate and gift taxes are reduced or eliminated, lifetime wealth transfers utilizing planned-gift vehicles may well enjoy a boost. Those who had planned to leave significant bequests at death may instead decide to make their gift during their lifetime in the form of a split-interest gift that features immediate income tax savings because of the deduction for the value of the remainder interest. Avoiding or delaying capital-gains taxes, and diversification, tax-free growth and preservation of assets will also continue to be attractive benefits.

Recently, a wealthy individual, 75 years old, who'd planned to leave to a charity in his will stock worth \$3 million, with a cost basis of \$1 million, changed plans and created a charitable remainder annuity trust that will pay him 5 percent per year for life. The securities used to fund the trust pay no dividends. He was advised that the planned elimination of the estate tax would mean there was no incentive to make the gift at death from a tax-planning standpoint and he might be better served to make the gift today in the form of a trust. In the event of the estate tax's elimination, there would be increased benefit from a charitable trust funded during one's lifetime rather than a bequest at death, assuming the trust earns 5 percent per year and at least maintains its value. (See "Inter Vivos Trusts," page 10.) If, as planned under the terms of the 2001 tax act, the ben-

### PREFERENCES

How the wealthy would redirect their tax dollars if they could:  
Charities would benefit almost as much as progeny

Beneficiaries	DISTRIBUTIONS	
	Expected	Desired
Children, Grandchildren	42%	58%
Other Heirs	5	6
Taxes	37	9
Charity	16	26
Other	0	1

Source: Bankers Trust Private Banking, "Wealth and Responsibility Study 2000"

### WHY GIVING WILL GO ON

As tax rates are lowered, the combined impact of estate taxes and the charitable gift falls while the net amount received by heirs rises.  
Note: Although the after-cost of the gift to the family rises with reductions in tax rates, the amount saved in taxes more than offsets the increased cost

Total Estate	( IN \$ MILLIONS)		Applicable Tax Rate	( IN \$ MILLIONS)		Percentage Cost
	Bequest Amount	Amount to Family		Tax Paid	Net To Family	
10	1	9	55%	4.95	4.05	60
10	1	9	50	4.5	4.5	55
10	1	9	45	4.05	4.95	51
10	1	9	40	3.6	5.4	46
10	1	9	35	3.15	5.85	42
10	1	9	30	2.7	6.3	37
10	1	9	25	2.25	6.75	33
10	1	9	20	1.8	7.2	28
10	1	9	15	1.35	7.65	24
10	1	9	10	0.9	8.1	19
10	1	9	5	0.45	8.55	15
10	1	9	0	—	9	10

Source: Robert F. Sharpe Jr.

efit of stepped-up basis for appreciated assets is restricted, we also can expect to see more *inter vivos* trusts funded to avoid capital-gains tax that might be incurred by heirs in the future.

From the charities' perspective, irrevocable deferred gifts completed during one's lifetime also may be more desirable than bequest commitments. The reason: Future social-policy changes such as reduced

### INTER VIVOS TRUSTS BECOME MORE ATTRACTIVE

If estate taxes are eliminated, a charitable trust funded during a lifetime has greater benefits than a bequest at death\*

TYPE OF GIFT	INCREASED ANNUAL INCOME	INCOME TAX DEDUCTION	ESTATE TAX SAVINGS	WHEN CHARITY BENEFITS	AMOUNT TO CHARITY
Bequest	\$0	\$0	0%	at death	\$3 million
Remainder Trust	150,000	1,733,000	0	at death	3 million

\* Note: Data assumes the trust earns 5 percent per year and maintains its value.

Source: Robert F. Sharpe, Jr.

Social Security benefits, higher co-pays and eligibility thresholds for Medicare may result in less being available for distribution to charity from diminished residual estates.

### OTHER BEQUEST SUBSTITUTES

Without the estate tax, people who are planning to leave assets to charity at death via wills and living trusts would be well-advised to explore other means. In many cases, a better alternative would be to make gifts to charity at death from retirement-plan assets that would be subject to income tax if received by heirs. Other assets that might have gone to charity then can be redirected to non-charitable recipients.

Many people also own large amounts of life insurance purchased to provide liquidity at death for payment of estate taxes. Were estate taxes eliminated, many estates would experience a windfall of found money in the form of those insurance proceeds. It is not likely, however, that an older individual who may no longer be insurable would drop a policy in the hopes that estate taxes might be eliminated. Still, it might be wise to arrange one's affairs in such a way that all or a portion of insurance proceeds not necessary for the payment of estate taxes be redirected to chari-

## Without the estate tax, it's wise to leave assets to charity by means other than wills or living trusts.

table purposes. (See "Why Giving Will Go On" page 9, to see how this could be a welcome planning option.)

### GIFT TAXES

One unanticipated surprise in the 2001 tax act was the retention of a unified gift tax with a threshold capped at \$1 million. Jan. 1, 2004 will mark the first time in many years that the amount one can transfer tax-free will differ depending on whether the transfer takes place during life or at death. (See "Maximum Tax-Free Amount," page 6.) Thus, charitable gift-planning vehicles that help one transfer property tax-free during life, such as the charitable lead trust, may assume greater importance. Because Congress has tied the valuation of lead-trust income streams to interest rates paid on federal securities with mid-term maturities, charitable lead trusts are especially attractive in today's environment.

For example, people who have not yet used their \$1 million lifetime

exemption from gift taxes could fulfill a \$1.2 million pledge commitment by placing \$2 million in a charitable lead annuity trust that pays 6 percent a year to charity for 10 years. At the end of the 10-year period, an heir who was 20 when the trust was established will receive the balance of the trust at age 30. The gift-tax deduction resulting from the lead trust is 50 percent of the amount transferred, or \$1 million. No tax is due on the remaining amount of \$1 million because of the \$1 million lifetime-exemption amount. If the donor funded a non-charitable trust for the

benefit of the child using \$1 million and claiming exemption from tax, the trust would have to earn a compounded annual pre-tax return in the 10 percent range for the child to receive \$2 million tax-free at age 30. In this case, the donor will not have made a \$1.2 million gift. This example illustrates how it is possible to use artificially low discount rates to, in effect, leverage the amount of the lifetime gift-tax exemption amount.

Of course only time will tell what the impact, if any, of changes in the estate tax will have on charitable gifts. In the meantime, astute planners who wish to help charitably minded clients meet multiple goals will increasingly advise their clients to consider ways they can maximize their charitable gifts while helping to preserve present and long-term financial security for themselves and their heirs. ■

#### Endnotes

1. "Planned Giving in the United States 2000—A Survey of Donors," published fall 2000 by National Committee on Planned Giving.
2. Giving USA 2001, AAFRC Trust for Philanthropy.
3. "Millionaires and the Millennium: New Estimates of the Forthcoming Wealth Transfer and the Prospects for a Golden Age of Philanthropy," Paul G. Schervish and John J. Havens, Boston College Social Welfare Research Institute.

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