FINANCIAL PLANNING

Estate Tax Debate: Choosing Children Over Charity?

By Ruthie Ackerman

January 12, 2010

When Congress allowed the estate tax to expire at the end of 2009 it may not have realized that it was setting up a social experiment that could test the values of high-net-worth individuals.

Most estate planners in the second half of the decade never thought that the government would allow the estate tax to be repealed. (Read more about this here: "Extending the Estate Tax: The Battle Heats Up") The expectation was that there would be some type of estate tax reform, but a repeal in 2010, which is what we currently have, was never in the cards. So the decision that planners never asked their clients to make, said Carol Kroch, Vice President and Managing Director Head of Wealth and Financial Planning at Wilmington Trust Corporation, was: “Am I going to give one dollar to my children or one dollar to charity?”

Under the estate tax as it stood in 2009, which was a 45% tax on estates of over $3.5 million for individuals, or $7 million per couple, if a client didn’t give to charity their children only got 55 cents for every dollar, Kroch explained. “Now we’re saying, as long as the repeal lasts, I’m really putting my values on the table. I can give my children the whole dollar versus giving the whole dollar to charity.”

Whether the repeal will stay in place long enough to examine trends in charitable giving is another question. Most tax experts believe that at some point in 2010, Congress will retroactively reinstate the 2009 tax rate of 45% with a $3.5 million exemption for individuals, back to Jan. 1.

Ben Harris, senior research associate at Brookings Institution and Urban Brookings Tax Policy Center, said that a 2003 Congressional Budget Office report on the estate tax and charitable giving reveals the impact of an estate tax repeal on philanthropy in even starker terms. The CBO report shows, Harris said, that the repeal of the estate tax affects significantly both charitable contributions made during life and charitable bequests made after death. “People will give less in life if they expect there to be repeal and they will also give less after they die,” he explained. “With repeal the price of charitable giving is more expensive.”

Research has shown that individuals respond to tax incentives, not only for estate taxes, but also for taxes in general. When people are given tax deductions on mortgages, for example, they respond to the incentive by taking out larger mortgages, Harris said. “To say that repeal has no effect on charitable giving turns your back on the broader incentives of tax policy, he said. “This is a monumental change in the estate tax rate. We’re not talking about going from a 45% estate tax to a 35% tax. We are talking about from 45% down to zero. Does this mean people won’t give to charity anymore? No. Of course they’ll give to charity; just less.”

In fact, Martin Shenkman, an estate tax lawyer, has seen charitable giving decline significantly as the estate tax exemption moved up from $1 million to $3.5 million in 2009. Charities have been hit with a “double whammy”, Shenkman said. The decline in philanthropy as a result of the higher exemption has been coupled with the recession, which has hit charities hard.

“I’d like to think we’re all altruistic,” said Sanford J. Schlesinger of Schlesinger Gannon & Lazatera LLP. “But especially in a dreadful economy, repeal will have a devastating effect on charity.”

But Doug Freeman of Freeman, Freeman & Smiley, disagrees. He believes the relationship between estate tax and philanthropy is highly misunderstood and that most people’s motivation will not be affected by the elimination of the estate tax. “I think the biggest risk to philanthropy, frankly, is that advisors think the giving is connected to the tax,” Freeman said. “Where you’ll see the impact is when advisors say to their clients that they don’t have to give to charity anymore and should give to their children instead. Tax advisors who believe that estate planning is based on tax motivation are not likely to recognize that philanthropy, though affected and shaped by tax, is not driven by tax.”