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Behavioral Implications of Tax Policy for the \$10 Trillion Transfer**

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Prepared for

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"Nonprofit Organizations as Public Actors:
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A study of the 1993 Federal Reserve wealth data by researchers at Cornell University (Avery and Rendall, 1993) estimated that baby boomers ranging in age from 30 to 49 will share a \$10 trillion transfer from their aging parents. Not surprisingly, much attention in philanthropic circles has been devoted to this transfer that is projected to occur over the next three decades. The dollar figure for this intergenerational transfer varies depending in part on how far into the future one is forecasting and on the rate of growth in wealth one assumes. Hoping to secure their share of this windfall, fundraisers and nonprofit professionals understandably have riveted their attention on three ideas: First, a disproportionate share (25-35%) of the intergenerational transfer will occur among the wealthiest 1.5 to 2% of the population (those with assets over \$600,000). Second, this intergenerational transfer has the potential to unleash vast sums of money for philanthropic purposes. Third, because those who possess an inordinately high percentage of the wealth have a considerably broader range of choices, it is therefore imperative to remind the recipients of this windfall about their choices and acquaint them with their charitable responsibilities.

Missing from such discussion of the wealth transfer, however, is how tax laws directly and indirectly affect the choices current wealth holders will make regarding this transfer of wealth. Also neglected, therefore, is a realistic assessment of the amount that may actually end up in the hands of the next generation and in the hands of the philanthropic sector. The fact is that in addition to philanthropy there are alternative trajectories for the projected trillions, not least of which is the potentially immense amount that will make its way to government via estate taxes and the amount that will remain embedded in family businesses and other non-liquid assets. In general, government

officials and tax attorneys are well aware of the implications of current tax policies for the distribution of the wealth transfer among government, investment, and philanthropy--as are some conscientious wealthy individuals. But for various reasons many wealthy individuals--especially among first-generation entrepreneurs--have not actively attended to the implications of estate taxes for the eventual disposition of wealth. Nor, for the most part, has the philanthropic community sufficiently comprehended the possible dissipation of its anticipated windfall. As a result it has not initiated appropriate strategies to persuade wealthy entrepreneurs to consider the economic, social, and personal advantages of making philanthropy the positive cornerstone for pursuing their general inclinations toward innovation and keeping revenue out of the hands of government. Although the current estate tax environment induces certain involuntary outcomes, it also allows for a range of additional voluntary outcomes for those wealth holders who make achieving such outcomes a goal of their financial management.

In this paper we hope to take a modest step toward alerting both the wealthy and the philanthropic community about the tax environment for the forthcoming wealth transfer and about how the effect of this tax environment will differ depending on whether and in what ways individuals actively deal with this tax environment. Throughout the paper, we emphasize how specific elements of the tax code affect the strategic choices the wealthy make about the alternative uses for their money. As such, we look more at the social-psychological processes by which tax laws produce their effects (especially in regard to philanthropy among the wealthy) than at purely technical aspects of the legal environment. It is not our intention here to advocate any specific policy alternative. Rather it is to draw out for philanthropic professionals a deeper intuitive understanding of decision making by the wealthy, and to provide a more realistic picture of what portion of that projected \$10 trillion is headed their way.

In the first two sections we provide an overview of the two contexts within which wealth holders make decisions. In section one we examine the current tax environment in

which wealth holders are constrained to make decisions. In the second section we examine how the level and composition of one's assets affects wealth holder decisions. We do this by describing four patterns of wealth composition and how these patterns differ in the latitude they allow for charitable giving. In the third section, we discuss four behavioral effects by which tax laws produce changes in the economic environment and thereby changes in the charitable capacity of wealth holders. We distinguish between individuals who passively accept the default levels of estate taxes dictated by the legal framework and those who actively work within the legal framework to reduce the amount of wealth going to government. Among the latter, it is important to distinguish between those for whom tax-reduction entails a socially productive commitment to philanthropy and those for whom tax-mitigation revolves around the socially counter-productive strategy of capital disinvestment of the family firm. In the final section, we discuss a range of reasonable policy changes to improve the congruence between the policy goals of economic growth and philanthropic giving.

The Tax Environment of Wealth-Holder Decision-Making

The major portion of the \$10 trillion transfer will go to next-generation offspring. But the United States government will also participate in the transfer through gift, estate, and inheritance taxes as will the philanthropic community for reasons partially related to taxes. The distribution among the three will be determined by the active and passive decisions of the present wealth holders. While it is difficult to quantify the relative share of wealth ending up among the participants, the factors that influence the decisions of wealth holders are easier to enumerate and will be developed in this paper. The first of these factors is the tax environment, the second is the amount and composition of the assets being transferred.

While much current thought in the philanthropic community has focused on the effects of this transfer on the charitable potential of the next generation, the enormity of the transfer has ramifications that extend far beyond the inheritors and into the public and private economy in ways not fully understood. In the United States wealth transfers from one generation to another or from one individual to another are accomplished within the framework of a gift and estate tax code which appropriates varying percentages of the transferred assets for public purposes.

The tax code distinguishes two types of transfer. One type of transfer, that between individuals (including family members), is subject to varying percentages of tax depending on the amounts transferred. A second or privileged type of transfer, that from an individual to a charitable cause, not only passes tax free but provides to the transferor a deduction from other income subject to tax. Such tax-privileged transfers are provided as incentives to encourage voluntary transfers for public purposes to organizations operated exclusively for religious, charitable, scientific, literary, or educational purposes as defined in section 170 (c) of the Internal Revenue code.

Given the foregoing tax environment, wealth holders in general seek to maximize their wealth holdings. The same wealth holders faced with the unavoidable prospect of estate taxes seek to maximize family wealth holdings by transferring assets among family members in ways that minimize transfer taxes. Wealth holders intuitively pursue the two goals of wealth accumulation and transfer of wealth among family members with emphasis on the former while young and emphasis on the latter as the wealth holder becomes older and estate taxes become less remote. At some subjectively determined point, the accumulation of wealth either personally or within a family reaches a point at which personal and family assets become adequate for what Aristotle calls the "good life." According to Aristotle, the art of acquisition is a natural part of the human condition and seeks to provide such things as are necessary to life and useful to the community and the state. Such acquisitions are the elements of true riches when they are limited to the amount

of property which is needed for the “good life.” But there is a second version of the art of acquisition which is best called the art of wealthgetting. Here riches and property have no limit. Wealth is an end in itself and not just a means to an end. Now it is mainly among the first group, who acquire sufficient riches for the “good life” and recognize it, that the opportunity for philanthropy is greatest. Such data as is available indicate that the two groups are growing rapidly and constitute close to 5% of all families.

The importance of private property as an individual right that could be asserted and defended, even against the claims of the sovereign, was long recognized in English Common Law. Sir William Blackston’s *Commentaries on the Laws of England*, the bible of 18th century English-speaking lawyers, observed that the “origin of private property was probably founded in nature.” Given the English orientation of the framers of the Constitution, it was no accident that Article IV of the Bill of Rights enunciated the right to have and to hold private property, stating that no individual shall “be deprived of life, liberty and property, without due process of law; nor shall private property be taken for public use without just compensation.” While Americans have the right to own private property for their use and enjoyment, the rights to transfer this property through lifetime gifts or bequests at death is limited by wealth transfer taxes. Table 1 summarizes the current federal wealth transfer tax schedule for cumulative lifetime and post-death gifts.

**Table 1
Gross Estate Tax Rates***

Taxable Estate (after marital and other deductions) (\$)	Tax (\$)	Marginal Income Tax Rate (on next \$)
600,000 or less	0	37%
750,000	55,000	39%
1,000,000	153,000	41%
1,250,000	255,000	43%
1,500,000	363,000	45%
2,000,000	588,000	49%
2,500,000	833,000	53%
3,000,000	1,098,000	55%

*The benefits of the graduated and gift tax rate and \$600,000 exemption are phased out for estate/gifts over \$10 million. Assets can be transferred tax free between husband and wife during their lifetime and to the surviving spouse at death. Additional annual lifetime asset transfers in the amount of \$10,000 (\$20,000 if joined by spouse) can be made to an unlimited number of transferees.

As we indicated, assets transferred for philanthropic purposes are privileged and no estate transfer tax is imposed. In addition, within limits the transferor is permitted to deduct the value of the gift for income tax purposes from income that would otherwise be taxable. Such transfers might be called voluntary transfers for the public good. The purposes for which such transfers can be made include qualified health, education, and religious organizations. The tax changes enacted in 1990 further limited the amount of the deductibility for these transactions to the amount by which these deductions when combined with specific other deductions exceed 3% of the donor's adjusted gross income.

Although not altering the amount of the estate tax, two specific provisions apply to the way in which family members can pay estate tax if the business is a major asset in the estate. One permits family members to withdraw moneys from the business by stock redemptions for estate tax purposes without having to pay income taxes on the withdrawal which, if withdrawn for other purposes, would be taxed as a dividend. The second (alone or in combination with the first) permits the estate to pay the tax that is owed in ten equal

installments beginning at the end of the fifth year with interest-only payments made during the first five years. Additionally, interest on the tax due on the first million dollars of value accrues interest at 4% per annum.

The Asset Environment of Wealth Transfer Decisions

The second context for wealth holder decisions is the amount and composition of the assets to be transferred. We examine this context by describing the situations of four individual wealth holders each of whom is representative of an important group of wealth holders. Although pseudonyms are used, the individuals are real people known to one of the authors. Each of the four individual wealth holders brings to the wealth transfer decision a unique combination of assets and tax constraints which evokes a different response. Examining the decision-making process of these four provides significant insights into how the aggregate allocations among family, government, and philanthropy will ultimately emerge and could, with some additional research, provide the basis for a quantitative forecast. For three of the four wealth holders, the decision-making process is straightforward. The relation of these three wealth holders to public policy is relatively unproblematic and the ramifications for the larger community easily discerned. The fourth case is substantially more complex but, if anything, more important. For the fourth person is representative of that already large and growing class of individuals who own those family businesses whose continued success and viability is important not only to the individuals involved but to the larger national economy.

Barry Baker² has been a lifelong senior-position employee (46 years) in a small wholesale distribution company. He took the job immediately upon graduating from college and has remained there ever since. Because of technological change in the company's marketplace, it has become necessary to terminate the defined benefit pension

plan, an event which resulted in Baker's receiving a check for over \$400,000, a sum which he believed himself unqualified to manage. This sum together with over \$200,000 in a diversified group of mutual funds, a debt-free house, and some other small holdings provided him with a measure of financial security which assured his living standard no matter what the future brought. His asset holdings placed him close to the million dollar level and on the taxable side of the estate tax threshold. A few months ago, he had just returned from a pleasure trip to Paris and parts of Switzerland. When the first author last talked to him, Baker and his wife were planning a trip to the Greek Isles.

While Mr. Baker is by most standards extremely well off, he does not consider himself among the rich. Such excess funds as are available to him he devotes to helping his five children. He is acutely aware of the inequities in income distribution in the United States and believes that the government should play a larger role in addressing the problem. His philanthropy is commensurate with his ability to give and is directed to the area of religion.

His financial situation is one of minimum risk, that is, clouded by little uncertainty. He is the personification of what Aristotle envisioned as someone who has mastered the "art of acquisition." He has sufficient funds to enjoy the "good life," and further acquisition of wealth is not one of his goals. He gives freely of his time and, if he had greater wealth, would give more.

Charles Cobb is a successful lawyer entrepreneur with diversified business holdings in construction, retailing, and real estate. In order to reduce the level of risk in his diversified portfolio, he took public one of the companies in which he was a principal shareholder. He placed his \$20,000,000 share of the proceeds from the sale of the stock in a charitable trust for a temporary period, since extended. The income from the trust assets provides the resources to fund his charitable initiatives. Driven by a strong religious commitment and grounded in an entrepreneur's pragmatism, Mr. Cobb is fully engaged in

many philanthropic activities in the United States, Europe, Africa, and Asia. His engagement is producing for these charitable activities the same successful results that characterized his commercial pursuits. To say that religion is important in his life is an understatement. He would enthusiastically argue that the only accurate description of his life is that he is an instrument through which God does His work.

Davis Donald is one of three children of an immigrant father who made his fortune in the real estate and construction business. All of Mr. Donald's wealth has been inherited from his now deceased father. Except for some real estate holdings, the greater portion of his wealth is in professionally managed trusts which produce income for Mr. Donald and his family. A significant part of the holdings are in generation skipping trusts, trusts which provide income to children of the donor but allow the corpus of the trust to pass tax free to the donor's grandchildren at the death of the children. The Tax Reform Act of 1986 sharply curtailed the use of this type of trust by limiting the amount of the generation skipping tax exemption to \$1,000,000. Fortunately for Mr. Donald, the change was not retroactive.

With no financial worries and a substantially redundant income stream relative to his life style, Mr. Donald is perfectly positioned to engage in philanthropic activities. Not an activist in philanthropy, his contributions of both time and money are in response to initiatives by the beneficiaries. Although generous to religious organizations and with a deep personal religious commitment, his financial commitment to religious organizations is secondary to his commitments first to education and then to health.

Under the guidance and influence of a battery of lawyers, accountants, and trust officers, Mr. Donald is pursuing a course of decision making the primary goal of which is to minimize the government's share of gift and estate taxes. The active part of this decision making involves a combination of lifetime gifts and bequests at death. For instance, he recently established a charitable trust partly as a way to grapple with the problems of estate

taxes. The divestiture of assets will continue until it reaches the point beyond which further reductions could affect Mr. Donald's standard of living. The bequests at death are an important part of this strategy. While Mr. Donald may not be familiar with Andrew Carnegie's famous quotation, "To die rich is to die in disgrace," he will very likely be less rich at the time of his death than he is today and by a considerable margin.

Alan Able presents the most complex situation. He is a naturalized citizen who arrived in the United States as a young man with little more than pocket change and the clothes on his back. The rise, fall, and recovery of his fortunes are illustrative. By 1989 he had built a prosperous real estate empire. However, his assets dramatically fell in value during the recession and real estate devaluation of the early 1990s. Recently his holdings have begun to recoup their value. Table 2 indicates the value of Mr. Able's wealth holdings at three points in time during the past six years.

Table 2
Financial Status of Alan Able, 1989-1994*

	1989	1991	1994
Real Estate	\$1,000,000,000	\$600,000,000	\$750,000,000
Mortgages	<u>500,000,000</u>	<u>500,000,000</u>	<u>500,000,000</u>
Net Equity	500,000,000	100,000,000	250,000,000

*Assumes tax basis of assets equals mortgage balance.

In 1989 Able's most reasonable allocation choices were to either (1) continue his investment portfolio as is or (2) sell property, pay capital gains taxes, reduce mortgages to zero, and invest the proceeds of the sales (approximately \$200,000,000 to \$335,000,000) in a diversified portfolio of low risk investments which would produce a secure income of \$15,000,000 to \$20,000,000 per year.

Now if Mr. Able had died in 1989 his estate taxes on \$500,000,000 net worth as calculated from Table 1 would be \$275,000,000. This would have left his heirs \$225,000,000. If it took two years to settle the estate and if (in order to come up with cash to pay the estate taxes) property had to be sold in the depressed market of 1991, the estate would have become bankrupt. A 40% reduction in market values of real estate between 1989 and 1991 has produced an 80% reduction in net worth. The heirs, who now possess real estate holdings worth \$600 million, are faced with \$500 million in mortgage debt and \$275 million in estate taxes, and so are left with a net worth of minus \$175 million.

By remaining alive in 1991, Able's prospects are far more advantageous, even if he chooses to sell his holdings in the midst of the depressed real estate market. Let's say that Mr. Able does sell his property to reduce debt. After capital gains taxes he will receive approximately \$70 million in net proceeds. If invested in a diversified portfolio this sum would produce an annual income of between \$5 and \$7 million. If Mr. Able dies in 1991 with a net worth of \$100 million, his estate taxes would be \$55 million leaving his heirs \$45 million.

It turns out that Mr. Able did not die; nor did he sell any of his properties to reduce the amount of indebtedness and the level of his risk. Like many business owners his life is inextricably tied to his business, making voluntary separation extremely difficult. As long as he desires to remain active in running his business, his enormous wealth will remain foundational to the business and cannot be easily diverted for philanthropic or any other purposes without weakening the underpinnings of the business. Consequently, even though Mr. Able does engage in philanthropic activities in the area of education and religion, he does so at a much lower level of activity than he might otherwise be capable of and prefer.

Although the dollar amounts are quite large and the real estate market values subjected to an inordinately high degree of volatility during the period observed, Mr. Able's situation differs from most privately held businesses only in degree. The problems and decisions he faces are qualitatively the same as those faced by small business owners

who now comprise 42% of the top 1% of wealth holders (over \$200,000 of income and \$3,000,000 of net worth).

Several general observations summarize what at this point we wish to emphasize about the four cases. First, all four wealth holders are in their 60s and so are operating at a time in their life when death is less remote and when it would be advantageous for them to consider decisions about managing their resources in view of their death. Indeed, two of the four wealth holders have suffered from serious heart complications in the past five years.

Second, the opportunity for philanthropy is greatest among those wealthy individuals (such as Barry Baker, Charles Cobb, and Davis Donald) whose holdings are concentrated in minimum risk assets and whose income stream is stable, predictable, and secure.

Third, the opportunity to engage in philanthropy is least among those wealthy individuals (such as Alan Able) whose holdings are concentrated in inherently volatile assets and whose income stream is unstable and unpredictable. These latter situations demand the full attention and focus of the wealth holder. In effect the wealth holders are captives of their wealth in a positive sense. As we have stated, 42% of the top 1% of wealth holders are in this class. Their incomes are greater than \$200,000 per year, their net worth greater than \$3,000,000 and they started their own businesses more than 22 years ago. Few of them have college degrees. Many of these individuals have the choice to sell their business, pay their capital gains taxes, and live the "good life." Why they do not do so can be captured by the lament of one who did sell. At the closing, a meeting which took two days and required the presence of twelve lawyers, one of the lawyers said to the seller, "You don't seem too happy, Bill. You are getting a very good price for this x. Why do you seem unhappy?" Bill responded, "Are you married?" To which she replied, "Yes." Bill's next question: "Do you have any children?" The reply again was "Yes." Bill's next and last question was "Would you sell one of them?" And she knew without having to reply why Bill was so sad despite being so rich. In regard to philanthropy, it is difficult to

get the attention of those who remain substantially devoted to raising their commercial offspring; and if you get their attention, it is difficult to get them to respond financially.

Fourth, in addition to the volatility of the income stream the small business owner's capacity for philanthropy is further limited by the contingent liability of estate taxes. Although, as we have indicated, such tax liabilities are substantial, they do not appear on the balance sheet of an estate until death intervenes. If a business owner does not actively attend to such potential tax liabilities before death, they will at the time of death become potent, if not intractable determinants in the ultimate disposition of an estate.

Mr. Able's case dramatically exemplifies this last point. He demonstrates the stark effects of uncontrollable contingencies (such as the tax code, death, and shifts in market value of assets) upon the magnitude of one's estate and on the ability of apparently wealthy individuals and their estates to make philanthropic contributions. At the same time, Mr. Able's case shows how important it is for wealth holders to actively face rather than passively acquiesce to such consequential environmental contingencies. For example, were he to have died in 1989, estate taxes would, by extracting equity from the business, have reduced the enterprise's capacity to withstand adversity at the very time when its management capability had been weakened by the death of its founder. These factors when combined with the uncertainty surrounding the market value of a privately held company (an uncertainty that usually results in a dispute between the executors of the estate seeking to minimize its value and the IRS seeking to maximize it) lessen to a considerable degree the capacity for philanthropy by Able and his counterparts.

Tax Laws, Behavioral Effects, and Philanthropy

We now consider how the interaction between the tax and wealth environments affect the level of philanthropic giving. That is, to understand the effect of tax provisions on philanthropic giving, it is necessary to explore how tax laws first change people's

financial decision making and how such changes influence philanthropic giving. We propose the following three-variable model as a starting point:

$$\mathbf{T} \dots\dots\dots > \mathbf{B}_{1,2,3,4} \dots\dots\dots > \mathbf{P}$$

Where \mathbf{T} is a Tax Provision
 \mathbf{P} is Philanthropic Contributions in \$
 \mathbf{B} is a set of Behavioral Effects produced by the Tax Provision.

This model indicates that tax provisions have a direct effect on philanthropic contributions, independent of any additional behavioral changes the tax provision may induce. That is, even those who passively ignore or avoid the potential behavioral effects of changes in tax provisions are required to act within the constraints of tax provisions in making philanthropic contributions.

The model also indicates that the effect of tax provisions on philanthropic giving is mediated by specific behavioral effects. That is, the tax provision provides an array of incentives and disincentives that change the behavior of individuals and hence the economic capacity to give to charity. There are four effects that we will consider here:

- \mathbf{B}_1 an income effect
- \mathbf{B}_2 a price effect
- \mathbf{B}_3 a composition effect
- \mathbf{B}_4 a wealth effect

Each of the four individuals in the previous section is representative of a broad group of wealthy individuals whose capacity to give would be effected differently by changes in the tax laws. The effect on capacity to give depends on the characteristics of the tax (tax rates and the types of assets affected) and the tax-induced behavioral changes-- especially those made by the wealth holders who actively rather than passively respond to the tax changes. This is illustrated for two changes which were incorporated into the tax code which was passed by the Congress and signed by the President in 1993. The first

was an increase in the top marginal income tax rate, the second concerned the charitable deduction for appreciated property.

Income and Price Effects

Theoretically one's capacity to engage in philanthropic activity can be captured by the following index: Capacity to give is equal to income--less taxes, less expenses--to maintain standard of living divided by expenses to maintain standard of living. Expressed symbolically,

$$Cg = \frac{Y - T - SLe}{SLe}$$

where Cg is capacity to give
 Y is income
 T is taxes
 SLe is expenses to maintain standard of living.

The 1993 tax law increased the marginal income tax rate on individual incomes greater than \$250,000 from 31% to 39.6%, an increase of 27.7%. For all four individuals the increases in marginal income tax rates decreases the capacity to give by an amount precisely equal to the amount transferred by way of the tax increase from the individuals to the government. This is an expression of the *negative income effect*. That is, all things being equal, higher income taxes reduce the level of discretionary income available to be given to charity by wealth holders. Because of this inverse relation between income tax rates and discretionary income, we refer to the income effect as negative. Therefore, before the 27.7% increase in marginal income tax rates, the capacity to give is greater because any wealthy individual would have been left with 8.6% more discretionary income. Expressed symbolically,

$$Cg(\text{at Time 1}) = \frac{Y - .31(Y) - SLe}{SLe}$$

while $Cg(\text{at Time 2}) = \frac{Y - .396(Y) - SLe}{SLe}$

At the same time, every change in marginal income tax rates also changes the cost of giving, or what amounts to the psychological capacity to give. That is, every increase in marginal income tax rates that produces a negative income effect also produces a countervailing *positive price effect*. As marginal income tax rates increase, the additional amount of discretionary income that a donor must contribute to determine the social use of a dollar decreases. For example, a marginal income tax rate of 31% means that for every philanthropic dollar donors choose to direct, it costs the donors 69 cents and the government 31 cents. However, with a marginal income tax rate of 39.6%, every dollar of philanthropy costs the donor 60.4 cents and the government 39.6 cents.

Because the price and income effects interact with each other and with the other effects we will discuss in a moment and because of potential additional changes in the cultural environment and motivational situation of donors, it is difficult to predict the long-term effects on charitable giving. For instance, while the changes in marginal income tax rates encourage giving by reducing the cost (or price) of making a gift from 69% to 60.4%, the same changes discourage giving by reducing the amount of donors' discretionary income. Fortunately, the third variable in the preceding formula provides a hint about how to determine the relative impact of the income and price effects. By taking into account the degree to which a new income tax schedule impinges upon a wealth holder's customary standard of living, we can begin to estimate how consequential the negative income effect may be. For instance, a high capacity to give index, say at 10, indicates there is a high degree of redundancy in the donors' capacity to give. As a result, the income effect may be more than offset by the price effect. If the capacity to give index is at or below 1, then the price effect is less likely to be offset by the income effect. Intuitively, this means that those wealthy individuals who lose a greater proportion of their discretionary income due to an increase in marginal income tax rates will reduce their giving more than the superwealthy whose income stream is relatively less affected. For instance, we would expect that small

business owners who have a greater proportion of their assets tied up in non-income generating investments to be especially sensitive to such negative income effects.³ In contrast, for wealth holders whose cash flow is derived from tax-free bonds or generated from real estate depreciation, the income effect on capacity to give is less significant and could be negligible.

The second 1993 tax change permitted a charitable deduction equal to the fair market value for gifts of appreciated property made to qualified charitable organizations. The difficulty in obtaining valid evaluations for appreciated property, particularly with respect to works of art, led lawmakers in 1986 to rescind the provision that allowed deductions to be determined by current market value of the appreciated assets. The 1993 change allows the donor to receive not only a deduction for the original cost of the gift but for whatever appreciation may have occurred since the asset was obtained by the donor.

This provision also affects charitable giving via a price and an income effect. But in this case, not only is the price effect extremely positive but the income effect is positive as well. The behavioral effect should be a short-term increase in gifts of appreciated property and a sustained high level over the long term. For example, let us consider a gift of a work of art with a current market or appraised value of \$100,000 and a cost basis of \$10,000. Subject to annual limitations, this gift now provides the donor a \$100,000 deduction or a reduction in taxes of \$39,600 (at 1993 top bracket of 39.6%) versus the situation prior to the change which provided a deduction of \$10,000 and a reduction in taxes of \$3100 (at pre-1993 top bracket of 31%). In addition, when capital gains savings are taken into account, the cost is reduced even further to just \$35,200 (\$100,000 less 28% capital gains tax on \$90,000 = \$74,800 less the income deduction of \$39,600=\$35,200). Prior to the change the net cost to the donor would have been \$71,700 (or \$74,800 -\$3100). Thus the tax change produced a reduction in the cost of giving this type of asset by 49%. For those who are in possession of such assets this change provides the opportunity not only to make a significant contribution of a non-income producing asset at a relatively low cost but also to

convert the reduction in taxes into a positive cash flow. Given these calculations one can, as we said, confidently predict that an increase in donations of this type of asset will occur.

The Composition Effect

A previous section of this paper pointed out that people's capacity for philanthropy cannot be defined without reference to the composition of their assets, (that is, the relative amount of one's wealth invested in various types of assets such as real estate, stocks, bonds, cash, collectibles and small privately held businesses) and the flexibility to shift or redistribute wealth among the various asset holdings as their needs change or in response to changes in the tax code.

The composition of a particular individual's assets reflect his or her preferences based on the characteristics of assets with respect to safety, liquidity and yield. With the exception of small privately held businesses, individuals allocate their wealth in pursuit of some or all of the following objectives:

- (1) preservation of capital or safety
- (2) return on investment that permits yield to function as a substitute for work
- (3) growth of capital to increase wealth
- (4) deployment for philanthropic purposes.

Both income and estate tax provisions influence these allocations. For example, an allocation that pursues growth may limit one's capacity for philanthropy in the short run while enhancing it in the long run. As we noted earlier, the cost to allocate assets for philanthropy depends not only on the asset, but whether or not one owns it, for example, appreciated stock, collectibles or IRA.

With respect to wealth stored within the structure of a small business, little if any flexibility is present because the wealth is foundational to the business and cannot be withdrawn without jeopardizing the health of the business. Frequently capitalized at levels that constrain growth, these entities provide the job creating growth that fuel the larger economy. The capital requirements of these businesses when combined with their relative inflexibility to reallocate assets in response to changes in the tax code, sharply curtail their philanthropic activities.

Although limited in their ability to respond to changes in the tax code, small businesses do respond when they can and pay additional taxes when they can't as the following two instances illustrate. When the tax law made it more advantageous to pay taxes at individual rates rather than at the higher corporate rates, the number of businesses which switched their tax-paying status to "Sub S" increased from 257,475 in 1970 to 545,389 in 1980 and to 1,575,092 in 1990. (See Table 3 for additional details on this response.) Conversely, recent changes in 1991 and 1993 increased marginal income tax rates for individual taxpayers and "Sub S" corporations from 28% to 31% in 1991 and to 39.6% in 1993. These increases in 1991 and 1993 have the effect of channeling what would be additional capital for investment growth into consumption which consumes capital and provides no growth.

The Wealth Effect

The fourth behavioral effect of tax laws returns us to our original question about the implications of estate tax laws for wealth transfer. The wealth effect is the behavioral response induced by tax provisions that affect both the short and long-term capacity to give by either encouraging or discouraging growth in individual wealth levels. How an individual wealth holder responds to tax provisions depends upon his or her income and

wealth levels relative to his or her economic needs. For the overwhelming majority of Americans, their present level of wealth accumulation is somewhat below that which they desire, and as such, they are motivated to increase their wealth through the investment of savings. For this large segment of the population, the motivation to increase their wealth holdings will most likely be more powerful and controlling than their efforts to minimize the adverse effects of tax changes. Large in numbers but with limited wealth, this group will pursue economic goals that are compatible with what has been the expressed national economic goal of growing GDP ever since John Maynard Keynes (1936) first theorized during the depths of the depression that increasing GDP was the single most important factor in producing job growth.

For a small but rapidly growing number of the wealthy who control in the aggregate an inordinately large percentage of the nation's wealth, their present levels of wealth are equal to or in excess of their present and future economic needs. We have previously noted that over 5% of the families have sufficient wealth to be subject to the Estate Tax provisions of the tax code. According to Edward N. Wolff (1992), an N.Y.U. economist, the top 1/2 of 1% of the population own 39.3% of all assets which he estimated as equal to \$7.9 trillion (39.3% times \$20.2 trillion) in 1989. It is in this area that income and estate tax laws interact with the personal motivations of the wealthy to encourage the allocation of assets in ways that are inimical to a national objective of providing job-creating economic growth. When the rewards associated with successful risk-taking entrepreneurial activities are taxed (income at a marginal rate of 39.6%; capital gains at 28% and gift and estates at 55%) at such high levels and the losses associated with unsuccessful ventures are born 100% by the investor, current owners of excess capital are dissuaded from pursuing such ventures. The result is such capital flows into safe wealth-preserving assets rather than job-producing growth ventures.

These effects enter into the decision-making of both those whose wealth is deployed in instruments easily transferable and those whose wealth is encased in small

family businesses. These effects become clearer in contemplating the explicit conflict that is present when one considers the purpose of government economic policy (increase GDP) juxtaposed against the purposes of both groups of wealthy. The purpose of those whose wealth is readily transferred among alternate investment vehicles is all too often preservation of capital and transfer to the next generation as opposed to growth of capital for the obvious reason that they have enough capital for their needs. The responses to the Estate Tax Laws among this group is, to an increasing degree, taking the form of:

- (1) Increased *inter vivos* (while living) transfers.
- (2) Removing assets to offshore tax havens outside the jurisdiction of the taxing authorities.
- (3) In a growing number of instances, changing the status of one's citizenship to that of a country with lower estate taxes. This has already provoked a response from the Treasury.
- (4) Allocation of funds for philanthropic purposes. There has been an increase in the number and amounts of mega donations.

Among those whose wealth is encased in family businesses, the area in which greater job growth takes place, (see Table 4) the responses take the following forms:

- (1) Eschewing the risk of taking the enterprise to the next level, for example, expanding from a city operation to a state-wide operation; from a state-wide operation to a regional or national operation; from a national to an international or global operation.
- (2) Focusing the attention of the business on presenting to the government a set of financial numbers that minimize the valuation of the businesses for estate tax purposes. Extracting 55% of the equity of many capital-short small businesses for estate taxes creates inordinately leveraged companies.

The effect of the risk/reward relationships built into the Estate Tax Code is to immobilize or channel huge pools of capital into risk adverse havens as opposed to entrepreneurial job-producing growth. To redirect these pools of capital in a way that harmonized national economic goals with individual goals in order to adopt some or all of the following:

- (1) Establish an objective criterion for determining the “market value” of a business where no market exists. Such a standard could be a function of book value, earnings, cash flow or some combination of the above that would be known in advance and not litigated after the fact. The establishment of such a criterion would remove both the uncertainty and the legal/administrative costs of settling estate taxes and would allow owners greater flexibility to plan lifetime gifts and charitable bequests at death.
- (2) Directly confront the contradiction between tax policy and economic policy by dramatically reducing the burden of estate taxes. Stating that “We’ve got to do something about estate tax rates,” incoming Chairman of the Ways and Means Committee, William Archer (R.Tex.), attacked current rates as “an intrusion” and a drain on capital “accumulated to build family businesses and family farms.” Echoing the sentiments of Rep. Archer, Rep. Christopher Cox (R.Cal.) submitted H.R. 2717, a bill to eliminate estate taxes in their entirety.

Certainly some may feel that the positive price effect of the 55% estate tax provides a good enough reason to leave well enough alone. But this is short-sighted. Although we can provide no empirical data, we argue on practical and theoretical grounds that the long-term negative impact of the wealth effect far outweighs any short-term impact of the price effect. Failure to attend to the negative wealth effect will have dire effects on both

philanthropy and GDP growth for the reasons cited in the previous paragraphs.

Additionally, failure to mitigate the negative wealth effect will reduce people's material capacity and psychological propensity for philanthropy and actually expand the range and intensity of short-term needs which the philanthropic community will be called upon to meet with diminished resources.

As more people pass through the fixed threshold of \$600,000⁴ because of both inflation and wealth growth, estate taxes will grow geometrically. If the past is any guide to the future, the potential massive shift of wealth to the government will spawn a new industry dedicated to circumventing the tax laws. Already beginning, this will occur in much the same way that tax shelter schemes proliferated during the late 1970's, schemes that channeled vast sums into economically unproductive areas.

The history of income taxes shows that, as marginal rates varied over time from a high of 90% to a low of 28%, the government's share as a percentage of GDP remained relatively constant at 19%. Unless altered, one can expect a similar experience with estate taxes, that is, tax avoidance will displace productive growth as the beacon of wealth management.

Table 3
Small Business Tax Returns Filed

	Subchapter S Returns	All Corporate Returns	% Subchapter S
1970	257,475	1,665,477	15.5%
1975	358,413	2,023,647	17.7%
1980	545,389	2,710,538	20.1%
1985	724,749	3,277,219	22.1%
1986	826,214	3,428,515	24.1%
1987	1,127,905	3,612,133	31.2%
1988	1,257,191	3,562,789	35.3%
1989	1,422,967	3,627,863	39.2%
1990	1,575,092	3,716,650	42.4%

Source: Kemper Financial Services Inc.

Table 4
Employment by Global Fortune 500

Year	Employment	Total Nonfarm Employment	% Employed by Top 500
1954	7,857,483	53,904,000	14.6%
1964	10,464,383	64,782,000	16.1%
1974	15,255,946	78,265,000	19.4%
1984	14,247,953	94,496,000	15.0%
1986	13,681,555	99,525,000	13.7%
1990	12,429,305	109,971,000	11.3%
1992	11,811,792	108,436,000	10.9%

Source: Kemper Financial Services Inc.

The Growing Potential For Philanthropy

The income and wealth statistics confirm that the potential for philanthropy remains strong both in numbers of people and in the magnitude of resources. The greatest part of this potential for philanthropy is entrusted to those “to whom much has been given.” Whether or not those “to whom much has been given” can, as Will Durant says in *Lessons from History*, “unlearn the lessons of endless acquisition that an industrial society so relentlessly teaches” will determine how much of this potential can be actualized. The rewards of philanthropy beckon invitingly not just to the rich but to all those who would but participate.

In an insightful paper, Gerald Auten, James Cilke, and William Randolph (1992) utilized sophisticated statistical techniques to develop a method for forecasting the effects on charitable giving of changes in tax laws. The inability of the model to forecast the effects more precisely was due, as the authors readily acknowledged, to the effect of variables that they were not able to measure. If increasing the level of philanthropy is to

be a goal, the authors believe one must look beyond the tax code and the dollars contributed to the quality of the relationships between donors and recipients.

These relationships, we believe, can be divided into the following three classes: (1) initiated by the recipient; (2) initiated by an intermediary on behalf of the recipient; and (3) initiated by the donor. The commitment of resources to a philanthropic initiative rests with the donor. If one wishes to increase the donor's willingness to respond favorably to philanthropic opportunities, either identified by the donor or others, it is necessary that a positive response from the donor should evoke for the donor a pleasurable emotion. Such a pleasurable emotion involves the anticipation that the resources required, time or money, will produce a favorable outcome for which the donor can claim some measure of responsibility. The greater the degree of the donor involvement, emotionally if not temporally, the greater will be the donor's positive experience and willingness to give.

Not all of the three types of donor-recipient relationships noted above are accorded favorable tax treatment. While one can give up to \$10,000 per year to another individual, there is no tax benefit to be derived by a donor giving money to a needy individual whether for education or subsistence. For the donor to receive a tax benefit, the donation must be channeled through a qualified intermediary organization and which is precluded from using the money for a specific donor-designated individual. This doesn't mean that much cannot be done to enhance donor satisfaction as the following instances illustrate.

A friend, Henry Bagley spends the best day of his year each Christmas season visiting two inner-city youths who are the recipients of a scholarship he established in his mother's name in a Jesuit High School. Henry brings them each a Christmas gift, checks on their progress and encourages them. Henry travels about 700 miles each way to pay this visit, but he insists it is well worth the trip. Five young middle managers spend four of the most fulfilling days of their young lives each year by working jointly with their young inner-city school partner on a school project that teaches them both a valuable lesson. It is the quality of the philanthropic experience, rather than its quantity, that will

cause sustained growth. The tax climate should be favorable, but reliance on taxes to spur these initiatives will not (and should not) be enough.

Perhaps the most underexplored aspect of charitable giving is the factors that stimulate potential donors to *initiate*, from within the context of their own experience, a project they consider worth doing. The bulk of the effort of the institutionalized philanthropic community is directed at encouraging donors to support causes (and at a level) the donors may not have otherwise considered. This, of course, is perfectly legitimate. But a greater opportunity to engage in philanthropy on a higher plane--to do a good deed just because it warrants doing--exists today among the growing numbers of wealthy, if only ways can be found to encourage such an approach. At its very essence the quality of a gift is determined not by tax considerations but by the donor's concern for the beneficiary. Gifts animated and driven by the donor's focus on the good that accrues to the beneficiary can emulate those heartfelt gifts that willing parents bestow on their children (see Schervish, 1992). For this reason, increasing the focus of philanthropy not on the dollars expended, as is done today, but on what good emerges from those resources can be a source of encouragement for prospective donors. Management guru Peter Drucker, for instance, estimates that publicizing philanthropic successes could produce a tripling of donations.

Still, it would be naive to neglect the role of tax considerations for bringing charitable giving into the purview of wealthy donors and for influencing the amount and timing of their giving. Otherwise, those who are either exceedingly fearful about their financial security or overly engrossed in their work will have little psychological or temporal wherewithal to pursue philanthropic purposes. Within limits, the *income tax* code with its price effects will encourage such individuals to choose between furnishing revenue to charities in the form of contributions instead of to government in the form of taxes. However, income tax incentives are simply not substantial enough to transform a wealthy

individual into a generous donor. Something more is need to generate the psychological and temporal priority for charitable giving.

This “something more,” we have already indicated, has mainly to do with a discerning disposition of care for the welfare of others coupled to a strategic analysis of what private initiatives can do to enrich people’s lives. But it has also to do with the combination of price, wealth, income, and composition effects of tax laws, especially in regard to the current estate tax code. One major implication of this paper is that for the growing number of wealth holders (and to a lesser extent for the affluent) the estate tax code is currently a fortuitous ally of charitable giving.

One of the most consequential determinants of substantial future giving among the upper income earners and wealth holders is the new estate tax environment instituted by the 1986 changes in the Federal Tax Code. Much research has been conducted on the effect of marginal income tax rates and of the role of charitable deductions for the level of charitable giving. Yet even more important, and therefore worthy of extensive research, is the effect of existing and prospective Federal and state estate taxes for charitable giving. Although heretofore neglected among researchers and commentators on charitable giving, the effect of estate tax laws for charitable giving is something now patently obvious to financial planners, tax accountants, and increasing numbers of wealthy individuals. This is the fact that the 1986 tax code has dramatically increased the incentives of wealthy individuals to make substantial contributions to charity in lieu of paying wealth taxes at the marginal rate of 55%. Research would be very fruitfully directed toward studying the implications for charitable giving of current estate tax laws which virtually require wealth holders to choose between dedicating their wealth (both while alive and at their death) to government uses or to charitable uses. As Richard E. Haas (1995), an experienced financial planner, explains, the only substantial tax shelter for the very wealthy is philanthropy.

How to communicate to wealth holders this unanticipated and unappreciated convergence between the 1986 tax reform and philanthropy is just one of several important

research topics. Equally important is research and practical strategies for leading philanthropically unengaged wealth holders to formulate their own entrepreneurial philanthropic agenda. As we said, wealth holders need to learn about and appreciate the opportunities for charitable giving that have now been thrust upon them by the estate tax code. But even this is not enough, counsels New York financial advisor, Stuart R. Miller in a private conversation. His experience concurs with ours: the indispensable starting point for a philanthropic vocation is for wealth holders to figure out what socially beneficial projects they deem important enough to pursue, and what this means for determining their moral identity. It is not unreasonable to expect that when they stop and reflect, wealth holders will respond in the affirmative to the following two simple questions: Do you have something you want to accomplish for society? And do you think you can do a better job than government in accomplishing it? From our point of view, tax considerations will not automatically lead the wealthy to the wells of charity; but once there, such considerations will entice them to drink more deeply.

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2. All names of individual wealth holders used here and in subsequent sections are pseudonyms for actual individuals.

3. This is not an insignificant point, especially since fundraisers and philanthropic professionals tend to view small business holders as a reluctant, if not stingy, segment of the wealthy class.

4. Congress is currently (September 1995) considering various proposals for estate-tax reductions. The House has passed legislation to increase the estate exclusion to \$750,000 by 1998 and to index it for inflation thereafter. The Senate is considering legislation to dramatically lower or eliminate the estate tax for a closely held business.



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