

# THE AMERICAN PROSPECT

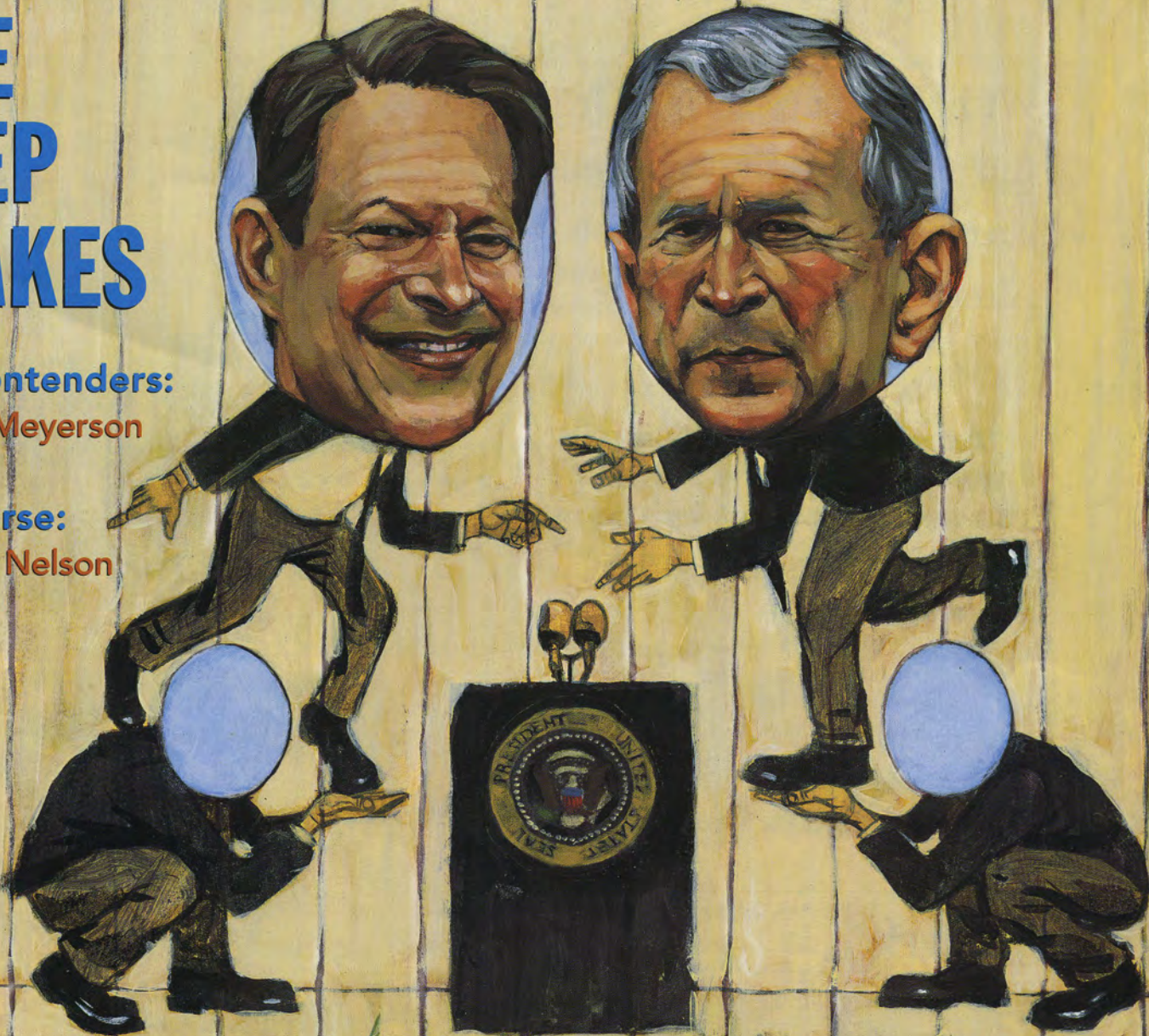
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# IT'S ALIVE!

## THE GOP'S PLAN TO END THE ESTATE TAX KEEPS RISING FROM THE DEAD.

BY SHELDON D. POLLACK

On June 10, amid much hoopla, the House of Representatives voted by a margin of 279–136 to repeal the federal estate tax—along with the federal gift tax and the so-called generation-skipping transfer tax. While the legislative initiative was orchestrated by the House Republican leadership, 50 Democrats joined as co-sponsors, and 65 voted for the bill. A few even attended a pep rally held prior to the vote to kill what Republicans derisively refer to (on the advice of their pollster, Frank Luntz) as the “death tax.” The legislation HR 8 (the Death Tax Elimination Act of 2000) phases out the estate tax over 10 years and carries an estimated price tag of \$20 billion over five years, \$105 billion over 10 years, and about \$50 billion a year thereafter. The Senate Finance Committee, chaired by William Roth of Delaware, is expected to take up consideration of the proposal sometime later this year.

The current Republican crusade to repeal the federal estate and gift taxes (which in 1976 were combined into a single “unified” tax on all transfers of wealth) can be traced to the 1994 Contract with America electoral campaign. Ever since the GOP took control of Congress following the November 1994 elections, numerous bills have been introduced to modify or eliminate the wealth transfer tax. Republicans slipped in a repeal of the dreaded taxes in a “taxpayer relief” bill in 1999, but President Clinton vetoed it, and he has already indicated that he will veto the present bill if it emerges from the Senate this year.

So for all the storm and thunder, Republicans have managed only to tinker with the estate tax, not to get rid of it. Changes that benefited the upper-middle class were achieved through negotiation and compromise with the White House in 1997, when legislation increased the individual lifetime exemption from the wealth transfer tax from \$600,000 (where it had been stuck for a decade) to \$1 million (to be phased in over 10 years). The 1997 act also created a new \$700,000 exemption for owners of small businesses and family farms—who already enjoy

numerous special breaks under the estate tax. (The new provision is so complicated and difficult to comply with that few taxpayers will ever be able to take advantage of the \$700,000 exemption.)

Overall, raising the exemption to \$1 million eliminates the tax for a significant number of citizens—all but the wealthiest 1 percent of the population. However, this compromise failed to appease those conservatives committed to outright repeal, which translates into giving the super-rich a significant tax cut. The current legislative initiative reflects their dedication to that

cause. With a presidential veto a foregone conclusion, the bill should be viewed more as the GOP's opening gambit; the end game is scheduled to begin the day Bill Clinton leaves the White House. Should George W. Bush (who has already expressed his support for the Death Tax Elimination Act) win the 2000 presidential election and the GOP retain control of the House, the campaign to repeal the wealth transfer tax could well succeed in the 107th Congress.

Who is behind this crusade? A key player in the House has been Ways and Means Committee Chairman Bill Archer of Texas. Soon after 1994, when he became chairman of the important committee with jurisdiction over tax and revenue matters, Archer pledged to push for the repeal of the wealth transfer tax. According to Ari Fleischer (a former spokesman for Archer, who now works for the Bush presidential campaign) the chairman is “philosophically opposed” to estate taxation as a form of “double taxation.” At the June pep rally against the “death tax,” Archer declared: “This tax is wrong. It is unfair. We’re going to make it right.” For Archer, who is retiring from the House after nearly 30 years, this is his last chance to make good on his promise. (Prospects look dim for his other longtime ambition—to “bury” the federal income tax.) After November, others on the Ways and Means Committee are prepared to lead the cause, most notably Representative Jennifer Dunn of Washington, who has played point guard for the GOP effort in the House.

On the Senate side, there is no shortage of proponents for repealing the wealth transfer tax. In recent years, Senator Jon Kyl of Arizona has regularly introduced legislation to that end. Of course, key to success in the Senate will be Majority Leader



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Trent Lott. Back in March 1997, Lott joined fellow Finance Committee member Charles Grassley of Iowa in sponsoring the legislation that raised exemption levels. Lott declared that “the estate tax is a monster that must be exterminated,” and lamented that revenue constraints then prevented its outright repeal. But that was in the days of projected budget deficits. Now, with expectations of trillion-dollar budget surpluses, Lott and other key players in the Senate (such as Finance Committee Chairman Roth) are willing to support outright repeal. The only thing that stands in the way is that Democrat in the White House.

### THE ADVANTAGES OF WEALTH

The debate over the wealth transfer tax is politically divisive and highly ideological. Liberals have largely defended the tax out of a gut reaction that the richest among us shouldn't be allowed to pass their fortunes on to their descendants without paying some sort of toll charge. Liberals also recognize that the wealth transfer tax, unlike the income tax, serves a basic redistributive function. One recurring metaphor found in classic eighteenth-century liberal political thought is reference to life as a “race.” Everyone begins this race at the same starting point, but due to the unequal distribution of natural talents and endowments, some inevitably reach the finish line ahead of others. The liberal case for some sort of inheritance tax is that without it, the children of those who have accumulated great wealth over their lifetimes will begin the race of life with an even greater head start over everyone else. To paraphrase the illiberal dictum of Justice Oliver Wendell Holmes, Jr.: One generation of idle rich is enough.

Of course, even at the maximum rate of 55 percent, the wealth transfer tax is incapable of completely breaking up concentrations of wealth in the hands of the likes of Bill Gates, Ross Perot, or Malcolm Forbes. With or without a wealth transfer tax, the descendants of those with fortunes in the billions will still start the race of life way ahead of their peers. Nevertheless, there is some overall equalizing of societal wealth on account of the tax.

Michael J. Graetz, former deputy assistant secretary for tax policy in the Treasury during the Bush administration and now professor at Yale Law School, expressed this classic liberal argument for retaining the wealth transfer tax in his 1983 law review article “To Praise the Estate Tax, Not to Bury It.” Graetz concluded that for all its faults and inadequacies, the estate tax adds a measure of progressivity to a tax system that otherwise does remarkably little to correct the inequality of wealth in the United States. Graetz estimated that about one-third of the progressivity of the tax system as a whole is attributable to the estate tax.

Of course, conservatives oppose the tax on precisely the same grounds. They argue that those who work hard (or invest well) should be able to pass on the fruit of their labor to their descendants. They also complain that the accumulated wealth of the family is already taxed once when it is earned and, hence, should not be subject to a second level of tax when it is transferred to the next generation. On one level, the argument is correct. There is “double” taxation of *some* transferred wealth, just as there is double taxation of corporate earnings distributed to shareholders as dividends.

On the other hand, critics of the wealth transfer tax conveniently ignore one important fact: A substantial portion of the wealth now being transferred to the next generation escapes taxation altogether. This is on account of the last great loophole left in the income tax code: the long-standing policy to forgive tax owed on the unrealized capital gains of someone who dies. Thus, if Bill Gates were to cash in on his valuable Microsoft stock in old age, he'd pay a large capital gains tax. But if he held onto the stock until his death, it would be inherited by the next generation—and all the built-in gain in the stock's value would not be taxed. This allows appreciated assets to be transferred from one generation to the next without paying income tax.

This loophole would have been repealed by the Revenue Act of 1976, but before the effective date of that legislation and in the face of strong lobbying, Congress changed its mind. So if the wealth transfer tax is eliminated too, a good deal of the wealth accumulated by Mr. Gates and his cohorts will escape taxation. It is one thing to argue that the government shouldn't double tax the wealth accumulated by one generation, but conservatives are now coming close to making the argument that such wealth should escape taxation *entirely*.

For the most part, wealth taxation is just one of those fundamental policies that divides liberals from conservatives and, generally, Democrats from Republicans. To inject a ray of hope into this dreary debate, however, there may be a compromise position upon which a bipartisan coalition could come together to support repeal of the current wealth transfer tax while avoiding an unwarranted tax cut for the wealthy. The trade-off ought to be this: an end to the estate tax in exchange for a better way of taxing inherited capital gains.

Critics of the “death tax” ignore the giant loophole that allows much wealth to be transferred to the next generation entirely tax free.

Why might a compromise be in order? For one thing, the estate tax may not be the best way to tax inherited wealth. Unlike the income tax, which replaced the tariff as the major source of revenue for the federal government during World War I and now raises over \$1 trillion annually, the estate tax has never been, comparatively speaking, a major source of revenue for the U.S. Treasury. The \$28 billion the wealth transfer tax raised in 1999 amounted to 1.5 percent of total federal receipts for the year, an increase from the record low of 0.8 percent in 1988, but still a trickle in the overall revenue stream.

Some conservative economists, such as Alan Reynolds of the Hudson Institute and William Beach of the Heritage Foundation, claim that the estate tax may even have a *negative* impact on revenue collection under the income tax—perhaps enough to offset whatever is collected under the estate tax. If so, the tax would be highly inefficient and hardly worth keeping. But that view is disputed by others, such as Charles Davenport and Jay Soled of Rutgers University, who call into question any such a negative revenue impact. In an important 1999 article in the professional journal *Tax Notes*, Davenport and Soled discount the negative impact of the estate tax on national savings and revenue collection and debunk grossly inflated estimates of the administrative and compliance costs of tax. Far from being an



inefficient tax that ought to be eliminated, they conclude, the wealth transfer tax is generally working, notwithstanding its many flaws and loopholes that allow considerable revenue to escape taxation. Their advice: Close the loopholes and leaks, but don't abolish the tax. Of course, closing those loopholes is no easy task, as the IRS knows.

The estate tax raises so little revenue because so few individuals are subject to the tax. In 1987, when the exemption was set at \$600,000, fewer than 19,000 individuals (or about 0.87 percent of deceased adults) were subject to the estate tax—a historic low. From 1987 to 1997, a greater percentage of the population faced estate taxation as inflation eroded the value of the \$600,000 exemption. Even still, only slightly more than 1 percent of deceased adults have been subject to the estate tax in recent years. This figure should decline further in future years as the exemption rises to \$1 million by 2006. (And a married couple with a joint estate of \$2 million will be exempt from taxation.)

On top of this, a notable exemption from the gift tax (which applies to transfers during the donor's lifetime) allows individuals to give up to \$10,000 a year to anyone else completely tax free. Every December, accountants and tax lawyers across the country remind their wealthy clients to make these \$10,000 gifts to their children and grandchildren. By making the gifts, they minimize their own estate tax, and more of the family's assets are passed on to the next generation tax free.

Such techniques (and there are many others) for minimizing the estate tax are commonly portrayed by the media as gimmicks used by the wealthy to "avoid" taxation. But using trusts and making \$10,000 gifts annually is not only legal; it is encouraged by tax laws. Moreover, Congress has created incentives for American citizens to organize their affairs this way to *comply* with the law. And compliance includes making use of those exemptions granted under the law. These are not abuses, although they are unproductive and expensive. The cost of compliance includes estate and financial planning, legal fees to set up wills and trusts, premiums for life insurance (a basic planning device), and estate administrative fees. Indeed, one of the strongest arguments for junking the wealth transfer tax is that so many lawyers, financial planners, and insurance agents are its main beneficiaries, not the U.S. Treasury. (For this same reason, those professionals who earn their livelihood off the current tax regime will be at the forefront of opposition to repeal.) The tax laws should not encourage people to consume their life savings *before* they die, to set up unwanted trusts, or to give away their assets in \$10,000 increments, just to avoid the estate tax.

#### A BETTER IDEA

In the end, liberals may find themselves only half-hearted supporters of the wealth transfer tax. After all, it's hard to support a tax system that fails in its main objective (breaking up concentrations of wealth), imposes significant compliance costs (even on those taxpayers who will never actually be subject to the tax but who still must pay professional advisers to remain exempt), and at best contributes minor revenue to the federal coffers. Still, for liberals to join efforts to abandon the wealth transfer tax, there must be some compromise that will avoid giving the wealthiest 2 percent of the population (and their heirs) a big tax cut.

The most sensible trade-off, one that will prevent family fortunes from escaping taxation altogether but also will put an end to the expensive, duplicative estate tax regime, is to impose some sort of tax on appreciated assets transferred at death. In other words, eliminate the unwarranted loophole in the *income* tax that forgives taxes on those capital gains. The U.S. Treasury estimates that this dubious rule will cost the Treasury \$27 billion in 2000, and some \$153 billion for the five-year period from 2001 to 2005—so getting rid of the income tax loophole would more than compensate for the repeal of the estate and gift taxes. It also could bring liberal Democrats on board the campaign to repeal the wealth transfer tax.

The Death Tax Elimination Act actually includes a provision that would be a step in this direction. The bill provides that once the wealth transfer tax is fully phased out by the year 2010, beneficiaries of transferred assets of \$1.3 million or more will lose the existing tax break—they will inherit the income tax liability for the capital gain inherent in transferred assets. Of course, if the generation that inherits those assets doesn't cash in but passes its wealth on to its children, the government still will not collect. So this "reform" doesn't necessarily raise much revenue. Even worse, this plan is an administrative nightmare for both taxpayers and the government. A beneficiary would have to keep track of his donor's "tax basis," i.e., the original cost of the inherited assets. Assuming that Dad even can compute his own tax basis in his property (on the family business, heirlooms, or the family vacation home), it is highly unlikely that his heirs will know such figures. If the heirs ever sell any of these inherited assets, it will be difficult, if not impossible, to compute the gain recognized. Such extensive record-keeping requirements make the plan unworkable.

**T**he worst of all results would be to repeal the wealth transfer tax without effectively dealing with the capital gains loophole. Even though the wealth transfer tax is a minor revenue stream, projections are that this will change dramatically as the baby boomers start to retire in the next decade or two. The Joint Committee on Taxation estimates that revenue from the tax will rise to \$35 billion by the year 2007 and will increase to \$50 billion annually thereafter. In addition, those lucky investors who made a killing in the stock market during the 1990s will be the source of significant tax revenue in future years as they begin to die off. So even if the short-term revenue cost of repealing the wealth transfer tax doesn't seem to be much, the long-term cost will be greater.

Revenue considerations aside, many liberals will oppose the GOP campaign to repeal the wealth transfer tax purely out of principle. Similarly, the army of professionals who make their living off the estate tax will be a strong part of the opposition, purely out of self-interest. Nevertheless, there is a compelling argument for supporting efforts to reform the tax laws that control the transfer of wealth. Democrats in Congress may support (or, at least, acquiesce in) the Republican-led campaign—so long as Republicans agree to tax the appreciated assets of the wealthy under the income tax. That trade-off could be the basis for a bipartisan tax reform coalition. Absent a complete sweep in the 2000 elections, Republicans will need Democrats in Congress to achieve this. If Democrats call the bluff of diehards leading the GOP crusade against the wealth transfer tax, genuine reform—rather than just a disguised tax cut for the rich—might succeed. ♦