65 STAN. L. REV. ONLINE 21
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THE DIRTY LITTLE SECRET OF (ESTATE) TAX REFORM

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Spoiler alert! The dirty little secret of estate tax reform is the same as the dirty little secret about many things that transpire, or fail to transpire, inside the Beltway: it's all about money. But no, it is not quite what you think. The secret is *not* that special interests give boatloads of money to politicians. Of course they do. That may well be dirty, but it is hardly secret. The dirty little secret I come to lay bare is that *Congress likes it this way*. Congress *wants* there to be special interests, small groups with high stakes in what it does or does not do. These are necessary conditions for Congress to get what it needs: money, for itself and its campaigns. Although the near certainty of getting re-elected could point to the contrary,[1] elected officials raise more money than ever.[2] Tax reform in general, and estate tax repeal or reform in particular, illustrate the point: Congress has shown an appetite for keeping the issue of estate tax repeal alive through a never-ending series of brinksmanship votes; it never does anything fundamental or, for that matter, principled, but rakes in cash year in and year out for just considering the matter.

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1. *See* Doug Mataconis, *Incumbent Re-election Rates in the 2010 Mid-terms*, OUTSIDE THE BELTWAY (November 9, 2010), http://www.outsidethebeltway.com/incumbent-re-election-rates-in-the-2010-mid-terms (finding that incumbents' reelection rates in 2010, not counting incumbent retirements, were 87% in the House of Representatives and 84% the Senate).

2 *See* CAMPAIGN FIN. INST., HOUSE CAMPAIGN EXPENDITURES, 1974-2010, *available at* http://www.cfinst.org/pdf/vital/VitalStats_t2.pdf (last visited July 11, 2012) (finding an increase in aggregate campaign spending over two years (2008-2010) of $179 million for House candidates); *id.* at 79-80 tbl.3-5, *updated in* Senate Campaign Expenditures, 1974-2010 (Net Dollars), The Campaign Fin. Inst., http://www.cfinst.org/pdf/vital/VitalStats_t5.pdf (last visited July 11, 2012) (finding an increase in aggregate campaign spending over two years (2008-2010) of $121 million for Senate candidates).

Mancur Olson, in his 1965 classic, *The Logic of Collective Action*,[3] first got us thinking along these lines. Olson hypothesized that, rather than a rapacious majority ganging up on a wealthy minority—the fear that motivated our founders to create a divided government with checks and balances,[4]—what *really* happens in a large, advanced, capitalist democracy is the opposite: small groups with high stakes pressure politicians to achieve narrow ends. Wealthy minorities rule. Only small, motivated groups can solve the collective action problems, such as free ridership (that is, letting other people do the work or pay the costs), that plague bigger groups with smaller stakes. The rich get richer; money wins. Meanwhile, big groups with small stakes—for example, the vast majority of American taxpayers—continue to lose, because they cannot even get a seat at the table.

So much is old news. The dirty little secret is that this now standard view of politics, the special interest model, is right so far as it goes but that it does not go far enough: it does not look back in time, to consider Congress's role in creating and perpetuating special interests in the first place. The standard view has special interests coming first, as the predator, and politicians coming later, as the prey. The constant complaints we hear from elected officials about lobbyists reinforce this standard view. It should hardly surprise us to learn, although it seems to do so, that more often than not, Congress is the predator and special interests are the prey. Congress, after all, has monopoly power over coercive legislative action, such as taxation (the power to destroy, remember?). Just as other professionals in positions of power and influence—such as doctors, dentists, car mechanics, and lawyers—"make their own market" by creating or exaggerating a need for their services, so too can and does Congress.

I first set out this idea at length with my coauthor Linda Cohen in 2006, with the estate tax as our primary example.[5] We wrote of a "reverse Mancur Olson phenomenon": in the initial stage of what will become a dynamic game, Congress creates the conditions under which special interests can form—it tees up a legislative action of potentially great consequence to small groups. Perhaps Congress does so consciously, eyes wide-open; perhaps, like a drunken sailor, it stumbles into the light. In any event, Congress awakens one day to realize that there is an intense and cash-filled fight going on for something within its powers. Congress then strings along the players in what we called the "Shakedown" game. The conditions that generate this game include that there be (1) an issue of high stakes to small groups (the "Mancur Olson conditions"); (2) two or more sides, to prevent Congress from coalescing (Lord forbid) on one side and actually doing something permanent; (3) plausible action, for ra-

3. Mancur Olson, Jr., The Logic of Collective Action: Public Goods and the Theory of Groups (1965).

4. *See* THE FEDERALIST NO. 10 (James Madison).

5. *See* Edward J. McCaffery & Linda R. Cohen, *Shakedown at Gucci Gulch: The New Logic of Collective Action*, 84 N.C. L. REV. 1159 (2006).

tional actors will not pay for extreme improbabilities; and (4) action that would be long-lived or at least valuable enough to be worth paying for.

To help understand the perfectly rational calculations behind the Shakedown game, imagine some great force with the power to do evil or good. It can, for example, take away your first-born (a bad thing) or confer great riches on you (a good thing). The good/bad thing will/will not happen on two conditions. First, the orchestrator of the game rolls two dice, and they must come up snake eyes (double ones, a one in thirty-six chance). Second, the potentially affected actor has paid the game's leader to avoid the harm or get the goodies. In other words, on the off chance that this is the time that something will happen—snake eyes appear, meaning that this time Congress will act—you'd better have paid to play. If the stakes are high enough, rational people will pony up each time the game is played. People do play lotteries, repeatedly, after all.

For the estate tax, there are two opposing sides. The repeal of the tax would be a good outcome for the wealthy families in the tax's target range and a bad outcome for the financiers and others who benefit, big time, from the very existence of the tax and the planning it pushes many wealthy people to do. No matter what Congress does, at least two sets of players—billionaire families on the one hand and their estate-planning advisers and financial institutions on the other—will always be willing to play because of the estate tax's high stakes. The game has indeed been played many times in the case of estate tax repeal. And it will continue to be played as long as there remains a plausible reform for Congress to make—which is why permanent repeal will almost certainly never happen.

Let's back up, for the game is best understood over a wide lens of time. Beginning in the mid-1990s, the possibility of repealing the estate tax became plausible, with frequent introduction of the well-named Death Tax Elimination Act.[6] By the end of Bill Clinton's presidency, both the Senate and the House had, in fact, voted to repeal the tax, which was saved at the bell by Clinton's anticipated veto. Coming into George W. Bush's presidency in 2001, the death of the death tax seemed a mere formality, with Bush having campaigned for its elimination, more than sixty sitting Senators having voted to repeal it, and Republicans in charge of both the Senate and the House. Alas, a funny thing happened on the way to the funeral. The estate tax did not die. Not completely, anyway. Bush's signature legislative act, the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), gradually weakened the estate tax over a ten-year window that started in 2001 and repealed it in full for the year 2010, only then to bring it back, at pre-EGTRRA levels, in 2011.[7]

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6. *See id.* at 1202, 1207-09, 1214.

7. Pub .L. No. 107-16, tit. 5, subtits. a-b, 115 Stat 38, 69-70 (codified as amended at 26 U.S.C. §§ 2001, 2210, 2664).

Why did Congress do this? We can rule out the special interest model—the only special interest that "won" under EGTRRA was the group that knew with certainty it would die in 2010, a null set. (And even this class could hardly rely on the law staying intact as the decade unfolded.) Instead, EGTRRA set the stage perfectly for a continued playing of the Shakedown game, because it made repeal of the estate tax possible but not certain. And so, indeed, Congress voted on the estate tax many times in the ensuing decade, never quite getting the magical sixty votes needed in the Senate to actually do anything permanent. Meanwhile, money poured in. A study published after my and Professor Cohen's article found that eighteen families orchestrated a lobbying campaign between 1998 and 2004 that netted almost $500 *million* in reported contributions to kill the death tax.[8] There was far more where that came from, including from lobbyists for interests bent on *keeping* the tax. Nice work if you can get it—and Congress has the work and has determined to keep it coming.

Estate-planning practitioners and citizens presuming good faith lawmaking just *knew* that things would be clarified before 2010. Only they weren't. Congress was somehow unable to agree on any legislation to "patch" things over in 2009. As a result, 2010 got started with the no-estate tax regime provided for in EGTRRA for those lucky enough to die within the year, like George Steinbrenner. Congress considered retroactive fixes to restore some tax, but became concerned over the constitutionality of any such move. It isn't so much that Congress felt shy about passing an arguably unconstitutional law—it has done that before[9] and will again—as that a court challenge would tie up the fate of the estate tax in court and take power away from Congress. Instead, Congress enacted a law, the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (TRA 2010), that gave the estates of 2010 decedents a choice: either face no estate tax but higher taxable gains if assets are sold in the future, as EGTRRA provided, or accept a $5 million-per-person exemption and lower taxable gains.[10]

Where are we now, in 2012? TRA 2010 gave us a patch for 2011-2012 by providing for a $5 million-per-person exemption in 2011 (indexed for inflation to $5,120,000 in 2012) and a 35% tax rate on the value of assets transferred beyond the exemption. The current exemption is "portable" between spouses and so easily combines to $10,240,000 for a married couple. Furthermore, for these two years (2011-2012) the exemption level and rates apply to gifts and genera-

8. *See* CONOR KENNY ET AL., SPENDING MILLIONS TO SAVE BILLIONS: THE CAMPAIGN OF THE SUPER WEALTHY TO KILL THE ESTATE TAX 8, 14 (2006), *available at* http://www.citizen.org/documents/EstateTaxFinal.pdf. According to the report, the families leading the effort would have saved approximately $71.6 billion if the estate tax had been successfully repealed. *Id.* at 8, 11.

9. *See* United States v. Carlton, 512 U.S. 26 (1994) (holding that retroactive application of an estate tax amendment is constitutional and not a violation of due process).

10. Pub. L. No. 111-312, 124 Stat. 3296 §301(c).

tion-skipping transfers as well as to bequests. These are very high exemptions and high enough rates to motivate suitably rich folks—such as the founders of Facebook—to take steps today to avoid or minimize their taxes forever.[11]

As with EGTRRA, however, TRA 2010 is set to expire. Without further legislative action, this would thrust us back to a $1 million exemption level and 55% tax rate starting January 1, 2013. Practitioners, many convinced by a logic that says Congress never does *anything*, are fretting about a return to an onerous estate tax, and advising clients to take action now, in case the sky falls.[12] The fallacy in the logic is that Congress indeed does not act *when tax rates will go down by inaction*, but it does manage to act *when tax rates will go up by inaction*. Hence the failure to act in 2009, allowing for a one year repeal, but the action late in 2010, precluding 2011's return of the strengthened estate tax empire. A parallel story played out for President Obama's payroll tax cut at the end of 2011.[13] In any event, the *fear* of significant action—a return to an onerous estate tax or the tax's repeal—is plenty to get another round of the Shakedown game going.

Still, some observers seem to think that we are set up for a nice round of "class warfare" heading into the 2012 presidential election, with President Obama and the Democrats holding out for a vigorous estate tax to restore meaningful equality to America and Republican nominee Mitt Romney and the Republicans preaching trickle-down economics and calling for an end to the bloody thing. I say "fat chance" to either outcome.

On the Democratic side, even Obama is comfortable with the 2009 levels, a $3.5 million exemption per person and a 45% tax rate.[14] That's more than enough to make the tax avoidable, at least for almost all Americans, including many Facebook insiders.[15] And neither Obama nor any other Democrat is go-

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11. *See* Laura Saunders, *How Facebook's Elite Skirt Estate Tax*, WALL ST. J., May 11, 2012, at B9, *available at* http://online.wsj.com/article/SB10001424052702304543904577395971333422002.html.

12. *See* Bill Bischoff, *Preparing for 'Taxmageddon,'* SMARTMONEY.COM (May 23, 2012, 12:27 PM), http://www.smartmoney.com/taxes/income/preparing-for-taxmageddon-1337724496427.

13. In December 2011, when the payroll tax cut was set to expire, Congress managed to extend the tax cut for two months and later extended it to the end of the year. Mark S. Smith, *Obama Signs Payroll Tax Cut Extension into Law*, HUFFINGTON POST (Feb. 22, 2012, 8:16 PM), http://www.huffingtonpost.com/2012/02/22/obama-signs-payroll-tax-cut-extension_n_1295208.html.

14. *See* OFFICE OF MGMT. & BUDGET, FISCAL YEAR 2013 BUDGET OF THE U.S. GOVERNMENT 4 (2012), *available at* http://www.whitehouse.gov/sites/default/files/omb/budget/fy2013/assets/budget.pdf.

15. *Cf.* George Cooper, *A Voluntary Tax? New Perspectives on Sophisticated Estate Tax Avoidance*, 77 COLUM. L. REV. 161, 169, 207-08 (1977) (showing that even with the estate tax exemption level at $175,000 for a single person with a top tax rate of 70%, those so motivated could easily escape the tax). I later updated and generalized Cooper's analysis. *See* Edward J. McCaffery, *A Voluntary Tax? Revisited*, 93 NAT'L TAX ASS'N PROC. 268 (2001).

ing to call for a *stronger* tax, for the simple reason that he or she would be tarred and feathered by the upper-middle class mobs who, in a time of falling stock markets and evaporating home equity, would suddenly be hearing from every business reporter that they just *had* to go see a lawyer or other planner to avoid this deadly tax.[16]

Why not just repeal the tax then, as Republicans have been seeking for *decades* by now? Because if that ever happened, the spigot would turn off, and the money from campaign contributions would dry up. It is important to understand that TRA 2010 had a very big winner—the financiers who perpetuate "Dynasty" and "Perpetual" trusts. A 2005 study estimated that such trusts held roughly $100 billion in assets, mainly in South Dakota, an early mover in eliminating the rule against perpetuities (okay, so some good might be coming from this story).[17] These trusts are set up to limit distributions and to last for a very long time. Who benefits? For one, a very large class of trust companies and other financial intermediaries.[18] Take a small piece of that enormous pie (say, 1% or 0.5% per year) in fees for assets under management, then lock the underlying assets up into perpetuity, and you will do very well for yourself. The increase in the current gift tax exemption to $5 million greatly helped this group of financiers. Wealthy families, like those of the Facebook founders, can get the dynasty-trust game going *now*, using their families' $5 to $10 million in exemptions. The rich setting up dynasty trusts are willing to pay their advisers for the privilege of avoiding transfer taxes forever. Those advisers and financial intermediaries, in turn, are willing to pay Congress to keep the fear of a death tax—and hence their lucrative business model—alive (forever). Congress is happy to cash the checks.

On the estate tax, then, it is easy to predict what will happen: not much. We will not see a return to year 2000 levels, and we will not see repeal. The one cautionary note I must add is that, going back to the game, *something* has to happen *sometime*, or the parties paying Congress and lobbyists will wise up and stop paying to play. But that has not kicked in yet, decades into the story, and it may not kick in until more people read this Essay, and start to watch the watch-

16. Obama does not want the estate tax to affect the upper middle class, but rather for it to target extremely wealthy citizens like Warren Buffet. Obama has stated, "There's a mid-level proposal that would exempt most – almost all family farms and nevertheless would still hit folks like Warren Buffet . . . ." Adam Aigner-Treworgy, *Obama Talks Estate Tax at Final Bus Tour Stop*, CNN THE 1600 REPORT (Aug. 17, 2011, 9:04 PM), http://whitehouse.blogs.cnn.com/2011/08/17/obama-talks-estate-tax-at-final-bus-tour-stop/.

17. *See* Max M. Schanzenbach & Robert H. Sitkoff, *Perpetuities or Taxes? Explaining the Rise of the Perpetual Trust*, 27 CARDOZO L. REV. 2465, 2467-68 (2006) (citing Robert H. Sitkoff & Max M. Schanzenbach, *Jurisdictional Competition for Trust Funds: An Empirical Analysis of Perpetuities and Taxes*, 115 YALE L.J. 356, 404 & n.125 (2005)).

18. *See, e.g.*, WILMINGTON TRUST, A WINDOW OF OPPORTUNITY: HARNESSING THE POWER OF A DELAWARE DYNASTY TRUST (last visited Aug. 4, 2012), http://www.wilmingtontrust.com/repositories/wtc_sitecontent/PDF/Window_of_Opportunity.pdf.

dogs. Fat chance of that happening, too, I suppose. In the meantime, without a meaningful wealth-transfer tax (the gift and estate taxes raise a very minimal amount of revenue and may even lose money when the income tax savings of standard estate-planning techniques, such as charitable and life insurance trusts, are taken into account), one fundamental insight of the special interest model continue to obtain. Big groups with small stakes—that is, most of us—continue to pay through increasingly burdensome middle class taxes for most of what government does, including stringing along those "lucky" enough to be members of a special interest group. It's a variant of a very old story, and it is time to stop keeping it secret.