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Through the Looking Glass: The Politics of  
Estate Tax Reform

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# Through the Looking Glass: The Politics of Estate Tax Reform

Edward J. McCaffery

## **Abstract**

This brief article summarizes an argument that the estate tax reform or repeal debate has always been about money: but not the government's money from the tax, which is modest at best, but the politicians money from campaign contributions elicited to retain or repeal the tax. The article uses that theory to predict likely short term legislative developments.

## Through the Looking Glass: The Politics of Estate Tax Reform

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Here we go again. Trusts and estates practitioners sleep anxiously, uncertain of what Washington will do next to affect the centerpiece of their professional lives: the gift and estate tax. Repeal or repair? Stronger or weaker? Whither the law?

As we lose sleep over these questions and write or read articles like this one, we ought to bear in mind that we have been down this path before. Many times. The past decade, centered around 2001's EGTRRA law that gave us gradual weakening and then the single-year repeal in 2010,<sup>1</sup> saw multiple votes to abolish estate taxation. When a simple elimination of the tax seemed to lose appeal, we saw a flirtation with a radical rate reduction, to 15%, combined with a stepped-up basis that would, in essence, give us a capital-gains-on-death law, much like Canada, of all places.<sup>2</sup> Widening the lens a bit, the decades before the present one saw frequent, major changes to the estate tax – unification of the gift and estate taxes in the Tax Reform Act of 1976, introduction of the unlimited marital deduction in 1981's ERTA,<sup>3</sup> generation-skipping taxes from 1986's TRA,<sup>4</sup> and

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<sup>1</sup> Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, 115 Stat. 38 (codified as amended in scattered sections of the I.R.C.).

<sup>2</sup> See Joel Friedman, *Estate Tax "Compromise" With Fifteen Percent Rate Is Little Different From Permanent Repeal, Center on Budget and Policy Priorities*, May 31, 2006, available at <<<http://www.cbpp.org/cms/?fa=view&id=338>>>. Indeed, if the law introduced by Senator Kyl (R- AZ) added a "basis offset," it would in fact give us capital gains at death: (fair market value – basis) x .15.

<sup>3</sup> Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172 (codified as amended in scattered sections of the I.R.C.).

the anti-estate freeze legislation of OBRA in 1990.<sup>5</sup> The only thing certain seems to be uncertainty.

It is tempting to see all this as a story of Good versus Evil. Well-meaning technocrats try to keep pace with big bad wolves of rich people and their advisors devising ever more clever ruses to escape the legislatively decreed marriage of death and taxes. Like all fairy tales, that would be more false than not. A deeper, more reflective look at the landscape of the estate tax shows that something important has held steady throughout the years. It's one of the oldest professions: making money. Money is at the root of all estate tax reform. The key, however, is to consider not the *government's* money, for the gift and estate taxes have long been small change at best in the federal fisc,<sup>6</sup> but rather the *politicians'* money. Estate tax repeal or reform debates have been good for the business of being an elected official. The insights gained from considering the role of money in the political process have been remarkably helpful to me in navigating through the past decade. Yet I have found in my academic work and various speaking engagements around the country that people cynical about politics in general are remarkably naïve

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<sup>4</sup> Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (codified as amended in scattered sections of the I.R.C.).

<sup>5</sup> Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, 104 Stat. 1388.

<sup>6</sup> For example, gift and estate taxes have long accounted for roughly one-fourth to one-fifth of the category of "other receipts" in the federal budget. This entire category has never accounted for more than 1% of GDP since the 1930s, and typically accounts for one-tenth or less of what the income tax does. Customs duties and fees and "miscellaneous receipts" from "federal reserve deposits" continue to exceed the gift and estate tax as a source of revenue. OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, HISTORICAL TABLES, BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 2009 (2008), Tables 2.3 and 2.5. And the gift and estate tax figures are gross. One scholar has speculated that the very existence of the tax costs the government tax revenue, because the kinds of planning devices used to avoid it – such as insurance and charitable trusts – cost the government *income* tax revenue. B. Douglas Bernheim, *Does the Estate Tax Raise Revenue?*, in 1 TAX POLICY AND THE ECONOMY 113 (Lawrence Summers, ed., 1987). By any light there is not much revenue generated for the government from the tax.

about their own fields. So here, again, is my basic advice on predicting the course of estate tax reform: Follow the money.

A word on my conversion experience: I began writing against the gift and estate tax some fifteen years ago, as a matter of principle.<sup>7</sup> I believe that a consistent progressive spending tax is a better tax – and a better way to get at concentrations of wealth and second and later generations – than what we have now.<sup>8</sup> I came to see that that argument, like sales of my books, was going nowhere. Politicians are, in fact, not all that interested in redistributing wealth. Ask President Obama about Joe the Plumber.<sup>9</sup> Then I had my great epiphany. Estate tax reform was about money – but not the government’s money, as more naïve commentators seem to think in the fairy-tale version of the story. It’s about the politicians’ money, stupid.

Let’s step back a bit. In crafting our Constitution, the founders worried that majorities would gang up on minorities: the concern of Madison in *Federalist No. 10*. In large part due to the genius of that founding document, that has not really happened. Indeed, the rather weak gift and estate tax is highly unpopular, suggesting that majorities do not always, in fact, even attempt to soak rich minorities. Mancur Olsen came along in 1965 with a new view of politics, *The Logic of Collective Action*.<sup>10</sup> Olson pointed out that organizing to get government benefits is costly. Potential members of a group have an

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<sup>7</sup> Edward J. McCaffery, *The Uneasy Case for Wealth Transfer Taxation*, 104 YALE L. J. 283 (1994).

<sup>8</sup> See e.g., EDWARD J. MCCAFFERY, FAIR NOT FLAT: HOW TO MAKE THE TAX SYSTEM BETTER AND SIMPLER, (2002).

<sup>9</sup> See Edward J. McCaffery and James R. Hines, *The Last Best Hope for Progressivity in Tax*, working paper, available online at <<[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1380602](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1380602)>>.

<sup>10</sup> MANCUR OLSON, THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS (1965).

incentive to sit on the sidelines and “free ride” while others do the work – and pay the costs. What kinds of groups could solve the collective action problems? Small groups with high stakes was Olson’s simple answer. What Olson called pressure groups have come to be known as “special interests.” Now everyone, from politicians to pundits, rues them.

Using the estate tax as a case study and working with a political economist friend, Linda Cohen, I developed what we call the “reverse Mancur Olsen phenomenon.”<sup>11</sup> In our view, politicians do not rue special interests at all. They like them, in fact, because they like money. Nor do politicians, having both a like for money and considerable power, sit around passively waiting for special interests to form somewhere out there on the hustings. Instead, politicians proactively create or frame issues of high stakes to small groups. Once they have them, they have little interest in finally resolving them. They string the issue along, milking the golden goose for all it is worth to get multiple bites at the apple – to mix as many metaphors as I can in one sentence. Whereas in the special interest story, special interests come first, and are the predator to politicians’ prey, in our story it is the reverse: politicians come first and act as predators. The last thing you want is to be a member of a special interest known to Congress.

Estate tax repeal was a perfect case study. Here was an issue of high stakes to small groups, with at least two sides. This latter fact was important to keep all politicians from bunching together on one side of the issue and actually getting something done. Rich

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<sup>11</sup> Edward J. McCaffery and Linda Cohen, *Shakedown at Gucci Gulch: The New Logic of Collective Action*, 84 NORTH CAROLINA L. REV. 1159 (2006). See also Edward J. McCaffery, *A Look Into the Future of Estate Tax Reform*, TAX NOTES, Nov. 15, 2004.

families would pay to get rid of the tax; investment banks, insurance companies, large nonprofits and others would pay to keep it. No matter what happened – as long as there were brinksmanship votes – there was money to be had. And so, we predicted, Congress would vote on the matter over and over, avoiding as much as they could final resolution. To keep the game going, action had to be plausible, and might even one day occur. Doubt this? Ask yourself how many times you, personally, or one of your friends in the profession shuddered to think that today was going to be the day the estate tax died. Why would sophisticated people pay to play under such conditions? Think of it like a game where some good or evil genie rolls the dice. If they come up snake eyes (double ones), something really good (estate tax repeal, to wealthy families) or bad (estate tax repeal, to financiers) will happen to you. If not, nothing happens. The rub is that the good thing will happen, or the bad thing will not, if the dice say so, but *only if* you have paid to play. If the dice come up right, and you have not paid to play, you could lose, big time. With the stakes high enough, you would, quite rationally, pay a great deal to play such a game.

We titled our article *Shakedown at Gucci Gulch*, echoing the journalistic account of the Tax Reform Act of 1986 as a heroic stare down of lobbyists by bipartisan legislators – another fairy tale.<sup>12</sup> The shakedown story explains a great deal, more than the naïve special interest one. To begin with, consider the structure of EGTRRA itself. Coming into the legislative session, there were enough votes for permanent repeal of the estate tax. There were ample resources in the 1.3 trillion dollar surplus left for the incoming

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<sup>12</sup> JEFFREY H. BIRNBAUM AND ALAN S. MURRAY, SHOWDOWN AT GUCCI GULCH: LAWMAKERS, LOBBYISTS, AND THE UNLIKELY TRIUMPH OF TAX REFORM (1987). For a critical commentary on the work, very much in the spirit of *Shakedown*, *supra*, see Richard L. Doernberg and Fred S. McChesney, *Doing Good or Doing Well? Congress and the Tax Reform Act of 1986*, 62 N.Y.U.L. REV. 891 (1987).

President George W. Bush, who had sworn death to death taxes repeatedly on the campaign trail. But instead of repeal, we got the bizarre structure of EGTRRA – very gradual weakening until 2010, when the tax disappears altogether, only to be brought back at pre-EGTRRA levels in 2011. Now ask yourself this, dear reader: if the traditional “special interest” story were in play, who won under EGTRRA’s strange result? The answer is people who knew with certainty that they would die in 2010 – and even they could hardly count on the law’s staying intact. That is, like sensible lawmakers, a null set. What EGTRRA did – and it did it beautifully – was to *guaranty* that there would be more votes on repeal or reform. It also made flat-out repeal a very viable option. It kept the spigot of campaign contributions running; indeed, it opened the spigot considerably wider than it had been before.

Two, consider the pattern of votes post-EGTRRA – over and over, coming up just short of the 60 needed for outright repeal in the Senate. As Professor Cohen and I chronicle at length in *Shakedown*, this was not because there were simply not the votes to repeal the tax. There were. Far more than 60 sitting Senators on multiple occasions had voted to repeal – but not at the same time. Senators, including many prominent Democrats, simply flipped back and forth, keeping the drama alive – and, yes, the spigots running.

Still not convinced? If we are going to follow the money, let’s do it. How’s this for a fact, unearthed after we published *Shakedown*. According to a study published by the pro-estate tax groups Public Citizen and United for a Fair Economy, a group of eighteen families, spending at least 27.7 million dollars of their own money, orchestrated a

lobbying effort between 1998 and 2004 that totaled almost 500 million dollars.<sup>13</sup> Compare that to your billings over the same time period. What about the other side? It is hard for an academic like me to track down campaign expenditures, well hidden by sophisticated actors. Simply consider that, by 2003, in large part as a direct result of the GST tax, some 100 *billion* dollars worth of assets had moved into dynasty trusts, largely in South Dakota.<sup>14</sup> Even a small piece of that enormous pie as fiduciary or other fees for assets under management would give some small groups high stakes to keep the estate tax alive.

Now, to the point: predictions. What does all this say about the future of estate tax reform as we sit here today, anxiously not sleeping? The *Shakedown* story does not, by its own terms, lead to precise predictions. It turns on the possibility but low probability of major change. If change were sure to happen or not, people would wise up and not pay. There must be some risk. That said, fools rush in, and *Shakedown* has helped me to be a pretty accurate fool over the past decade while my friends in the profession sweated things out. So here goes.

One, we will not get repeal. This was never terribly likely – Congress could have done it in 2001, when there was a huge surplus, or at any of several times thereafter. (Professor Cohen and I discuss a moment when the “Byrd Rule” had expired, such that Republicans could have killed the estate tax with 50 votes in the Senate – but they quietly renewed the

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<sup>13</sup> PUBLIC CITIZEN AND UNITED FOR A FAIR ECONOMY, SPENDING MILLIONS TO SAVE BILLIONS: THE CAMPAIGN OF THE SUPER WEALTHY TO KILL THE ESTATE TAX. April 2006.

<sup>14</sup> Robert H Sitkoff and Max Schanzenbach, *Perpetuities or Taxes? Explaining the Rise of the Perpetual Trust*, 27 CARDOZO L. REV. 2465 (2006).

Byrd Rule instead.<sup>15</sup>) Congress is not going to kill the tax now, with mounting deficits and a solid Democratic majority. And they never really wanted to do it in any event. Estate tax repeal, under the Shakedown story, was always about *possibly* doing it, not really doing it.

Two, we may not get final action in 2009. The trusts and estates practitioners I talk with almost always assume something will happen this year – it *has to*, right? Not right. Fixing the one-year repeal before it becomes effective would be good lawmaking. But this is not about good lawmaking, remember? The thought that things must happen will drive one or more brinksmanship votes before year end. My sources inside the Beltway, however, who of course never want to be named, tell me that Congress could well wait and do something in 2010, with a retroactive effective date. Then the concern will not be over repeal, but the return of the much higher estate tax in 2011, so the nature of the brinksmanship votes would shift. That would be crazy, you protest. See EGTRRA, I respond.

Three, expect the ultimate compromise to feature relatively lower exemption levels and higher rates than some estimates would have them be. Why? Because this brings the game back sooner. Note that this has been the longstanding trend in estate tax reform: raise exemption levels, keep rates high. This is the precise *opposite* of the decades-long trend in income tax reform, where we have seen base broadening and rate lowering. What we do in the income tax, at least in that regard, is sound economics: wider bases and lower rates are less distorting. But in part because the estate tax is marginal in its revenue

<sup>15</sup> *Shakedown, supra*, at 1215-16

significance, its reform has never been about sound economics. Higher exemption levels and rates preserve the *Shakedown* game: they keep the estate tax a matter of high stakes (because of the rates) to small groups (because of the exemption levels). So the game continues. Expect the 2009 levels of 3.5 million per person and 45% rates to hold; as we recover from the current economic hard times and more families exceed those numbers, we can have another round of votes on estate tax repeal.

Four, also expect there to be what I call “legislative tinkering,” as we had seen every decade before the present one. Repeal became a viable option by the middle 1990s, and it has dominated the politics of the estate tax ever since. Some – temporary – end to the repeal movement will reopen the doors to business as usual, which is legislative tinkering. Now we are going to get that, in part for the campaign contribution story, but also in part for another side of money – the politics of budgeting.<sup>16</sup> Government now, like public corporations, has to make its numbers. There is thus a reality to budget projections. So expect some movement on fractional share discounts, as with a “family attribution” rule like I.R.C. § 318. Why? Because it is easy to *say* that such a provision will raise vast sums: simply assume that every one keeps using the same planning techniques as they are now, but without discounts, and voila, we have a vast increase in gift and estate taxes. I doubt it. The history of gift and estate tax repeal is full of unintended consequences. For but one example, the introduction of a brave new generation-skipping transfer tax in 1986 “simply” led to the repeal of the rule against perpetuities and the rise of dynasty trusts – which when combined, create a massive tax-

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<sup>16</sup> See generally, ELIZABETH GARRETT, ELIZABETH A. GRADY AND HOWELL E. JACKSON, EDITORS, *FISCAL CHALLENGES: AN INTERDISCIPLINARY APPROACH TO BUDGET POLICY*, 2008.

saving device.<sup>17</sup> So much for raising revenue by closing loopholes. The fact is that the estate tax as a percent of GDP has held steady for decades, notwithstanding various legislative attempts to tighten the regime. So two sub-predictions follow here: One, expect there to be politicking, by which I mean money, around any major legislative initiative. Two, expect the profession to adjust and come up with planning techniques in light of the changes.

Five, a quick prediction about “portability,” allowing a surviving spouse to use her deceased spouse’s unused unified exemption level. Now I personally think that this is simply a good idea: it removes the unfairness of penalizing some families for not planning in advance of a first, perhaps tragically early, death. So my prediction is that this probably won’t happen. Why? Because there is no obvious money in it. Who would pay to get the provision? The wealthy families spending tens of millions on repeal clearly don’t care. Financiers and practitioners might fret, in good faith or not, that portability means less and shorter-term planning, and hence less and less lucrative business. Where’s the money? The first article I ever published as an academic in, gulp, 1990, was titled *The Holy Grail of Tax Simplification*.<sup>18</sup> I’m still waiting on that one. Good faith sensible reform of the gift and estate tax is also a highly endangered species, I fear.

Six, and finally: come back in five to ten years. Politicians have found a lucrative game, in the estate-tax-repeal-or-reform drama. Expect their memories for such games to be as long as their desires for cash.

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<sup>17</sup> See Sitkoff and Schazenbach, *supra*.

<sup>18</sup> Edward J. McCaffery, *The Holy Grail of Tax Simplification*, 1990 WISCONSIN L. REV. 1267.