
A Voluntary Tax? Revisited
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Edward J. McCaffery

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University of Southern California Law School
Los Angeles, CA 90089-0071

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A Voluntary Tax? Revisited

Edward J. McCaffery

University of Southern California Law School

California Institute of Technology

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Abstract

This Article explains, updates and generalizes Cooper (1979), which had labeled the estate tax a voluntary tax. The tax has remained “voluntary” in the sense of being easily avoidable, even by those engaging in activities within the tax’s ostensible normative target (i.e., significant intergenerational wealth transfers). Further, all taxes on the yield to capital are voluntary in this sense. The federal tax system, writ large, is increasingly a wage-based tax. Citizens who own large stores of capital can live – and die – tax-free using common tax planning techniques. These facts ought to call the normative justification for the status quo, including the estate tax, into question. A consistent progressive cash flow tax – without a separate estate tax – is a far better, more consistent tax on both the yield to capital and inheritance than is the present, highly flawed, income plus estate tax.

1. Introduction

I have been writing about – mostly against – the gift and estate tax for some time now.

McCaffery (1994a and b), (1996), (2000). I welcome this opportunity to clarify my position and advance some of my arguments yet again, a bit further, and to a sophisticated economics audience.

Most academic writing on the gift and estate tax (which I hereafter shorten to the “estate tax”) suffers from at least two defects. One is the failure to take into account the real-world estate tax system, as opposed to the abstract idea or ideal of estate taxation. Arguments such as that we need an estate tax to level the proverbial playing field or to break up large concentrations of wealth proceed without a deep consideration of whether the actual estate tax does either of these things, or does them well. Two, scholars tend to view the estate tax in isolation from the broader tax system or — what is worse — to take that broader tax system as fixed and immutable when analyzing the estate tax. Supporters thus laud the estate tax as the most progressive tax, or as an indispensable “back up” to the income tax and its failure to capture all or much of the yield to capital among the living, without considering whether or not these praises of the estate tax ought best be recast as condemnations of other taxes.

Louis Kaplow (2000) has recently noted the latter problem, and attempted to generate an economic, classically utilitarian framework for analyzing the estate tax within the broader context of all taxation. Kaplow’s analysis explicitly draws on the optimal tax tradition of welfare economics. This is not my preferred framework for answering all of the normative question of

tax, perhaps especially those raised by estate taxation,¹ but Kaplow's work is nonetheless quite generally helpful in sketching out a range of issues to be considered, and in particular for situating analysis of the estate tax in a wider context of tax. Efficiency matters. Kaplow's work also proceeds from what I take to be the best form for tax policy scholarship, a point to which I return in the Conclusion.

The classic exposition of the former problem — of the gap between the estate tax as it appears in scholarly discourse and as it really is — is George Cooper's 1979 volume, commissioned by the Brookings Institution, and from which I take the title of this essay. Cooper surveyed estate tax planners and practices, and concluded that sophisticated and fully legitimate avoidance techniques were widely known, readily available, and potentially powerfully effective. These were conclusions that called — or should have called — just about any plausible justification for the tax into question.

In this brief essay I update and then generalize Cooper's observations; point out that the actual estate tax in the context of the wider tax system is not well connected to any appealing normative justification for it; and conclude by arguing that the goals asserted by estate tax proponents might best be met in a tax system without an estate tax.

2. The Voluntary Tax, Then and Now

The estate tax has become even more voluntary since Cooper's book appeared. When that analysis began, before the Tax Reform Act of 1976 was fully phased in, the exemption level

under the gift and estate tax was \$60,000 per person, \$120,000 for a married couple, and the annual exclusion under the gift tax was \$3,000 per donor per donee. The equivalent values are now \$675,000 (on its way to \$1,000,000 by 2006, thereafter indexed for inflation) per person; \$1,350,000 (\$2,000,000) per couple; and \$10,000, indexed. Marginal rates, still high at a maximum 55%, are actually lower than they were in the 1970s. See generally Joulfaian (2000a) for helpful background on the history of estate tax reforms. As I write this, further weakening of the tax is a near political certainty, and outright repeal is a distinct possibility.

While certain kinds of estate tax minimization techniques discussed by Cooper have been curtailed or, in some cases, eliminated, as under the new generation-skipping transfer tax rules or the anti-estate freeze provisions,² others have arisen to replace them — just as Cooper predicted. Cooper (1979) at 11. The history of the estate tax suggests that whenever its burdens get too high as a percent of GDP, avoidance techniques flourish and legislative weakening is forthcoming. Much the same can be said for the income tax. Indeed, this phenomenon is so common that it would suggest a fiscal political law — taxes quickly rise to the maximum level the public will bear and then persist at that level — were it not for the striking case of the federal payroll tax system, which has only seen increases in its sixty some odd year history, a pattern at little risk of reversing itself. McCaffery (1994c).

In any event, relatively standard valuation discounts, typically used in conjunction with family limited partnerships, have cut the effective rate of estate taxation, for those who do pay it, far below its nominal 55% rate. Sullivan (2000a), Poterba (2000). There is little reason to believe

that more dramatic avoidance isn't at least as common as it was at the time of Cooper's study, although pinning this down can be difficult. Gale and Slemrod (2000), Shackleford (2000). One among many examples is a new and disturbing trend towards "dynastic trusts." Hirshey (2001). These thoroughly modern creatures are typically funded with the \$1,000,000 per donor exemption from generation-skipping transfer taxes. This value is placed into a trust of potentially infinite duration. This is possible because many states (eight as I write this, and the number is growing) — each in the last few years — have abandoned the hallowed Rule against Perpetuities simply to make such long-lived vehicles possible. What generations of perplexed law students could not undo, a new generation of the very rich has torn asunder. Anyone who doubts the interest of at least some rich in avoiding taxation while passing on wealth should pay heed to such trends; the miracle of compounding interest will assure that we have some very large concentrations of wealth, indeed, within a century or two.

Of course, people do continue to pay estate taxes, as the continuing and not insignificant yield of the tax proves readily enough. This suggests that the tax is constraining on the *very* rich and/or that some persons are not highly motivated to evade it, whether out of ignorance, indifference, or the surprise of an early death. I suspect that both factors hold to some extent, although it bears noting that Cooper stressed the latter: it *is* after all possible to avoid the tax, even for very wealthy individuals, if they want to do so. Cooper's analysis here bears revisiting.

A continued theme in the academic literature on the estate tax, heightening of late, is the call for more empirical analysis. In fact, there has been a proliferation of such analysis — fueled no doubt

by the suddenly real prospects of significant legislative change or outright repeal of the tax – in the last few years, with many articles in this *Journal* among others, and with several conferences and attendant conference volumes on point. Slemrod (2000). Gale, Hines & Slemrod (forthcoming). Joulfaian (2000b). This work has been important and helpful in understanding the tax and its aggregate economic effects. There are reasons, however, to be skeptical that such empirical analysis will ever definitively answer all, or even the most important, questions to be asked. A large problem is that the “super rich” people within the estate tax’s shadow are too few, and the data needed to study them too unavailing, to make much headway in answering practical questions. Holtz-Eakin (1996), Alm and Wallace (2000), Sullivan (2000).

It helps to look to the real world.³ People with experience advising the rich well know that some are more or less oblivious to the estate tax, even viewing it as a good thing — these are the willing or “voluntary” estate taxpayers. But others are dead set against the tax. As Cooper wrote of his survey, “In the words of one lawyer, his clients would ‘stand on one ear, wiggle four toes, and disavow their families to save \$20 in taxes.’” Cooper (1979) at 7. Attend any of the many annual national institutes on sophisticated estate planning, or read any issue of the many monthly journals devoted to the same, and there can be little doubt that at least some rich people go to at least some fairly extreme lengths to avoid the tax. This sense of the real world — that it is divided among the non- and the highly estate-tax averse rich — is consistent with both the observed yield of the tax and the continued existence of the sophisticated estate tax planning cottage industry. It is also consistent, of course, with the trend of increasing wealth inequality in this country. Wolff (2000).

In any event, the estate tax's persistent yield has led some commentators to suggest that it might not be such a bad tax. Indeed, economically-minded commentators point out that literally voluntary taxes are efficient. This is true as far as it goes — a truly voluntary tax will fall only on those presumably low-elasticity types unmotivated to escape it, although there would still be efficiency effects, as on those who take steps to avoid it, and on the recipients of wealth. Kaplow (2000). But on closer inspection, the argument for voluntary taxes as efficient taxes doesn't go very far. *All* real world taxes — academic niceties such as lump sum, capitation, or faculties taxes aside — are in some sense voluntary. What exactly did Cooper mean by the term?

Real world taxes are conditioned on the taxpayer's engaging in some activity being taxed. A true income tax is conditioned on the voluntary act of earning income; a consumption tax on the voluntary act of consuming, and so forth. The voluntary nature of the estate tax turns on the act (or fact) of leaving a sizable net estate on death. Cooper's point was that the tax is *not* conditioned on what one might think it ought to be — on the fact of passing on wealth to one's heirs. Anyone so motivated could plan to pass on extremely significant amounts of wealth without paying the tax, a fact as true today as then. The estate tax might better be called an "avoidable tax," for the key variable for many wealthy people is simply whether or not they want to pay it. Neither those who want to spend their wealth on themselves and die broke (the easiest and surest way to avoid the estate tax), nor those who want to pass wealth on to others need pay the tax. But because all taxes are in some sense avoidable, too — you can avoid an income tax by not earning income, and so forth — we might best call the estate tax an "optional," or even a

“gratuitous” tax, for it is possible to have your cake (wealth) and eat it, yourself or vicariously, too.

3. Beyond the Estate Tax

I mean now to extend Cooper’s insight. The entire federal tax system has become voluntary, in just the same sense that the estate tax is, for those with capital.

Much academic writing still centers on the income versus consumption tax debate, arguing about the ideal tax base. This literature has noted, of course, the equivalence of the two forms of consumption tax, pre- and postpaid, given a constant rate of tax and the lack of windfall, infra-marginal returns to capital disproportionate to the net amount invested. McCaffery (1992). But the actual “income” tax system is in fact a complex and increasingly incoherent mixture of different tax models: income, pre- and postpaid consumption taxes. The still standard academic approach has failed to focus on the fact that the *timing* of tax — when, in a taxpayer’s flow of funds, the tax gets levied — might matter more than the tax’s base per se for decisions about the ideal or practical level of progressivity in the rate structure.

The reason this matters is that the canonical classification gets rearranged when looked at with time in mind. The standard view (with the two assumptions noted above) is to equate both forms of consumption tax, prepaid or yield-exempt and postpaid or cash-flow, to see each as a single tax on earnings and neutral as between present and deferred consumption, and to set both against an income tax with its “double” tax on wealth that is saved. Looked at through the lens of

timing, however, an income tax and a prepaid consumption tax each stand on the same side of a divide: both are taxes on in-flows. A postpaid consumption tax, in contrast, stands on the other side: it is a tax on outflows. If we are going to have progressivity — as all adherents of an estate tax want, to some degree — this matters. The equivalence of pre- and postpaid consumption taxes gets destroyed by variable and progressive marginal rates; we face a question of when we want to levy progressive taxes. As I have consistently argued in my work, the moment of ultimate private preclusive use is a better time — for normative as well as political and pragmatic reasons — to make decisions as to the appropriate rate structure.

But the present tax system, broadly conceived, goes the other way: It is in essence a prepaid consumption or wage tax. Wage earners are taxed heavily, consumers out of capital are not. One can see this in considering the payroll tax system, Mitrusi and Poterba (2000), combined with the ability to avoid taxes on the yield to capital under basic income tax planning. Gordon and Slemrod (1988), Shackleford (2000). Payroll plus income taxes fall on wages, highly burdening labor income — and the law has actually and dramatically improved its ability to prevent the sheltering of wage income, as in the Tax Reform Act of 1986's passive activity loss rules and elimination of unlimited interest deductions.⁴ Meanwhile, the taxation of any yield to capital is a scattershot affair, categorically exempt from payroll taxation and typically burdened by no more than a deferred, and low, capital gains rate.

Now, as with the estate tax, people do indeed pay capital gains taxes. Auerbach et al (2000), Gravelle (2000), Eichner and Sinai (2000). But they need not. These taxes are optional or

gratuitous in just the way that the estate tax is: they can be avoided without impinging on one's abilities to earn further capital "income" or to engage in present consumption. Once again, it is possible to have one's cake and eat it, tax-free, too. That people pay tax on the yield to capital only shows that some taxpayers are not motivated to avoid paying it.

I teach my law students what I call Tax Planning 101 on the very first day of class, right after we have discussed *Eisner v. Macomber*.⁵ It is elegantly simple, consisting of three basic steps:

- Buy,
- Borrow,
- Die.

The rub, of course — an annoying one to my students, about to embark on long careers as hard working, high earning wage earners — is that you have to have property to play the game, and you can no longer effectively borrow to get it started. A taxpayer with property or capital can purchase investment assets such as stocks; hold his winners and sell his losers; borrow against the appreciation to finance expenditures — and pay no tax. By no tax, I mean no tax: No payroll, no income, no estate taxes. The proceeds of debt can be used to finance one's own or other people's consumption, the latter through gifts. In either event, there is no estate tax if the game is played out to perfection, because there is no net estate: one has borrowed down his net wealth. The heir can take the assets with the fabled stepped-up basis for assets transferred on death,⁶ sell them for no tax, and pay off the decedent's debts. Voilà.

Transaction costs, risk aversion, relative indifference — and relatively low capital gains rates — keep many from taking Tax Planning 101 to its limit. But the financial marketplace is getting increasingly sophisticated about helping taxpayers to do so, both through relatively simple devices such as better and more complete annuities, and also through more complex mechanisms such as swap funds, “cuffs,” and “collars” that help the taxpayer so motivated to diversify her portfolio without realizing gains. Shackleford (2000). Cooper or anyone else could today write a sequel to the initial Voluntary Tax text, now subtitled, more simply, “New Perspectives on Sophisticated Tax Avoidance.”

4. A Tax without Reasons?

It is the very possibility of tax avoidance — coming out of the structural properties of the hybrid income/consumption plus estate tax — that concerns me, not so much the aggregate effect on work or capital formation. Ironically, both capital taxation generally and the estate tax more particularly might not be all that inefficient, because their very avoidability mitigates whatever labor or savings disincentives they might have. The greater inefficiencies are more likely to be driven by transactions costs — the costs incurred by people, in the form of professional fees but also, and probably more importantly, encumbered forms of ownership, in avoiding the taxes. With the high tax rates of the estate tax, these transaction costs can be high indeed: a tax averse rich person would pay a lot to avoid more than half of his estate being turned over to the government on his death. This is, of course, an estate planner’s dream client.

The real problems lie on the equity side of the tax policy ledger. The general efficiency of voluntary taxation leads to a converse of a situation noted by Boris Bittker years ago. Bittker saw that pricing effects — capitalization — equilibrated the after-tax returns of different forms of investments, and thus that inefficiencies drove out inequities. Bittker (1975). In the case of the estate tax, the opposite might apply: efficiencies drive out its equities.

The best and most enduring arguments for the estate tax have always sounded more in equity than efficiency concerns. John Rawls, for example, supports the idea of estate taxation not to raise revenue but to promote the goals of a liberal egalitarian society. Rawls (1971) at 279.

There are concerns about progressivity, making the rich pay their due, leveling the playing field, breaking up concentrations of wealth. To return to Kaplow's analysis, it is possible of course to fit such concerns into a utilitarian calculus readily enough: to talk about the income distribution as a public good, say, to question the possibly pernicious efficiency effects of concentrated capital, or, more simply, to support a redistributive social welfare function (but then one encounters the argument, pressed in Kaplow (2000), that one ought to redistribute in the least distortionary way, which may or may not single out wealth transfers).

But let us take the usual candidates as worthwhile and freestanding normative goals, aside from efficiency. We want, that is, to equalize wealth and to mitigate the adverse effects of its inequality on liberal values. The problem is that the actual, avoidable estate tax — actual, avoidable wealth taxes more broadly — do not well serve these goals. We get little or no progressivity among the capitalists who want to avoid taxation, either by spending on themselves

or through sophisticated transfers of wealth. Similarly, we do not break up concentrations of capital or level playing fields for those who do not want us to do so. Is it a better world where we break up the concentrations of wealth only of those who don't care to perpetuate theirs, while letting others set up dynastic trusts, stretching from now to eternity? Once again, the recent rash of empirical analysis of the estate tax and of the behavior of wealthy taxpayers has been important and valuable. But none of this has served to fully discredit a rather facile argument: We have had an income plus estate tax in place for nearly a century now, during a period of dramatically increasing inequality of wealth. Isn't it possible that our means of taxation are not serving our ends?

Mine is not, as some have suggested, (Gale and Slemrod (2000a and b)), a simple "horizontal equity" analysis — that spenders are preferred over savers under an estate tax. It is true that the current tax system fails to touch sophisticated high-end spenders, and heavily taxes certain high-end savers (that is, those who do not avoid it), and I believe that this is unfair and suspect that it is inefficient to boot. But this is not my central claim. Nor is my argument one over the effects of capital or estate taxation on the aggregate level of savings, as an earlier group of critics seems to have thought. (See my response to these critics in McCaffery (1996)). Rather, my argument is and always has been what I take to be a simple one, grounded in liberal political theory and accepting the broader normative goals of estate tax supporters: The actual income-plus-estate tax fails to meet any of its most important normative goals, and a better system, in both theory and practice, is readily available to do so.

5. A Better Way: Towards a Non-Voluntary Tax

Continuing, my criticisms of the estate tax or the broader tax system would not mean much if there weren't a better way to meet the normative goals of estate tax supporters: More progressivity, getting the yield to capital to bear some tax, breaking up large concentrations of capital, moving towards a level playing field. None of these are especially well met by the status quo. But all of them could be better met with a consistent postpaid, cash-flow consumption tax — without an estate tax. Such a tax would allow a systematic and unlimited deduction for savings, isolating out consumption for present taxation. Savings would then have no tax “basis,” as not yet having been taxed. Capital could be passed on, in life or at death, at any time, with its zero basis. Heirs would be taxed when, as, and if they consume wealth. A separate estate or wealth transfer tax is not necessary. The key step is to pick up borrowing as an in-flow in the tax base. Seidman (1997).

Several points are worth noting about a progressive cash-flow consumption tax, although I shall not deal at length with them here. See McCaffery (forthcoming) for much more detail.

One, a consistent cash-flow consumption tax has important base-broadening features: the inclusion of debt-financed consumption and the elimination of a need for a special capital gains preference. It is therefore not obvious that rates would have to increase under it, although the systematic deduction for savings would have a base-constricting effect, as would repeal of the estate tax.

Two, the argument is logically independent of one over the aggregate capital stock; effects on capital can be calibrated through rate adjustments. It is mainly an argument about the best time, place, and manner to effect progressivity in a tax system: that this is better done at the time of outflow rather than inflow, in short.

Three, a consistent cash-flow consumption tax at progressive marginal rates operates as both an accessions tax *and* as a tax on spending out of capital, to the extent that the spending patterns push one into the upper brackets. In other words, the equivalence of a pre- and postpaid consumption tax is, consciously, destroyed by progressive rates. A postpaid consumption tax is thus a better accessions tax and a better capital tax than is the current flawed income plus estate tax. These are points obscured by the classic income versus consumption dichotomy, made manifest by sorting taxes by means of the time of their imposition.

Four, a progressive consumption tax does not break up large concentrations of capital, per se, but it does redefine them, and property rights more generally. Under a consistent cash-flow consumption tax, the government has a lien on large stores of nominally private capital. Spend it too quickly, in too large amounts, and the progressive rate structure will operate to make the public's share larger. As a consistent tax on use, not earnings, a cash-flow tax can monitor use: it can require political expenditures to be made with after tax dollars, for example, as present law attempts to do by denying a deduction for lobbying. I have also argued that by regulating the types of investments allowed in tax-favored savings accounts — just as the law now does for qualified pension plans, IRAs, and other large stores of private capital, such as the endowments

of nonprofits — the progressive consumption tax generates a social vehicle for monitoring the private use of capital, protecting liberal concerns about undue power and influence.

Finally, a consistent cash-flow tax no longer makes it possible — as the present system does, for those with capital — to live well and pay no tax. The only voluntary thing is choice of lifestyle, a normatively coherent variable, as opposed to the level of tax aversion or sophistication, normatively arbitrary ones. And yet all of the major goals of estate taxation, as noted by Cooper and others, can be better met under a global tax system without an estate tax.

6. Conclusion

To complete my analysis, I can join with the still-growing chorus of scholars asking for more empirical work, which I am not well suited personally to do. But I believe that we must first get the theory, or the structure of the theory, down right. I for one have questions about the ideal rate structure under a progressive consumption tax; about the efficacy of various means for including debt within the tax base; about the wisdom and feasibility of substituting a broad-based consumption tax such as a national sales or value added tax plus a rebate for the lowest positive and zero brackets of the tax, leaving a supplemental cash-flow tax to effect progressivity on the spending decisions of the relative few; about the mechanisms for monitoring the investments within the untaxed savings accounts. And so forth. These are large and complex questions. But they follow from the structure of my argument, which in turn follows from the pursuit of attractive normative goals, and not from the structure, however ill-conceived, of the status quo.

I share with Kaplow (2000) the belief that sophisticated thinking about tax policy ought to begin this way — that is, with a clearly articulated set of ends. I do not share Kaplow’s precise utilitarian ends; my preferred goals are more in line with the traditional liberal egalitarian arguments for the estate tax — progressivity, breaking up concentrations of wealth, more equal opportunity, and so forth. But I share his sense of method. Rather than starting with the current and to my mind’s eye highly flawed tax system, and asking what effects it happens to have — letting the cart lead the horse — researchers would do better to start with their normative goals, and then to consider all possible means of effecting them. This is so whether or not these means, in the end, happen to feature an estate tax, or not.

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End Notes

1. I discuss what I take as the potential uses and limits of optimal tax theory in McCaffery (1997), chapters 7 and 8.
2. IRC §§ 2601-2663 (generation-skipping tax); 2701-04 (special valuation rules for, *inter alia*, estate freeze transactions).
3. Like Cooper, I have spent time advising the rich, and have worked, as a tax lawyer and tax law academic, with their advisors. Thus I share first hand Cooper's sense that the rich are not all the same, and that many are highly motivated to avoid the estate tax.
4. IRC § 469 (passive activity loss rules); 163 (interest deductions).
5. 252 U.S. 189 (1920).
6. IRC § 1014.