Why the Nonprofit Sector Should Care About Transfer Tax Reform

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Definitions and scope

What does it mean to say the nonprofit sector "should" care about transfer tax reform? Who is "the nonprofit sector"? What is "transfer tax reform"? And how do we derive "should," which seems on its face to imply a value judgment?

Obviously I want to focus our discussion over the next hour on the third question -- getting to "should" --, but it will be useful at the outset to define these other terms.

By "the sector," I am of course referring generally to (c)(3) organizations and to the people who work with or for these entities, which share a unique status under the federal tax Code.

But more specifically, for purposes of the present discussion, I am referring to the handful of national organizations who present themselves as voicing the collective concerns of "the sector."

Most visibly, these include

- the Alliance for Charitable Reform, which is an initiative of the Philanthropy Roundtable,
- the Council on Foundations,
- Independent Sector, and of course
- the National Association of Charitable Gift Planners, of which most of us in this room are dues-paying members.

I do not want to go into who exactly is the money behind some of these organizations. That would be the subject of at least another hour's talk. But I will mention

- the Philanthropy Roundtable, with an annual budget of about 1.7 million, spends a couple or three hundred thousand dollars a year on what they characterize on their 990s as "self-defense" lobbying, and closer to a million a year on the ACR initiative itself,

- the Council on Foundations, with an annual budget of about 15.6 million, spends close to three million a year on what they characterize on their 990s as "public policy," but they treat very little of this as reportable lobbying expense,

- Independent Sector, with an annual budget of about 8.8 million, spends about a million and a half per year on "public policy," but again treats almost none of this as reportable lobbying expense.

Again, without going into funding sources, suffice it to say at least two of these three could be perceived as representing the interests of what someone might call "the donor class," that is, people whose financial self-interest is tied to the status quo.

We here in this room might be more concerned with the NACGP, which reports spending only 25k to 30k per year on "direct lobbying" from an annual budget of about 1.2 million.

Although the NACGP is a (c)(3) organization, it perhaps more resembles a (c)(6) trade organization, to which membership dues would be deductible as a business expense -- except to the extent they were spent on lobbying, either direct or grassroots, at anything beyond the "local" level.

The mechanisms by which the NACGP develops its policy positions are not exactly transparent. Apparently there is a "government relations" committee which develops policy positions that may then be adopted by the board of directors. Who all is on that committee, how they go about forming policy positions to submit to the board, and what criteria the board uses to evaluate these, are unclear.

In fairness I think this lack of transparency is mostly a matter of inadvertence, and our president and CEO, Michael Kenyon, tells me he is working to bring some clarity to the process.

Finally, by "transfer tax reform," I am referring not only to proposals on the one hand to repeal the estate and generation-skipping transfer taxes altogether, or on the other hand to restore much lower exemption amounts and impose higher marginal rates, but also proposals

- to make it impossible to "zero out" a grantor retained annuity trust, by requiring a minimum term of ten years and a minimum present value for the remainder of 10 pct. or 25 pct.,

- to limit the term over which a trust may be exempted from the generation-skipping transfer tax to ninety years, and

- to treat a transfer of appreciated property at death as a capital gain recognition event.

These latter items have featured in the last several budgets proposed by the Obama administration, and legislation along these lines has been proposed in each of the last several sessions of Congress, but of course none of it has been reported out of committee. Yet.

H.R. 5171

But before we go there, let's look briefly at some of what "the sector" has been doing on the income tax front.

The so-called charitable IRA "rollover" was finally made permanent last December. And almost immediately we have begun to see bills introduced that would allow "rollovers" to donor advised funds, supporting organizations, and private foundations.

And we have a bill that might actually get some traction, H.R. 5171, which would allow a taxpayer aged 59.5 or older to direct nontaxable distributions of up to 400k per year from an IRA to a charitable remainder trust or to an immediate gift annuity paying at least five pct.

Income from the remainder trust or gift annuity could be made payable only to the IRA account holder and/or his or her spouse, not to other third parties, and the income interest would be non-assignable -- not even to the issuing charity.

Distributions from a remainder trust would be treated entirely as ordinary income, without regard to the "four tier" ordering rule of Section 664(b). Similarly, a rollover would not be treated as an "investment" in a gift annuity contract, meaning the entire annuity payout would be treated as ordinary income.

These provisions would sunset at the end of 2020 unless extended.

This bill, incidentally, was drafted by a newly created (c)(4) organization called the Charitable IRA Initiative, funded in part by the NACGP and in part by the American Council on Gift Annuities, which does not ordinarily engage in lobbying. It is probably fair to credit the Initiative with the final push that made the charitable IRA "rollover" in its present form permanent.

A couple of things to note about H.R. 5171 in passing:

- The Joint Committee on Taxation estimated the legislation would cost about 150 million over ten years. Because of the sunset provision, the estimated revenue losses are front-loaded, averaging about 38 million per year.

- This figure would seem to imply a projection of about 95.96 million per year in contributions that would otherwise have been taxed.

- That in turn implies current withdrawals of 101.01 million going into these split interest entities, with current payouts of at least 5.05 million.

- A five pct. minimum payout from a gift annuity at ACGA recommended rates would require the transferor to be age 69 or older. For a joint and survivor annuity, the minimum age for both parties would be age 75.

- So the incentives are largely with remainder trusts, where you can have higher payouts at younger ages.

The charitable IRA "rollover" itself

But let's take a step back and look at the charitable IRA "rollover" itself, in the form that has now been made a permanent feature of the Code. This was a longstanding project of the various entities mentioned earlier.

The mechanics

How the charitable IRA "rollover" works is this. You are age 70.5 or older, therefore you are taking minimum required distributions from your IRA. These are taxed as income at let us say 39.6 pct. Also, you are making contributions to (c)(3) organizations.

You could claim those contributions, up to fifty pct. of adjusted gross income, as itemized deductions. And/or you could direct the trustee to make distributions from the IRA directly to charity. These would not be reportable as income, and while they would also not be deductible, they would not count against your fifty pct. limitation. But they would count toward your minimum required distribution.

Under what circumstances might you want to do this?

One, maybe you do not itemize. Two, maybe you have already maxed out the fifty pct. limit. Or three, maybe taking the RMDs into income would push you over the threshold where the "Pease" limitation on itemized deductions kicks in, and/or the 3.8 pct. Medicare surtax on net investment income.

Let us look at each of these in turn. And to keep it simple, we will look at joint filers. But first some basic data.

Calendar 2014 filing data

Of 53.9 million joint filers for calendar 2014, about 24.8 million itemized, somewhat under half. Of these, 21.9 million claimed charitable contribution deductions, aggregating 152.9 billion, or an average of 6.9k per return. State and local taxes paid averaged 15.4k per joint return, and mortgage interest averaged 10.3k.

Altogether, 36.2 million filers claimed charitable deductions in 2014, aggregating 210.6 billion, or an average of 5.8k per return. Clearly, joint filers made up the bulk of these numbers. Roughly one-quarter of joint filers had adjusted gross incomes between 100k and 200k.

Fewer than 2.9 million returns reported itemized deductions triggering the "Pease" limitation, which in 2014 was 254.2k for a single taxpayer, 305.05k for joint filers. Most of these were just above the threshold, but almost all of the dollar value was on a handful of returns reporting adjusted gross income of ten million or more.

About 13.7 million taxpayers took taxable IRA distributions in 2012, aggregating 235.0 billion, or about 17.2k per return. Of these, 7.9 million were joint filers, reporting taxable IRA distributions aggregating 153.7 billion, or about 19.5k per return.

It is not until you get into income ranges above five million that you see IRA distributions averaging above 100k per return. In 2014 there were 12.0 million joint filers over age 65. Only 8.5k reported income over five million, about seven-tenths of one pct. Some apples in among the oranges here, but you get the general idea.

What about nonitemizers?

The standard deduction for 2016 for joint filers is 12.6k -- and since we are talking about people over age 65, another 1.25k each, total 15.1k.

Of 102.6 million filers who claimed the standard deduction in 2014, more than half had adjusted gross incomes below 25k, less than 200 pct. of the federal poverty level for a family of two.

But about 11.5 pct. were in the 50k to 75k range, and another 5.5 pct. were in the 75k to 100k range, so let's suppose we are talking about those folks. Dick and Jane, both in their 70s, taxable income on the edge between the 15 pct. marginal rate bracket, which this year tops out at 75.3k, and the 25 pct. bracket, which tops out at 151.9k.

Add back the 15.1k standard deduction and two personal exemptions at 4.05k each, we are looking at AGI right around 98.5k.

Absent whatever they might want to give to charity in the form of an IRA "rollover," their itemized deductions are less than 15.1k. Not much medical expense in excess of ten pct. of AGI, not much in the way of deductible state and local taxes, not much or any home mortgage interest.

If Dick and Jane are completely typical for their income bracket, again using 2014 figures, their taxable IRA distributions would be 18.55k. If they took this into income and then contributed some or all of it to charity, a portion of the deduction would be "wasted" until they hit the 15.1k threshold. Also, taking taxable IRA distributions might affect the portion of their Social Security benefits that are taxable.

So they would have to do some math to determine how much to take into income versus how much to put into the "rollover" to get the maximum benefit.

Maxing out the fifty pct. limit

Alternatively, we might suppose Dick and Jane have already given somewhere around 49.25k to charity, which of course would make them very unusual in this bracket. But in a moment, when we are looking at the "Pease" limitation and the 3.8 pct. Medicare surtax on net investment income, this might make more sense.

In any event, if Dick and Jane took the RMDs in above the line, yes it would increase AGI and raise the limit, but they could only give about half to charity without having to carry some forward. The carryforward is wasteful in the sense you are paying tax today on something you will be deducting next year, or as many as five years from now.

Crossing the thresholds

The threshold for imposing the 3.8 pct. Medicare surtax on net investment income is 250k for joint filers, near the lower end of the 33 pct. marginal rate bracket.

If Dick and Jane have both retired, it may be unrealistic to assume their net investment income is less than the amount by which their adjusted gross might exceed the surtax threshold. So as a practical matter their marginal rate is 36.8 pct., even though any distributions they take from IRAs are not literally subject to the surtax.

The AGI threshold at which the "Pease" limitation begins to reduce itemized deductions for joint filers is 311.3k in calendar 2016. So let us put Dick and Jane right at that edge, solidly in the 33 pct. marginal rate bracket, with at least 61.3k of net investment income. The floor for the 35 pct. bracket is 413.35k for joint filers.

At this income level, incidentally, average taxable IRA distributions are more in the neighborhood of 47.3k.

The "Pease" limitation reduces itemized deductions by the lesser of three pct. of the amount by which AGI exceeds the threshold or eighty pct. of itemized deductions otherwise allowable. In effect, if Dick and Jane are itemizing, each additional dollar of income over 311.3k is taxed at 33.99 -- actually, at 37.79 pct., because of the surtax --, while itemized deductions reduce taxable income by only 33 pct.

So if Dick and Jane took 47.3k in RMDs into income above the line and contributed all of it to charity, assuming itemized deductions already exceeded 15.1k, they would end up paying an additional 2.265k in tax, roughly.

Obviously it gets a little more complicated when you are at the edge of the next marginal rate bracket.

Let us say Dick and Jane are sitting right at 413.35k before taking RMDs. Again, assuming enough net investment income that the 3.8 pct.

surtax will apply to every additional nickel. We are still in an income range where the average taxable IRA distribution is 47.3k.

Here the marginal rate above the line would be 39.85 pct., with the "Pease" limitation effectively taxing each additional dollar as 1.03, while itemized deductions would reduce taxable income by only 35 pct.

So if Dick and Jane took the entire IRA distribution above the line and contributed it all to charity they would pay an additional 2.294k in tax, roughly. Half of one pct. of their adjusted gross income.

Some further observations

Back in December, the Joint Committee on Taxation estimated making the charitable IRA "rollover" permanent would cost 556 million in revenue in 2016 alone, and 700 million in 2017, trending upward at about five pct. per year in outlying years.

Of course the JCT's methodology is not quite this simple, but even assuming everyone is in the 39.6 pct. marginal rate bracket, this would suggest at least 1.4 billion in contributions in 2016 that would otherwise not have been made or would at least to some extent have been made from otherwise taxable distributions. Taxable distributions from IRAs in 2014 were 149.5 billion.

The tax policy behind allowing you to defer recognition of wages you put into an IRA, and of the return on those deferrals, is to encourage you to save for retirement. Not to create an inheritance.

When you turn 70.5 you have to start taking the money out over your projected life expectancy, 27.4 years, and paying income tax. To the extent you do not need the money, the tax incentive is inefficient.

The average IRA balance for taxpayers aged 70 and over was 226.9k in 2013, and the median was 84.6k. If at age 70.5 your minimum required distribution is 100k, this means you have 2.74 million in the account.

Only about 15.6 pct. of traditional IRA account holders have balances of 250k or more. These represent fewer than two pct. of all taxpayers.

Optics or Fundamentals

I have a similar rant posted to my website concerning ACR's lobbying to exclude the charitable deduction from the "Pease" limitation on itemized deductions.

But my purpose here today is not to argue the substance of my own views on these matters. What I want to do instead is to suggest that if "the sector" is going to align itself with this or that tax policy position, it "should" be arguing from a set of principles somewhat more fundamental than self-interest.

Incentive or base-defining

What is, or ought to be, the policy rationale of the income tax charitable deduction? Should it be seen as an incentive, *i.e.*, as a subsidy? or should it be seen as a mechanism for defining what constitutes the taxpayer's taxable income?

Or to put it another way, if we accept something like the Haig-Simons definition of income -- consumption plus change in net worth --, should a contribution to charity be treated as consumption? or simply subtracted from net worth?

With a few exceptions, the academic literature has trended toward the view that charitable contributions are a form of consumption, and that the deduction should therefore be seen as an incentive or subsidy. Pursuant to the 1974 Budget Control Act, the Congressional Budget Office and the Joint Committee on Taxation treat the deduction as a "tax expenditure," that is, as analogous to a spending program -- albeit of course with essentially no Congressional or administrative oversight.

The distinction matters.

If the charitable deduction reflects a policy to exclude contributions from the income base, then it makes no sense to allow a deduction for unrealized appreciation, nor to offer an above the line deduction to nonitemizers, who are already in theory covered by the standard deduction.

If on the other hand the policy is to create incentives at the margins for contributions that might otherwise not be made, then it may make sense to talk about ceilings or a deduction for nonitemizers, subject to a floor, or even nonrefundable credits. In its present form, the incentive can be seen as regressive.

Under either rationale it is reasonable to discuss whether some types of (c)(3) organizations should be treated differently from others -- just as the existing regime treats private foundations and donor advised funds differently from 170(b)(1)(A) charities.

If the taxpayer continues to exercise some control over the disposition of contributed funds, this can be seen as a form of consumption. If a nonprofit hospital relies mostly on program service revenue, the incentive for contributions is inefficient. Do we want to subsidize private liberal arts colleges at the same rate as homeless shelters or soup kitchens. Again, these are values questions.

Why income as a tax base

But of course all of this discussion depends on the fact we are using income rather than, say, wealth or consumption, as the tax base. Setting aside for the moment the question why we have taxes at all, we need to ask what should be the base, and to answer this we need to agree on some basic principles.

For purposes of this discussion we will assume we are talking about funding the general operating budget, rather than specific government functions that might appropriately be covered by user fees.

Everyone benefits more or less from roads, and from a functioning courts system -- though the argument has been made the massive amounts we spend on the military, on and off budget, primarily benefit multinational corporations.

If we are collecting taxes to finance general government operations, then the burden of those taxes "should" be borne fairly. But how do we measure fairness?

It may be difficult for us to imagine this today, but prior to the adoption of the 16th Amendment in 1913 and the enactment of the predecessor to the present income tax, the federal government was financed primarily through tariffs and excise taxes. Today the income tax accounts for nearly half of federal tax receipts.

Another third comes from payroll taxes, which are paid into the Social Security trust fund and then lent out to fund other government operations. This is a regressive tax, taking 15.3 pct. of only the first 118.5k in wages.

If a primary function of government is to protect the institution of private property -- maintaining not only the physical infrastructure that makes commerce possible, but also the mechanisms of law that help to stabilize it -- one might argue that those who have accumulated wealth "should" pay more. You didn't build this, etc.

In any event, at some point it becomes necessary to talk about "ability to pay." You cannot collect tax from someone who has nothing, but on the other hand, accumulated wealth might be illiquid, and we probably want to minimize the extent to which the tax regime distorts economic activity by requiring taxpayers to sell assets to generate cash.

Although currently realized income is subject to fluctuation from one tax year to another and may bear little correlation to accumulation of wealth over a lifetime, it does have the virtue of liquidity.

What about progressivity

If you exempt some individuals at the low end of the income distribution from paying income taxes altogether, even a proportional, or "flat," tax is progressive. The marginal rate is flat, but the effective rate never quite approaches the marginal rate unless you phase out the exemption in higher income ranges.

But with a graduated rate structure, you introduce all kinds of complexities. Defining the taxable unit, timing of income and expenses, differential treatment of realized long-term gains, carryover of capital losses, and so on.

And, relevant to our conversation today, how to structure various tax incentives in such a way as not to undermine the desired level of progressivity.

One of the stronger arguments against progressivity is that it incentivizes consumption over saving -- but the data are slight, and in any event there are those who would argue this is a feature rather than a bug, at least during a period of recession or stagnation.

In the end, the rationale for progressivity must rest on a theory that money has a declining marginal utility.

A progressive rate scheme seeks to impose "proportionate sacrifice" across income ranges, taking a dollar from a person with income just above the exemption amount, while taking somewhat more than ten dollars from a person with ten times that income.

How much more is the difficult question, as it seems impossible to define the utility curve, though we think intuitively it must be there.

If the logic is extended to effecting "minimum sacrifice" among taxpayers in the aggregate, you get a confiscatory tax at the top end, which runs you up against the argument that sufficiently high marginal rates will kill productivity.

But stopping somewhat short of that extreme, the theory does seem to justify some level of progressivity, and in doing so it brings the question of using the tax system as a tool to redistribute wealth right out onto the table.

Why do we have taxes

I am going to take you down a bit of a rabbit hole here, and suggest there are plausible arguments for the view that taxes are primarily a monetary control mechanism.

These arguments are advanced by a group calling themselves "modern monetary theorists" and are fleshed out in relentless detail on a website called "New Economic Perspectives."

In brief, the idea is that a national government that "floats" its own currency -- not convertible to precious metals or a foreign currency --, through lending into the banking system and through direct spending, does not "need" to collect taxes in order to spend. It spends first and taxes later.

But it does need to collect taxes in order to create a demand for its currency. And taxation then becomes a tool for controlling aggregate demand, providing a countercyclical stimulus, rising during economic expansions and falling during contractions.

This is not so much counter-intuitive as it is a reversal of the narrative we have been fed.

It may very well be that revenues of about 17 or 18 pct. of gross domestic product, expenditures of about 20 or 21 pct., and a running deficit of about three pct. is exactly what is needed to keep a post-industrial consumer economy reasonably stable. In effect, the federal government is feeding in net three pct. of new money annually.

Or it might be argued that a system that relies on perpetual "growth," measured in monetary terms, is unsustainable in a world of finite material resources.

If the tax system is essentially a monetary control mechanism, then its specific features -- not only deductions, but the definition of the tax base itself -- are an amalgam of incentives and disincentives to various behaviors which have been monetized.

If these incentives are not calibrated to prevent a speculative runup in prices of credit default swaps and other financial instruments, then we have a problem.

Part of the difficulty is that money created by private bank lending is added to the aggregate without having already been "floated" by the government. It is "floated" after the fact in the clearing process.

One implication of this theory, not so incidentally, is that because the flow of money is driven by taxable transactions, any money someone might want to divert to nonprofit endeavors is going to have to come out of the supply already created by for-profit activities.

What is money

A little farther down the rabbit hole we get to the question why we have money at all.

It is a cliche to say money is a medium of exchange, and a mechanism for storing exchange value. Because it is fungible, it allows much greater flexibility in executing exchanges than a system of barter. And its value is at least potentially more stable than, say, a silo of rotting grain.

But skipping over a lot of history concerning cowrie shells and gold ingots, and stopping a little short of bitcoins, we can see that control of the monetary system is an essential component of centralizing political authority, right alongside the state monopoly on violence.

This is as far as we need to go down this particular path for the moment. My point here is that we cannot have a serious discussion about what incentives the tax system should offer for diverting money into the nonprofit sector until we have some understanding of what the question even means.

Transfer tax reform

Transfer taxes comprise a very small percentage of total revenue, about 19.3 billion in 2014, or 0.6 pct. The estate tax affects fewer than five thousand decedents' estates per year, about two-tenths of one pct. These figures are very considerably down from the high water mark in the mid 1970s.

The Office of Management and Budget has estimated that restoring the estate tax to its 2009 parameters would increase revenues by about 17.8 billion per year. IRS statistics indicate there were 12,940 estate tax returns filed for decedents who died in 2009, when the exemption was still 3.5 million and the top marginal rate was still 45 pct. Of these, fewer than half were taxable. Net estate taxes payable were 13.6 billion.

[note: Despite taking out estates under 5.xx million, and despite dropping the top marginal rate to 40 pct., the aggregate estate tax on the remaining larger estates increased. Just over 70.6 pct. of the aggregate tax burden was carried by estates larger than 20 million.]

Nonetheless, these taxes may have disproportionately strong economic effects, largely in the form of diverting resources to the creation of elaborate tax mitigation strategies.

It is a truism that the financial services industry creates nothing. What it does is allocate existing capital resources -- or perhaps more accurately, it extracts something north of one pct. for handling transactions that have the effect of allocating existing resources. The invisible hand does the actual allocation.

But I digress.

Transfer taxes have functioned as a "backstop" to the income tax, capturing unrealized appreciation at death, and limiting the degree to which taxpayers can "game" the system by shifting income to lower marginal rate brackets.

In other words, although the overt revenue effect appears to be small, the mere presence of transfer taxes may have significant effects in maintaining the progressivity of the income tax.

That is, until the bankers and lawyers step in and start putting marketable securities into family limited partnerships, leveraging remainder values with "zeroed out" grantor retained annuity trusts, and tying everything up in "dynasty" trusts that can escape transfer taxation potentially forever.

The proposed 2704 regs

The pending proposed revisions to existing regulations under Code section 2704 are a case in point.

Section 2704 says the lapse of a voting or liquidation right in a corporation or partnership controlled by a family is treated as a transfer of that right, either by gift or by inclusion in the transferor's estate.

A restriction on the ability of a shareholder or partner to force liquidation is to be disregarded in valuing a transfer to a family member, if either (a) the restriction lapses after the transfer or (b) the transferor or other family member can remove it. Unless.

Unless the restriction is "imposed by" state law. Regulations finalized in 1992, two years after the statute was enacted, construed this exception to mean "not more restrictive than" state law.

This rough paraphrase leaves out much detail, because I want to focus for the moment on the exception for restrictions "imposed by" or "not more restrictive than" state law.

Since 1992, quite a number of states, acting at the behest of the organized bar and bankers associations, have enacted statutes imposing default restrictions on liquidation at least as restrictive as those commonly imposed in an entity's governing documents. The effect, as noted in the Treasury's preamble to the pending proposed regulations, has been to render the existing regulations "substantially ineffective."

My point here is to note the lengths to which players in the financial services industry -- including tax planning lawyers --, will go to influence public policy for the private benefit of their clients and themselves. And, sadly, to note the susceptibility of state legislatures to their influence.

The proposed regulations would simply delete the reference to state law altogether, leaving the statutory language to fend for itself.

Of relevance to the nonprofit sector, the proposed regulations would also disregard, in determining whether a transferor's family can remove a restriction, an interest in the entity held by an unrelated party -- such as a donor advised fund -- unless that interest

- has been held for at least three years,
- represents at least ten pct. of equity interests in the entity -- and in combination with interests held by other unrelated parties, at least twenty pct. --, and
- has a put right to receive the "minimum value" of its interest (roughly, net asset value) in cash or property -- not an unsecured or deferred or below market note -- on no more than six months' notice.

Obviously very few family limited partnerships formed primarily for the purpose of securing valuation discounts will meet these criteria.

Not incidentally, there has been pushback, including

- a letter to Treasury Secretary Lew from Senate Finance Committee Chair Orrin Hatch, signed by forty other Senate Republicans, urging him to withdraw the proposed regulations,

- two bills introduced in the House, H.R. 6042, which would nullify the proposed regulations, and H.R. 6100, which would also forbid IRS to spend any money to "finalize, implement, administer, or enforce" them, and

- an effort coordinated by something called the Family Business Coalition to solicit public comments objecting to the proposed regulations, using a set of prepared talking points.

Anyway, finally to my main point.

Generation skipping and perpetuities

Since the enactment of the generation-skipping tranfer tax in its present form in 1986, more than two dozen states have abrogated the common law rule against perpetuities, allowing settlors to remove large pools of assets permanently from the transfer tax system -- and from the reach of beneficiaries' creditors.

At least five of these states have language in their constitutions forbidding "perpetuities." Two of these are of particular interest.

1. Nevada. In 2002, Nevada voters rejected by a margin of three to two a legislative referendum that would have repealed the state constitutional prohibition of perpetuities.

Despite this setback, proponents of repeal persuaded the legislature only three years later to extend the "wait and see" period under the statutory rule against perpetuities to 365 years, effectively eviscerating the rule.

A detailed writeup of the legislative maneuvering leading to the enactment of this statute is posted here.

Whether a transfer designed to take advantage of the extended period would violate the state constitutional prohibition has not yet been tested in a Nevada court.

2. North Carolina. When the North Carolina legislature enacted a statute in 2008 abrogating the common law rule as to a trust if the trustee had a power of sale, the organized bar manufactured an ostensibly adversarial lawsuit, with the minor children of a trust settlor pretending to challenge the validity of a perpetual trust in the face of a similar prohibition in that state's constitution.

The state bankers association filed an amicus brief, openly acknowledging the purpose of the statute was to benefit the trust industry by making North Carolina a haven for perpetual trusts.

Lawyers for the nominal plaintiffs did not offer an argument that a perpetual restraint on alienation of the equitable interests of remote contingent beneficiaries -- an "entailment," albeit not of the legal title to trust assets -- would violate the policy expressed by the state constitutional prohibition.

Despite numerous procedural anomalies, the trial court ruled the constitutional prohibition applied only to restraints on alienation and not to remote vesting of contingent interests, and the state appeals court affirmed. *Brown Bros. Harriman Trust Co. v. Benson*, 202 N.C. App 283, 688 S.E.2d 752 (2010).

The state supreme court twice refused to put its imprimatur on this result -- see, 684 S.E.2d 692 (2009), denying a petition for discretionary review prior to determination by the appeals court, and 364 N.C. 239, 698 S.E.2d 391 (2010), dismissing a notice of appeal from the appeals court and denying discretionary review --, but the appeals court decision still stands as a shaky precedent.

A detailed writeup of the "prodecural anomalies" mentioned above is posted here.

No one has yet pursued a similar course in Nevada -- nor in Arizona or Wyoming, both of which have also enacted legislation extending "wait and see" statutes out hundreds of years, despite state constitutional prohibitions on perpetuities.

In each case, the legislation was drafted by the organized bar and supported by the state bankers associations. Both these groups have a strong self interest in drawing fees from creating and maintaining these arrangements.

The constitutional question was given short shrift in legislative committee hearings, and no one asked what might be the social consequences of abrogating the rule, though these are reasonably predictable:

> - multiple generations of beneficiaries insulated from civil liability for their actions because their assets are tied up in perpetual spendthrift trusts;
> - large pools of financial assets controlled by a handful of families -- or a handful of corporate trustees --, who can then manipulate the mechanisms of government through their armies of bankers and lawyers;

and so on.

In brief, abrogating the rule will likely have far-reaching effects on the stability of the experiment in representative democracy launched here only a couple of hundred years ago.

Rising Inequality

The fact of rising income and wealth inequality in the "developed" world, and in particular in this country, has entered the popular discourse in recent years with the Occupy Wall Street movement and with Thomas Piketty's book *Capital in the 21st Century*.

In Piketty's analysis, rising inequality can be traced to the fact that the return on capital has been consistently higher than the rate of "growth" -- what Piketty calls "the fundamental force for divergence." When we are in a period of low growth, this disparity allocates increasing amounts of income to capital rather than to labor.

We seem to have entered an era of low growth -- what some economists have been calling "secular stagnation" -- which may turn out to be permanent. The runup in the stock market has not been accompanied by an increase in real wages.

Some have argued the high rates of growth we have seen over the past century or two -- which are anomalous by historical standards -- may be a freak of the availability of relatively "cheap" fossil fuels.

While we may or may not have passed "peak oil," it is certainly the case that the costs of extraction and refinement are rising as we move into "tar sands," etc., and our dependence on access to petroleum has contributed significantly to what some are calling a permanent state of war in the Middle East and elsewhere.

In any event, if the rate of return on capital remains high while growth remains low, the shares of wealth allocated respectively to capital and to labor will continue to diverge. The stock of capital, increasingly in the form of financial instruments, will continue to grow in a positive feedback loop, gradually destroying the wage class.

The solution Piketty proposes is to reduce the stock of capital through taxation -- expressly for the purpose of redistribution, *i.e.*, not for revenue. An alternative mechanism for destroying capital stock is of course war or insurrection.

In a recent review of Piketty's book, USC Gould law professor Edward J. McCaffrey argues the existing tax regime gives only the appearance of being progressive.

Those with much higher incomes and much larger accumulations of wealth, he notes, have access to sophisticated tax planning that can deflect most tax liabilities. He gives the example of "casino magnate" Sheldon Adelson, who was able to transfer 7.9 billion to his heirs without paying gift tax, through a series of "rolling" short-term grantor retained annuity trusts.

McCaffrey describes a scenario he calls "Tax Planning 101," in which the wealthy avoid nearly all taxation by

- buying financial assets that appreciate without paying taxable dividends,
- financing current consumption by borrowing against those assets rather than selling, and then
- leaving the appreciated assets to descendants, who get a step up in basis and can pay off the debt without recognizing gain.

Meanwhile the less wealthy, whose accumulations are largely held in tax-deferred retirement plans, are subject to tax at ordinary income rates as those accumulations are drawn down.

An alternative method of avoiding tax is of course to transfer accumulated wealth to a private foundation, which you and your family continue to control.

Ultimately, McCaffrey's argument is that it is not politically feasible to restructure the income and transfer regimes in a way that would actually impose higher burdens on the wealthy -- in large part because "[t]he people do not understand tax well enough to support a grassroots movement to effect the technical changes needed."

Instead, he proposes a progressive consumption tax.

The mechanism would be analogous to an IRA. Untapped savings would not be taxed, but withdrawals would. Borrowing would be treated as a taxable withdrawal, cutting off the second leg of the "101" strategy. Steeply progressive rates would impose essentially confiscatory taxes on extravagant spending.

The idea is of course not new. Among others, Columbia law professor Michael J. Graetz provided an excellent discussion in an article he published in 2002 when he was at Yale. And of course, many other countries have had value added taxes in place for many years, though these do not typically feature the graduated rates McCaffrey proposes.

Conclusion

To be clear, I am not suggesting a consumption tax is a panacea.

My purpose here has been to place at least some relevant considerations on the table, and to invite "the sector" to give serious, disinterested thought to whether the existing tax system might be inflicting or perpetuating injustices or inefficiencies, and to how it might be changed, without clinging unthinkingly to existing tax incentives for charitable giving.

Even if it is the case that the levels at which individuals in higher income ranges contribute to charity are highly sensitive to the strength of existing tax incentives -- and the data are by no means unequivocal on this question --, that fact in itself is not a sufficient reason for the sector to identify itself so strongly with the status quo that we cannot have a conversation about changes to the tax regime that might improve the situation of "the least among us."

And as noted at several points in this paper, there are other features of the tax Code that might be changed to increase progressivity, thereby strengthening incentives for charitable contributions, on which the sector has remained silent.

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About the Greystocke Project

The Greystocke Project is a 501(c)(4) organization whose purpose is to lobby Congress to enact a statute limiting the interval over which a trust may be exempted from the generation-skipping transfer tax to ninety years.

A version of this proposal was advanced back in 2005 by the staff of the Joint Committee on Taxation, and another version has appeared in each of the the Obama Administration's budget proposals for the past several years.

The 2005 Joint Committee staff proposal would prohibit the allocation of GST tax exemption amounts to a transfer to a perpetual trust, except to the extent the trust required distributions to the first or second generation. The Obama Administration's proposal would limit the duration of the exemption to ninety years from the date the trust was funded.

Under either proposal, the change would be effective only with respect to trusts created after the date of enactment.

University of Michigan law professor Lawrence W. Waggoner has suggested a third alternative, denying exemption to a trust that does not conform to the common law rule -- lives in being plus twenty-one years --, or to the ninety-year "wait and see" proviso of the Uniform Statutory Rule, or to the "two-generation" rule of the Third Restatement.

Prof. Waggoner argues such a change in the statute could be made to apply to existing trusts by providing a "grace period" within which these could be brought into compliance. The Greystocke Project shares this view. To the extent possible, existing trusts should be brought back into the transfer tax system.

The Greystocke Project also intends to lobby state legislatures, to frame and promote voter initiatives and referenda, and to support appropriate litigation in state courts to reverse the trend toward abrogating the common law rule against perpetuities by statute.

Early initiatives will focus on states in which statutes effectively abrogating the rule would appear to conflict with state constitutional provisions forbidding perpetuities or entails.