Tax Lawyers Critique Graetz Reform Plan at Judicial Conference

by Sheryl Stratton

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No members of the tax bar are on President Bush's tax reform panel, pointed out Michael J. Graetz, a law professor at Yale University. He said that economists are driving the reform movement and that it's time for tax lawyers to get involved.

To that end, Tax Court Judge Maurice Foley organized the panel to critique Graetz's hybrid tax reform plan. Each panel member took on the role of a different player in the legislative process.

The Graetz Plan

"We are moving inexorably toward a crisis of compliance with our income tax," said Graetz, who served in the Treasury Department under President George H.W. Bush. Filing a tax return no longer links the American people to their government, he said. "Instead it is just one more commercial operation." Congress uses income tax incentives as an elixir for every economic or social ill, he said. And now the IRS is incapable of administering or enforcing the income tax laws, he said.

The alternative minimum tax is an imminent train wreck, according to Graetz. But the "pony in this manure is that the coming AMT disaster offers politicians a terrific opportunity to make some major improvements in our nation's tax system," he said.

The four pieces of Graetz's proposal for a "fair and balanced tax system for the 21st century" would:

- repeal the regular individual income tax, index the alternative minimum tax, increase the AMT exemption for married couples to $100,000, and lower the AMT rate to 25 percent;
- reduce the corporate income tax rate to 25 percent and more closely align book and tax accounting;
- impose a value added tax at a 10 percent to 14 percent rate to replace revenue that would be lost; and
- replace the earned income tax credit with a refundable payroll tax offset.

Graetz's plan would keep deductions for charitable contributions, home mortgage interest, and large medical expenses. Congress could also allow a deduction for state and local taxes and could tax capital gains at the standard 25 percent rate or lower, Graetz said.

The tax shelter problem will be solved only with greater book- tax conformity, in Graetz's view. Identical tax rates for individuals and corporations would allow the income of small corporations to be taxed on a flow-through basis, he said.

Under the proposal, Graetz said, 150 million families would no longer file tax returns, the so-called marriage penalty would be eliminated, and the IRS workload would be significantly reduced. The proposal would reduce compliance costs and counter the cynicism created by complexity, he said.

And by combining taxes commonly used throughout the world, the system would aid international coordination and cooperation with trade agreements, Graetz said.

Winners and Losers

The proposal shifts burdens and identifies the winners as savers and investors, said Steve Rosenthal of Miller & Chevalier, whose job on the panel was to represent the House Ways and Means Committee. But the proposal purports to be revenue neutral, he said, and he asked who the losers are and if they vote.

Sandra G. Swirski, a tax lobbyist and principal at Venn Strategies, asked about the fate of the financial services sector. The insurance industry would lose half of its products under the plan, she said. Other businesses would be loath to give up their various deductions and credits, she said.

Representing 25 percent of the U.S. gross domestic product, the financial services industry is important, acknowledged Graetz. It has been both over- and undertaxed through exemptions, he said.

Purporting to represent the Treasury Department, Ronald Pearlman, a professor at Georgetown University Law Center, wondered what the plan would do to the tax base.

Graetz maintained that his plan would keep the distribution of the tax burden about the same. The redistribution would be within income classes, he explained, and the spenders would pay more and the savers less. The key is getting middle-income taxpayers out of the tax base, he said. Under the plan, those subject to income tax would be a much more homogenous group, he said.

Stanford Law School Prof. Joseph Bankman observed that retirees' purchasing power would go down under the plan. Seniors won't appreciate that they were subject to income tax throughout their lifetimes and then are getting hit with a consumption tax at the end, Rosenthal said.

Graetz argued that the elderly would benefit greatly from the exemption and that because many seniors have little income, they could come out ahead.

The political reality, however, according to James C. Gould of Capitol Tax Partners, is that the Senate won't get near the plan because of the AARP. "Someone has to pay the piper to give [the plan] the juice," he said.

Representing practitioners, Jack B. Anderson from Ernst & Young's Paris office worried about the potential for a value added tax to be a "money machine" in the hands of an undisciplined Congress.

There is a risk that a value added tax creates the opportunity for spending, Graetz acknowledged. But he added that he believes that setting the VAT rate high enough -- above the OECD and European Union averages -- would prevent Congress from raising it. He said his proposal could require any VAT or income tax rate increases to be approved by a supermajority vote of Congress.

Future Predictions

Swirksi deemed Graetz's proposal "smart" because of its hybrid nature. Any fundamental reform plan that is untested in the American market is doomed to political failure, she said.

The U.S. is unique in the OECD for having no VAT, Anderson said. The proposal's strongest point is that it makes economic sense and is on target for the times, he said. But it will require cooperation in Congress to see the light of day, he added.

Graetz said that although the proposal is not perfect, it is much simpler and more economically stable than others being debated. By combining two of the world's most common tax mechanisms and exploiting the nation's substantial economic advantages, said Graetz, "we can achieve low tax rates and a much simpler tax system."

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