POINT & COUNTERPOINT: DISCLOSURE AND PRIVATE ENFORCEMENT

INTRODUCTION: Recently, Senator Charles E. Grassley wrote a letter to Treasury Secretary Paul O'Neill and Securities and Exchange Commission Chairman Harvey Pitt asking whether the government might benefit from the disclosure of corporate tax returns to other agencies and to the public. Senator Grassley did not give any reasons for or against disclosure of corporate tax returns—he merely raised the issue. Professor Theodore S. Sims embraced the idea, however, and expanded on it. In an article in *Tax Notes, 95 Tax Notes 735* (July 29, 2002), he suggested that the disclosure of corporate tax returns might help the Service police corporate tax shelters. Going further, he suggested that the public be allowed to assist the Service in such enforcement efforts. In this point-counterpoint feature, Section member Allen Madison of Palo Alto, California, challenges Professor Sims' arguments for disclosing corporate returns and even "privatizing" corporate tax enforcement. Professor Sims replies below and expands on the thinking behind the proposal in his *Tax Notes* article.

POINT: DON'T PUBLICIZE CORPORATE TAX RETURNS OR PRIVATIZE ENFORCEMENT

by Allen D. Madison, Palo Alto, CA

The federal government should not make corporate tax returns available to the public. Not for corporate governance purposes. Not for tax enforcement purposes. Requiring disclosure of corporate tax returns is a bad idea all around, and deputizing the public to enforce the tax laws is an even worse one.

In his *Tax Notes* article, Professor Sims made two arguments in support of the disclosure of corporate returns and the partial "privatization" of corporate tax enforcement. First, he argued that the Service does not have sufficient resources to fight the proliferation of corporate tax shelters. Second, he suggested that disclosure of corporate tax returns could help restore respect for our system of self-assessment. On the basis of these two premises, Professor Sims concluded that the only way to combat corporate tax shelters is to make it as profitable to prevent them as it is to create them. Disclose corporate returns publicly, says Professor Sims, and let the public pore over them and enforce the tax laws for the Government.

I disagree with both of Professor Sims' premises. Because I disagree with his premises I also disagree with his conclusion. But there are also independent reasons to disagree with his conclusion.

I disagree with Professor Sims' first premise, that the Service lacks the resources necessary to combat corporate tax shelters. After the Service reorganized it created a new Office of Tax Shelter Analysis focused solely on the shelter problem. The regulations regarding registration of tax shelters, maintenance of investor lists, and separate disclosure by corporations of shelter transactions are just now beginning to be implemented and bear fruit. Large corporate taxpayers are regularly audited, and more and more abusive transactions are being identified. Finally, while salaries are modest, the Service and the Treasury Department still attract some of the brightest minds in the tax field. Consequently, when the Service included tax shelter enforcement in its budget plan, it asked for only a modest increase in its budget for 2003. The Service and the Treasury Department themselves evidently do not believe they are short on resources.

Even if we assume that the Service is short on resources, Professor Sims' solution of privatizing tax enforcement does not necessarily follow from the problem. The more practical solution would simply be to give the IRS more resources. Does Professor Sims, a former government employee, believe the government would be incapable of enforcing our tax laws even with unlimited resources? Professor Sims does not explain why he does not take the more practical approach, e.g., suggest that we give the Service more resources.

I also disagree with Professor Sims' second premise, that our voluntary assessment system is in shambles. Professor Sims supported this premise with the rhetorical suggestion that corporate tax departments have been focusing on tax savings rather than compliance, referring to contemporary tax departments as "profit centers." Although I would agree that participation in abusive corporate tax shelter transactions is not desirable, the pursuit of tax efficiency is not the equivalent of such participation. Moreover, tax efficiency at the corporate level is in itself good (for shareholders, customers, and whoever else the corporate income tax may fall on) and should not be frowned upon. The General Accounting Office estimates that individual taxpayers overpaid $945 million because of failing to make legitimate elections. It is quite possible that corporate taxpayers overpay as well. If corporate tax departments are generally focusing on legitimate reductions in tax, I don't see why Professor Sims would characterize our voluntary

assessment system as in shambles. As Judge Learned Hand said in *Commissioner v. Newman,* 159 F.2d 848, 850–51 (2d Cir. 1947) (L. Hand, J., dissenting), "[T]here is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. . . . Nobody owes any public duty to pay more than the law demands."

This is not to say that abusive corporate tax shelters are acceptable. Rather, I merely doubt that corporate tax shelters have eroded our voluntary assessment system. The vast majority of the work of corporate tax departments and the tax professionals that assist them is devoted to compliance issues that are fully within the law. Indeed, corporate tax officers have a fiduciary duty to their shareholders to ensure such compliance. By contrast, it is possible that any problems with our voluntary assessment system might result from misperceptions rather than from too acute an understanding of our tax laws. Recent cases like *Compaq, UPS, Boca Investerings,* and *IES Industries* suggest that the lines between legitimate and abusive corporate transactions are extraordinarily fuzzy. If the problem is that we have fuzzy lines, then the solution should be to make the lines less fuzzy, by providing taxpayers with more guidance and clearer rules. We can remedy such problems within the existing system, by educating taxpayers and eliminating ambiguities, rather than privatizing tax enforcement.

Uprooting our existing tax enforcement system does not follow from these highly debatable premises. On the contrary, turning over corporate tax returns for private enforcement would damage our voluntary assessment system.

First, it would smack of unfairness. Corporations have valuable trade secrets and business information that can be discerned from their tax returns. Examples of the kinds of subject matter that one might discern from tax returns and that have been given trade secret protection by statute or the courts include: merchandising data regarding the characteristics and nature of customers, plans for the introduction of new products, costs and pricing (particularly transfer pricing), sources of supply, information regarding economic efficiencies, payroll information, business models, patterns of business, and information regarding royalties.

But a trade secret remains judicially protected only as long as it remains a secret or is communicated "to others pledged to secrecy." Currently the Service is pledged to secrecy under sections 6103 and 6110. To make corporate tax returns available for private consumption would effectively strip corporate America of its valuable intellectual property because the tax enforcers would no longer remain pledged to secrecy. This would be unfair to the corporations and their shareholders, who consist of almost any citizen who has done any planning for retirement.

Confidentiality of these trade secrets helps American corporations compete in the global market. To my knowledge, no other developed countries allow public disclosure of corporate tax returns. Requiring the disclosure of corporate tax returns in the name of private tax enforcement would impair competitiveness of American corporations.

The cost to corporations of defending against enforcement actions would also skyrocket. The Service coordinates its enforcement actions at the administrative and litigation levels. For example, if there are 1,000 corporations under audit for the same issue, one of the corporations may seek a technical advice memorandum. The decision in that memorandum creates a uniform position throughout the Service on that issue. If the Service decides in favor of the taxpayer, it removes the issue from the audit of the other corporations. It is unlikely that private enforcers would be willing or able to coordinate administrative enforcement in such a manner. Corporations would thus incur the cost of fighting issues that they might not have to face under our current system.

Similarly, if the same group of corporations has the same issue under audit, the Service may coordinate its litigation and take only one of the corporations to court. Although the Service may litigate the case in another jurisdiction if it does not like the outcome of the first case, it can still exercise restraint, and not litigate against each and every taxpayer facing the issue. Again, it is unlikely that private enforcers would be able or willing to coordinate their litigation in the same manner, and again corporations will face costs that they do not have to incur under the present system.

A lack of centralized authority in private enforcement would burden our court system with tax cases. The Service has centralized administrative authority to conduct audits. Without centralized administrative authority the courts would have to handle every minor dispute that arises in a tax case and that the Service currently handles administratively.

A lack of centralized authority in private enforcement would also cause an administrative nightmare for corporations undergoing audit. With economic incentives, every private enforcer, potentially the entire population (would we exclude foreigners

from acting as private enforcers?), would attempt to take on every audit now underway. Presumably, if Professor Sims wants to rid society of tax shelters, the private enforcers would require the Service's authority to issue judicially enforceable document requests. For the Service to find tax shelters on audit now it issues endless document requests. Every corporation, then, might end up answering endless document requests from hundreds or even thousands of private enforcement firms.

In his counterpoint, Professor Sims suggests that auctioning off the right to audit tax returns would solve some of these problems. I disagree. As discussed, the Service does not find what it considers a tax shelter until it has already requested numerous documents; private enforcers would probably do no better. Prior to the discovery of what one might consider a tax shelter, bidders may value a corporate tax return as the cost to the company of avoiding litigation. Even corporations that engage in only legitimate transactions may therefore be held hostage to freelance private enforcers. Similarly, corporations that do engage in illegitimate transactions with huge tax savings might be able to buy off the winning bidder before any action is taken for an amount much less than the tax the evading corporation might end up paying if subject to government enforcement.

At bottom, Professor Sims' proposal is to fight fire with fire. He perceives taxpayer abuse of the system, so he proposes a system of private enforcers with no accountability. It is hard to doubt that private enforcers would abuse the system and eventually bring the system down. Private enforcement in the securities field led to the Private Securities Litigation Reform Act of 1995. In the legislative history, Congress criticized private enforcer abuse and sought to rein it in. Tax law with its fuzzy lines would likely attract even more abuses than the securities field and lead to enforcement actions against legitimate transactions. Taxpayers engaging in legitimate transactions ought to be able to remain free from the abuse of private tax law enforcers. In tax law, the enforcement function should remain with the government. ■

COUNTERPOINT: PRIVATE AUDITING MAKES SENSE

by Theodore S. Sims, Boston, MA

In response to my short piece in *Tax Notes,* in which I suggest that if corporate returns are to be publicly disclosed we might also consider private audit and enforcement, Allen Madison essentially argues that (1) our system of self-assessment through confidential returns and government enforcement ain't broke, and (2) fixing it would inflict unacceptable collateral damage. I think Mr. Madison makes a persuasive case for neither of those claims.

Part of Mr. Madison's argument is addressed to the predicate question of public disclosure, which I took as given for purposes of my piece, and on which I will therefore not dwell. The standard claim is that public disclosure would compromise "trade secrets." Much of what Mr. Madison enumerates, while commonly viewed as confidential, does not rise to the level of a true trade secret, and is not actually disclosed in the return. If the need to preserve trade secrets is the principal objection to disclosure, I think it incumbent on those making the objection to be specific about just what actually is a trade secret, what might actually be disclosed, and what harm the disclosure would actually do.

Mr. Madison's principal ground for asserting that the system needs no fixing is the claim that the Service's resources are already adequate to its tasks. He points to the creation of an Office of Tax Shelter Analysis, and the fact that the Service is currently requesting only modest increases in its budget. But the creation of the new Office—*not* the first "special" group to combat tax shelters ever created by the Service—is no substitute for adequate resources. And the absence of a request for increased funding, by a deficit-plagued Administration for which tax reduction appears to be more of a priority than tax enforcement,[1] is hardly persuasive evidence that we are devoting sufficient resources to the task.

There is ample evidence that we are not. Between 1975 and 2000, when the number of individual returns grew from about 82.2 million to over 127 million, audits of individual returns declined from 1,839,558 to 617,765 (or by more than 65 percent). During the same period audits of corporate returns fell by over 80 percent, from 154,889 to 27,835. In just the six years between 1995 and 2000, the examination rate for all individual returns dropped from nearly 1.7 percent to under 0.5 percent, or by nearly two-thirds, and the audit rate for all corporate returns declined from over 20 percent to nearly 11 percent. For large corporations the decline was even more dramatic, from over 48 percent examination to just over 16 percent. As noted by the Service on February 16, 2001, these declines reflect the combined effects of a 17 percent decline in overall staffing between 1992 and 2000, a 13 percent growth in the number of returns, the additional burdens and customer service obligations imposed by the 1998 Restructuring Act, and the ongoing use of outdated information systems. Those same concerns were underscored in the Commissioner's September 2002 Report to the IRS Oversight Board. It is hardly a picture

1 Witness the apparent assertion by Mark Weinberger, former Treasury Assistant Secretary for Tax Policy, that, since the Bush administration was "against capital gains taxes in general," it would "not take any action against" the apparent misuse of exchange funds. David Cay Johnston, "A Tax Break for the Rich Who Can Keep a Secret," *New York Times,* C1, col. 2 (September 10, 2002). While Mr. Weinberger did not confirm the exact quote, he apparently did not contradict it either, saying only that he "recalled making much less-definitive remarks."

I note also that the claim that the Service's resources are currently sufficient is inconsistent with the need for growth in funding outlined in outgoing Commissioner Rossotti's final Report to the IRS Oversight Board. *See* Rossoti, Assessment of the IRS and the tax System (September 2002).