2008 Erwin L. Griswold Lecture Before the American College of Tax Counsel

Constancy and Change in Our Federal Tax System

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The opportunity to deliver this year's Griswold Lecture is an honor for which I thank the officers and Board of Regents of the American College of Tax Counsel. My introduction to Dean Griswold was in law school where quite literally after studying his casebook on federal taxation,[1] I decided to become a tax lawyer. For me, he was a living legend with distinguished careers in academia, government service, and private practice. After I had admired him from afar for many years, he invited me to lunch shortly after I left the Service in 1989, and we traded lunches periodically thereafter. I still recall his penetrating eyes, his congeniality and graciousness, and the breadth and depth of his knowledge of the law in general and the tax law in particular. My last conversation with Dean Griswold was about a tax case I had involving the spendthrift provisions of a trust agreement that had been written in the 1930s. In our conversation, he never mentioned his 1936 seminal work entitled *Spendthrift Trusts*.[2] When I brought it up, he said with a twinkle in his eye that I apparently had done my homework, and then from memory he cited two authorities, a case and a law review article, that helped me resolve the issue with the Service's National Office.

In his autobiography, Dean Griswold tells the story that after completing the initial manuscript for his casebook on federal taxation, he submitted it to several publishers.[3] However, none would publish it because, they said, there was no market for a casebook limited to federal taxation. As incomprehensible as the story may sound to us who are involved in the federal taxation area today, it is even more astonishing that these events took place only 70 years ago. What changes have taken place in our tax system, in our national

*I wish to express my appreciation to Ryan McCormick, Phil Mann, Don Rocen, and others whose comments and assistance were invaluable. The responsibility for all statements made in the lecture and this article remain with me, but the encouragement and assistance of those with whom I discussed the matters presented in both were most appreciated.

[1]Erwin N. Griswold, Cases and Materials on Federal Taxation (5th ed. 1960).

[2]Erwin N. Griswold, Spendthrift Trusts: Restraints on the Alienation of Equitable Interests Imposed by the Terms of the Trust or by Statute (1936).

[3]*See* Erwin N. Griswold, Ould Fields, New Corne: The Personal Memoirs of a Twentieth Century Lawyer 125 (1992).

economy, and in the world economy over these last seven decades. And what changes are poised to take place in the foreseeable future. Hence, the subject of my remarks today, "Constancy and Change in Our Federal Tax System."

In preparing my remarks, I was struck by the number of changes that have taken place or are about to take place over the course of the next year or so among key personnel who direct our tax system: Doug Shulman, the new Commissioner at the Service; Nathan Hochman, the new Assistant Attorney General at the Tax Division of the Department of Justice; and Ed Kleinbard, the new Chief of Staff of the Joint Committee on Taxation. Already-announced House Ways and Means Committee retirements mean we will see new faces in important tax places in the Congress.[4] And next November we will elect a brand new President. So, within the next year or so, we are assured of having an unusually large number of newly appointed and elected officials in key tax positions at both ends of Pennsylvania Avenue with new energies, attitudes, viewpoints, and priorities.

Despite similar changes over the last 50 years, each of the 14 IRS Commissioners who served during that time chose in one way or another to emphasize tax compliance, taxpayer service, and upgrading or modernizing what we today call information technology to receive, process, and manage tax return information.[5] Each IRS Commissioner did so, knowing that a rising workload and limited resources would require innovation to ensure the delivery of appropriate levels of tax compliance, taxpayer service, and modernization of the tax information systems.

You may recall that a little over 21 years ago, my tenure as Commissioner began on the heels of an unusually difficult 1985 tax filing season in which the Service was delayed in processing tax returns and paying refunds because of software reprogramming problems. Eighty-five million taxpayers expecting refunds averaging over $1000 a refund were not paid on time, and for that reason the 1985 filing season became and remained one of the top media stories in the country for over six months in a row. The media's coverage of the 1985 filing season was so significant that a journalist at the *Philadelphia Inquirer*, Arthur Howe, won a Pulitzer Prize for his stories about the filing

[4]Representative Jim McCrery (R-LA), the ranking Republican member of the House Ways and Means Committee, has announced he will retire at the end of the 110th Congress. He will be joined by senior committee members Representative James Ramstad (R-MN), the ranking Republican on the Ways and Means Oversight Subcommittee; Representative Jerry Weller (R-IL); Representative Ron Lewis (R-KY); and Representative Thomas M. Reynolds (R-NY).

[5]Dana Latham (1958-1961), Mortimer M. Caplin (1961-1964), Sheldon S. Cohen (1965-1969), Randolph W. Thrower (1969-1971), Johnnie M. Walters (1971-1973), Donald C. Alexander (1973-1977), Jerome Kurtz (1977-1980), Roscoe L. Egger, Jr. (1981-1986), Lawrence B. Gibbs (1986-1989), Fred Goldberg, Jr. (1989-1992), Shirley D. Peterson (1992-1993), Margaret Milner Richardson (1993-1997), Charles O. Rossotti (1997-2002), Mark Everson (2003-2007).

season problems.[6] A year later Congress and my new boss, Jim Baker, then-Secretary of the Treasury, told me in no uncertain terms that job one for me was seeing that it never, ever happened again. To emphasize the point, when I made a courtesy call on Senator John Heinz from Pennsylvania, an old college classmate of mine and the then-ranking minority member on the IRS Oversight Subcommittee of the Senate Finance Committee, he arranged for me to meet Mr. Howe in my very first ambush media interview, just to remind me of the importance of avoiding any repeat of the problems of the 1985 filing season. And for 21 years, the Service saw to it that it did not happen again.

Imagine, then, my surprise last December when the politicians themselves created the potential for a significant delay in the tax filing season by failing to pass an alternative minimum tax amendment in time to allow the Service to make the necessary computer changes to process tax returns and pay refunds to expectant taxpayers.[7] That something like this could happen in a presidential election year seemed unimaginable.

The incident reminded me that we have a remarkable but in some ways fragile tax system that all of us, our politicians included, too often take for granted. In no other country in the world do over 100 million individual taxpayers intentionally withhold more than they owe each and every year, thereby effectively making interest-free loans to the government that last year totaled

[6]The Pulitzer Board awarded Howe the Pulitzer Prize for National Reporting for "his enterprising and indefatigable reporting on massive deficiencies in IRS processing of tax returns—reporting that eventually inspired major changes in IRS procedures and prompted the agency to make a public apology to U.S. taxpayers." Pulitzer Prize Winners: 1986, http://www.pulitzer.org (last visited May 18, 2008). Howe's *Philadelphia Inquirer* articles include: *Beware the IRS Computer*, Apr. 21, 1985, at A01; *Computer Problems Create IRS Backlog*, Feb. 28, 1985, at A01; *IRS Backlog Frustrating Thousands*, June 7, 1985, at A01; *Philadelphia's Center Is Still Behind Commissioner Is Unwilling to Disclose How Far*, June 6, 2006, at B15; *Senators Will Hold a Hearing on Problems at IRS Service Center*, June 28, 1985, at D18; *Tax Deadline IRS Union Says Problems Will Delay Refunds*, April 16, 1985, at A01; *Tax Refunds Still Backlogged Despite Overtime Work by IRS*, Apr. 24, 1985, at B06; *Up to 178,000 Taxpayers Wrongly Notified, IRS Says*, Apr. 30, 1985, at A01; *Why So Many Tax Files Vanish at Philadelphia Center*, Mar. 31, 1985, at A01.

[7]*See* Carl Hulse & Suevon Lee, *Tax Stalemate Threatens Chaos as Filing Nears*, N.Y. Times, Dec. 6, 2007, at A33; Alexander Bolton, *Dems and GOP Deadlocked as Adjournment Draws Near*, The Hill, Dec. 12, 2007, *available at* http://thehill.com/leading-the-news/dems-and-gop-deadlocked-as-adjournment-draws-near-2007-12-12.html. After the 2008 Griswold Lecture, Congress increased the burdens on the Service and its information systems by passing the Economic Stimulus Act of 2008, Pub. L. No. 110-185, 122 Stat 613, which will require the Service to make refunds to taxpayers later in 2008. *See* Linda Stiff, Acting Commissioner, Internal Revenue Serv., Testimony Before the House Committee on Ways and Means Subcommittee on Oversight on the 2008 Filing Season 2-3 (Mar. 13, 2008), *available at* http://waysandmeans.house.gov/media/pdf/110/stiff.pdf (describing the challenges related to distributing economic stimulus rebate checks to millions of taxpayers).

nearly a quarter of a trillion dollars.[8] In doing so, taxpayers take for granted that the Service will repay these loans the following year during the filing season, usually within about ten days after a taxpayer files his or her return. Each year between mid-January and mid-February, 32 million individuals routinely file their returns and request and receive refunds, last year averaging $2733 per taxpayer.[9] For many such individuals, who are predominantly low-income taxpayers, their refund is one of their largest assets, certainly their largest liquid asset. Like clockwork, each year for the past 21 years, the Service has paid these refunds. But if that does not happen and if taxpayers do not receive their refunds on time, 1985 taught us that it is—and should be—a big deal.

Last year, it was well-known that the alternative minimum tax provisions would have to be amended so that about 20 million individual taxpayers could avoid an unexpected, unwelcome tax increase that was unintended by the politicians, especially during the 2008 tax filing season, which falls right in the middle of the presidential primaries. As much as I would like to see the responsibility for the current situation remain with the politicians, if a significant delay materializes, I suspect we ultimately may see the politicians press the Service about why it took the Service so long to re-program and test its information systems. My concern is that in the final analysis, the Service may have to defend the same basic computer system I had to defend over 20 years ago—a computer system that essentially was designed in the 1950s and built in the 1960s—a computer system that relies on magnetic tape and not on the Internet to communicate—one that is programmed in basic computer language, a language that almost no one other than the Service still uses—in short, a system that is old, slow, inflexible, and fragile.[10]

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[8] *See, e.g.*, J. Scott Moody, The Cost of Complying with the Federal Income Tax 3 (Tax Found., Special Report No. 138, 2005), *available at* http://www.taxfoundation.org/news/show/1281.html (observing that if United States taxpayers had conservatively invested the money withheld from their paychecks in United States Treasury bonds rather than lending it to the Service, they would have earned approximately $24.8 billion in interest). For a discussion of this phenomenon, see Donna D. Bobek, Richard C. Hatfield, & Kristin Wentzel, *An Investigation of Why Taxpayers Prefer Refunds: A Theory of Planned Behavior Approach,* 29 J. Am. Tax'n Ass'n 93 (2007). Using 2003 data indicating an average refund of $2400, the authors observe that, "[a]verage forgone interest resulting from the overpayment of taxes ranges from around $68 (based on T-bill rates of return) per tax return per year to approximately $306 if money were used instead to pay off credit card bills (assuming an 18% rate)." *Id.* at 93–94.

[9] Oversight Board, Internal Revenue Serv., Impact of Late AMT Legislative Changes on 2008 Filing Season 3 (2007), *available at* http://www.treas.gov/irsob/releases/2007/AMT-IssuePaper.pdf; *see also IRS Oversight Board Suggests Prompt Passage of AMT Relief*, 2007 Tax Notes Today 228-15 (Nov. 27, 2007).

[10] *See, e.g.*, Gen. Gov't Div., U.S. Gen. Accounting Office, Tax Systems Modernization: IRS Needs to Resolve Certain Issues with Its Integrated Case Processing System 1-2 (1997) ("IRS has invested millions of dollars in [Integrated Case Processing or "ICP"]; but unresolved issues with the costs and benefits of ICP, the testing of ICP, the redesign of work

Given the limitations of the Service system, it is impressive that the Service technicians were able to come up with a way to permit the 2008 filing season to begin on time for most taxpayers. If, as the Service has projected, fewer than five million taxpayers will be delayed in filing their tax returns by only one month and fewer than four million will have their refunds delayed, it will be a remarkable accomplishment.[11] Hopefully, no further problems will be encountered, and this year's filing season, like the last 21 filing seasons, will be unremarkable.[12]

On the one hand, I am as impressed today as I was 20 years ago that the Service technicians can make such an ancient system perform as well as it does year after year. On the other hand, I am even more impressed by the argument that it is well past time for the entire system to be replaced with a modern system that has been on the drawing board in one form or another for over 20 years. It makes little sense that the system responsible for our country's $3 trillion annual tax revenue system, upon which our citizens and our entire government operations rely so heavily, should depend upon such an outdated, antiquated information system. It therefore will not surprise me if Commissioner Shulman is greeted this year, as I was greeted 21 years ago, with calls for the delivery of a more dependable information system. I wish Doug well and hope that this event may become a catalyst for changes to facilitate the completion and implementation of a new, more dependable system.

Twenty-one years ago, I also was confronted with taxpayer service systems that were not responsive to the needs and growing demands of taxpayers. In

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processes, and software development weaknesses raise serious concerns about IRS' capability to successfully develop and deploy ICP."); Info. Mgmt. & Tech. Div., U.S. Gen. Accounting Office, ADP Modernization: IRS' Redesign of Its Tax Administration System 8 (1987) ("The initial automation of portions of this [tax administration] system were based on a plan approved by the Congress in 1959 . . . . Since its inception, the system has operated in the same basic manner."); U.S. Gov't Accountability Office, 2007 Tax Filing Season: Interim Results and Updates of Previous Assessments of Paid Preparers and IRS's Modernization and Compliance Research Efforts (2007) ("IRS has more to do to fully address GAO's prior recommendations such as developing a long-term strategy that would include timeframes for retiring legacy computer systems."); David Cay Johnston, *At I.R.S., a Systems Update Gone Awry*, N.Y. Times, Dec. 11, 2003, at C1.

[11]*See Filing Season Opens on Time Except for Certain Taxpayers Potentially Affected by AMT Patch*, IR-News Rel. 2007-209, *available at* http://www.irs.gov/newsroom/article/0,,id=176948,00.html; *see also* Internal Revenue Serv., *Highlights of 2007 Tax Changes: Law Raises AMT Exemption, Filers of Five Forms Must Wait Until Feb. 11*, Fact Sheet 2008-1 (2008), *available at* http://www.irs.gov/newsroom/article/0,,id=177049,00.html; AMT and Filing Season 2008: Q&A, http://www.irs.gov/newsroom/article/0,,id=177009,00.html (last visited May 18, 2008).

[12]Recent reports suggest that the centerpiece of the modernized tax return processing system at the Service, the Customer Account Data Engine (CADE), is having a significant impact. *See IRS CADE Processing System Tops 15 Million Tax Returns*, IR-News Rel. 2008-39, *available at* http://www.irs.gov/pub/irs-news/ir-08-039.pdf. As of March 12, 2008, CADE had successfully processed 25% of all individual income tax returns received so far this year by the Service. *Id.*

the 1980s, most of the taxpayer education and assistance capability of the Service was provided by paper forms, instructions, and publications and a telephone answering system that struggled to handle and deal with taxpayers' basic questions about their return, filing and tax compliance responsibilities. Jake Pickle, then Chairman of the IRS Oversight Subcommittee of the House Ways & Means Committee, once told me quite publicly that he had better odds of placing the right bet at the gaming tables here in Las Vegas than he did in trying to get the right answer to a tax question when he called the Service.[13] He said it was unlikely that the Service would even answer his telephone call without a seemingly interminable wait, and once his call was answered, his chances were less than 50-50 that he would receive the correct answer. Today, we rarely hear such criticisms. One reason is that the Service has replaced its primary reliance upon paper with an excellent website that provides up-to-date, real-time education and assistance to taxpayers and also to practitioners.[14] And the Service telephone answering system to provide taxpayers advice and assistance is a world-class system.[15] The Service technology in this regard has come a long way in the last 20 years.

Turning to Service compliance and enforcement activities, some have complained that the Service was too slow on the uptake to prevent widespread noncompliance during the tax shelter years of the late 1990s and early 2000s. Some of this criticism may be fair, but I personally believe much of it overlooks the impact on Service compliance programs of the politicians' protracted criticisms during the 1990s of our income tax system and its most visible symbol, the Service. The elimination of the Taxpayer Compliance Measurement Program without a substitute capability for the Service to measure and report the levels of tax compliance,[16] the various iterations of the Taxpayer

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[13]*See The 1988 Tax Return Filing Season*, *Hearing Before the Subcomm. on Oversight of the H. Comm. on Ways & Means*, 100th Cong. PAGE (1988) (statement of J.J. Pickle, Chairman of the IRS Oversight Subcommittee of the House Ways & Means Committee); *see also* Gary Klott, *Little Improvement Is Seen in Mistake Rate of I.R.S.*, N.Y. Times, Apr. 14, 1988, at D2; Robert Pear, *Phoning I.R.S. with Tax Queries? 39% of the Replies May Be Wrong*, N.Y. Times, Feb. 23, 1988, at A1.

[14]*See* Internal Revenue Service, http://www.irs.gov.

[15]According to a recent Government Accountability Office study, the Service estimates the accuracy rate of its telephone assistors' responses to taxpayers' tax law and account questions is over 90%. The improvements are attributable to "better and more timely performance feedback for telephone assistors, increased assistor experience, better training, and increased use of the Probe and Response Guide, a script used by telephone assistors to understand and respond to tax law questions." U.S. Gov't Accountability Office, Assessment of the Interim Results of the 2006 Filing Season and Fiscal Year 2007 Budget Request 9-11 (2006).

[16]*See Taxpayer Compliance Measurement Program*, IR-News Rel. (Oct. 23, 1995) ("[I]t is clear that the 1996 budget will require the IRS to limit its compliance programs. For that reason, in addition to other possible program cuts, the IRS has decided to postpone indefinitely the TCMP program."); *see also Taxpayer Compliance Measurement Program: Hearing Before the Subcomm. on Oversight of the H. Comm. on Ways & Means*, 104th Cong. (1995); George Gutman, *Citing Budget, IRS Announces Indefinite Suspension of TCMP*, 1995 Tax Notes Today 212-25 (Oct. 30, 1995).

Bill of Rights,[17] and the congressional hearing attacks on specific activities of Service compliance functions that led up to the passage of the 1998 Interal Revenue Service Restructuring and Reform Act[18] may not have been totally off the mark. But I believe the cumulative, overall impact of these and other similar actions was to increase public disrespect for, lessen public support of, and diminish the compliance capabilities of the Service to the point that from 1998 to 2002, there was so little compliance and enforcement presence by the Service that overly aggressive and sometimes abusive tax planning and the resultant tax noncompliance became so pervasive that *Forbes* magazine suggested you were a chump if you were not involved in tax schemes.[19] While some may criticize certain aspects of the government's responses to tax shelters and other forms of tax noncompliance since 1998, I generally give the Service, the Treasury, and the Department of Justice high marks for their efforts, particularly over the last six years.

But prior discussions of tax shelters and the Service responses to them seem to me to have largely ignored a more fundamental and important change in the way the Service today is dealing with tax compliance and noncompliance. For most of my career as a tax attorney, the Service has relied upon traditional, generalized audits of taxpayers' returns, supplemented by withholding at the source and third-party reporting and Service document matching, to detect and deter tax noncompliance and thereby to ensure tax compliance. Over the last 20 years, as Service workload in terms of the number of tax returns filed each year continued to increase and the Service's compliance resources remained about the same, the Service could no longer afford to continue its

[17]Omnibus Taxpayer Bill of Rights, Pub. L. No. 100-647, 102 Stat. 3730 (1988) (enacted as Title VI, Subtitle J of the Technical and Miscellaneous Revenue Act of 1988); Taxpayer Bill of Rights 2, Pub. L. No. 104-168, 110 Stat. 1452 (1996); Taxpayer Bill of Rights 3, Pub. L. No. 105-206, 112 Stat. 726 (1998) (enacted as Title III of the Internal Revenue Service Restructuring and Reform Act of 1998); *see also Exploring the Development of Taxpayer Bill of Rights III Legislation: Hearing Before the Subcomm. on Oversight of the H. Comm. on Ways & Means*, 104th Cong. (1995).

[18]*IRS Restructuring: Hearings on H.R. 2676 Before the S. Comm. on Finance*, 105th Cong. (1998) (the first set of Senate hearings were held on January 28, 29; February 5, 11, and 25, 1998); *IRS Oversight: Hearings Before the S. Comm. on Finance*, 105th Cong. (1998) (the second set of Senate hearings were held on April 28, 29, 30, and May 1, 1998).

[19]*See* Janet Novack, *Are You a Chump?*, Forbes, Mar. 5, 2001, at 122; *see also* IRS Oversight Board, Annual Report 2001, at 2 (2002) ("The Oversight Board is concerned that the broad decline in enforcement activity increases our reliance on voluntary compliance, and fears that the public's attitude towards voluntary compliance is beginning to erode."); Larry Levitan, Chairman, IRS Oversight Board, Testimony Before the Joint Committee on Taxation: Joint Hearing on the Strategic Plans and Budget of the IRS (May 14, 2002); Alison Bennett, *IRS Compliance Activity Increasing but Audit Rates Rising Slowly, Data Show*, Daily Tax Rep. (BNA), Mar. 21, 2003, at GG-1.

traditional approach to tax compliance.[20] In the face of a rising workload and the politicians' reluctance to increase Service resources, the Service has shifted a significant portion of the cost and burden of tax compliance to the private sector. The Service also has begun to leverage, target, and use its compliance resources in ways quite different from those of 20 years ago.

For example, 20 years ago, I was able to obtain additional funding to hire more Service compliance personnel to clean up the remnants of the individual tax shelters of the 1970s and early 1980s.[21] To deal with the more recent tax shelters of the 1990s, regulations initially and later legislation now require taxpayers, promoters, and advisors to self-identify and disclose to the Service listed, reportable, and other transactions with respect to which the Service believes the risk of tax noncompliance is high.[22] Today, Service examination procedures and certain penalty provisions encourage taxpayer self-identification and disclosure of non-compliance to minimize the taxpayer's risk of increased costs and, in some cases, adverse publicity associated with significant penalties.[23]

For large corporate taxpayers, the Schedule M-3, financial accounting disclosures required by FIN 48, and in some cases, Service requests for tax accrual

[20]From 1990 through 2007, the number of individual income tax returns increased by over 21%; corporate income tax returns, by almost 51%; partnership income tax returns, by 74%; estate and trust income tax returns, by 42%; tax-exempt organizations returns, by almost 77%; employment tax returns, by 3%; and excise tax returns, by less than 1%. *See* Statistics of Income Div., Internal Revenue Serv., 26 Statistics of Income Bulletin 295-97 tbl.21 (2007). Only estate and gift tax returns declined. *Id*. The number of Service personnel today, 93,088, is about the same as it was when I left in 1989. Even allowing for productivity gains from electronic filing and Service modernization efforts, the workload increases clearly have outstripped personnel increases in the last 20 years.

[21]*See* Nathaniel C. Nash, *A New Tax Code in the Spotlight: Gibbs Looks Not for Love but Respect for the I.R.S.*, N.Y. Times, Mar. 6, 1988, § 3A, at 10 (noting that "[a]fter rising by 2500 last year [the number of auditors and investigators has] jumped another 2500 this year and will rise yet another 2500 in 1989"); *see also* Gen. Gov't Div., U.S. Gen. Accounting Office, IRS Implementation of the 1987 Revenue Initiative (1987); Daniel F. Cuff, *Devising Strategies: The I.R.S. and You: Closer than Ever Before*, N.Y. Times, Mar. 6, 1988, § 3A, at 18. In doing so, I relied heavily on the arguments made by Gene Steuerle in his book, Who Should Pay for Collecting Taxes?: Financing the IRS (1986).

[22]*See* T.D. 8877, 2000-1 C.B. 747, *amended by* T.D. 8961, 2001-2 C.B. 194 (temporary regulations applicable to corporations); T.D. 9000, 2002-2 C.B. 87 (extending the temporary regulations to taxpayers other than corporations for transactions entered into after 2000). Final regulations were issued in 2003. *See* T.D. 9046, 2003-1 C.B. 614, *amended by* T.D. 9108, 2004-1 C.B. 429. Congress enacted significant anti-tax shelter legislation in 2004. *See* American Jobs Creation Act of 2004, Pub. L. No. 108-357, §§ 811–820, 118 Stat. 1418, 1575–86. For commentary on the application of the tax shelter reporting and penalty rules, see Boris I. Bittker & Lawrence Lokken, Federal Taxation of Income, Estates, and Gifts ¶ 111.1A (Cum. Supp. No. 1 2008).

[23]*See* Rev. Proc. 94-69, 1994-2 C.B. 804, §§ 2.10, 3.01 (allowing taxpayers subject to the Coordinated Examination Program to avoid accuracy-related and substantial understatement penalties by providing the Service with a written disclosure within 15 days of being notified by the Service with regard to the opening of an examination).

workpapers are examples of instances in which taxpayers increasingly are being called upon to provide the Service with information that, in effect, will self-identify potential sources of noncompliance.[24] Letters and questionnaires sent last summer to at least two dozen large companies by the Permanent Subcommittee on Investigations of the Senate Committee on Homeland Security and Government Affairs raise the prospect that Congress will soon intervene in the debate.[25]

In addition to the steps the Service has taken to require taxpayers to self-identify the soft spots in their own tax returns, the Service is experimenting with ways to use its existing resources to audit more taxpayers. Thus, the Service is shortening its audit cycles, thereby allowing its existing audit personnel to audit more taxpayers.[26] To lessen the risk that shorter audit cycles will result in major tax noncompliance going undetected, the Service is not only relying on increased taxpayer self-identification but also is moving away from generalized audits of entire returns to more selective audit programs, such as that in the Large and Mid-Size Business Division (LMSB) Industry Issue Focus program, that focus primarily upon a limited number of particularly high risk issues.[27]

The Service also is using accelerated audit programs, like the Compliance Assurance Process (CAP) audits and the Limited Issue Focus Examination (LIFE) audits, to provide incentives and encouragement to cooperative, compliant taxpayers, thereby freeing up more Service resources to audit more taxpayers and target more noncompliant taxpayers.[28] Under the CAP and

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[24] *See generally* David Click, *Taxing Standards: Recent Changes in the Practice of Tax Law*, 118 Tax Notes (TA) 293 (Jan. 14, 2008); Sam Young, *LMSB Officials, Practitioners Spar over Taxpayer Transparency*, 2007 Tax Notes Today 197-6 (Oct. 11, 2007); John K. Cook, *IRS Tax Accrual Workpapers Requests: An (Un)limited Expansion?,* 76 Prac. Tax Strategies 260, May 2006.

[25] *See generally* Jesse Drucker, *How Accounting Rule Led to Probe—Disclosure of Tax Savings Firms Regard as Vulnerable Leaves Senate Panel a Trail*, Wall St. J., Sept. 11, 2007, at A5; *Levin Asks Corporations for Information on Tax Benefits, FIN 48 Compliance*, 2007 Tax Notes Today 170-24 (Aug. 23, 2007).

[26] *See generally* Allen Kenney, *Corporate Audit Rate on Track; OIC to Get Help, Say IRS Officials*, 2004 Tax Notes Today 214-2 (Nov. 4, 2004); Thomas W. Wilson, Jr., *Architect of IRS Currency Initiative Advises LMSB Taxpayers Prepare for Impact of CAP Initiative, Form 1120 E-Filing, Schedule M-3, Section 199*, Daily Tax Rep. (BNA), Jan. 4, 2006, at J-1.

[27] *See* Internal Revenue Serv., Industry Issue Focus (IIF) Fact Sheet (Mar. 2007), *available at* http://www.irs.gov/businesses/article/0,,id=168490,00.html; *see also* David B. Blair & George A. Hani, *LMSB's Industry Issue Focus Approach: Applying Lessons Learned from Battling Tax Shelters to Mainstream Tax Issues*, 59 Tax Executive 237 (2007).

[28] *See Compliance Assurance Process*, Announcement 2005-87, 2005-2 C.B. 1144; *Examinations—Limited Issue Focused Examination*, IR-News Rel. 2002-133; see also Michael I. Saltzman, IRS Practice and Procedure ¶ 8.15[6][h] (2d ed. 2007) ("Limited Issue Focused Examinations"); Robert E. Brazzil, *Life in the Fast Lane: IRS Aims for Audit Currency*, Prac. Tax Strategies, Sept. 2005; Deborah Nolan, *LMSB's Compliance Assurance Program (CAP): One Year Later*, 58 Tax Executive 26 (2006).

LIFE audit programs, a taxpayer's participation is by invitation only, and so far the Service has invited only those companies with reputations as generally cooperative, compliant taxpayers to participate in the programs. Accelerated audits in these programs cover only those issues that are significant enough to exceed certain materiality standards agreed to in advance by taxpayers and the Service, plus a handful of other specified issues the Service considers to be high tax risk issues.

In the more recent CAP program, the Service begins the audit of each year well before the taxpayer even files a tax return for the year. At least quarterly each year CAP taxpayers must identify and fully disclose to the Service each tax position arising in a completed transaction that involves either a material amount of tax or a specified high risk issue. The Service then tries to complete an audit of the disclosed issues before the return for the year is filed. If all goes well, the Service and the taxpayer execute a closing agreement covering all agreed issues within a short time after the return is filed. If the Service cannot complete the audit of identified issues before the taxpayer's return is filed, the audit continues. If a taxpayer fails to identify a material tax position or specified tax issue to the Service, there is no audit or closing agreement covering the undisclosed position or issue and, therefore, no certainty about its tax consequences. Finally, after the taxpayer files its return, the taxpayer must represent to the Service that no undisclosed tax position on any issue increased the taxpayer's financial tax reserve for that year.[29] The reduction in FIN 48 costs and concerns alone has made the CAP program increasingly popular with large corporate taxpayers, over 100 of which are expected to be using CAP this year.

Outsourcing is another technique the Service has used to shift the cost and burden of tax compliance to the private sector. For example, under legislation passed by Congress, the Service has outsourced part of its collection function to the private sector because the Service had more delinquent taxpayer accounts than existing Service collection personnel could handle and for years

[29]The Service amended the wording of its form Memorandum of Understanding that companies that join the CAP program must sign, effective November 19, 2007, to add the following provision:

> Within thirty days of the return filing date, an officer of the Taxpayer with authority to sign the Taxpayer's U.S. income tax returns will be asked to provide a representation that all completed transactions and items that have a material effect on its income tax liability have been disclosed and there are no remaining undisclosed transactions or tax positions related to U.S. taxes that would require the taxpayer to report reserves for purposes of any financial statement for the CAP year or any period subsequent to the CAP year.

Compliance Assurance Process (CAP), M.O.U. (Version 2, Nov. 19, 2007) (on file with author).

the politicians had failed to appropriate more funding for additional collection personnel.[30] The National Treasury Employees Union and even the National Taxpayer Advocate have opposed the collection outsourcing, stressed its shortcomings, and urged that additional funding be provided to take up the slack in collection.[31] I too would prefer to see additional Service funding for collection, but I am skeptical that will happen in light of the appropriations shortfalls of the last 20 years at the Service. Last year, for example, the House passed legislation that would have terminated the collection outsourcing program but proposed no additional funding for collection. Because of the risks to our system when taxpayers learn that the Service does not have sufficient collection personnel to pursue all taxpayers who fail to pay what they owe, I favor the outsourcing, unless and until the politicians agree to provide the Service with the sufficient, sustained funding to permit the Service to pursue taxpayers who fail to pay what they owe. The government has an obligation to honest taxpayers who pay their fair share of taxes to pursue taxpayers who fail to do so. Until the politicians provide additional funding on a sustained basis to permit the Service to discharge that obligation, outsourcing should continue, with whatever legislative changes are needed to make it work effectively.

Another outsourcing technique involves government programs to reward individuals for blowing the whistle on non-compliant taxpayers. President Lincoln and Congress used a prior variation of this idea after creating the Service to help defray the cost of the Civil War when they staffed the agency on

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[30] *See* American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 881, 118 Stat. 1418, 1625–27 (adding Code sections 6306 and 7433A and authorizing the Treasury Secretary to enter into "qualified tax collection contracts"); Jeffrey B. Tate, *Debt and Taxes: A Look at the IRS Private Debt Collection Program*, 2007 Tax Notes Today 157-33 (Aug. 14, 2007).

[31] News Release, Nat'l Treasury Employees Union, NTEU's Kelley Calls on House to Approve H.R. 3056 (Oct. 9 2007), http://www.nteu.org/PressKits/PressRelease/PressRelease.aspx?ID=1160 ("In addition to cost, NTEU has underscored the dangers to taxpayers not only in terms of the security of their personal financial information but of the risks of facing the abusive tactics that debt collectors are so well-known to use."); 1 Nat'l Taxpayer Advocate, Taxpayer Advocate Serv., Internal Revenue Serv., 2007 Annual Report to Congress 411–431 (2008). In her annual report, Taxpayer Advocate Nina Olson states:

> Today the [private debt collection] initiative is failing in most respects. It is not meeting revenue projections . . . . It is not more successful than the IRS at finding hard-to-locate taxpayers . . . . It is significantly less successful than IRS employees at fully resolving taxp ayer past due accounts . . . . Most importantly, the IRS has placed the interests of the PCAs above the interests of taxpayers and tax administration by failing to require the PCAs to disclose training materials, scripts, letters, and operational plans relating to taxpayer contact—items that the IRS itself must disclose about its own collection operations.

Id. at 411–12 (footnotes omitted).

a very limited basis and made tax returns public.[32] Twenty years ago, the Service informant program was informal, sporadic, and produced mixed results, in part perhaps because rewards to informants were discretionary and rarely exceeded 15% of amounts collected as a result of the information received from an informant.[33] A little over a year ago, Congress passed a new Service whistleblower program that significantly increases the potential bounties for whistleblowers, who now can receive 15%-30% of amounts the Service collects, including not only tax but also interest, penalties, and other amounts.[34] The Service has opened a new whistleblower office and last December announced new procedures to process and pursue claims submitted by individuals.[35] Even before the new office opened last year, the Service confirmed

[32]Prior to the Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520, all income tax returns were "public records," but were open to inspection only under regulations approved by the President or under presidential order. Staff of Joint Comm. on Tax'n, 94th Cong., General Explanation of the Tax Reform Act of 1976, at 313 (Comm. Print 1976). The public nature of individual and corporate income tax returns is traceable to the first income tax, enacted at the behest of President Lincoln in 1861 during the Civil War. *See* Revenue Act of 1861, ch. 45, § 22, 12 Stat. 292, 299–300. The Revenue Act of 1861 created a Commissioner of Taxes and directed tax assessors to post tax valuations for public review. Specifically, the Act provided that:

> [I]mmediately after the valuations and enumerations shall have been completed . . . the assessor in each collection district shall, by advertisement in some public newspaper, if any there be in such district, and by written notifications to be publicly posted up in at least four of the most public places in each collection district, advertise all persons concerned of the place where the said lists, valuations, and enumerations may be seen and examined.

§ 22, 12 Stat. at 299. *See also* Joe Thorndike, *An Army of Officials: The Civil War Bureau of Internal Revenue*, 2001 Tax Notes Today 249-39 (Dec. 24, 2001). The Tariff Act of 1916, Pub. L. No. 63-16, 38 Stat. 114 (1913), which established the modern income tax after ratification of the Sixteenth Amendment earlier the same year, provided that income tax returns "shall constitute public records and be open to inspection as such: *Provided*, That any and all such returns shall be open to inspection only upon the order of the President, under rules and regulations to be prescribed by the Secretary of the Treasury and approved by the President." Tariff Act of 1916, § 2(G)(d). The general regime created by the Revenue Act of 1913 lasted until 1976. Under the Tax Reform Act of 1976, as a general rule, income tax returns and return information are confidential and not subject to disclosure except as specifically provided in section 6103 or other sections of the Code. *See* General Explanation of the Tax Reform Act of 1976, *supra*, at 315.

[33]Treasury Inspector Gen. for Tax Admin., The Informants' Rewards Program Needs More Centralized Management Oversight (2006); Thomas Kostigen, Commentary, *Tax Cheat Whistleblower Program Pays Few Returns*, MarketWatch, June 23, 2006, *available at* http://www.marketwatch.com.

[34]*See* Tax Relief and Health Care Act of 2006, Pub. L. No. 109-432, § 406, 120 Stat. 2922, 2958–60; Notice 2008-4, 2008-2 I.R.B. 1 (providing interim guidance for claims submitted to the new Service Whistleblower Office under section 7623).

[35]*Claims Submitted to the IRS Whistleblower Office Under Section 7623*, Notice 2008-4, 2008-2 I.R.B. 1; *see also IRS Issues Interim Guidance on Submitting Award Claims to Whistle-Blower Office*, 2007 Tax Notes Today 245-13 (Dec. 20, 2007).

it had already received 80 claims for unpaid taxes, some in the hundreds of millions of dollars.[36] Two recent claims for back taxes in the billions of dollars also have been reported.[37]

To deal with serious non-compliance problems, the Service increasingly is requiring non-compliant taxpayers to hire and pay private sector monitors. The monitors report to the Service and are responsible for assuring that the taxpayers make the necessary changes to comply with their tax obligations in the future.[38] An example is a provision of KPMG's deferred prosecution agreement requiring KPMG to employ Richard Breeden to monitor KPMG's tax compliance and report periodically to the Service. Variations of this type of outsourcing have become popular in other executive agencies, including the Securities and Exchange Commission, the Office of the Comptroller of the Currency, the Customs Department at Homeland Security, and the Department of Justice in administering the Foreign Corrupt Practices Act (FCPA).[39] For that reason, it will not be surprising if the Service makes even greater use of this kind of compliance outsourcing technique in the future, in effect shifting part of the cost and burden of assuring compliance to noncompliant taxpayers.

The Service also has leveraged its resources through its relationships with state, local, and foreign governments and international institutions. Properly structured, these relationships can expand Service compliance capabilities and improve taxpayer compliance. Twenty years ago, organized information sharing arrangements primarily involved formal agreements between the Service and the states that disproportionately benefited the states. Significant instances

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[36] *See Procedure Unveiled for Reporting Violations of the Tax Law, Making Reward Claims*, IR-News Rel. 2007-201; *see also IRS Announces Procedure for Reporting Tax Law Violations, Making Reward Claims*, 2007 Tax Notes Today 245-17 (Dec. 20, 2007).

[37] *See* J.P. Finet, Tax *Whistleblower Action Claims $1 Billion Underpayment by Fortune 500 Company,* Daily Tax Rep (BNA), Oct. 12, 2007, at G-5; J.P. Finet, *Whistleblower Action Claims Major Firm Underpaid Its U.S. Taxes by $2 Billion*, Daily Tax Rep. (BNA), Dec. 12, 2007, at G-9.

[38] *See* Lawrence B. Gibbs, *Reflections on Practicing Tax in Today's World*, 57 Tax Executive 533 (2005); Jonathan D. Glater & Lynnley Browning, *Deal Likely to Let KPMG Avoid Charge in Tax Case*, N.Y. Times, Aug. 11, 2005, at C1; Arshad Mohammed, *'Bulldog' Breeden to Monitor Tax-Fraud Deal*, Wash. Post, Aug. 30, 2005, at D1.

[39] *See* Lawrence D. Finder & Ryan D. McConnell, *Devolution of Authority: The Department of Justice's Corporate Charging Policies*, 51 St. Louis U. L.J. 1 (2006); Thomas Jaworski, *Panelists Discuss Perceived Improprieties of Foreign Corrupt Practices Resolution Process*, 2008 Fin. Reporting Watch 34-14 (2008) (noting that "the appointment of independent monitors to evaluate a company's compliance and risk assessment systems has increasingly become a major part of the resolution of FCPA violations involving bribery and books and records issues"); Corporate Crime Reporter, Crime Without Conviction: The Rise of Deferred and Non-Prosecution Agreements (2005), *available at* http://www.corporatecrimereporter.com/deferredreport.htm.

of tax non-compliance in the 1990s, including outright tax evasion facilitated by the use of off-shore credit cards, changed that.[40] The Service discovered that if it failed to develop productive, reciprocal relationships with foreign jurisdictions, many just miles off our shore, the difficulty of enforcing our tax laws and preventing tax evasion could not be contained. As the Service, Chief Counsel, and the Tax Division of the Department of Justice became more adept at dealing with tax shelters and other forms of civil and criminal tax noncompliance, other countries discovered that such schemes were being imported into their countries.[41] Jeffrey Owens, Director of the Center for Tax Policy and Administration at the Organisation for Economic Co-operation and Development (OECD), remarked two years ago at a conference I attended in London that the tax shelter phenomenon was at least as serious a threat to the tax bases of OECD countries as transfer pricing.[42] As a result, during the last five years there has been a steady dialogue and increased sharing of tax compliance information and ideas among tax collection agencies around the world. The Service continues to enter into more and better information sharing and cooperation arrangements with states and foreign governments, such as the agreement opening the Joint International Tax Shelter Information Center (JITSIC), agreements to share information in bilateral transfer pricing matters, agreements for tax consultation and cooperation through the OECD, and the recently announced memorandum of understanding between the Service and state workforce agencies.[43]

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[40]Brant Goldwyn, *Grassley, Baucus Want Sustained Effort Against Offshore Accounts; Questions IRS*, Daily Tax Rep. (BNA), July 30, 2003, at G-8; Brant Goldwyn, *IRS Seeks Additional Credit Card Records in Campaign Against Offshore Accounts*, Daily Tax Rep. (BNA), Mar. 26, 2002, at GG-1; Stephen Siciliano, *Service Plans To Aggressively Pursue Offshore Credit Card Fraud Cases, Official Says*, Daily Tax Rep. (BNA), Aug. 26, 2003, at G-4.

[41]*European Parliament Adopts Report on Cross-Border Losses*, 2007 Worldwide Tax Daily (TA) 247-15 (Jan. 15, 2008); Glenn R. Simpson & Dan Bilefsky, *EU's Tax Changes Scatter Corporations*, Wall St. J., Oct. 9, 2003, at 1.

[42]*See* Jeffrey Owens, *Abusive Tax Shelters: Weapons of Tax Destruction?*, 40 Tax Notes International (TA) 873 (Dec. 5, 2005); Jeffrey Owens, Director, OECD Center for Tax Policy and Administration, Testimony Before Senate Finance Committee on Offshore Tax Evasion (May 3, 2007).

[43]*See IRS and States to Share Employment Tax Examination Results*, IR-New Rel. 2007-184; *Joint International Tax Shelter Information Centre Expands and Opens a Second Office in the United Kingdom*, IR-News Rel. 2007-104; Memorandum from the Office of Chief Counsel, Internal Revenue Serv., Disclosure in State Tax Proceeding (Aug. 17, 2007) (regarding the disclosure of return information in state tax proceedings); Org. for Econ. Co-operation & Dev., Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (1995); Sam Young & Dustin Stamper, *IRS, States Agree to Share Tax Return Data*, 2007 Tax Notes Today 216-3 (Nov. 7, 2007); *see also* Karen Setze, *IRS-State Information Sharing Initiative To Go Nationwide in 2009, Brown Says*, 2007 Tax Notes Today 115-8 (June 14, 2007); Ernst & Young, *Tax Administration Goes Global: Complexity, Risks, Opportunities*, 2007 Tax Notes Today 39-48 (Feb. 26, 2007).

New information technology, a driver of productivity growth within the private sector over the last 20 years, also has helped the Service enhance its tax compliance capabilities. The Office of Tax Shelter Analysis uses Service technology to identify potential non-compliance and to disseminate the information quickly throughout the Service to enable existing Service personnel to more effectively locate and deal with potential non-compliance.[44] Despite Service problems in modernizing its returns processing operations mentioned earlier, the growth of electronic filing of tax returns will not only make it easier for the Service to match information reporting documents with taxpayers' returns, but also is expected to provide tax return information more quickly to Service examination personnel. In the future, electronic filing should help the Service to more easily identify outliers in the compliance area and facilitate a more efficient use of the data to address noncompliance.[45] About 80 million (or almost 60% of) individual returns are now filed electronically, and the Service has begun to require that business returns be filed electronically.[46] As a result, electronic filing is another area in which the Service is reducing its operating costs and will be able in real time to use the information from electronically-filed returns to identify potential areas of tax non-compliance in the future.

For many taxpayers, their only personal interaction with the tax system is through a third party intermediary, often an accountant or other tax return preparer. As the tax law has grown more complex, about 60% of individual taxpayers now rely on professionals to prepare and file their returns.[47] Many affluent individual and business taxpayers rely on tax accountants and tax attorneys to assist them in their tax planning and compliance. Ensuring that such tax advisors are well-trained, well-informed, and honest brokers of tax planning information and advice to taxpayers is a critical component of tax compliance. Some lawmakers advocate licensing and more regulation of tax preparers by the Service.[48] Through Circular 230 and the Office of Professional Responsibility, the Service and Treasury have taken aggressive steps to

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[44]Sheryl Stratton, *Inside OTSA: A Bird's-Eye View of Shelter Central at the IRS*, 2003 Tax Notes Today 174-2 (Sept. 9, 2003).

[45]*See* Mary Mosquera, *Oversight Board: IRS Can Reach E-Filing Goal of 80 Percent by 2012*, Fed. Computer Wk., Feb. 8, 2008, *available at* http://www.fcw.com/online/news/151588-1.html; *see also* Philip J. Harmelink & William M. VanDenburgh, *An Assessment of the E-Filing Agreement*, 2002 Tax Notes Today 251-19 (Dec. 30, 2002); Lawrence H. Summers, Sec'y of the Treasury, A New IRS for a New Century, Remarks at the Service Modernization Conference (Jan. 13, 2000), http://www.treas.gov/press/releases/ls332.htm.

[46]*See* Statistics of Income Div., Internal Revenue Serv., *supra* note 20, at 296 tbl.21; *IRS Announces Electronic Filing Requirements for Large Corporations, Exempt Organizations*, IR-News Rel. 2005-8.

[47]*See* Statistics of Income Div., Internal Revenue Serv., *supra* note 20, at 298 tbl.22.

[48]*See, e.g.*, Taxpayer Protection and Assistance Act of 2007, S. 1219, 110th Cong. (2007).

deal with inappropriate behavior by tax professionals.[49] At the international level, the OECD's Tax Intermediaries Study Group developed and recently published proposed strategies for tax administrators to pursue with tax advisors as well as taxpayers to reduce abusive tax planning.[50]

These are important changes the Service has made and is making to enhance tax compliance and to preserve the integrity of the United States tax base. Protecting our tax base is going to become even more important as politicians cope with the effects of the impending demographic shift caused by the baby boomers' retirements that will require the government to defray the increased costs of our federal healthcare and retirement programs.[51] There appears to be general agreement between both of our political parties that the present unfunded, discounted-to-present-value amount of future Medicare and Social Security obligations, based on the level of benefits provided by present law, is around $45 trillion.[52] Maintaining the integrity of our tax system to assist in addressing a deficit of this magnitude will be critical. At the same time, it is important to realize that one impact of these escalating

[49] *See IRS and the Treasury Department Amend Circular 230 to Promote Ethical Practice by Tax Professionals*, IR-News Rel. 2004-152; *New Director Named for IRS Office of Professional Responsibility*, IR-News Rel. 2003-148; Kenneth A. Gary, *Treasury Officials Discuss Changing Role of OPR, Circular 230*, 2004 Tax Notes Today 7-2 (Jan. 9, 2004); Dustin Stamper, *OPR Director Offers Warning for Appraisers and In-House Tax Counsel*, 2007 Tax Notes Today 197-4 (Oct. 11, 2007).

[50] Org. for Econ. Co-operation & Dev., Study Into the Role of Tax Intermediaries (2008). The working papers from the OECD's Tax Intermediaries Study are available on the OECD's website at: http://www.oecd.org/document/27/0,3343,en_2649_33749_39006683_1_1_1_1,00.html (last visited May 18, 2008).

[51] *See Retirement Policy Challenges and Opportunities for Our Aging Society: Hearing Before the H. Comm. on Ways and Means*, 109th Cong., 7–10 (2005) (statement of Douglas Holtz-Eakin, Director, Congressional Budget Office); 2007 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds, H.R. Doc. No. 110-30 (2007), *available at* http://www.ssa.gov/OACT/TR/TR07/tr07.pdf; Ben S. Bernanke, Chairman, Federal Reserve, Long-Term Fiscal Challenges Facing the United States, Testimony Before the Senate Committee on the Budget (Jan. 18, 2007), *available at* https://www.federalreserve.gov/newsevents/testimony/bernanke20070118a.htm.

[52] *See Retirement Policy Challenges and Opportunities for Our Aging Society*, *supra* note 51; Jagadeesh Gokhale & Kent Smetters, Fiscal and Generational Imbalances: New Budget Measures for New Budget Priorities 42 (2003):

> Based on OMB's policy-inclusive budget projections, the federal government's Fiscal Imbalance is $44.2 trillion as of fiscal-year-end 2002. This is the amount of resources in present value that the government must produce, either by cutting spending or increasing revenues, in order to put the nation's fiscal policies on a sustainable path. This value is more than ten times as large as the size of debt currently held by the public; it is also several times larger than similar values published elsewhere under a seventy-five year projection horizon.

Gokhale & Smetters, *supra*.

federal entitlement costs is that it will be even more difficult for the Service to obtain sufficient annual appropriations to cover its operating costs. Therefore, it should be anticipated that the Service will likely use more of these new audit and compliance approaches and techniques to ensure tax compliance, and in the process, the Service will likely be looking for new ways to shift and share with others even more of the cost and burden of assuring tax compliance.

The importance of maximizing tax revenues and protecting our tax base also are likely to cause our politicians to support and encourage Service utilization of these new compliance approaches and techniques. The new IRS National Research Program audits will measure tax compliance levels, and the periodic tax gap reports will provide up-to-date estimates of overall compliance and non-compliance. These Service activities are likely to keep the politicians focused on, and supportive of, Service programs, techniques, and activities to further reduce the tax gap, especially if they do not require additional Service appropriations.[53]

Despite the importance of these changes in the way the Service is deploying its resources to maintain and enhance tax compliance, many of the changes the Service has made and is making raise sensitive, difficult, and important issues. How these issues are dealt with is likely to affect the credibility and long-term success of these new Service compliance efforts.

For example, attempts to shift more of the cost and burden to the private sector to identify and report tax non-compliance is encountering resistance, some of it anticipated, some of it unanticipated. It is no surprise that the small business community is resisting additional withholding and information sharing obligations because of the additional costs and burdens such measures entail for small businesses.[54] But I am surprised by the testimony of Small Business Administration officials who oppose any such additional withholding

[53] *See IRS Moves to Ensure Fairness of Tax System; Research Program Works to Increase Compliance Program Effectiveness, Reduce Burdens on Taxpayers*, IR-News Rel. 2002-05; Office of Tax Policy, U.S. Dep't of Treasury, A Comprehensive Strategy for Reducing the Tax Gap (2006), *available at* http://www.ustreas.gov/press/releases/reports/otptaxgapstrategy%20final.pdf; *see also* Joint Committee on Taxation, *Highlights of the Joint Forum on Tax Compliance: Options for Improvement and Their Budgetary Potential*, GAO-08-703SP (June 2008), *available at* http://www.gao.gov/htext/d08703sp.html.

[54] *See* Macey Davis, Tax Counsel with Nat'l Fed'n of Indep. Bus., Statement at Internal Revenue Service Roundtable on the Tax Gap (Mar. 9, 2006) (noting that the tax system "is so complex and burdensome that small businesses are spending valuable time and financial resources on record keeping and outside help to ensure compliance instead of using these resources to invest and grow their business . . . [a]nd now, we want to talk about piling on more burdens that they simply can't afford"); J.D. Tuccille, *The Tax Gap: The Feds Target Small Businesses*, Small Bus. Rev., Apr. 6, 2007, http://smallbusinessreview.com/regulations/feds-target-small-businesses.

and information reporting, particularly in light of the 2006 Tax Gap Report's results suggesting that noncompliance by small businesses is a key component of the Tax Gap.[55]

It also is no surprise that large and midsized businesses have expressed concern about the Service's requests to obtain more FIN 48 and tax accrual workpaper disclosures.[56] However, the intersection of such Service requests with taxpayers' privileges and rights raises important issues about the nature and extent of taxpayer rights and obligations. A good recent example of this intersection is the trial court's taxpayer-favorable decision and the government's recently announced appeal in the *Textron* case involving the taxpayer's refusal to provide certain information largely on the basis that it was protected by the work-product doctrine.[57]

Another area of potential conflict between the government's desire for tax information and taxpayers' rights is the increasing number and type of congressional requests for taxpayer information. The 2002 tax shelter investigation by the Senate Permanent Subcommittee on Investigations, including hearings in 2003 and the Subcommittee's report in 2005, has been credited for triggering the grand jury investigations by the Southern District of New York.[58] These investigations so far have led to pending criminal investigations of former employees of two of the largest accounting firms and two prominent law

[55] *See S Corporations—Their History and Challenges: Hearing Before the Subcomm. on Regulatory Reform & Oversight of the H. Comm. on Small Business*, 109th Cong. 4 (2006) (testimony of Thomas M. Sullivan, Chief Counsel for Advocacy, Small Business Administration) (claiming that tax compliance is 67% higher in small firms than large firms and arguing that tax gap-related audits "may punish those that voluntarily comply with the law, based on the failures of those that do not").

[56] *See FIN 48 Work Paper Fears Surface in PricewaterhouseCoopers U.S. Poll*, Daily Tax Rep. (BNA), Dec. 27, 2007, at G-1; Rob Hanson, Cory Tull, & Henry Singleton, *FIN 48, IRS Enforcement, and the Policy of Restraint*, 2007 Tax Notes Today 215-51 (Nov. 6, 2007); *Poll of Tax Professionals Reveals Fears FIN 48 Will Prompt Increased IRS Audits*, Daily Tax Rep. (BNA), Dec. 18, 2006, at G-6.

[57] *See* United States v. Textron, Inc., 507 F. Supp. 2d 138 (D.R.I. 2007); *Government Files Notice It Is Appealing 'Textron' Work Product Privilege Ruling*, Daily Tax Rep. (BNA), Oct. 24, 2007, at K-1; Neil D. Kimmelfield & William C. Hsu, *Textron, the Work Product Doctrine, and the Impact of FIN 48*, 2007 Tax Notes Today 228-28 (Nov. 27, 2007).

[58] *See U.S. Tax Shelter Industry: The Role of Accountants, Lawyers, and Financial Professionals: Hearings Before the Permanent Subcomm. on Investigations of the S. Comm. on Homeland Security & Governmental Affairs*, 108th Cong. (2003) (published in four volumes); Permanent Subcomm. on Investigations of the S. Comm. on Homeland Sec. & Governmental Affairs, The Role of Professional Firms in the U.S. Tax Shelter Industry, S. Rep. No. 109-54 (2005), *available at* http://levin.senate.gov/newsroom/supporting/2005/psitaxshelter-report.021005.pdf; *see also* Warren Rojas, *Senate Shelter Hearings to Highlight Corporate Culpability*, 2003 Tax Notes Today 221-1 (Nov. 17, 2003).

firms for their roles in tax shelters.[59] In 2006 the Senate Permanent Subcommittee on Investigations held hearings and published a report summarizing the results of its investigation of tax haven abuses. The report relied upon six case histories to demonstrate how United States taxpayers hid assets, shifted income offshore, and used offshore entities to circumvent United States laws.[60] Last summer's letters and questionnaires of the same Senate Subcommittee to large companies requesting disclosures about the companies' FIN 48 and tax reserve financial information raise the prospect of another investigation with hearings and a report in these sensitive areas. Recently, there have been media reports that the Subcommittee on Permanent Investigations has served subpoenas to obtain information from taxpayers that already are involved in Service audits of the use of derivatives to permit the avoidance of withholding on the payment of dividends abroad.[61] In deciding whether and how to respond to these types of congressional inquiries, taxpayers and their advisors often are presented with difficult decisions that implicate potential waivers of attorney-client privilege and work-product doctrine rights in view of the likelihood of public hearings and publicity accompanying such congressional investigations and the possibility that any information furnished ultimately may find its way to the Service or other federal authorities.[62]

For the better part of the last year, the Service, Chief Counsel, and Treasury have been discussing whether or not the Service should relax its traditional

[59] *See* Jonathan D. Glater, *Prosecutors Advance KPMG Tax-Shelter Case*, Int'l Herald Trib., Aug 5, 2005, at 14; Sam Young, *Ernst & Young Partners Indicted for Tax Fraud*, 2007 Tax Notes Today 105-1 (May 31, 2007); News Release, Michael J. Garcia, U.S. Attorney for the S. Dist. of N.Y., Two Additional Defendants Charged with Criminal Tax Fraud Related to Ernst & Young Tax Shelter (Feb. 20, 2008). The Senate investigation also helped facilitate civil suits against the accounting firm. *See* Jeff Bailey & Lynnley Browning, *KPMG May Dodge One Bullet, Only to Face Another*, N.Y. Times, June. 21, 2005, at C1 ("The Senate inquiry, built on internal e-mail messages and testimony, provides a road map for plaintiffs suing KPMG and other firms.").

[60] Minority & Majority Staff of Permanent Subcomm. on Investigations of S. Comm. on Homeland Sec. & Governmental Affairs, 110th Cong., Tax Haven Abuses: The Enablers, The Tools, and Secrecy (2006) (four volumes), *available at* http://hsgac.senate.gov/public/_files/TAXHAVENABUSESREPORT8106FINAL107.pdf. More recently, the Permanent Subcommittee on Investigations has initiated an investigation into the possibility that United States citizens are hiding financial assets in Liechtenstein to avoid taxation. *See* Randall Jackson, *Senator to Investigate Possible Tax Evasion Involving Liechtenstein Bank*, 2008 Tax Notes Today 37-2 (Feb. 25, 2008); *Levin Says Investigation on Tax Haven Abuse, Tax Dodgers Is Past Due*, 2008 Tax Notes Today 40-33 (Feb. 26, 2008); News Release, Office of Senator Carl Levin, Statement of Senator Carl Levin on the Need to End Offshore Secrecy and Tax Abuse (Feb. 21, 2008).

[61] *See e.g.*, Anita Raghavan, *Wall Street Facing New Senate Probe*, Wall St. J., Jan. 15, 2008, at C1.

[62] Jean A. Pawlow, Stephen M. Ryan, & Kevin Spencer, *Hands-Off My Tax Accrual Workpapers:* Textron, *FIN 48, and Related Issues*, 59 Tax Executive 421, 425 (2007).

policy of restraint in requesting tax reserve financial information, including FIN 48 information, to the extent that it is not already public.[63] The Senate Permanent Subcommittee on Investigations also could become involved in this subject.[64] For those who oppose the relaxation by the Service of its policy of restraint from requesting such FIN 48 and tax reserve financial information, the threshold question is likely to be the following: In view of the Supreme Court's decision in the *Arthur Young* case, upholding the Service's authority to summons tax accrual workpapers,[65] why should the Service not be permitted to change its own self-imposed policy[66] not to routinely request such information in view of the concerns about the inability of Service auditors to discover areas of potential non-compliance without access to such information?[67]

The history of the *Arthur Young* case and the reasons for the Service adoption of the policy of restraint may be instructive in answering this question. In 1980, the district court initially sustained the Service's summons for Arthur Young's tax accrual workpapers for its client, Amerada Hess. Thereafter, concern was expressed about the possibility that companies might begin to rely on attorneys for advice concerning the adequacy of a company's tax reserve and then attempt to protect that advice under the attorney-client privilege from further disclosure, including not only disclosure to the Service but also to the company's outside auditors.[68] In response, there were rumors about possible legislative attempts to restrict the Service's summons power to obtain such information, thereby making it unnecessary for attorneys' opinions and avoiding any potential compromise of the ability of independent auditors to examine companies' tax reserves.[69] The potential seriousness of these kinds of

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[63]Stephen Joyce, *IRS Mulling Change to 'Policy of Restraint' Concerning Accrual Papers, IRS Official Says*, Daily Tax Rep. (BNA), Feb. 9, 2007, at G-1; Stephen Joyce, *IRS Not Amending 'Policy of Restraint' on Taxpayer Tax Accrual Workpapers*, Daily Tax Rep. (BNA), Oct. 12, 2007, at G-6; Stephen Joyce, *Nolan Discusses Efforts to Create Efficiencies While Providing Taxpayers Certainty Sooner*, Daily Tax Rep. (BNA), Apr. 13, 2007, at G-2; Dustin Stamper, *No Plans to Change Restraint Policy for Workpapers, Stiff Says*, 2007 Tax Notes Today 205-1 (Oct. 23, 2007).

[64]*Key Issues in Tax Policy, a 2007 Tax Analysts Conference*, *Financial Reporting and Corporate Transparency: How Do Releases of New Information Under FIN 48 Affect the IRS's Disclosure Needs?*, 2007 Tax Notes Today 144-39 (July 13, 2007) (statement of Bob Roach, Minority Counsel, Senate Permanent Subcommittee on Investigation).

[65]United States v. Arthur Young & Co., 465 U.S. 805 (1984).

[66]I.R.M. 4.10.20 (last revised Jan. 15, 2005) (providing internal guidance to Service field agents on when it is appropriate to request audit, tax accrual, or tax reconciliation workpapers).

[67]*See* David Cay Johnston, *Agents Say Fast Audits Hurt I.R.S.*, N.Y. Times, Jan. 12, 2007, at C1; David Cay Johnston, *I.R.S. Agents Feel Pressed to End Cases*, N.Y. Times, Mar. 20, 2007, at C1.

[68]United States v. Arthur Young & Co., 496 F. Supp. 1152 (S.D.N.Y. 1980), *aff'd in part, rev'd in part*, 677 F.2d 211 (2d Cir. 1982), *aff'd in part, rev'd in part*, 465 U.S. 805 (1984); Tamar Lewin, *Some Audit Data Ruled Private*, N.Y. Times, Apr. 15, 1982, at D12.

[69]*See* John Nolan, *Comments on the Tax Compliance Act of 1982*, 15 Tax Notes 699 (May 31, 1982).

considerations was reflected by the rationale of the Second Circuit's 1982 decision in the *Arthur Young* case. The Second Circuit fashioned an accountant's work-product doctrine to protect Arthur Young's tax accrual workpapers from disclosure to the Service,[70] an approach that ultimately was rejected by the Supreme Court two years later.[71] Nevertheless, these kinds of concerns appear to have led my predecessor as Commissioner, Roscoe Egger, in the early 1980s to adopt the present Service policy of restraint in requesting companies' tax accrual workpapers.[72]

It is not clear, however, that any such concerns underlying the original adoption of the Service policy of restraint retain their same vitality today. The American Institute of Certified Public Accountants (AICPA) has made it clear that a company desiring an unqualified financial audit opinion can-

[70]United States v. Arthur Young & Co., 677 F.2d 211, 220–21 (2d Cir. 1982), *aff'd in part, rev'd in part*, 465 U.S. 805 (1984).

[71]United States v. Arthur Young & Co., 465 U.S. 805, 816 (1984) ("We are unable to discern the sort of 'unambiguous directions from Congress' that would justify a judicially created work-product immunity for tax accrual workpapers summoned under section 7602. Indeed, the very language of section 7602 reflects precisely the opposite: a congressional policy choice *in favor of disclosure* of all information relevant to a legitimate IRS inquiry.").

[72]*See Commissioner Egger's Remarks for California CPA and Tax Section*, IR-News Rel. 81-49. In his speech to the California accountants, Commissioner Egger described the key changes to the Service's policy regarding tax accrual workpapers:

> First of all, before an examiner can consider requesting tax accrual workpapers the following actions *must* be taken: Schedule M-1 of Form 1120 must be reconciled; [t]he examination must be substantially completed; and [s]pecific issues must be identified; [a]ll known facts must be requested from the taxpayer which relate to the issues and any supplementary analyses—not necessarily contained in the workpapers—of facts relating to the issues must have been requested from the taxpayer's accountant. This change will eliminate routine requests for tax accrual workpapers by examiners when they first walk in the door . . . .
>
> After the examiner takes these actions and then still determines a need to request access to the tax accrual workpapers, the request must be: [a]pproved by the Chief of the Examination Division; and [l]imited to those portions of the tax accrual workpapers that are material and relevant and related to the specific issue or issues identified . . . .
>
> Let me repeat for emphasis that the revised procedures are not intended to close the door to our examiners in requesting tax accrual workpapers. Instead, they are meant to ensure that requests for such workpapers do not become a standard examination procedure and that our requests for them are limited to those cases when unusual circumstances make it necessary to have access to the workpapers to complete an examination.

Id.; Announcement 84-46, 1984-18 I.R.B. 18 (announcing that in response to the *Arthur Young* decision, the Service would not alter its current procedures for requesting tax accrual workpapers relating to the evaluation of a corporation's reserves for contingent tax liabilities); *see also* Ad Hoc Subcomm. of the Comm. on Law & Accounting, *A Qualified Privilege for Tax Accrual Workpapers*, 39 Bus. Law. 247 (1983); Announcement 84-46, 1984-18 I.R.B. 18.

not refuse to disclose to its outside auditor any advice the company may have received from its attorneys about material financial statement items, even if such disclosure waives privilege.[73] The American Bar Association has developed legislation to protect clients' traditional rights under the attorney-client privilege and the work-product doctrine from intrusion by federal authorities.[74] Although the House passed this legislation last fall, the legislation does not appear to affect the AICPA's position nor overrule the Supreme Court's decision in the *Arthur Young* case. Therefore, with the possible exception of *Textron* types of situations, it is not clear that the Congress today would be willing to pass legislation to curtail the ability of the Service to request or summons tax accrual workpaper information if the Service were to decide to relax its traditional policy of restraint, especially if any such legislation might produce a significant revenue loss in today's pay-go environment.

It has been suggested that any relaxation of the Service policy of restraint to permit its auditors to request tax accrual workpaper information would likely chill relationships and communications between affected taxpayers and the financial auditors and increase the likelihood of controversy and litigation between taxpayers and the Service.[75] While that may be true, it is not clear that these considerations will be sufficient to deter the Service if it decides to change its policy. Perhaps there may be other reasons for the Service not to relax its policy of restraint. If so, they should be identified and discussed. In light of the concern being expressed by the corporate community over

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[73] *See* Am. Inst. of Certified Pub. Accountants, Codification of Statements on Auditing Standards, AU § 9326, ¶ 2.22 ("If the client's support for the tax accrual or matters affecting it, including tax contingencies, is based upon an opinion issued by an outside adviser with respect to a potentially material matter, the auditor should obtain access to the opinion, notwithstanding potential concerns regarding attorney-client or other forms of privilege.").

[74] *See* Attorney-Client Privilege Protection Act of 2007, H.R. 3013, 110th Cong. (2007); Attorney-Client Privilege Protection Act of 2007, S. 186, 110th Cong. (2007).

[75] *See* Letter from David A. Heywood, Chairman, Fin. Executives Int'l (FEI) Comm. on Taxation, & Arnold C. Hanish, Chairman, FEI Comm. on Corporate Reporting, to Kevin Brown, Acting Commissioner, Internal Revenue Serv., & Eric Solomon, Assistant Sec'y for Tax Policy (Sept. 17, 2007), *in* 2007 Tax Notes Today 245-25 (Sept. 17, 2007):

> Altering the policy of restraint so that the IRS would more regularly seek access to tax accrual workpapers, including documents underlying FIN 48 disclosures, is likely to have a chilling effect on communications between taxpayers and auditors. We believe it is in the best interests of the financial statement user community to encourage open dialogue between financial statement issuers and their audit firms . . . . It is also important to note that modifying the policy of restraint could result in greater IRS audit controversy and increased litigation.

Id.; *see also* Letter from David A. Heywood, Chairman, Fin. Executives Int'l (FEI) Comm. on Taxation, to Linda Stiff, Acting Commissioner, Internal Revenue Serv., & Eric Solomon, Assistant Sec'y for Tax Policy (Jan. 22, 2008) (commending the Service for reconsidering its conclusion that effective tax rate reconciliation workpapers are not covered by the Service's policy of restraint).

the possibility that the policy of restraint might be relaxed and the apparent countervailing view of the Senate Permanent Subcommittee on Investigations, a public forum to discuss such conflicting views and any other relevant considerations might be helpful.

Certainly, Service requests for more information about the content of the taxpayer's tax reserve for financial accounting purposes in some cases may lengthen rather than shorten a Service audit and also may result in the utilization of more, not fewer, Service resources. The reason is that once the Service has obtained such information, it may still be necessary for the Service to audit areas identified by the information. If, for example, a Service request were to identify transfer pricing as a material part of a taxpayer's reserve, any Service audit of the taxpayer's transfer pricing could become time consuming and contentious because of the inherent uncertainty of the outcome of the transfer pricing issues and the potentially significant amounts of tax and applicable penalties.

Speaking of penalties, few subjects have engendered as much discussion as the proper role of penalties to encourage and obtain compliance by taxpayers.[76] In my experience, taxpayers may not enjoy paying additional tax as a result of a Service audit, but the imposition by the Service of a penalty—even a so called "no-fault" penalty—is likely to trigger a much stronger taxpayer reaction. For most taxpayers, a penalty carries with it the connotation of a serious impropriety and, therefore, may have an impact well beyond that of an economic sanction for an inaccurate calculation of tax liability.[77] For some taxpayers, such as those involved in listed tax shelter transactions, the economic sanction and stigma of a penalty may be appropriate. But the Service long ago realized that it must be careful in how it administers any penalty system to ensure that penalties will have the desired compliance effect on taxpayer

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[76] *See, e.g.*, *Review of the Civil Penalty Provisions Contained in the Internal Revenue Code*, *Hearing Before the Subcomm. on Oversight of the H. Comm. on Ways & Means*, 100th Cong. (1988) (testimony of Lawrence B. Gibbs, Comm'r, Internal Revenue Service); Staff of Joint Comm. on Tax'n, 106th Cong., Study Of Present-Law Penalty And Interest Provisions as Required by Section 3801 of the Internal Revenue Service Restructuring and Reform Act of 1998 (Comm. Print 1999) (two volumes); Marvin J. Garbis & Miriam L. Fisher, *The Tilted Table: Penalties and Interest on Federal Tax Deficiencies*, 7 Va. Tax Rev. 485 (1988); Eric Zolt, *Deterrence via Taxation: A Critical Analysis of Tax Penalty Provisions*, 37 UCLA L. Rev. 343 (1989).

[77] *See* Section of Taxation, Am. Bar Ass'n, Comments Concerning Possible Changes to Penalty Provisions of the Internal Revenue Code (Mar. 12, 1999):

> [P]enalties and interest are important contributors to a generalized belief in the legitimacy of our tax system and the moral importance of discharging one's tax obligations, both because they signify society's disapproval of noncompliance and because taxpayers believe that they and others who fail to discharge their responsibilities will be punished if their noncompliance is detected.

Id.

attitudes and behavior and to avoid unintended effects and consequences of penalty imposition.[78]

During the tax shelter days of the recent past, the Service often took a very aggressive approach to the use and imposition of penalties against taxpayers involved in tax planning transactions the Service viewed as abusive.[79] Penalty management policies required Service auditors to justify and obtain management approval for the nonassertion of penalties in certain situations.[80] Service auditors and Appeals officers were required to separately consider the resolution of substantive issues on the merits from the resolution of penalties. They were specifically precluded from trading off the disposition of substantive issues for the disposition of penalties.[81] The threat of penalties was sometimes used to encourage taxpayers to disclose, and ultimately to settle, tax shelter transactions.[82]

Perhaps the proliferation and widespread nature of tax noncompliance in the tax shelter days justified such penalty policies. But we should understand that once such habits are learned by Service employees, they may be difficult to change, even though the transactions now being audited no longer involve abusive tax shelter transactions. The transition from the appropriate use of penalties for abusive tax shelter transactions to the appropriate use of penalties in the post tax-shelter years is likely to present training and management challenges for the Service that will be as difficult as they will be important.

The Service faced a similar challenge after the passage of the 1986 Act. To deal with the individual shelters of the 1970s and 1980s, Congress had

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[78] *See* Executive Task Force, Comm'r's Penalty Study, Internal Revenue Serv., Report on Civil Tax Penalties (1989) ("[A] penalty should be proportional to the culpability of the noncompliant taxpayer and to the harm caused by the instance of noncompliance."); *see also* Office of Tax Policy, Dep't of Treasury, Report to Congress on the Penalty and Interest Provisions of the Internal Revenue Code 2 (1999) ("The penalty and interest regime also cannot be evaluated in isolation; it is one important facet of a complex and interactive system of tax collection mechanisms.").

[79] *See, e.g.,* Notice 2000-44, 2000-2 C.B. 255 (warning promoters and participants regarding penalties for taking part in tax shelter arrangements that generate artificial deductible losses); Notice 2000-60, 2000-2 C.B. 568 (cautioning taxpayers to avoid certain transactions marketed for purposes of tax avoidance and reminding potential shelter participants of penalties that may apply); *see also* Lawrence B. Gibbs, *Tax Controversy in the Post-Shelter Era*, 59 Tax Executive 231, 232 (2007).

[80] *See* Mkt. Segment Specialization Program, Internal Revenue Serv., Accuracy-Related Penalties for Taxpayers Involved in Tax Shelter Transactions: Audit Technique Guide 25-31 (2004); *see also* Richard A. Shaw, *Enhanced Reporting Penalties Are the Newest IRS Weapons*, Bus. Entities, Mar.-Apr. 2005, at 6, 14 ("Section 6707A imposes strict liability when there is a failure to report a listed transaction. The Commissioner . . . is given only limited authority to rescind a penalty that is imposed for a failure to report a non-listed reportable transaction if rescission would promote compliance with the tax laws.").

[81] Shaw, *supra* note 80 at 6, 14.

[82] *See supra* note 78.

enacted and the Service enforced a series of increasingly harsh penalties.[83] The 1986 Act relegated the individual versions of shelters of the 1970s and 1980s to things of the past.[84] In the wake of the 1986 Act the Service began a penalty study to determine what needed to be done to ensure the proper role and administration of penalties to obtain better taxpayer compliance. The study led to the passage of the so-called IMPACT legislation by Congress to restructure the entire tax penalty system to maximize the ability of the Service to use penalties to obtain better taxpayer compliance.[85]

Once again, there appears to be a need and an opportunity for the Service and the Congress to review the existing penalty structure to determine what changes might be made to ensure that penalties will be asserted only at appropriate times and in appropriate ways to maximize tax compliance and not to simply punish taxpayers or to raise revenue. Penalty legislation over the last three years to deter the overly aggressive tax planning behavior by taxpayers, practitioners, and others may have been appropriate,[86] but I urge another look at the restrictions that some of these penalty provisions have placed on the administration of the penalty system by the Service. Based on my experience over the last 45 years in the private and public sectors, I question the premise that mandatory, nondelegable, nonwaivable penalties of up to 40% of the amount of a tax adjustment are appropriate measures to obtain better tax compliance in every case to which a codified economic substance doctrine may apply.[87] My experience suggests that in some cases, such penalties may not be asserted when they should be and in other cases, may be asserted when they should not be. The Service's studies that led to the IMPACT legislation of 20 years ago focused on tailoring the penalties and the training and management of Service personnel in the use of penalties to maximize the chances

[83]*See* Richard C. Stark, *A Principled Approach to Collection and Accuracy-Related Penalties*, 2001 Tax Notes Today 63-62 (Apr. 2, 2001).

[84]*See* Tax Reform Act of 1986, Pub. L. No. 99-514, § 501(a), 100 Stat. 2085, 2233 (imposing strict limitations on passive activity losses); *see also* Joseph Bankman, *The Case Against Passive Investments: A Critical Appraisal of the Passive Loss Restrictions*, 42 Stan. L. Rev. 15 (1989).

[85]*See* Improved Penalty Administration and Compliance Tax Act (IMPACT), Pub. L. No. 101-239, 103 Stat. 2388 (1989); Stark, *supra* note 83.

[86]*See* Small Business and Work Opportunity Tax Act of 2007, Pub. L. No. 110-28, § 8246, 121 Stat. 190, 200–03 (extending the income tax return preparer penalties to all tax return preparers, altering the standards of conduct that must be met to avoid imposition of the penalties for preparing a return which reflects an understatement of liability, and increasing applicable penalties); American Jobs Creation Act of 2004, Pub. L. No. 108-357 §§ 811-820, 118 Stat 1418, 1575–85 (imposing harsh penalties for tax shelter preparers and participants committing violations under the listed and reportable transaction regime).

[87]*See* Abusive Tax Shelter Shutdown and Taxpayer Accountability Act of 2007, H.R. 2345, 110th Cong. (2007); Abusive Tax Shelter Shutdown and Taxpayer Accountability Act of 2005, H.R. 2625, 109th Cong. (2005); Abusive Tax Shelter Shutdown and Taxpayer Accountability Act of 2003, H.R. 1555, 108th Cong. (2003); Abusive Tax Shelter Shutdown Act of 2001, H.R. 2520, 107th Cong. (2001).

that penalties could and would be used to induce the desired, compliant taxpayer behavior.[88] I commend the principles of that Service penalty study to the members and staff of the Congress today because I remain concerned about the temptation to use penalty changes to raise revenue in a pay-go environment.

The whistleblower provisions present similar challenges to the Service, which will have to take steps to ensure they will be used in appropriate ways to encourage tax compliance. Whistleblowing may never be popular with taxpayers. On the other hand, our experience with qui tam actions under the False Claims Act, permitting private enforcement of public law to punish persons submitting false claims to the government, suggests that so long as the tax whistleblower provisions are limited by the Service to apply to knowing, intentional violations of the tax law, their enforcement may not engender significant public opposition.[89] Unfortunately, unlike the qui tam provisions, there appears to be no requirement for tax purposes that a taxpayer's failure to comply with tax law be a knowing or intentional act or omission.[90] This may result in situations in which whistleblowers report unintentional failures. For example, large corporate taxpayers typically accumulate their tax return errors, rather than periodically filing complex, expensive amended returns to correct the errors, but with the intention to disclose the errors to the Service at the beginning of the audit of the years in which the errors occurred.[91] Perhaps the Service will be able to fashion appropriate rules to effectively deal with situations in which a whistleblower reports such mistakes to the Service before the company reports them. However, one can envision difficulties if corporate taxpayers are required to prove that, although errors had not been reported to the Service before a whistleblower identified them, the taxpayer intended to and would have voluntarily reported them to the Service. In any event, how the Service administers the whistleblower program will be important to

[88] *See* Executive Task Force, Comm'r's Penalty Study, Internal Revenue Serv., *supra note* 78.

[89] *See* False Claims Act, ch. 67, 12 Stat. 698 (1863) (codified at 31 U.S.C. §§ 3729–3733); *see also* Joel Androphy & Adam Peavy, *Bringing Rogues to Justice: The Qui Tam Provisions of the False Claims Act*, 65 Tex. B.J. 128 (2002); Ben Depoorter & Jef De Mot, *Whistle Blowing: An Economic Analysis of the False Claims Act*, 14 Sup. Ct. Econ. Rev. 135 (2006); Marc S. Raspanti & David M. Laigaie, *Current Practice and Procedure Under the Whistleblower Provisions of the Federal False Claims Act*, 71 Temple L. Rev. 23 (1998).

[90] Under the tax provision, the Treasury Secretary is authorized to pay such sums as he deems necessary for detecting underpayments of tax, or detecting and bringing to trial and punishment persons guilty of violating the internal revenue laws or conniving at the same. I.R.C. § 7623(a). Under the False Claims Act, liability is generally limited to situations in which a person acts knowingly or with the intent to defraud the government. 31 U.S.C. § 3729.

[91] This is the reason for the adoption by the Service of the procedure in Rev. Proc. 94-69, *supra* note 23, permitting large corporations to make disclosures at the beginning of audit cycles in order to avoid penalties being asserted as a result of adjustments made by the Service during the cycle.

ensure that taxpayers see the program as a fair and reasonable part of Service compliance activities.

Tax practitioners have not escaped criticism for the roles some practitioners played in the tax shelter schemes of the last ten years or so.[92] Whether as promoters or as facilitators of such schemes, it is unfortunately the case that more than a few tax practitioners across the country, some in large and prominent law and accounting firms, failed to act as pillars to support our tax system and instead acted as architects of its circumvention.[93] Not surprisingly, the backlash against such behavior has been substantial, particularly by the government. Tax opinion requirements have been tightened.[94] Tax return preparer standards have been raised.[95] Attorneys and accountants have been compelled to identify their clients and turn over client information.[96] New penalties applicable to tax advisers have been enacted.[97] The IRS Office

[92] *See* Floyd Norris, *The Rise of Phony Corporate Tax Shelters*, N.Y. Times, Feb. 8, 1999, at A22; Janet Novack & Laura Saunders, *The Hustling of X Rated Shelters*, Forbes, Dec. 14, 1998, at 198; Dennis J. Ventry, Jr., *Raising the Ethical Bar for Tax Lawyers: Why We Need Circular 230*, 2006 Tax Notes Today 94-35 (May 16, 2006) ("The reluctance and inability of the organized bar to rein in members participating in aggressive shelter work indicates that self-regulation doesn't work.").

[93] *See The U.S. Tax Shelter Industry: The Role of Accountants, Lawyers, and Financial Professionals*, *supra* note 58; Lynnley Browning, *Texas Law Firm Will Close and Settle Tax Shelter Case*, N.Y. Times, March 30, 2007, at C3; Sheldon D. Pollack & Jay A. Soled, *Tax Professionals Behaving Badly*, 2004 Tax Notes Today 198-43 (Oct. 13, 2004); Sheryl Stratton, *More Tax Professionals Charged in KPMG Shelter Conspiracy*, 2005 Tax Notes Today 200-2 (Oct. 18, 2005).

[94] *See* Regulations Governing Practice Before the Internal Revenue Service, T.D. 9201, 2005-1 C.B. 1153 (codified at 31 C.F.R. § 10.35).

[95] *See* Small Business and Work Opportunity Tax Act of 2007, Pub. L. No. 110-28, § 8246, 121 Stat. 190, 200-03 (extending the application of the income tax return preparer penalties to all tax return preparers, altering the standards of conduct that must be met to avoid imposition of the section 6694(a) penalty for preparing a return which reflects an understatement of liability, and increasing applicable penalties under sections 6694(a) and (b)).

[96] *See* United States v. Sidley Austin Brown & Wood, LLP, 2004 U.S. Dist. LEXIS 6452; 93 A.F.T.R.2d 1849 (N.D. Ill. 2004); United States v. Jenkins & Gilchrest, P.C., 2004 U.S. Dist. LEXIS 6919, 93 A.F.T.R.2d 2074 (N.D. Ill. 2004); John Doe 1 v. KPMG, LLP, 325 F. Supp. 2d 746 (N.D. Tex. 2004); United States v. BDO Seidman, 337 F.3d 802 (7th Cir. 2003); *see also* Richard Lavoie, *Making a List and Checking it Twice: Must Tax Attorneys Divulge Who's Naughty and Nice?*, 38 U.C. Davis L. Rev. 141 (2004).

[97] *See* American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 816, 118 Stat. 1418, 1583-84. Section 816 of the legislation amended section 6707 of the Code to establish a penalty for material advisors who are required to file a return under section 6111 with respect to any reportable transaction, and who fail to file a timely return or who file a false or incomplete return with respect to the reportable transaction. The penalty for failing to file a timely return or filing a false or incomplete return with respect to any reportable transaction other than a listed transaction is $50,000. I.R.C. § 6707(b)(1). The penalty with respect to a listed transaction equals the greater of $200,000, or 50% of the gross income derived by the material advisor. § 6707(b)(2). If the failure to file with respect to a listed transaction is intentional, the penalty is the greater of $200,000, or 75% of the gross income derived by the material advisor. *Id.*

of Professional Responsibility has been enlarged and strengthened to police practitioner violations. Further regulation of tax return preparers has been proposed.[98] Tax practitioners themselves are being sued civilly in a variety of malpractice and other actions, and some are being prosecuted criminally for more serious violations.[99]

Sad to say, much of the backlash is deserved, and hopefully will have a desired effect on practitioner behavior. As is so often the case, however, some of the backlash is raising problems and highlighting prior deficiencies in the mechanisms that regulate practitioner behavior. For example, there has been significant criticism of last year's legislative amendment to section 6694 that raised the tax return preparers' standard to a belief that undisclosed positions in clients' tax returns must meet the more-likely-than-not test, while permitting clients to take an undisclosed tax return position if the client has only substantial authority for the position that may be unlikely to prevail upon audit.[100] Certainly, the disparity in the levels of assurance between that of the tax advisor and that of the client raises legitimate cause for concern.[101] At least one bill has been introduced to resolve the disparity by lowering the preparer standard.[102] I suspect further discussion may take place about whether to raise the taxpayer's standard rather than lower the tax practitioner's standard.

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[98] *See* Dustin Stamper, *For OPR, 'Getting out of the Way Is Not an Option' in Upholding Standards*, 2006 Tax Notes Today 119-2 (June 21, 2006); *see also supra* note 49.

[99] *See* Ducote Jax Holdings, LLC v. Bradley, No. 04-1943, 2007 U.S. Dist. LEXIS 49088 (E.D. La. July 5, 2007); Stratton, *supra* note 93.

[100] *See supra* note 95; *see also* Staff of Joint Comm. on Tax'n, 110th Cong., Technical Explanation of the "Small Business and Work Opportunity Tax Act of 2007" and Pension Related Provisions Contained in H.R. 2206, as Considered by the House of Representatives on May 24, 2007, JCX-29-07 (2007). The amendments to section 6694 were enacted without consideration by either the House Ways and Means Committee or the Senate Finance Committee.

[101] *See* David L. Click, *Taxing Standards: Recent Changes in the Practice of Tax Law*, 2008 Tax Notes Today 10-25 (Jan. 15, 2008). Click's article makes the following astute observation:

> Hypothetically, it is entirely possible that a taxpayer may take a return position that certain income was tax exempt and, if incorrect, may avoid imposition of a penalty for negligence if the taxpayer had a reasonable basis for believing the income was tax exempt. If the taxpayer instructs the return preparer to report the income as tax exempt and that position is incorrect, the return preparer is subject to penalties under section 6694 if the return preparer was not at a more likely than not level of confidence on the position.

Id.; *see also* Jeremiah Coder & Lee A. Sheppard, *Preparer Penalty Headaches on Full Display at ABA Midyear Meeting*, 2008 Tax Notes Today 15-2 (Jan. 23, 2008) ("A taxpayer can point to substantial authority for a return position to avoid a section 6662 penalty. A tax return preparer cannot do the same for a section 6694 penalty, potentially causing tension between advisers and sophisticated clients.").

[102] *See* H.R. 4318, 110th Cong. (2007) (introduced by Representative Joseph Crowley, D-NY).

Granted, the tax law today changes rapidly and often is numbingly complex; nevertheless, some may contend that these are insufficient reasons not to adopt higher standards for taxpayers and practitioners to curtail the professionals pandering to those clients who wish to play hide-and-seek or audit lottery games that too often typified prior tax shelter planning.

Turning to the Office of Professional Responsibility (OPR), I generally support the Service's attempt to reinvigorate OPR to improve ethical standards for tax professionals and to curb abusive tax planning by attorneys, accountants, and in-house tax advisors of large businesses. In this regard, I believe practitioners have obligations to the tax system as well as to their clients, although I admit that delineating and satisfying such obligations can be difficult.[103] That said, however, I welcome the recently announced efforts of Mike Chesman, the new Director of OPR, to make the rules, procedures, actions, and sanctions of OPR more easily and readily understood.[104] There presently is very little public guidance available to tax practitioners and their advisors about the manner in which OPR operates, how OPR interprets the provisions of Circular 230, or what an administrative judge is likely to decide if a practitioner disagrees with and decides to litigate OPR's interpretations and proposed actions.[105] Unlike other dealings with Service functions, if a practitioner

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[103] *See, e.g.*, Paul J. Sax, *Lawyer Responsibility in Tax Shelter Opinions*, 34 Tax Law. 5, 30–39 (1980); Camilla E. Watson, *Tax Lawyers, Ethical Obligations, and the Duty to the System*, 47 Kan. L. Rev. 847 (1999); Frank J. Gould, *Giving Tax Advice—Some Ethical, Professional, and Legal Considerations*, 2002 Tax Notes Today 209-26 (Oct. 29, 2002).

[104] *See* Jeremiah Coder, *OPR Director Chesman Details Office to Allay Practitioner 'Mistrust'*, 2007 Tax Notes Today 191-5 (Oct. 2, 2007); Kathleen David & William H. Carlile, *Chesman Says Increased Transparency Is Goal of Professional Responsibility Office*, Daily Tax Rep. (BNA), Jan. 24, 2008, at G-6.

[105] *See* Nat'l Taxpayer Advocate, Taxpayer Advocate Serv., Internal Revenue Serv., 2007 Annual Report to Congress: Executive Summary (2008). The Taxpayer Advocate's report makes the following observations regarding the lack of transparency at OPR:

> The IRS's Office of Professional Responsibility (OPR), which is charged with regulating tax practitioners, has not published sufficient guidance or procedures to assure the public that it operates fairly and independently. If there is any question about OPR's independence from the IRS, practitioners (and taxpayers) may fear OPR will serve as an extension of the IRS enforcement function and arbitrarily target practitioners who are appropriately advocating for taxpayers. This belief would chill zealous advocacy by practitioners and harm taxpayers as well. OPR should improve both the reality and perception of its independence and establish reasonable limits on its discretion by issuing guidance on which practitioners can rely. This guidance should more directly address who is subject to regulation by OPR, what conduct is prohibited, how OPR follows up on referrals, how OPR will adjudicate an allegation (including policies governing practitioner access to information that could bear on the result), and what penalties OPR will seek for a given offense. OPR should develop such guidance quickly using an open process.

Id. at I-3 to I-4.

disagrees with OPR's interpretation of Circular 230, the practitioner has no right to administratively appeal within the Service or to request that OPR refer its interpretation to Chief Counsel.[106] And there usually is no guidance about what a practitioner may anticipate in litigation if the practitioner wishes to evaluate a potential judicial appeal from OPR's proposed action involving a sanction against the practitioner.[107] There is a real need for more guidance and transparency about OPR's rules, procedures, interpretations, actions, and sanctions in view of the potency of the sanctions that OPR can impose against an offending practitioner. Sanctions can range from a private reprimand to a public censure to a suspension or disbarment from practicing before the Service and can include monetary sanctions, all of which involve the potential for damage to a practitioner's professional reputation and livelihood.[108] Without more in the way of guidance and transparency about OPR, there is a real danger that OPR could be perceived as a modern day Star Chamber, a perception that eventually is likely to negatively impact OPR's effectiveness in changing practitioner behavior.[109]

The preparer standards and provisions of sections 6694 of the Code and the rules, regulations, and activities of OPR are important subjects that directly affect tax practitioners. I therefore urge responsible groups like the American Bar Association Section of Taxation, perhaps in collaboration with the American College of Tax Counsel and other professional organizations, to become more deeply involved in these matters on an ongoing basis. In so proposing, I hope and expect that the professional organizations would be sensitive to each of the difficult and sometimes conflicting demands that a practitioner often faces—and should face—between the practitioner's obligations to the

[106] 31 C.F.R. §§ 10.60-10.78; *see also* Am. Inst. of Certified Pub. Accountants, Comments on Proposed Regulations, REG-122380-02 Regarding Regulations Governing Practice Before the Internal Revenue Service (May 9, 2006). The AICPA's comments observed that:

> The proposed amendments would severely restrict the right of a practitioner to appeal an adverse ALJ decision to the Secretary or his delegate . . . . [A]n ALJ decision becomes final unless the Secretary decides to appeal the decision or . . . grants a practitioner's petition for review. If the Secretary simply declines to grant the practitioner's petition, the practitioner has no further administrative appeal rights.

Id. at 9. Although the final regulations included some changes to the proposed regulations, the final regulations did not significantly expand the administrative appeals process. *See* Regulations Governing Practice Before the Internal Revenue Service, T.D. 9359, 2007-45 I.R.B. 931.

[107] Other than an administrative appeal directly to the Secretary of Treasury, the provisions of Circular 230, 31 C.F.R. §§ 10.1-10.91, do not address the litigation options available to a practitioner following a decision by an administrative law judge to censure, reprimand, suspend, or disbar the practitioner.

[108] *See* 31 C.F.R. §§ 10.52, 10.79.

[109] *See* Nat'l Taxpayer Advocate, Taxpayer Advocate Serv., Internal Revenue Serv., *supra note* 31, at 124–39.

client and those owed to the laws that comprise our tax system.[110] The issues are likely to be difficult, and consensus may not always be easy. But developing good answers to hard questions in this area will be important.

In closing, my review of the events of the last 20 years suggests that the only constant in the tax area may be the certainty of change—changes for those in the public sector as well as those in the private sector. I am impressed by the resiliency of those in the public sector and their willingness and ability to adapt and respond to changes in the tax law and in the behavior of taxpayers and tax practitioners. I remain hopeful that the private sector, with the leadership of its professional institutions and organizations, will be able to respond in a similar fashion to such changes. I have been encouraged over the last five years by the willingness of friends and colleagues, some of whom have been privileged, as I have been privileged, to practice tax in both sectors. I have been pleased to join them in speaking up about the importance of enhancing—and protecting and defending when necessary—our tax system, even as we criticize, hopefully constructively, those aspects of the system that could be improved. In this, I agree with Dean Griswold's remarks that:

> [B]eing a lawyer in the twentieth century [and I would add, in the twenty-first century] has been an exciting privilege. The work has been interesting, though in the memorable words of Justice Holmes in his Ninetieth Birthday Address "the work is never done." The challenge is always great. And the opportunities which the profession gives to make what one feels to be contributions to the better and fairer operation of our society are rewarding.[111]

I cannot say it any better.

[110] *See* Sax, *supra* note 103; Watson, *supra* note 103; Gould, *supra* note 103; Ventry, *supra* note 92.

[111] Erwin N. Griswold, Ould Fields, New Corne, The Personal Memoirs of a Twentieth Century Lawyer 406 (1992).