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Richard D. Hobbet

J. Bruce Donaldson

ADMINISTRATIVE PROCEDURE IN FEDERAL TAX CASES: OPPORTUNITIES AND BRAMBLEBUSH

By RICHARD D. HOBBET AND J. BRUCE DONALDSON*

The United States today is committed, as its principal revenue source, to a tax upon income—individual and corporate. This tax reaches out its fingerlets to tap the sum total of successful economic endeavor in this country. To apply a net income tax to all taxpayers in an infinite variety of situations and circumstances, is inherently complex. Added to this complexity is a political factor which exerts direct force on the enactment of revenue legislation and which can quickly transform the best laid order into a special situation hodgepodge. The result is, of course, an Internal Revenue Code which is difficult to apply correctly and perhaps impossible to administer with more than substantial fairness.

The Internal Revenue Service has the responsibility for administration of our taxing system and the responsibility has been complemented by Congress with almost plenary administrative powers. As the taxpayer base expands and the revenue provisions evolve into greater complexity, more and more Americans are being brought into direct, and sometimes painful, contact with this administrative agency. It is of increasing importance, therefore, to fully grasp the sweep of authority placed in the Internal Revenue Service and to know well the administrative processes which have been set up to resolve disputes between the collector and the payor.

First in importance of the powers given to the Internal Revenue Service is the authority which the Commissioner has to fill gaps in the law and interpret ambiguities by regulation. Second, Congress has given broad investigative powers to the Commissioner and required the filing of many types of returns in an attempt to make it easy for the Commissioner to uncover facts pertinent to the tax liability of any taxpayer. Third, the Commissioner has been given the power to make determinations relating to the tax liability of individual taxpayers which are deemed correct, if not arbitrary and unreasonable, unless the taxpayer proves the determination wrong by a preponderance of evidence. Fourth, the Commissioner has been given broad powers to collect taxes

*Mr. Hobbet is associated with Michael, Spohn, Best & Friedrich, Milwaukee, Wisconsin and Mr. Donaldson is a partner in the firm of Raymond, Chirco, Fletcher, Cohan & Donaldson, Detroit, Michigan. Before their present associations, both of the authors served as trial attorneys for the chief counsel's office of the Internal Revenue Service in Chicago, Illinois. They have collaborated on numerous articles and talks on subjects in the field of federal income taxes.

due, or secure their payment by liens, in some cases even before it has been determined that the tax is owed.

The taxpayers' contacts with these powers are varied and frequent. The purpose of this article is to outline these potential contacts, in some cases to analyze the utility of particular types of contacts, both to the government and to the taxpayer, and suggest some modifications in these contacts where administration of the tax laws could be improved.

Self Determination of Income

A taxpayer's first contact with the tax laws and the Internal Revenue Service comes when he is enjoined to maintain records which will be sufficient for him, and the government, to determine his correct taxable income.[1] Compliance with this injunction demands some acquaintance with the laws and regulations on January 1 of each tax year and the persistent and consistent accumulation of information from which income and deductions can be accurately reported. Too little attention to this requirement of the law is not unfrequently the shifting sand that permits the taxpayer's position to be undermined in subsequent contacts with the taxing authority. It cannot too often be emphasized that the Commissioner has been given the right to make a determination of tax liability which will stand as correct, though wrong, unless the taxpayer can prove it wrong. The absence of proper records make this proof time consuming, expensive and oftentimes impossible in subsequent proceedings.

Self Assessment

In point of time the next duty imposed on taxpayers is the reporting of income and tax.[2] This duty now arises early in a taxable year for many taxpayers who are required to estimate the year's income by April 15, file a return showing that estimate,[3] and pay one-fourth of the estimated tax.[4] This duty, long applicable only to individual taxpayers, now is also imposed on corporations.[5] Following the end of the taxable year, the return is filed which is the basic statement by the taxpayer of his position. On this document will later turn decisions as to deficiencies in tax, negligence or fraud in reporting income, commencement of the running of the statute of limitations and other determinations. It may be used as an admission of facts by the taxpayer,[6] but as a self supporting statement, it can furnish no evidence of a taxpayer's correct income or tax.[7]

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[1] Int. Rev. Code of 1954, §6001.
[2] *Id.* §6012.
[3] *Id.* §6015.
[4] *Id.* §6153.
[5] *Id.* §§6016, 6154.
[6] E.g. Roche v. Commissioner, 63 F. 2d 623 (5th Cir. 1933); Bedell v. Commissioner, 30 F. 2d 622 (2d Cir. 1929).
[7] E.g. Watab Paper Co., 27 B.T.A. 488 (1932).

In addition to the return filed by the taxpayer, persons making various types of payments to the taxpayer, such as wages, dividends, interest and other income, may be required to file information returns showing payments to the taxpayer.[8] These are coordinated to some degree by the Internal Revenue Service in obtaining facts relating to the taxpayer's liability.[9]

Most individuals have their first contact with the Commissioner's rule making powers at this return stage as he pores over the return form, itself carrying elaborate instructions for determination of income, and the instruction sheet which is mailed to each taxpayer with his return. The instructions are an attempt to condense the position of the Commissioner, set forth in lengthy regulations and rulings, into a few pages. It is a necessary thing to do but a taxpayer should remember that these instructions may not always be an accurate statement of his own rights and where income is not small or issues simple the taxpayer is well advised to delve deeper than the instruction sheet.[10]

The long lines of taxpayers at federal buildings around the country at return time attest to one method of "delving deeper." The Internal Revenue Service has established a taxpayer assistance program to help individuals in the preparation of their returns. Useful and necessary as this service is, its limitations should be recognized and taxpayers who can afford assistance of non-government experts should do so. The Internal Revenue Service can hardly be expected to help taxpayers give themselves the benefits of doubts which may exist in determinations of their income. Some taxpayers persist in the belief that agents of the Internal Revenue Service can never be wrong, or that a return prepared with their help will never be questioned or audited. This is not the case. It was long ago held that the government is not estopped to question a return simply because the taxpayer was advised by an agent that his method of reporting was the correct one.[11]

Assessment By The Commissioner

Although additional assessments of tax by the Commissioner normally occur late in the administrative processes we mention it here because all of the subsequent procedures that we discuss are directed, in the Commissioner's case, toward additional assessments of tax, and in the taxpayer's case toward defending against the proposed assessments. The explanation of this assessment mechanism will be helpful in understanding the later administrative procedures.

[8] Int. Rev. Code of 1954, §§6031-6051.

[9] The Internal Revenue Service is in the process of installing electronic return processing equipment which someday will make it possible to fully coordinate all of this information.

[10] This year the Commissioner has publicly announced that there is an error in the explanation of the medical expense deduction which was discovered too late to correct.

[11] Schafer v. Helvering, 83 F. 2d (D.C. Cir. 1936), aff'd, 299 U.S. 171 (1936).

Before the Commissioner can collect a tax he must first assess it.[12] Normally, before he can assess the tax he must make a formal determination that there is a deficiency in the amount of tax reported by the taxpayer on his return.[13] This determination is made in the notice of deficiency, which is often referred to as the 90-day letter. The latter name is derived from the fact that the taxpayer is given notice in the letter than he has 90 days from the date it was mailed to appeal the Commissioner's determination to the Tax Court of the United States. If the taxpayer takes such an appeal within the 90-day period the Commissioner is restrained from assessing the determined deficiency until such time as the Tax Court's decision re-determining the correct amount of tax has become final.

The notice of deficiency is probably the most important single document in the tax case. As long as the determination contained in it is not arbitrary the taxpayer has the burden of proving that the determination is wrong in all subsequent proceedings. This burden of proof cannot be taken lightly as many tax cases are decided by the Tax Court on simple failures of proof. Therefore the manner in which issues are framed by the statutory notice of deficiency can assume a great deal of importance.

An illustration of this might be helpful. Suppose a taxpayer has purchased a piece of property adjoining his manufacturing facilities and that there is an old house on this piece of property. Suppose also that the taxpayer leases the house for several years and then razes it in order to provide space for a parking facility. Assume that the taxpayer paid $20,000 for the land and building and allocated $15,000 of such amount to the building and $5,000 to the land. Upon destruction of the building the taxpayer takes a loss of $15,000 for abandonment of property used in a trade or business.

On these facts the Commissioner has two possible issues presented. First he could take the position that when the taxpayer purchased the land he intended to demolish the building and therefore the entire $20,000 represents cost of land and no loss is allowable upon demolition. A second issue would be that the taxpayer's allocation of $15,000 to the building and $5,000 to the land was not correct. Suppose in the notice of deficiency the Commissioner determined that $7,500 of the claimed $15,000 is nondeductible because of a reallocation of the purchase price. In later proceedings the taxpayer would simply have the burden of proving that the values of the land and building at the time of purchase were in the same proportion in which he allocated the purchase price. If he did not sustain this burden of proof $7,500 of loss would be allowed and $7,500 of loss would be disallowed.

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[12] INT. REV. CODE OF 1954, §6303.
[13] *Id.* §6213.

The Commissioner could, however, take the position in the 90-day letter that the entire loss was disallowed and give as a reason that the entire purchase price was properly allocable to the cost of land. This would frame the issues in such a manner that the taxpayer would have the burden of proving both that the loss was allowable and secondly how great a loss was sustained. Obviously the Commissioher's position in the latter instance would be stronger.

If the Commissioner worded his notice of deficiency in the first way discussed above and subsequently decided that he would like to disallow the entire loss he would then have the burden of proving that the loss was not an allowable one in the first instance.[14] This could materially affect the outcome of the case.

Having once stated his position in the notice of deficiency the Commissioner cannot make a new determination in another notice of deficiency if the taxpayer appeals from the determination of the Tax Court.[15] If an appeal is taken the Commissioner is entitled to raise new issues before the Tax Court and ask for an increase in the deficiency.[16] However, this imposes upon the Commissioner the burden of proving the new determination is correct.[17] If the Commissioner wins on his new contention in the Tax Court and the decision of the Tax Court becomes final the Commissioner can then assess this increased deficiency notwithstanding that it never was part of a notice of deficiency.[18]

There are several situations in which the Commissioner may make an assessment of additional tax without following the procedure of sending out a notice determining a deficiency in tax to be due. If it appears that the taxpayer has made a mathematical error on his return the Commissioner can correct this mistake and make immediate assessment of the additional tax.[19] Also if an amount has been refunded to the taxpayer pursuant to an application for a tentative carryback adjustment the Commissioner can make an assessment of an amount which he determines to be in excess of the overpayment attributable to the carryback.[20] Furthermore, if the Commissioner determines that the collection of any tax is in jeopardy and will be hindered by a delay in the assessment he can make what is called a jeopardy assessment without following the normal statutory notice of deficiency procedures.[21]

AUDIT OF THE RETURN

The Internal Revenue Service recognizes the propensity of humans

[14] *E.g.* Cedar Valley Distillery, Inc., 16 T.C. 870 (1951); Vincent C. Campbell, 11 T.C. 510 (1948); Pepsi Cola Co., 5 T.C. 190 (1945).
[15] INT. REV. CODE OF 1954, §6212(c).
[16] *Id.* §6214(a).
[17] Tax Ct. Rule 32.
[18] INT. REV. CODE OF 1954, §6214(a).
[19] *Id.* §6213(b)(1).
[20] *Id.* §6213(b)(2).
[21] *Id.* §§6851, 6861.

to err in arithmetical computations, so the first step in the checking of returns is to quickly review each return for mistakes in addition, subtraction and the like. Each return is given this check and if errors are found appropriate refunds or assessments are promptly made. In the normal case the Government cannot assess an additional tax without following the various procedures discussed above; one exception is this one. The return is simply corrected, the assessment made and notice and demand for payment sent to the taxpayer.

The Commissioner occasionally stretches his authority for assessing deficiencies due to mathematical errors. One example was common several years ago. The dividend credit[22] was limited to four per cent of taxable income. If the taxpayer's capital gains were substantial and if taxpayer used the alternative capital gain computation of tax the Commissioner took the position that the entire gain should be excluded in determining the taxable income which was the basis for the four per cent limitation. At best the statute gave room for argument that such result was intended by Congress. Taxpayers who did not follow the Commissioner's position were well within the plain language of the statute. Yet the Commissioner's position was enforced by immediate assessments under the guise of correcting mathematical errors.

In this manner the Commissioner foreclosed the ordinary remedies of taxpayer. The assessments cut off use of administrative appeals within the Internal Revenue Service as well as use of the Tax Court. Two procedures were available. Taxpayer could bring an action in federal district court to enjoin the collection of the assessment on the grounds that it was illegal.[23] This would not necessarily result in a determination on the merits; if the court determined that the assessment was illegal without deciding whether it was erroneous the taxpayer might have been forced to begin a new suit in the Tax Court or district court to establish the correctness of his position.

The second available procedure would involve payment of the tax and the filing of a claim for refund. This would permit the issue to be considered by the appellate division in the Internal Revenue Service. If the claim were denied, then suit would have to be brought in District Court or the Court of Claims to recover the tax claimed. This is the course that was actually taken by taxpayers in upsetting the Commissioner's interpretation of the dividend credit.[24]

When returns are checked for mathematical errors they are also spotchecked for obvious deviations from the law. Returns are selected in this and other ways for a more complete audit. Two types of audits of the returns are conducted. The one is called an office audit, the

[22] *Id.* §34.
[23] *Id.* §6213(a).
[24] See, *e.g.* Springs v. United States, 153 F. Supp. 514 (W.D. S.C. 1957).

other a field audit. The former is done by an agent who stays in an office, calls the taxpayer or writes to him and asks him to come in and bring his records with him; the agent conducting a field audit goes into the field, calls on the taxpayer and investigates his records on the premises and makes any other investigation he deems appropriate.

By and large the office audit is used for returns revealing simple issues and relatively small amounts of income. Taxpayers are not often represented by tax counsel at this stage and few taxpayers quarrel with the determinations made by these office auditors. It is not unusual for local offices to adopt policies to be imposed at this level without specific direction from Washington or even the local director's office. An example which came to our attention in the Milwaukee office involved the allowance of an exemption for a dependent parent living with the taxpayer. A typical situation was a mother and daughter living together, the daughter working and having the only source of income, the mother remaining at home and doing the housework. The local office took the position that the mother was contributing her services to the household, thus apparently earning a portion of the income expended by her daughter for the mother's support, and that therefore the daughter was not contributing over one-half of her mother's support. Apparently this local ruling was successfully imposed on a number of taxpayers subjected to office audit in Milwaukee. As far as we could determine, field audit did not apply such a rule and it never was a national office policy. It was without merit under the law and office audit soon backed off from the policy when some taxpayers showed up with legal counsel.

Most problems dealt with at this level are not of sufficient importance in dollars to justify the expense of tax representation; yet it appears that some representation is needed to prevent injustices such as that described above. Some voluntary contribution of time by tax counselors and organizations such as legal aid for representation of taxpayers with small tax problems would be helpful in improving the administration of our tax laws.

The basic authority under which the Commissioner and his agents conduct the office and field audits is contained in §7602 of the Internal Revenue Code of 1954 which authorizes the examination of any books, papers, records or other data relevant or material to the purpose of ascertaining the correctness of any tax return, making a return where none has been made, determining the liability of any person for a tax or collecting any such liability. The Commissioner is further authorized to summon a person to appear before his agent and give testimony relevant to such purposes. Such testimony can be taken under oath.

This authority is limited somewhat by §7605 of the 1954 Internal Revenue Code which provides that no taxpayer shall be subjected to unnecessary examination or investigation and that only one inspection

of his books of account shall be made for each taxable year unless the taxpayer requests it or unless the Secretary of the Treasury or his delegate, after investigation, notifies the taxpayer in writing that an additional inspection is necessary.

There is some question as to what is an unnecessary investigation or examination.

On first examinations the courts have granted rather broad discretion to the Commissioner of Internal Revenue to determine whether an investigation is necessary. For example, in the case of *In re Keegan*,[25] the court permitted a first examination for a year barred by the statute of limitations simply on the allegation of the Government that it wanted to investigate the possibility of fraud.[26] And in *Application of the United States*,[27] the court refused to require the Internal Revenue Service to make a showing of reasonable cause for believing the taxpayer to be a resident of the United States before permitting an investigation of income earned by the taxpayer in Germany.

In the case of second examinations the courts have generally imposed some restrictions on the Commissioner's rights to examine the taxpayer's books and records. Normally the second examination is not conducted until after the three-year statute of limitations has expired and therefore the cases dealing with second examinations generally require the Commissioner to make some showing in his application for a subpoena that there is probable cause to believe the taxpayer was guilty of fraud during the barred year.[28] In this connection an affidavit of a revenue agent is generally not sufficient.[29] The necessary showing by the Commissioner has been likened to that which the state must make in support of the validity of an arrest by an officer without a warrant and his incidental search of the prisoner. If the facts and circumstances before the Commissioner's agents are such as to warrant a man of prudence and caution in believing that a fraud has been committed, proof of these facts is sufficient to show the necessity of examining barred years, even though a first examination was previously conducted.[30]

The United States Circuit Court of Appeals for the Fifth Circuit has not required as much of the Commissioner in supporting his demand for a summons to a taxpayer to produce his books and records for a closed year. The Fifth Circuit seems to feel that the testimony of the

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[25] 18 F. Supp. 746 (S.D. N.Y. 1937).

[26] See also People's Deposit Bank & Trust Co. v. United States, 212 F. 2d 86 (6th Cir. 1954) and In re Wood, 123 F. Supp. 297 (W.D. Ky. 1954).

[27] 246 F. 2d 762 (2d Cir. 1957).

[28] O'Connor v. O'Connell, 253 F. 2d 365 (1st Cir. 1958).

[29] U.S. Aluminum Siding Corp. v. Eshleman, 170 F. Supp. 112 (N.D. Ill. 1958).

[30] Lash v. Nighosian, 273 F. 2d 185 (1st Cir. 1959). *Cf.* Pacific Mills v. Kenefick, 99 F. 2d 188 (1st Cir. 1938).

Commissioner's agent that he believed an examination necessary to investigate a possible tax liability and fraud would be sufficient.[31]

The taxpayer's right to resist a second examination is a right which may be waived by him. Thus if he produces his records upon request of a revenue agent he may not later complain that the evidence obtained thereby is inadmissable in a proceeding against him.[32]

A somewhat different question is presented as to how far afield the Commissioner can go in investigating the tax liability of a particular taxpayer. It has been held that upon a first examination of the year 1952 the Commissioner is entitled to examine the records of the taxpayer for the year 1951 in order to help determine the correct depreciation for the year 1952. The Commissioner was permitted this second examination of the year 1951 even though he had not requested the second examination in the prescribed statutory method.[33]

Often the Commissioner's agents wish to examine records of a third party in determining the liability of a taxpayer. On this situation the court will issue a summons to the third party only upon a showing of relevancy in the examination of the taxpayer's returns. The summons must specify the documents wanted with reasonable particularity so that the third party is not subjected to fishing expeditions. The agents of the Commissioner are not the sole judges of what they need in the examination but the courts must be satisfied of the necessity for the examination.[34] But where the year being examined is barred by the statute of limitations, the Commissioner must also show reasonable cause for suspecting fraud.[35] The Sixth Circuit, however, would seem to be more liberal in this regard as it granted a summons against a third party upon the testimony of a revenue agent that from his investigation he concluded there was a strong suspicion of fraud. The court did not require proof of facts showing reasonable grounds for believing the fraud to exist.[36]

The Commissioner frequently demands that a taxpayer assist his agents in obtaining information pertinent to a determination of taxable income by some other method than that used by the taxpayer in keeping his books and records. The most common instance is the Commissioner's desire to estimate taxable income by a net worth and expenditures method. In making such examinations the agents demand that the taxpayer furnish information concerning his assets and liabilities at the

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[31] Globe Construction Co. v. Humphrey, 229 F. 2d 148 (5th Cir. 1956) and Falsone v. United States, 205 F. 2d 734 (5th Cir. 1953).
[32] Philip Mangone Co. v. United States, 54 F. 2d 168 (Ct. Cl. 1931).
[33] Norda Essential Oil & Chemical Co. v. United States, 230 F. 2d 764 (2d Cir. 1956).
[34] First National Bank of Mobile v. United States, 160 F. 2d 532 (5th Cir. 1947).
[35] Arend v. DeMasters, 181 F. Supp. 761 (Ore. 1960).
[36] People's Deposit Bank & Trust Co. v. United States, 212 F. 2d 86 (6th Cir. 1954).

beginning and end of each year, and that he further give evidence of nondeductible expenditures. In addition, of course, it is necessary to determine all receipts of property which are nontaxable, such as gifts, inheritances and various types of statutory exempt income. Many of these facts are outside the scope of the books and records which a taxpayer is required to keep under §6001 of the Internal Revenue Code and the Commissioner's Regulations thereunder. Both the *Falsone* case[37] and *O'Connor v. O'Connell*[38] arose out of the Commissioner's net worth examination. However, there has been little discussion by the courts of the right of the Commissioner to subpoena from a taxpayer information relating to nondeductible expenditures and nondepreciable assets, which have no effect on a taxpayer's income. It is submitted that since a taxpayer is not required to keep records of this type that an investigation of these facts would constitute an unnecessary investigation by the Commissioner unless the taxpayer had failed to meet the statutory requirements of keeping records by which the taxpayer and the Commissioner could accurately determine taxable income. This proscription would be of little use if the net worth examination could be used to show the inadequacy of the books and records and therefore it is submitted that a taxpayer can resist such an investigation unless the Commissioner first shows reasonable cause for believing that the taxpayer has not complied with his statutory duty of keeping books and records.

Many net worth investigations go back many years and although this method has been helpful in turning up unreported income, it has great possibilities for error because taxpayers generally keep no records by which an adequate determination on this basis can be made. The use of this method has undoubtedly resulted in overassessment of taxes in some instances and as much care should be exercised in avoiding this result as is exercised in preventing innocent persons from being unjustly convicted of crimes. The Commissioner has pushed the use of this method in cases involving no fraud and for the purpose of redetermining small amounts of income.[39] If this trend continues it would appear that legislation will be required, either to approve of the method and require taxpayers to keep records by which income can be determined in this manner or limiting the Commissioner's rights to commence net worth investigations. We believe it would be unwise to impose further bookkeeping requirements on taxpayers.

Regardless of what the taxpayer's rights may be in this area, a practical problem is presented when an Internal Revenue Agent asks the taxpayer to submit net worth statements to him. The natural urge, and

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[37] *Supra* note 31.
[38] *Supra* note 28.
[39] *E.g.* Eugene Tehan, ¶59,140 P-H Memo T.C. (June 30, 1959).

it is a powerful one, is to cooperate with the agent, hoping, in this way, to gain his confidence so that he will be more apt to accept explanations and statements of fact.[40]

The danger in cooperating with the revenue agent is nowhere more apparent than it is in net worth examinations. By giving net worth statements and estimates of living expenses the taxpayer furnishes evidence against himself. If the Commissioner was required to accept all of the information in the net worth statement as correct, should he make use of any part of it, the danger would be less apparent. However, the Commissioner will often accept the taxpayer's statement as to certain assets and liabilities which are subject to documentation, but reject the taxpayer's undocumented statement as to other assets and liabilities. In this way the taxpayer has furnished evidence by which the Commissioner can construct an estimate of unreported income which may be wholly unreasonable. The assets and liabilities at the end of the period are usually susceptible of accurate proof. The Internal Revenue Service then refuses to acknowledge the existence of any assets at the beginning of the period that the taxpayer has been able to prove. Since the point of time for which the proof of these assets is necessary may be many years in the past, this is often a very difficult or even impossible burden of proof. The large number of cases in which the courts have rejected unsupported testimony of cash on hand at the beginning of the period attests to this.

If there is any doubt as to what a net worth analysis will reveal it would, therefore, seem better to refuse to prepare a net worth statement for the revenue agent. Thus it would seem necessary, in all instances, to prepare an accurate net worth analysis before giving the agent any information of this type. If information is to be given to the agent, it would then be best to present the net worth analysis as the investigation of taxpayer's counsel, without having it signed or verified by the taxpayer in such a way as to constitute an admission in later proceedings.

Settlement of Issues With the Agent

If there is any contest over the accuracy of the taxpayer's reported net income the first opportunity which the taxpayer has to settle this contest is with the revenue agent during his audit of the return. The use of the word "settle" may be misleading in this context because the revenue agent has no authority to do anything other than adjust the return to conform with the Commissioner's position on the various issues. However, many tax contests turn on questions of fact and the revenue agent is the principal fact-finding agency employed by the Internal Revenue Service. This gives him some discretion in the settle-

[40] See, *e.g.* 1 Casey, Federal Tax Practice §3.14 (1955).

ment of cases. For example, if there is a question concerning the reasonableness of salary allowances, the revenue agent can adjust his findings in order to reach an agreement with the taxpayer as to what is a reasonable allowance. This may involve some give or take by both the taxpayer and the revenue agent and therefore represent a settlement in every sense of the word. Determination of useful life and salvage value in depreciation issues, valuation of inventories, reasonableness of a bad debt reserve and other issues of this type are susceptible of similar types of settlement at this level.

In some cases a taxpayer is well advised to do his own negotiating with the revenue agent, who may become defensive or suspicious should a lawyer appear on the scene at this point in the administrative processes. In other cases, perhaps if the agent is unsure of himself, or unduly impressed by lawyers, negotiation by a lawyer may be distinctly better. This is a judgment decision which must be made in each case, but clearly it is a good idea for the taxpayer to be well advised of his legal rights and to be aware of what types of dispositions courts make of similar issues before commencing any negotiations with an agent.

There are, of course, many issues, (for example, a determination as to when a liability accrues, the nature of income received from the sale of subdivided real estate and the deductibility of demolition losses) with which the agent has little discretion except to determine whether taxpayer has reported the transactions in accordance with the Commissioner's policy. If the taxpayer has not done this, the revenue agent must make such an adjustment in his report and there is little or no chance of settling such an issue at the audit stage. In rare instances an agent will trade one such doubtful issue for another, but this type of settlement is uncommon at the audit level.

If the taxpayer has this type of issue in his case, the best course is probably to answer all questions and furnish all requested information as courteously as possible but refrain from volunteering either facts or argument. Arguing with the revenue agent and volunteering facts to him usually do nothing more than help him buttress his foregone determination. In general, the taxpayer's chances of settling this type of an issue at a later stage in the administrative processes will vary inversely with the degree of completeness in the agent's investigation and report.

Informal Conference

After the agent has completed his audit of the taxpayer's return, he prepares a written report setting forth all of the adjustments which he proposes to make to the taxpayer's reported income. A copy of this report is furnished to the taxpayer who is then invited to discuss the various issues raised at an informal conference. The letter in which this invitation is extended is customarily referred to as the 10-day letter

because the taxpayer is given ten days to request the opportunity for such conference.

When the informal conference procedure was adopted, the plan was that the taxpayer would discuss the revenue agent's adjustments with the agent's group supervisor and any errors or misunderstandings could be cleared up at that point.[41]

This procedure did not work satisfactorily. Since the revenue agent had usually discussed the case with his supervisor, his report would represent the views of both the agent and the group supervisor. Having prejudged the issue the supervisor could not be expected to take a position different than that taken by the agent.

On the other hand it was not uncommon that group supervisors would, at these conferences, discover weaknesses in the agent's investigation and, through requests for additional facts and group supervisor-instigated reinvestigations, the Government's file with respect to the taxpayer's case would be augmented, often making settlement more difficult at subsequent administrative hearings. Whereas the taxpayer would go into informal conferences with the single purpose of reaching an agreement with respect to his tax liability, the group supervisors conducted the hearings in such way as to indicate they had two purposes, one, to reach agreement with respect to the tax liability and, two, to continue the audit of the taxpayer's return.

When the taxpayer has a legitimate position on a question of application of the internal revenue laws, he gains little by assisting the agent in making a complete and thorough investigation. Desirable as this may be from an administration standpoint, the taxpayer dealing with his own case may validly consider himself in the position of an advocate. On a great many issues the Commissioner and his agents take the position of advocates on the side of the revenue service and therefore the taxpayer's reluctance to aid and abet a thorough investigation is perfectly justified and practical.

Recently the Commissioner has revised his informal conference procedure.[42] If the taxpayer requests, he is now entitled to a conference with a full-time conferee who spends none of his time supervising revenue agents. This conferee is therefore in a position to take a fresh look at both the revenue agent's determination and taxpayer's arguments with respect to the adjustments. This procedure is so new that no statement can be made, with any degree of certainty, as to its effectiveness. In many respects this procedure bears a close resemblance to a conference procedure that was abandoned by the Commissioner about eight years ago. At that time the various offices of the Internal Revenue Service had functioning conference sections and many of the sections

[41] Treas. Reg. §601.105(c) (1960).
[42] Rev. Proc. 60-24, 1960 INT. REV. BULL. No. 46, at 44.

around the country were quite successful in settling cases. Some of the conferees found it possible to settle even the most difficult legal issues through the device of trading one issue for another or adjusting findings of fact to fit legal theories. Therefore, some of them found it possible to function successfully as tribunals for settling disputes within the limits of rather circumscribed authority.

The new informal conference procedures could operate effectively in this same manner. Much will depend upon the personnel involved, as they must have confidence in their own decisions and technical ability. However, it seems unlikely that it will not operate in this manner, if ever, until enough time has passed for the conference positions to be staffed by experienced, mature, career men.

In the meantime it is unlikely that the taxpayer is apt to get more advantage from the informal conference than he has in the past. The new conferees are still limited in their authority in the same manner as the group supervisor was. Both of them, like the revenue agent, are subject to post-review and their authority is principally that of determining facts and applying the Commissioner's position to these facts. If it appears that the revenue agent has mistakenly interpreted the Commissioner's position, or has made a clear error with respect to a finding of fact, it may be possible to use the informal conference procedure to correct the error. However, it would still seem undesirable to take to the informal conference issues which are not susceptible of this type of resolution.

CERTIORARI PROCEDURE

Two years ago the Commissioner established a procedure by which a taxpayer can seek review of a decision made by a revenue agent, group supervisor or informal conferee in Washington.[43] The taxpayer has been given the right to request that such decision be submitted to the Washington office for review as to whether it is in accordance with national policy. The local chief of the audit division decides whether the question is one which merits submission to Washington. If he decides that it does not, he must still submit to Washington the taxpayer's request for review, together with the taxpayer's reasons for desiring such review. The national office then decides whether to take jurisdiction.

So far, according to statistics of the Internal Revenue Service, the various chiefs of audit around the country have not turned down very many requests that an issue be submitted to Washington. Furthermore, Washington has taken jurisdiction over many of the cases which the chiefs of audits have declined to submit to Washington. Therefore it

[43] Rev. Proc. 58-14, 1958-2 CUM. BULL. 1125. This was an outgrowth of an earlier procedure pursuant to which the field office could request technical advice from Washington. However, the taxpayer had no right to cause the issues to be submitted to Washington. Mim. 6293, 1948-2 CUM. BULL. 59.

appears that this procedure has given the taxpayer an effective way to obtain a hearing in Washington at the audit level should he feel that the local office is not treating him fairly.

Post-Review

There is, in every district of the Internal Revenue Service, an office, functioning under the district director, known as "post-review". The taxpayer has very little contact with this section but its operations may often affect him. This office reviews all reports coming out of the audit division and any settlements or adjustments to tax liability occurring as the result of audit or informal conference. The purpose of this review is to correct any errors which audit or the informal conferee may have made in applying the Commissioner's position to the facts reported by the agent. The taxpayer is not given an opportunity to confer with this office.

Post-review serves another function in review of protests. This function will be discussed in a later section.

Appellate Division

If the taxpayer has been unable to reach an agreement with the Internal Revenue Service with respect to his tax liability, and if post-review has approved the report of the examining agent, a so-called 30-day letter is sent to the taxpayer. This letter notifies the taxpayer that the Commissioner is proposing to make certain adjustments to the taxpayer's reported income and that, unless the taxpayer protests such adjustments, a notice of deficiency incorporating them will be mailed to the taxpayer. This is not a statutory procedure. It is one devised by the Commisioner in order to help dispose of cases prior to the issuance of notices of deficiencies.[44]

In the 30-day letter the taxpayer is offered a chance to accept the Commissioner's proposed findings. If he does not wish to do this the letter invites him to file a protest setting forth, in a sworn statement, the reasons why the taxpayer believes that the proposed adjustments are erroneous.

If such a protest is filed it is first examined by the post-review section and they consider, in light of the new information given in the protest, whether the Commissioner's proposed adjustment is correct. It is seldom that post-review reverses its stand at this point but occasionally the protest will reveal clearly an error made by the agent and post-review will change the Commissioner's determination. If post-review does not do this, the file is sent to the appellate division.

The appellate division was established by the Commissioner to act as a type of appellate tribunal within the administrative department.[45]

[44] Treas. Reg. §601.105(d) (1960).
[45] *Id.* §601.106.

Although it has offices in most of the local offices of the Internal Revenue Service, it is not under the jurisdiction of the district directors. It derives its settlement authority from the Regional Commissioners and is subject to direct supervision by the appellate division in Washington, D.C.

The appellate division has the authority to settle cases, taking into account the hazards of litigating the various issues in the case. A settlement by the appellate division in most matters is not subject to review by any other agency of the Internal Revenue Service and therefore it is at this stage that taxpayers have their greatest success in settling cases. Thus, it might appear that it would always be advantageous for a taxpayer to protest the adjustments proposed by the audit division and try to settle the case with the appellate division. However, there are some disadvantages to this procedure which may in some cases weigh heavily against the use of this procedure.

The major disadvantage is the possibility of adding new issues to the case before the notice of deficiency is issued. The appellate division is made up of some of the most able technicians that the Internal Revenue Service employs. For the most part they are well trained in the interpretation and application of the tax laws and it is not uncommon for them to see issues in a case which a revenue agent may have missed in his examination. Even more frequently they see gaps in the facts reported by the Internal Revenue Agent and they frequently make requests for the taxpayer to furnish additional information. Therefore the taxpayer is well advised to consider that the process of auditing his return is continuing throughout the use of this conference procedure. If a new issue is raised by the appellate division at this stage it will be incorporated in the statutory notice of deficiency and therefore the taxpayer will have the burden of proving the determination wrong in all later proceedings. Accordingly, there is an advantage in by-passing this procedure and letting the Commissioner issue his notice of deficiency before the appellate division has reviewed the case. The taxpayer will have subsequent opportunities to confer with the appellate division in an attempt to settle the case and therefore it may not always be important that the protest procedures be followed.

If the taxpayer does not file a protest, the notice of deficiency is customarily a copy of the same adjustments set forth in the 30-day letter. This is normally prepared by the audit division. If the taxpayer files a protest but fails to settle the case with the appellate division, then the notice of deficiency is prepared by the appellate division. The case is then sent to the regional counsel's office which will handle the trial of the case in the Tax Court should the taxpayer appeal to this court. The regional counsel's office is asked to accept the case for defense and they accordingly review the file to determine whether the position of the

appellate division is defensible in court. If it is, the regional counsel's office will indicate its acceptance and suggest any rewording of the notice of deficiency that may improve the Government's position from a trial standpoint. From this it can be seen that the filing of a protest sets in motion certain administrative procedures which may work to the taxpayer's disadvantage should the case be litigated. Accordingly, a well considered judgment at the outset of the case as to whether or not it is possible to settle it is important in determining whether it is advisable to file a protest.

If the taxpayer does not file a protest he will immediately receive a statutory notice of deficiency. If he then appeals the case to the Tax Court the appellate division again obtains jurisdiction over the settlement of the case. Therefore, whether or not a protest is filed, the taxpayer will eventually have an opportunity to obtain a hearing from the appellate division.

What then are the advantages, if any, of filing a protest? Some taxpayers are anxious to avoid publicity. If the case is settled with the appellate division prior to the issuance of the notice of deficiency all of the proceedings are secret and there will be no publicity of the case, or the settlement. However, as soon as a petition is filed with the Tax Court, appealing from a notice of deficiency, the existence of the case and the issues in it are made public. The newspaper wire services customarily watch all of the petitions filed in Washington and release news stories to local newspapers with respect to the various taxpayers who file petitions.

If it appears that a settlement with the appellate division is possible then some time may be saved in following the protest procedure. If no protest is filed it generally takes several months before a notice of deficiency is issued and it is usually another three or four months before the case is at issue. Only then does the appellate division receive the file. Therefore if time is a factor it may be advisable to file a protest.

Still another advantage in filing a portest in some cases is the possibility of eliminating one or more issues from a case. If the taxpayer desires to use the district court or the court of claims as a forum for the litigation of his case, it is first necessary that he pay all of the tax determined to be due. This may often impose a very difficult burden if the determination of the Commissioner is unrealistically high. If on the other hand a conference with the appellate division results in the elimination of a part of the deficiency it may make it easier for the taxpayer to pay the resulting deficiency and bring suit in the district court or court of claims for a refund of the tax paid.

Settlement Jurisdiction in Tax Cases

The ordinary procedure established by the Internal Revenue Service for settling tax cases is the hearing before the appellate division follow-

ing a protest to the proposed adjustments contained in the 30-day letter. This was discussed in the preceding section. There are other opportunities for settling the case, however. As was mentioned, if the case is appealed to the Tax Court of the United States the appellate division again obtains jurisdiction over settlement of the case. However, before a settlement can be reached at this stage the regional counsel's office, which has the responsibility for trying the case in the Tax Court, must concur in the settlement.[46]

If the case is not settled prior to the time that the case is called for trial, settlement jurisdiction passes from the appellate division to regional counsel's office.[47] The moment when this takes place is the time when the case is called by the judge of the Tax Court for a report on the opening day of the trial calendar at which the case is set to be heard.

This settlement jurisdiction of the regional counsel's office is fairly new in administrative procedures. It has been in existence for only two years. As a practical matter the regional counsel's office settles few cases that appellate division is not willing to settle. However, the existence of this authority tends to give the regional counsel a greater role in the negotiations for settlement prior to the time that settlement jurisdiction is transferred to him. His opinions with respect to the desirability of settling tend to receive more weight because of the knowledge that at some point he will be able to settle the case without the concurrence of the appellate division. This tends to insert into the settlement negotiations a greater emphasis on the litigating hazards of the case because the lawyer who must try the case is generally more aware of these hazards than is the technical adviser associated with the appellate division.

If the taxpayer would prefer to litigate his case in either a federal district court or the court of claims instead of the Tax Court, he must at some stage in the administrative processes, prior to an appeal to the Tax Court, pay all of the tax determined to be due by the Commissioner and then file a claim for the refund of such tax.[48] If such a claim is filed the audit division obtains initial jurisdiction over the claim. However, if the claim relates to matters which have previously been the subject of an audit and asks simply for a refund of taxes which were collected as deficiencies, then the action of the audit division on the claim is a formality only. Audit will then issue a letter advising the taxpayer that the Internal Revenue Service proposes to disallow his claim for a refund. The taxpayer thereupon has an opportunity to protest the action of the audit division and if such a protest is filed the appellate division obtains jurisdiction over the claim. However, in a re-

[46] *Id.* §601.106(a)(2).
[47] *Ibid.*
[48] Flora v. United States, 357 U.S. 63 (1958), rehearing granted, 360 U.S. 922 (1959).

fund proceeding the appellate division's jurisdiction is not as great as it is in the deficiency procedures. If the proposed settlement by the appellate division involves a refund of more than $100,000 of tax the settlement must be reviewed by the chief counsel's office of the Internal Revenue Service and approved by the joint committee on income taxation.[49] This is a committee established as a technical advisory staff of the House Ways and Means Committee and the Senate Finance Committee.

Six months after the refund claim has been filed, if the Internal Revenue Service has not taken formal action on the claim, or at any time after formal disallowance of the claim, the taxpayer may file a suit in either a federal district court or the court of claims to recover the tax claimed.[50] As soon as this suit is filed the Department of Justice is given control of the case. This control extends both to settlement of the case as well as to the trial of it.

Settlement procedures in the Department of Justice must be initiated by a written offer by the taxpayer. However, it is not uncommon that the taxpayer will confer with representatives of the Department of Justice prior to the submission of an offer in order to determine whether the parties are close enough to merit a formal offer.

Once a written offer of compromise has been submitted to the Department of Justice it is referred to the chief counsel's office of the Internal Revenue Service in Washington for an advisory opinion as to whether the offer should be accepted. This opinion is prepared by an attorney in the chief counsel's office and must be reviewed and approved by his superior prior to transmittal to the Justice Department.

Meanwhile the attorney in the Department of Justice assigned to the trial of the case gives the settlement offer his independent consideration. He also submits a written report recommending action on the settlement proposal, and after his report is reviewed and approved by his superior it, together with the report of the chief counsel's office of the Internal Revenue Service, is submitted to the compromise section of the tax division in the Department of Justice. This compromise section is not engaged in litigation and its single purpose is to act on offers of compromise. It reviews the reports of the chief counsel's office and the trial attorney and makes its own recommendation as to whether the settlement offer should be accepted. All three reports are then transmitted to the assistant attorney general in charge of the tax division of the Department of Justice who must make the final decision, based upon these reports, as to whether the case should be settled.

If the three reports are unanimous, this decision is an easy one.

[49] INT. REV. CODE OF 1954, §6405. The statute requires only that a report be made to the joint committee. In practice the Internal Revenue Service does not make a refund until its report has been approved by the committee.

[50] *Id.* §6532.

However, the three persons considering the settlement do not always concur with each other. More often than not, in such circumstance, the assistant attorney general will act in accordance with the recommendation of his compromise section. However, the view has been expressed that the Department of Justice considers the Internal Revenue Service to be in a position vis-a-vis the Department of Justice which is similar to the position that a client occupies with respect to his attorney. Therefore the Department of Justice is reluctant to take action on a settlement contrary to the views expressed by the Internal Revenue Service.

This settlement machinery can seem, in the words of Dickens, a "triumphant perfection of inconvenience." Dealing with it can be difficult. We suggest that it will usually be desirable to arrange a conference with the trial attorney, the representative of the chief counsel's office who is preparing the Internal Revenue Service recommendation and the member of the compromise section who is assigned to the case. At this conference the case can be frankly discussed and views exchanged as to possible areas of compromise before a written offer is submitted to the Department of Justice. In this way the taxpayer can obtain some idea concerning the attitude of each of the three departments toward the settlement of the case. This will help him formulate an offer of settlement which can emphasize the taxpayer's arguments on the points which appear particularly troublesome to the government lawyers.

Suggestions for Improving Tax Administration

At the present time there is a profusion of notices given to the taxpayer that an adjustment is to be made in his reported income. He gets a 10-day letter, a 30-day letter and a 90-day letter. In addition, he is offered conferences with agents, group supervisors, informal conferees, reviewers in Washington, appellate advisors and government lawyers, any of which conferences may result in settlement of various issues. It would seem that these procedures could be compressed.

We would suggest that the first notice sent the taxpayer after audit of a return be the statutory notice of deficiency, and that a six-month period be permitted within which a petition could be filed in the Tax Court. Upon the mailing of this notice, the appellate division would assume exclusive jurisdiction over settlement of the case. This time should be adequate to settle any case which has been properly investigated in the audit stage. The existence of the deadline for taking an appeal to the Tax Court would encourage prompt settlement by both the taxpayer and the appellate division.

We would further suggest that upon filing a petition in the Tax Court, jurisdiction for settlement of the case should reside in the chief counsel's office. This authority should be exerciseable without any recommendations or advisory opinions from any other department of

the Internal Revenue Service. It would seem that the attorneys representing the Government in the trial of the case should be as well prepared to determine the reasonableness of a settlement offer as any other department.

If the tax is paid and a claim for refund is filed, jurisdiction to consider the claim should be given to the appellate division if that division has not already considered the case in a previous deficiency status. Where the appellate division has considered the case the taxpayer should be permitted to bring suit immediately and settlement jurisdiction should then reside in the Justice Department as it does now.

We would suggest that a streamlining of the settlement procedures in the Department of Justice would be desirable and possible without any prejudice to the revenue. In no event should more than two departments have to pass on the settlement offer and it would be best if either the trial department or the compromise section be given the entire voice in making settlements.

How then would this work in a particular case? After auditing a return the agent and his group supervisor would follow their normal procedures for trying to obtain an agreement from the taxpayer as to their proposed adjustments. However, if no agreement is obtained it would be necessary for the agent to write the notice of deficiency immediately. With this added responsibility we believe the agent and his group supervisor would be less apt to pad a case with issues which have little or no merit. In this event post-review would also take on added responsibilities, as it would make the final check on the form of the notice of deficiency and the correctness of the position taken by the agent before mailing the notice of deficiency.

When the taxpayer receives the notice of deficiency he would not be presented with a choice. The case would automatically go to the appellate division and, if the taxpayer wanted to settle with that department, it would be necessary for him to negotiate with the appellate division at that stage in the proceedings. It would also be necessary for this to be done promptly, as the appellate division would lose its jurisdiction at the end of six months.

The taxpayer would be less concerned about the appellate division raising new issues. Of course, issues could be raised, but at that stage in the proceeding the Government would have the burden of proving these issues should the case go to court. This would not be an unfair burden to impose on the Government since it has had ample opportunity at the audit stage to discover all issues and it would avoid much of the jockeying for position which now occurs during conferences in the pre-notice-of-deficiency stage of the case. This procedure would result in freer discussion of facts and argument, with a resulting improvement in the efficiency of the appellate division proceedings.

If the Government and the taxpayer were unable to settle the case at this stage they would have further opportunity at the time taxpayer filed a suit to litigate the case. At that point, settlement jurisdiction would reside in the counsel trying the case for the Government and settlement negotiations would be conducted in an atmosphere similar to that prevailing in civil litigation between two private litigants. This too would improve the possibilities of settling a case prior to trial. With greater control over the settlement of cases government counsel would have a better idea as to which cases it would be necessary to try and therefore they could improve their efficiency in preparing cases for trial.

The changes which we have suggested have been sketched only in broad outline. They would require some changes in the statute and many changes in the Commissioner's internal procedures. Obviously some refinement would be required. However, we believe that the goals sought to be accomplished are sound and merit further consideration. These goals are, basically, (1) to reduce the number of administrative steps between the audit of a tax return and the trial of a case—without sacrificing the number of settlements reached and (2) to concentrate settlement jurisdiction in a single department at any given time in order to make it easier for the Government and the taxpayer to negotiate effectively.

Conclusion

There are many areas of contact between the taxpayer and the Internal Revenue Service which we have not been able to cover in this article. One large and painful area for the taxpayer is in the collection of taxes. This includes the subject of liens for unpaid taxes, methods for enforcement of liens, priority of liens and compromises of admitted tax liabilities. We have also avoided the subject of advance rulings by which taxpayers may, in some cases, obtain a ruling from the Internal Revenue Service relating to the tax effect of a particular transaction before it is consummated. For the most part we have dealt simply with the various contacts which a taxpayer may have in dealing with the Internal Revenue Service's procedures for investigating returns and determining deficiencies in tax.

We have tried to show that the taxpayer has certain possibilities of shaping a tax case at the administrative level. It is here that an imaginative and knowledgeable approach to administrative procedures will accomplish the most in the handling of a tax case.

In many ways the existing procedures are cumbersome and inefficient. Much could be done to improve them. Yet they have achieved a degree of success and if used with intelligence and good faith by both the Government and the taxpayer they are capable of handling, fairly, a complex income tax statute.