Law Quadrangle (formerly Law Quad Notes)

Volume 15 | Number 1 Article 5

Fall 1970

Internal Revenue Service Conflict Resolution Procedures

L. Hart Wright
University of Michigan Law School

U.S. TREASURY DEP
INTERNAL REVENUE
OFFICE FO

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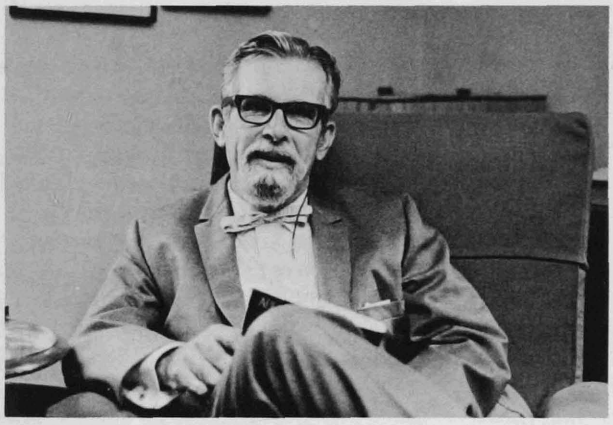
Based on the introduction to Professor Wright's new work: Needed Changes in Internal Revenue Service Conflict Resolution Procedures, published by the American Bar Foundation, which provided funds to assist the study.



by Professor L. Hart Wright

Within the Internal Revenue Service, disputable income tax questions may be resolved at any one of several administrative levels. Each such tier differs from the others in terms of authority. In aggregate, however, they are expected to resolve issues efficiently, conveniently to both government and taxpayers, with justice in each case, uniformity among cases, and with a minimal burden being imposed on the judiciary.

That these goals cannot be achieved in any absolute sense is not due to the human factor alone. Equally disabling are their inherent conflicts. Undue emphasis on one goal necessarily is at the expense of another. Thus, at best the Service can hope only to achieve a proper balance. Even this, however, is not adequately accomplished by existing procedures. Their shortcomings and the remedies are the concern of my study.

Proposed changes will not affect those giant strides heretofore made toward one goal. Today, viewed relatively or comparatively, few disputes suffer the added burden of litigation. In context, this achievement is almost miraculous, for the Service, in administering our tax law, faces two formidable obstacles not encountered in like measure by any comparable tax system.

One obstacle is the unmatched complexity of the law the Internal Revenue Service administers. When applied to the countless and varied transactions which make up our sophisticated economy, a vast number of interpretative problems emerge. Thus, to confine litigation within reasonable limits, the Service must achieve bilateral agreements in an enormous absolute number of cases. This is not easy. The law's basic principles have spawned, in the interest of tax equity or nontax societal needs, a host of significant statutory deviations and subdeviations. The substantial nature of the consequent tax differentials necessarily intensifies interpretative pressure at all the joints and makes each such agreement that much more difficult to achieve.

The pattern of court organization also complicates the administrative conflict resolution process. In contrast to many other highly developed countries, the judicial pyramid which presides over U.S. tax affairs lacks an effective apex. Because of their nationwide jurisdiction, two of the three trial forums disclaim allegiance to any particular intermediate court of appeals. The intermediate courts, in turn, view one another with respect but no more. If

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only one appellate court has spoken on an issue, uncertainty continues because a second appellate court later might not agree; typically, until then the Supreme Court will not assume jurisdiction. Contributing to uncertainty in the interim is the real prospect—proven by our experience—that, when and if the Supreme Court will not assume jurisdiction, it may disagree with the appellate court that first addressed itself to the issue.

Given the untold number of varied transactions hidden behind subtotals reflected in the 75,000,000 final income tax returns filed in fiscal 1967, and the consequent uncertainties generated by the formidable obstacles just recited, it should not surprise us to find that district audit personnel felt called upon to assert 2,059,000 deficiencies. Nor is it surprising that, in 76,000 of these cases, taxpayers entered an administrative appeal upon failing to resolve their differences with the appropriate tax examiner. Attesting, however, to the Service's relative success in ultimately securing agreements is the fact that, in that same year, the judiciary—far from being inundated—had to resolve on the merits only 1,340 income, estate, and gift tax cases. This represented less than two per cent of the cases administratively appealed and only an infinitesimal fraction of total deficiencies asserted. Comparatively speaking, the number of trial determinations was little more than the number in Belgium or the Netherlands and was far less than the number in Britain, France, or Germany.

These statistics, though reassuring in the relative infrequency with which asserted deficiences are litigated, leave open whether the administrative procedures, in resolving the host of other issues, were reasonably calculated to achieve in proper balance the other four goals—efficiency, convenience, justice, and uniformity. My study demonstrates that before such disputable issues actually will have a reasonable chance to be disposed of in accord with a properly balanced version of those aims, procedures at each administrative level must be modified in some respect. A brief resumé of the most important of the necessary changes follows.

The first suggested modifications relate to the highest field level—the region. Ordinarily that level should seek, as it now does, to "settle"—on the basis of mutual concessions responsive to the competing strengths and weaknesses of the two sides—even those marginal or arguable issues which, if litigated, a court, to conform to the statute, would have to decide *entirely* for one side or the other ("all-yes-or-all-no" issues). Also equally valid, generally speaking, is the longstanding requirement of the settlement process: neither side shall be expected to concede outright any issue unless its contention possesses, solely by reference to the litigation hazards, only nuisance value. But in one respect this standard must be changed.

The need, in the interest of justice, is to enlarge the *government's* outright concession practice in relatively *small* cases, to include arguable all-yes-or-all-no issues where the taxpayer is acknowledged, on the basis of anticipated litigation hazards, to have at least a slight edge which, economically speaking, he can ill afford to demonstrate by actual litigation.

Another change in regional practices is required to improve the timeliness, orderliness, and efficiency with which settlements are reached in cases even now ultimately settled. Present arrangements actually contribute not only to substantial delay in reaching agreements but also to an unnecessary and expensive drain on the Service's most talented field personnel. The preferred remedy for both the delay and waste is to consolidate the appellate division and the regional counsel's office, though certain preliminary steps regarding personnel practices must be initiated well in advance.

A second set of proposed changes relate to the quite different conflict resolution role performed by personnel in the more densely populated and widely scattered district audit divisions.

That the latter do, by agreement with taxpayers, resolve most issues involving potential deficiencies obviously contributes to both efficiency and convenience. But this achievement itself emphasizes the importance (in the interest of justice and uniformity) of the need to redefine the conflict resolution role of the two echelons within these divisions (agents and conferees) and to do so with greater precision than currently exists.

Redefinition is required primarily because there is a frequently recurring inherent conflict between (i) the responsibility imposed on tax examiners to try to persuade taxpayers to agree to an asserted deficiency and (ii) the Service's own ultimate notion of "administrative" justice as reflected in the settlement practices of the yet higher regional offices. The conflict is most dramatically revealed in cases which include at least one truly marginal or arguable all-yes-or-all-no issue.

Lacking true settlement authority, audit division examiners are expected both to set up a deficiency for the entire amount at issue and attempt to secure the taxpayer's agreement to it. This attempt may conflict with the Service's own ultimate standard of administrative justice. The regional level to which this ulti-

mate standard is entrusted, on considering an appeal of such truly arguable issues, ordinarily is expected to seek an appropriate "settlement," not the outright concession sought by the audit division's examiner.

Because small cases of this type often involve unsophisticated and unrepresented taxpayers, justice will not be attained unless the examiner's role as an advocate is revised in a manner that tends to assure that these particular cases will reach officials empowered with the type of full settlement authority now reserved to the regional level. For a variety of reasons, that authority generally cannot be extended to examiners themselves. Nevertheless, in small cases, taxpayer convenience does affect the prospect of according to these cases the Service's ultimate notion of administrative justice. To this end, full settlement authority should be extended to the districts' own conveniently located circuit-riding conferees.

Certain other compelling practical considerations, and a need to conform national office instructions to existing practice in the interest of integrity, require a yet different arrangement to accommodate the host of small, arguable all-yes-or-all-no issues which emerge in the audit of corporate giants. As to these issues, full settlement authority should be extended officially to the highly experienced agents who conduct such audits, the settlements being subject only to their group supervisor's approval.

Changes also are required at the national office level in the procedures pertaining to both the *letter* and *published* rulings programs. In contrast to most other highly developed countries, the national office, in the interest of taxpayer certainty, undertakes on an enormous scale the difficult burden of responding in advance to requests for rulings on *prospective* transactions. Most of the 13,774 substantive letter rulings issued in fiscal 1967 were of this type. These private letter rulings, together with 3,118 answers to requests from field offices for substantive technical advice, also furnished the subject matters for 392 substantive published rulings.

While certain shortcomings in each program tend to be inherent, these difficulties have been accentuated by the nature of the relationship which exists between the two programs. Because of this relationship, either private rulings are too long delayed or, in the published version, the Service suffers substantial risk of inaccuracy or of violating a publication commitment made to Congress.

Another problem has emerged because the Commissioner ordinarily refuses to rule on certain prospective transactions which either are associated with the so-called avoidance area or raise issues deemed primarily factual in nature. Usually, practical considerations appear to be legitimate deterrents to any asserted claim for rulings in these areas. However, a competing societal value, of great significance to our *entire legal order,* and thus transcending in importance the administrative tidiness of our tax system standing alone, should lead the Commissioner to rule on certain avoidance-type questions. This change should be complemented by yet another which would cushion the drastic effect of the only two alternative answers (favorable or unfavorable) should he rule on such questions. What is needed is an escape valve which provides greater flexibility, enabling the Commissioner to take more adequate account of real differences in the degree of taint and doubt he may associate with prospective transactions. Specifically he should be able to rule adversely and simultaneously provide both the taxpayer and himself with the opportunity to secure confirmation or rejection of that view by an independent tribunal (the tax court) before the taxpayer is forced to abandon the affected prospective transaction.

Three other proposed changes relate solely to published rulings. If the Service's past behavior is indicative, this program will not be sustained as well as it should be. Given the outside pressure which focuses almost exclusively on timely production of letter rulings, a mechanism is needed to assure adequate personnel for both rulings programs and that the attention of personnel will be spread more evenly between the two.

There also is a serious discrepancy between the two rulings programs in the procedural safeguards accorded taxpayers. In the case of private letter rulings, the Service has gone about as far as it can in according a hearing to the affected taxpayer. But no such safeguard is provided the nameless host of other taxpayers who may be affected substantially by a published ruling. The unfairness of this should be, and easily can be, corrected without harming the program itself.

A final set of proposed changes relate to an administrative function carried out by a congressional committee—the Joint Committee on Internal Revenue Taxation. Practical considerations having nothing to do with the constitutionally oriented separation-of-powers doctrine warrant repeal of a statutory provision from which has grown this committee's case-by-case review of large refunds. The repeal should be accompanied, however, by a broadening of the scope of this committee's activities in relation to general review of the Service's entire range of administrative procedures.

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