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Analyzing the Schizoid Agency: Achieving the Proper Balance in Enforcing the Internal Revenue Code

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ANALYZING THE SCHIZOID AGENCY: ACHIEVING THE PROPER BALANCE IN ENFORCING THE INTERNAL REVENUE CODE

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I. INTRODUCTION

The Internal Revenue Service (the "Service")[1] has been attempting to ratchet up its enforcement efforts in the last few years.[2] While this is no surprise given the spate of abusive tax shelter transactions peddled by lawyers and accountants since the late 1990s,[3] it should strike a measure of fear into the heart of the general taxpaying public.[4] Not fear driven of a guilty conscience, but fear that overzealousness on the part of the Service will be directed at honest taxpayers rather than the intended targets. In these times of historic government budget deficits,[5] taxpayers should be legitimately concerned that Service employees auditing tax returns may assert aggressive positions on behalf of the government in an effort to increase government revenues. Similarly, taxpayers should be concerned that policymakers at the Service will, in an attempt to anticipate and foreclose future abusive tax shelters, adopt one-sided

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1. In reality, several governmental agencies play a role in administering the federal income tax system. The Service is a bureau within the Treasury Department and has responsibility for enforcing the Code and providing general guidance to taxpayers. Nevertheless, the issuance of regulations, legislative proposals regarding taxation, and certain other policy functions have not been delegated by the Secretary of the Treasury to the Service and therefore remain the responsibility of Treasury Department officials outside the Service. Similarly, in certain litigation contexts, the Tax Division of the Justice Department assumes responsibility for litigating, and potentially settling, specific tax matters. 28 C.F.R. § 0.70 (2007). The controversy themes discussed in this article apply equally to all these governmental actors. Consequently, for ease of discussion they will all be referred to collectively as the "Service" herein.

2. *See generally* IRS PUB. NO. 3744, IRS STRATEGIC PLAN 2005-2009 18-25, *available at* http://www.irs.gov/pub/irs-utl/strategic_plan_05-09.pdf (emphasizing the need for improved enforcement); Mark Everson, *Closing 'Tax Gap' Is IRS Goal*, TAX NOTES TODAY, Apr. 7, 2004, LEXIS 2004 TNT 68-18, ¶ 7 (stating that "we must restore the balance between service and enforcement"); Mark Everson, *Everson Endorses Continued Use of Private Debt Collectors as Tax Gap Tool*, TAX NOTES TODAY, Feb. 20, 2007, LEXIS 2007 TNT 34-206; Mark W. Everson, *Everson Testifies on Tax Shelters at Finance Committee Hearing*, TAX NOTES TODAY, Oct. 22, 2003, LEXIS 2003 TNT 204-28, ¶ 79 (stating that "the IRS must allocate additional resources to enforcement"); Kenneth A Gary, *Enforcement Remains Priority for LMSB, Nolan Says*, TAX NOTES TODAY, Oct. 19, 2004, LEXIS 2004 TNT 202-2; Kenneth A. Gary, *IRS Officials Echo Everson: Quicken Audit Cycle, Push Enforcement*, TAX NOTES TODAY, Nov. 4, 2003, LEXIS 2003 TNT 213-2.

3. *See generally* U.S. Department of the Treasury, *Treasury White Paper on Corporate Tax Shelters* (pts. 1 & 2), TAX NOTES TODAY, July 2, 1999, LEXIS 1999 TNT 127-12, 127-13 (discussing tax shelter problem generally).

4. Mark Everson, *Everson Endorses Continued Use of Private Debt Collectors as Tax Gap Tool*, TAX NOTES TODAY, Feb. 20, 2007, LEXIS 2007 TNT 34-206, para. 11 (noting a 44% increase in revenues attributable to increased enforcement efforts from 2002 to 2006).

5. Edmund L. Andrews, *Bush Plan Would Raise Deficit by $1.2 Trillion, Budget Office Says*, N. Y. TIMES, Mar. 4, 2006, at A14.

interpretations of the law favoring the government.

To its credit, the Service's National Taxpayer Advocate Service has been mindful of past abuses that have occurred under similar circumstances and has proposed several initiatives to curb overzealous enforcement actions by Service employees.[6] However, these proposals are limited in their scope and fail to address the threshold question of what standards should apply in determining whether the Service should assert a position in a specific enforcement action.[7] While a fairly clear understanding has evolved over time regarding the appropriate standards that apply to taxpayers in asserting positions on their tax returns,[8] the state of the law regarding the reciprocal question of what positions should be asserted by the Service in controversy matters remains unsettled.[9]

The purpose of this article is to examine the considerations that should influence the development of appropriate controversy position standards for the Service. In this regard it is crucial to understand the inherent duality in the Service's role. On one hand it is charged with enforcing the Internal Revenue Code (the "Code"), and as a result it attempts to maximize the collection of all legally owed taxes. On the other, the Service is charged with maintaining the efficient and fair operation of the tax system as a whole. The United States federal income tax system is premised on voluntary taxpayer compliance with the Code.[10] Taxpayer compliance is linked to perceptions regarding the overall fairness of the tax system.[11] When taxpayers perceive the Service as overreaching, they lose faith in the system and voluntary

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6. Nina E. Olsen, Nat'l Taxpayer Advocate, *National Taxpayer Advocate Issues Report on Fiscal 2005 Objectives,* TAX NOTES TODAY, June 30, 2004, LEXIS 2004 TNT 128-21.

7. *Id.*

8. *See* discussion *infra* Part II.A.

9. *See* discussion *infra* Part II.B.

10. United States v. Arthur Young & Co., 465 U.S. 805, 815-16 (1984) ("Our complex and comprehensive system of federal taxation, relying as it does upon self-assessment and reporting, demands that all taxpayers be forthright in the disclosure of relevant information to the taxing authorities. Without such disclosure, and the concomitant power of the Government to compel disclosure, our national tax burden would not be fairly and equitably distributed."); Couch v. United States, 409 U.S. 322, 335 (1973) (describing system as one "where obligations of disclosure exist and under a system largely dependent upon honest self-reporting even to survive"); Treas. Reg. § 1.461-1(a)(3) (as amended in 1999) ("Each year's return should be complete in itself, and taxpayers shall ascertain the facts necessary to make a correct return."). While not technically accurate, the U.S. approach of having taxpayers shoulder the initial burden of determining and paying their tax liability is generally referred to as a "self-assessment" system.

11. LILLIAN DORIS, THE AMERICAN WAY IN TAXATION: INTERNAL REVENUE, 1862-1963, at 1-2 (1963) (noting that self-assessment system is threatened if public loses confidence that tax laws are operating fairly).

compliance is harmed.[12] For instance, when the Service publishes one-sided guidance it undercuts its important taxpayer education efforts because taxpayers "learn" that the tax law will be interpreted in a biased manner. To avoid these pitfalls, it is necessary for the Service to strike an appropriate balance in taking positions to mitigate the tensions inherent in its dual role of facilitating voluntary compliance and policing against non-compliance.

Part II of this article reviews the current position standards that apply to taxpayers and the Service. Part III examines the key considerations which should be taken into account in developing controversy position standards for the Service. Part IV makes an initial attempt at developing a set of controversy guidelines for the Service and analyzes some possible critiques of the proposed guidelines. Part V concludes that in order to protect the integrity of the self-assessment tax system the Service must articulate clear and administrable position standards for use by Service employees that take a balanced view of the tax law and prevent overreaching by the government.

II. EXISTING POSITION STANDARDS FOR TAXPAYERS AND THE GOVERNMENT

A. Taxpayer Position Standards

Under the Code, it is the responsibility of each taxpayer to determine how the Code applies to her situation and then report and remit the tax owed to the government.[13] While the Service has the power to check compliance by auditing taxpayers, in reality only a tiny fraction of filed returns are audited.[14] Consequently, the tax system

12. *Id.*; Douglas A. Kahn, *Compensatory and Punitive Damages for a Personal Injury: To Tax or Not to Tax?*, 2 FLA. TAX REV. 327, 351-52 (1994) ("Our self-assessment system of taxation relies on a willingness of the populace to report honestly to the government, and that willingness rests on a popular belief that the government's system of taxation is fair."); Robert J. Peroni, *A Policy Critique of the Section 469 Passive Loss Rules*, 62 S. CAL. L. REV. 1, 5-6 (1988) ("[T]ax shelters destroy the horizontal and vertical equity of the tax system and lead average taxpayers to feel that they are fools for paying their fair shares of the income tax burden, thereby undermining the foundation of the self-assessment system.").

13. Treas. Reg. § 1.461-1(a)(3) (as amended in 1999) ("Each year's return should be complete in itself, and taxpayers shall ascertain the facts necessary to make a correct return."). *See also* I.R.C. § 6065 (2007) (requiring returns to be signed under penalty of perjury); Valverde v. Comm'r, 53 T.C.M. (CCH) 628, 629 (1987) (taxpayer has obligation to file correct return); Wiseley v. Comm'r, 13 T.C. 253, 256 (1949) (taxpayer must file correct returns), *rev'd on other grounds*, 185 F.2d 263 (6th Cir. 1950).

14. The Service currently audits less than 0.6 percent of all income tax returns. Pamela J.

relies heavily on taxpayers correctly reporting their tax burden in the first instance. Preparing tax returns requires taxpayers to understand the relevant provisions of the Code and apply them to their particular factual circumstances. Every tax return thus requires legal judgments regarding both the meaning of the Code and its application to specific situations.

In most cases, the interpretation of the law will be well-settled and easily applied by the taxpayer, but in others the law or its application will be open to varying interpretations. In these cases, what standard should the taxpayer use in determining whether his position is appropriate? While no single authoritative statement of the relevant standards for taxpayer return positions exists, a set of fairly well accepted return position standards has evolved over time. These standards find their sources in the ethics codes and opinions issued by professional organizations,[15] the Service regulations governing practice before the Service,[16] and the various penalty provisions of the Code and regulations.[17]

What emerges from these various sources is a baseline standard that a taxpayer must have a "realistic possibility of success" for his position in order to file his tax return on that basis without specifically disclosing the position to the Service.[18] While using percentages to define the strength of a legal position is always fraught with some peril,[19] the

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Gardiner, *TIGTA Reviews IRS's 'Falling' Examination Rate*, TAX NOTES TODAY, June 25, 2002, LEXIS 2002 TNT 123–23, ¶ 2. Even audits of large corporate taxpayers declined "significantly" between 1997 and 2002. JOINT COMM. ON TAXATION, REPORT OF THE JOINT COMM. ON TAXATION RELATING TO THE INTERNAL REVENUE SERVICE AS REQUIRED BY THE IRS REFORM AND RESTRUCTURING ACT OF 1998 at 36 (JCX-53-03 2003), *available at* http://www.house.gov/jct/x-53-03.pdf.

15. ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 85-352 (1985) (realistic possibility of success standard); ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 346 (Revised) (1982) (tax shelter opinion rules); ABA Comm. on Prof'l Ethics, Formal Op. 314 (1965) (reasonable basis standard).

16. 31 C.F.R. § 10 (2007) (generally referred to as Circular 230).

17. I.R.C. § 6662 (2007) (accuracy related penalty); Treas. Reg. § 1.6662-3(b) (as amended in 2003) (negligence, reasonable basis, and realistic possibility of success); Treas. Reg. §§ 1.6662-4(d), 1.6662-4(g) (as amended in 2003) (substantial authority and more likely than not); I.R.C. §§ 6664(c), 6664(d) (2007) (reasonable cause exceptions); Treas. Reg. § 1.6664-4 (as amended in 2003) (reasonable cause exceptions); Treas. Reg. § 1.6694-2(b) (as amended in 1992) (realistic possibility of success).

18. Treas. Reg. § 1.6662-3(c)(1) (as amended in 2003); 31 C.F.R. § 10.34 (2007); ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 85-352 (1985).

19. A legal opinion essentially represents an educated guess by a practitioner regarding the likelihood that a court will rule in a certain matter based on all the relevant facts and legal authorities. As such, quantifying such a judgment in precise mathematical percentages is counter-intuitive at best and a fool's errand at worst. While historically tax practitioners were reluctant to undertake such quantifications of their opinions, most tax practitioners now routinely use such percentages in describing their assessments. Jasper L. Cummings, Jr., *The Range of Legal Tax*

realistic possibility of success standard is generally defined as a one in three chance of success on the merits if the position is litigated.[20] Still, no single standard can cover all the situations a taxpayer may face. Consequently, this general standard is subject to modification based on the particular situation involved. Thus, the accepted standards provide that a return position having a "reasonable basis" can be taken on a tax return without penalty as long as it is adequately disclosed to the Service,[21] but negligent or frivolous positions are inappropriate for an initial tax return and are subject to penalty even if disclosed.[22] In terms of probability percentages, a position is typically thought to have a reasonable basis if it has a greater than 20% chance of success on the merits.[23] In this scheme, a frivolous position would be one with a less than ten percent chance of success.[24]

Conversely, sometimes the Code specifically imposes higher reporting position standards than the realistic possibility of success norm. For instance, penalties for certain large understatements of income can be imposed for non-disclosed positions if the position lacks "substantial authority."[25] If a tax shelter transaction is involved, taxpayers must reasonably believe that they have a "more likely than not" chance of success, even if they adequately disclose the transaction to the Service.[26] Using percentage probability benchmarks again, "substantial authority" is thought to represent approximately a 40 percent chance of success on the merits[27] and the "more likely than not"

Opinions, with Emphasis on the 'Should' Opinion," 98 TAX NOTES 1125 (2003); Detlev F. Vagts, *Legal Opinions in Quantitative Terms: The Lawyer as Haruspex or Bookie?*, 34 BUS. LAW. 421 (1979). *See generally* Am. Bar Ass'n Section of Taxation Comm. on the Standards of Tax Practice, *Standards of Tax Practice Statement*, 54 TAX LAW. 185 (2000); Frank J. Gould, *Giving Tax Advice – Some Ethical, Professional, and Legal Considerations*, 97 TAX NOTES 523 (2002).

20. Treas. Reg. § 1.6694-2(b) (as amended in 1992); 31 C.F.R. § 10.34 (2007).

21. Treas. Reg. § 1.6662-3(c) (as amended in 2003).

22. Treas. Reg. §§ 1.6662-3(a), 1.6662-3(b) (as amended in 2003). For these purposes a position is never negligent if it meets the reasonable basis standard. *Id.*

23. Burgess J.W. Raby & William L. Raby, *Painting the Accounting Practitioner into a Tax Practice Corner*, TAX NOTES TODAY, Sep. 15, 2005, LEXIS 2005 TNT 178-4.

24. *Id.*; Burgess J.W. Raby & William L. Raby, *'Reasonable Basis' v. Other Tax Opinion Standards*, TAX NOTES TODAY, Dec. 9, 1996, LEXIS 96 TNT 237-28; Bernard Wolfman, James P. Holden & Deborah H. Schenk, ETHICAL PROBLEMS IN FEDERAL TAX PRACTICE 42 (3d ed. 1995).

25. Treas. Reg. §§ 1.6662-4(a), 1.6662-4(d) (as amended in 2003).

26. Treas. Reg. § 1.6662-4(g) (as amended in 2003).

27. The relevant regulations define substantial authority as a position that is stronger than a mere realistic possibility of success (i.e., 33%) but less than more likely than not (50%). Treas. Reg. § 1.6662-4(d)(2) (as amended in 2003). *See also* Sheldon I. Banoff & Harvey L. Coustan, *Final Regulations on Return Preparers' Penalties: IRS Refuses to Deal, Preparers' Fears Prove to Be Real/Penalty Roulette – Roll the Wheel/Who Knows How the Courts Will Feel?*, 70 TAXES 137, 159 (1992) (suggesting 35-40%); Raby & Raby, *supra* note 23 (suggesting 35-40%).

standard represents a greater than 50 percent chance of success.[28] Finally, even if a taxpayer fails to adhere to the relevant position standard, penalties can generally be avoided if the position is taken in good faith and the failure is attributable to reasonable cause.[29]

These taxpayer reporting standards are driven in significant part by a weighing of competing interests. On the one hand, taxes are forced impositions by the government on its citizens and therefore taxpayers should have the legal right to challenge their obligation to pay such impositions even if they only have a small chance of success. On the other hand, the inability of the Service to fully and systemically audit individual taxpayer compliance while maintaining a functional tax system necessitates that taxpayers be required to report their income and taxes owed fairly and correctly in the first instance.

The baseline realistic possibility of success standard strikes a balance that is tilted somewhat in the taxpayer's favor. The government can have a two-thirds chance of being correct and yet the taxpayer can generally take the opposite position on her tax return without specifically highlighting the item for the Service.[30] Further, even more aggressive positions (*e.g.*, ones where the government would be expected to win 75-80% of the time) can be taken if adequately disclosed on the tax return.[31] These taxpayer leaning standards are generally justified by viewing the Service in the traditional role of an adversarial party in litigation.[32] The Service has generally accepted these pro-taxpayer reporting standards and only sought statutory adjustment to them for situations it found particularly troubling to effective tax administration (*e.g.*, by requiring substantial authority to exist for positions resulting in large income

28. Indeed, in drafting written opinions for clients, tax attorneys typically further refine the relative strength of positions meeting the "more likely than not" standard by stating their legal conclusions in terms of "should" (sometimes further refined as "weak" and "strong" shoulds) and "will." Marvin A. Chirelstein & Lawrence A. Zelenak, *Tax Shelters and the Search for a Silver Bullet*, 105 COLUM. L. REV. 1939, 1941 n.5 (2005); Cummings, *supra* note 19. These terms roughly equate to increments of certainty reciprocal to the standards for certainties below 50%. *See, e.g.*, *New Regs., Merrill Lynch Settlement Highlight Tax Shelter News*, 95 J. TAX'N 254, 254 (2001); Michael L. Schler, *Ten More Truths About Tax Shelters*, 55 TAX L. REV. 325, 353 (2002). Thus, "should" opinions are often viewed as representing a 60%, 67%, or 80% chance of success on the merits depending on their qualification as weak, normal or strong, and a "will" opinion represents a more than 90% probability of success.

29. Treas. Reg. § 1.6664-4 (as amended in 2003).

30. *See supra* notes 18-20 and accompanying text.

31. *See supra* notes 21-22 and accompanying text.

32. ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 85-352 (1985); ABA Comm. on Prof'l Ethics, Formal Op. 314 (1965). *See also* Dennis J. Ventry, Jr., *Raising the Ethical Bar for Tax Lawyers: Why We Need Circular 230*, 111 TAX NOTES 823 (2006).

omissions and by mandating that a more likely than not standard be applied to certain tax shelter transactions).[33]

On the other hand, the current standards are not completely pro-taxpayer. A taxpayer generally can challenge a law in court as long as her position is not frivolous.[34] However, under the currently accepted tax return reporting standards, a non-frivolous position is only permitted without penalty if it has a realistic possibility of success or the position is disclosed and has a reasonable basis.[35] Thus, a gap exists where a position could be litigated in court, but could not be initially asserted on the taxpayer's tax return without incurring potential penalties. This is not an unfair elimination of a taxpayer's right to maintain such a position and challenge the law since, while the taxpayer cannot take the position on an initial tax return, he could pay the tax and file a refund claim asserting the non-frivolous position.[36] If the Service rejects the claim, then the taxpayer could pursue the matter in court.[37] Refusing to allow taxpayers to take such positions on their initial tax returns is a means of bolstering the efficient operation of the self-assessment system and ensuring that very extreme taxpayer positions are only raised in situations where the Service has been made fully aware of the positions and can prepare to litigate the matter in a clear adversarial context.[38]

B. Government Position Standards

While a generally accepted set of position standards exist for taxpayer return positions, the same cannot be said for Service positions.[39] The primary guidance on the relevant controversy standards for the Service is contained in Revenue Procedure 64-22.[40] In relevant part the procedure provides that:

> At the heart of [tax] administration is interpretation of the Code. It is the responsibility of each person in the Service, charged with the duty of interpreting the law, to try to find the true meaning of the statutory provision and not to adopt a strained construction in the belief that he

33. Treas. Reg. §§ 1.6662-4(a), 1.6662-4(d), 1.6662-4(g) (as amended in 2003).

34. I.R.C. § 6673 (2007) (providing penalties or court costs where taxpayer's position in litigation determined to be frivolous); T.C. R. 33; MODEL RULES OF PROF'L CONDUCT R. 3.1 (2002).

35. Treas. Reg. § 1.6662-3(c)(1) (as amended in 2003); 31 C.F.R. § 10.34 (2007); ABA Comm. on Ethics and Prof'l Responsibility, Formal Op. 85-352 (1985).

36. *See, e.g.*, Yuen v. United States, 825 F.2d 244, 245 (9th Cir. 1987).

37. *See id.*

38. *See id.*

39. Wolfman, Holden & Schenk, *supra* note 24, at 332-34.

40. Rev. Proc. 64-22, 1964-1 C.B. 689.

> is 'protecting the revenue.' The revenue is properly protected only when we ascertain and apply the true meaning of the statute.
>
> The Service also has the responsibility of applying and administering the law in a reasonable, practical manner. Issues should only be raised by examining officers when they have merit, never arbitrarily or for trading purposes. At the same time, the examining officer should never hesitate to raise a meritorious issue.[41]

This statement recognizes that the primary function of the Service is to ensure the efficient functioning of the tax system but that this goal is best served by interpreting and applying the law in a fair and balanced manner.[42] The Service's key role in facilitating the operation of the self-assessment system is further stressed in the Service's own statement of its mission, which is to "[p]rovide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all."[43]

Taking these announced standards at face value, one would expect the Service to eschew extreme interpretations of the tax laws and only raise issues on audit that the Service believes embody the "correct" interpretation of the relevant Code provisions.[44] However, the actual application of the Service's own standards is quite mixed. Regarding interpretive matters, practitioners frequently maintain that the Service

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41. *Id.*

42. Internal Revenue Service, *IRS Releases 'Oral History Interview' of Former Commissioner Caplin*, TAX NOTES TODAY, June 22, 1994, LEXIS 94 TNT 120-25, para. 36 [hereinafter *Caplin Interview*].

43. Internal Revenue Service, *The Agency, Its Mission and Statutory Authority*, http://www.irs.gov/irs/article/0,,id=98141,00.html (last visited Sep. 1, 2007). *See also* I.R.M. 8.1.1.4 (2003) ("The mission of the service is to encourage and achieve the highest possible degree of voluntary compliance with the tax laws and regulations and to conduct itself so as to warrant the highest degree of public confidence in its integrity and efficiency.").

44. However, it is worth noting that prior to 1998 the Service's mission statement included a specific acknowledgement that the role of the Service was limited to collecting the "correct" tax. This language was dropped in 1998 when the Service amended its mission statement in response to the IRS Restructuring and Reform Act of 1998, § 1002, Pub. L. No. 105-206, 112 Stat. 685 (directing the Service to "review and restate its mission to place a greater emphasis on serving the public and meeting taxpayers' needs"). Prior to 1998 the mission statement read: "The purpose of the Internal Revenue Service is to collect the proper amount of tax at the least cost; serve the public by continually improving the quality of our products and services; and perform in a manner warranting the highest degree of public confidence in our integrity, efficiency and fairness." Internal Revenue Service, *Full Text: Revised IRS Policy Statement on Privacy*, TAX NOTES TODAY, Mar. 18, 1994, LEXIS 94 TNT 53-47. Some commentators believe the omission of the "proper tax" concept signals a paradigm shift in the Service's approach to controversy matters. *E.g.*, Bryan T. Camp, *Tax Administration as Inquisitorial Process and the Partial Paradigm Shift in the IRS Restructuring and Reform Act of 1998*, 56 FLA. L. REV. 1, 78-86 (2004).

has engaged in over-reaching when providing guidance on the Code's meaning. At the audit level, the Service specifically instructs its examining agents to raise all meritorious issues, even if the agent actually believes the taxpayer's legal position is the correct one.[45] Additionally, an agent is prohibited from raising an issue based on a "strained construction" of a statute.[46] The juxtaposition of these standards may lead some agents to conclude that *any* position has "merit" and must be raised as long as it is not based on a "strained construction;" thereby creating a very low threshold for raising issues.[47]

A government slanted audit approach is arguably justified based on the functional division of authority within the Service. The role of examining agents is generally limited to issue spotting and fact finding, while the authority to weigh the merit of legal issues and settle cases is housed within the Service's Appeals Office.[48] However, while Appeals Officers weigh the legal merits of the issues presented to them, their primary function is to settle cases.[49] Unlike a court decision (where the law's application is typically resolved on an all or nothing basis in favor of one party), Appeals settlements often involve splitting the issue on a percentage basis.[50] Thus, if the Service has a 30% chance of winning it might attempt to settle the dispute for 30 cents per dollar of tax involved. A taxpayer might be willing to accept this settlement (even though he expects that a court would rule completely in his favor) based on the 30% risk of losing in court and the costs in time and money of defending his position.[51] Thus, by asserting aggressive positions at the

45. Rev. Proc. 64-22, 1964-1 C.B. 689; *Caplin Interview*, *supra* note 42, at 52; Frederic G. Corneel, *The Service and the Private Practitioner: Face to Face and Hand in Hand – a Private Practitioner's View*, 11 AM. J. TAX POL'Y 343, 359-60 (1994).

46. Rev. Proc. 64-22, 1964-1 C.B. 689; I.R.M. 31.1.1.1 (2004); I.R.M. 32.2.1.1 (2004); I.R.M. 33.2.2.2.3 (2004).

47. Corneel, *supra* note 45, at 359-60; Joint Committee on Taxation, *JCT Interest and Penalty Study* (pt. 1), TAX NOTES TODAY, July 27, 1999, LEXIS 1999 TNT 143-33, para. 477.

48. I.R.M. 8.1.1.1 (2003); I.R.M. 8.1.1.3 (2006).

49. I.R.M. 8.1.1.1 (2003); I.R.M. 8.1.1.3 (2006).

50. George Guttman, *News Analysis: IRS Averages: Winning Little, Losing Big*, 61 TAX NOTES 155, 156 (1993) ("Unless there is an IRS policy to the contrary, the hearing officer in the appeals office makes a settlement offer on the basis of the quality of the case sent up by the auditor and the hazards of litigation. For example, if the officer thinks that the IRS has only a 30-percent chance of succeeding in litigation, an offer will be made to settle the case for 30 cents on the dollar."). Still, there are limits on the Appeals officer's settlement authority. For instance, Appeals officers generally refuse to settle any issue on a percentage basis where they believe the taxpayer has less than a 20% chance of success on the merits. The goal of this rule is to dissuade nuisance settlements. L. HART WRIGHT, NEEDED CHANGES IN INTERNAL REVENUE SERVICE CONFLICT RESOLUTION PROCEDURES 12 (1970).

51. Corneel, *supra* note 45, at 359-60.

examination level, the government is essentially able to extort payments from taxpayers whose positions are most likely the correct view of the law. This seems counter to the Service's stated goal of trying "to find the true meaning of the statutory provision."[52] By pushing one-sided positions the Service harms its own credibility with taxpayers and confirms taxpayer beliefs that the Service interprets the laws unfairly.

Where legal issues predominate, what should be the appropriate standard to apply in deciding whether the Service should pursue an issue in a controversy matter? The current standards are unclear. At a 1993 conference where this issue was discussed, one Service panelist, speaking for himself, stated that he felt the Service should have "a reasonable basis . . . to believe that we have a chance of prevailing" and "should feel reasonably confident that the position is correct."[53] If "reasonable basis" is interpreted to indicate the same standard used for taxpayer positions, then this panelist's statement seems to equate roughly a 20% chance of success on the merits coupled with a good faith belief that the position is nevertheless correct.[54] However, the panelist went on to state, "I don't think we have to have better than 50 percent. . . . We have to feel we have a pretty good shot at winning."[55] In light of this comment the report of the conference took the position that the standard being advocated by this panelist was "probably equivalent" to the "realistic possibility of success" standard (i.e., 33%) applicable to taxpayer return positions.[56] In any event, despite this panelist's attempt at formulating a standard for the Service, no consensus was reached at the conference regarding the appropriate standard.[57]

III. CONSIDERATIONS IN DETERMINING APPROPRIATE CONTROVERSY POSITION STANDARDS

The foregoing discussion demonstrates that the Service's controversy position standards are ill-defined at best. The lack of justifiable standards for the Service promotes taxpayer disrespect for the tax law and permits unwarranted overreaching by the Service. However, the consideration of more appropriate government position standards

52. Rev. Proc. 64-22, 1964-1 C.B. 689.

53. Michael Mulroney, *Report on the Invitational Conference on Professionalism in Tax Practice, Washington, D.C. October 1993*, 11 AM. J. TAX POL'Y 369, 388 (1994).

54. *See* discussion *supra* Part II.A.

55. Mulroney, *supra* note 53, at 389.

56. *Id.* at 396.

57. *Id.* at 396-97; Wolfman, Holden & Schenk, *supra* note 24, at 332-34.

first requires an understanding of the competing considerations that must be balanced to ensure that the Service is sufficiently dissuaded from taking one-sided positions while still retaining an effective ability to police the self-assessment system. This section highlights several of the key considerations.

A. Promoting Compliance through Fair and Equal Government Positions

In developing controversy position standards for the government, it is important to always keep in mind the nature of the self-assessment tax system and the Service's delicate role as the guardian of that system.[58] Under the self-assessment system, taxpayers must interpret the tax laws themselves and properly apply that law to their own situation.[59] For the system to work efficiently, taxpayers must be able to understand the law and be willing to comply with it.[60]

The Service plays a key role in fostering both taxpayer understanding and compliance. By issuing interpretive guidance regarding the law's meaning, the Service sets the stage for taxpayer understanding. It also creates a possible dynamic for taxpayer frustration. No one relishes paying taxes, but if the laws are perceived as fair, then the burden is less onerous. Conversely, if taxpayers read Service guidance as being slanted in the government's favor, they lose respect for the law and are less likely to obey it.[61] To promote compliance, the Service must interpret the law in a manner that taxpayers perceive as just and equitable.[62] Indeed, the Service must be especially vigilant in being evenhanded in its interpretations since it is the perception that matters as much as the reality. As with any battle of perceptions, it is often the case that a lifetime of good can be tarnished with even one misstep. Even a few notable instances of Service overreaching are likely to taint the perceptions of taxpayers and tax practitioners and cause them to overlook the majority of instances where the Service's interpretations are fully in line with a balanced view of the law.

The Service is also charged with preventing taxpayer abuse of the system. As a result, it must audit taxpayers to spot check compliance.

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58. *See supra* note 10 and accompanying text.
59. *See supra* note 10 and accompanying text.
60. *See supra* note 12 and accompanying text.
61. *See supra* note 11 and accompanying text.
62. *See supra* note 11 and accompanying text.

The most obvious consequence of an audit is the assertion of a tax deficiency which, if upheld, directly increases the government's tax receipts. However, the more significant role of the audit process is to help maintain the integrity of the self-assessment tax system. The possibility of an audit dissuades taxpayers from taking unwarranted return positions.[63] It also provides taxpayers with assurances that the Service is making sure that others are complying with the law and the tax burden is being fairly shared. Thus, while no one relishes the prospect of being audited, it is reassuring to know that the Service is doing its job.

The benefits of audits for the tax system, however, can also be turned into a detriment to compliance if the Service is too heavy handed and one sided in pursing them. Again, perceptions matter. If taxpayers feel they are being dealt with unfairly, then their discontent is likely to spread to others and ultimately impair faith in the self-assessment system throughout society. For instance, when examining agents assert aggressive positions, taxpayers are forced to spend time and money defending positions that are most likely correct or settling the case to avoid incurring these expenses. Such situations may promote the perception that the Service uses its enforcement powers unfairly to exact improper amounts of tax. Consequently, while the Service needs to enforce the tax laws, its enforcement efforts can become counterproductive if they leave the taxpaying public with the impression that the Service is a Goliath trying to bully them into submission.

B. Defining the Law to be Applied

A key goal of the Service is to find the "true meaning" of the tax laws and help taxpayers "understand . . . their tax responsibilities."[64] While this is an important goal, it subsumes several important questions. In particular, what method of statutory interpretation should the Service use in finding the true meaning of the law and how should the Service exercise any discretion it has in interpreting such true meaning?

Reasonable minds can differ regarding methods of statutory interpretation. Indeed, the debate regarding the proper approach for interpreting statutes is a perennial one in American jurisprudence.[65] The

63. I.R.M. 1.2.1.4.10 P-4-21 (1974) ("The primary objective in selecting returns for examination is to promote the highest degree of voluntary compliance on the part of taxpayers."); Byron L. Dorgan, *Narrowing the $100 Billion Tax Gap*, 37 TAX NOTES 925, 927 (1987) (discussing the relationship between increased IRS funding and increased compliance).

64. Rev. Proc. 64-22, 1964-1 C.B. 689.

65. *See, e.g.*, LON L. FULLER, THE LAW IN QUEST OF ITSELF (1940); Antonin Scalia,

purpose of this article is not to undertake yet another rehashing of this debate in the tax arena.[66] Rather, at this juncture it is merely important to highlight that one's views regarding the statutory interpretation issue will have an impact on determining the appropriate controversy position standards applicable to the Service.

For instance, if the law is to be interpreted using a form of strict statutory construction focusing closely on the literal text of the statute, then the Service should adhere closely to the statute's plain meaning in determining which issues to raise when auditing a tax return. Under such an approach, the Service arguably should only raise issues that are very clearly incorrect under the literal language of the statute. At the other extreme, the Service might take the position that it is free to interpret the relevant statutes broadly to implement the Service's interpretation of the law's purpose and the requirements of some over-arching concept of good tax policy. In that case, the Service would seem remiss in not asserting positions that would further the Service's view of good tax policy, even if there is a substantial chance that a court would refuse to interpret the statutory language in that manner.

In Revenue Procedure 64-22, the Service gives an indication of its traditional approach by noting that the role of determining tax policy resides with the Congress and that the Service must carry out that policy by determining "the reasonable meaning of various Code provisions in light of the Congressional purpose in enacting them."[67] While Revenue Procedure 64-22 is still in force, one might question whether its focus on

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Common-Law Courts in a Civil-Law System: The Role of United States Federal Courts in a Interpreting the Constitution and Laws, *in* A MATTER OF INTERPRETATION 3, 17 (Amy Gutmann ed., 1997); Neil Duxbury, *Faith in Reason: The Process Tradition in American Jurisprudence*, 15 CARDOZO L. REV. 601, 622 (1993); William N. Eskridge, Jr., *Dynamic Statutory Interpretation*, 135 U. PA. L. REV. 1479, 1479 (1987); William N. Eskridge, Jr. & Philip P. Frickey, *Statutory Interpretation as Practical Reasoning*, 42 STAN. L. REV. 321, 321 (1990); L. L. Fuller, *American Legal Realism*, 82 U. PA. L. REV. 429 (1934); John F. Manning, *Textualism and the Equity of the Statute*, 101 COLUM. L. REV. 1, 1 (2001); William D. Popkin, *Law-Making Responsibility and Statutory Interpretation*, 68 IND. L.J. 865, 865 (1993); Antonin Scalia, *The Rule of Law as a Law of Rules*, 56 U. CHI. L. REV. 1175, 1186-87 (1989).

66. *See, e.g.*, Mary L. Heen, *Plain Meaning, the Tax Code and Doctrinal Incoherence*, 48 HASTINGS L.J. 771, 771 (1997); Michael Livingston, *Practical Reason, "Purposivism," and the Interpretation of Tax Statutes*, 51 TAX L. REV. 677, 677-78 (1996); William D. Popkin, *An "Internal" Critique of Justice Scalia's Theory of Statutory Interpretation*, 76 MINN. L. REV. 1133, 1181 (1992); Lawrence Zelenak, *Thinking About Nonliteral Interpretations of the Internal Revenue Code*, 64 N.C. L. REV. 623, 623 (1986). However, the proposed controversy guidelines presented in Part IV *infra* are premised in part on the view that the Service should be given a significant role in tax policy and administration matters and therefore should be free to employ a broad array of authorities beyond the literal text of a statutory provision in making such determinations.

67. Rev. Proc. 64-22, 1964-1 C.B. 689.

Congressional purpose continues to represent the actual position of the Service. In the forty years since the Revenue Procedure was written there has been a resurgence in strict textual modes of statutory interpretation in the federal courts. Further, since the mid-1980s when Justice Scalia joined the Supreme Court, the appropriateness of using Congressional reports and other legislative history to inform the meaning of statutes has been frequently criticized.[68] Consequently, despite the language of Revenue Procedure 64-22, the proper mode of statutory interpretation that should be employed by the Service is likely still open for debate.

However, even if the recent evolution of statutory interpretation theory would imply a reduced role for the Service in interpreting the meaning of the tax laws, several other factors cut in the other direction. Most notably, the Service is a creature of the executive branch rather than a court. As such, it is charged by the legislative branch with implementing the laws and therefore should have a freer hand in determining the meaning of a law. Congress itself often drafts tax legislation with the explicit intention that the Service will issue legislative regulations to implement a generalized statutory provision or extend a specific provision into an analogous area.[69] Even in areas where Congress has not given explicit authority to the Service to issue legislative regulations, the inherent complexity of the tax laws and the daunting task of applying them to the myriad of economic activity in the country mean that as a practical matter the Service will often need to apply statutory language in situations unforeseen by the drafters of that legislation. In recognition of this reality, the Supreme Court has been increasing the deference given to administrative interpretations of statutory language despite its general movement toward strict textual rules of statutory interpretation.[70] Given the high degree of judicial

68. *See, e.g.*, William N. Eskridge, Jr., *The New Textualism*, 37 UCLA L. REV. 621, 623 (1990); Thomas W. Merrill, *Textualism and the Future of the* Chevron *Doctrine*, 72 WASH. U. L.Q. 351, 355 (1994); Patricia M. Wald, *The Sizzling Sleeper: The Use of Legislative History in Construing Statutes in the 1988-89 Term of the United States Supreme Court*, 39 AM. U. L. REV. 277 (1990).

69. *See, e.g.*, 26 U.S.C. § 351(g)(4) (2006); 26 U.S.C. § 1275(d) (2006); 26 U.S.C. § 5041(c)(7) (2006); 26 U.S.C. §§ 6049(c)(2)(b), 6049(d)(8)(c) (2006).

70. *See, e.g.*, United States v. Mead Corp., 533 U.S. 218, 226-27 (2001) ("We hold that administrative implementation of a particular statutory provision qualifies for *Chevron* deference when it appears that Congress delegated authority to the agency generally to make rules carrying the force of law, and that the agency interpretation claiming deference was promulgated in the exercise of that authority. Delegation of such authority may be shown in a variety of ways, as by an agency's power to engage in adjudication or notice-and-comment rulemaking, or by some other indication of a comparable congressional intent."); Chevron, U.S.A., Inc. v. Natural Res. Def.

deference to administrative interpretations and the difficulty faced by Congress in drafting tax legislation that adequately anticipates all situations, it seems incumbent on the Service to be deliberate in its interpretation and application of the tax laws to ensure that it arrives at fair and balanced positions that mesh with sound tax policy.[71]

C. Addressing Institutional Realities

While weighing the strength of a particular tax position is often a perplexing endeavor,[72] the task is made even more complex when it must be accomplished in the context of a large organization. Unlike a taxpayer, who needs to be concerned only with the appropriateness of a position in the context of their particular situation, the Service must also consider how asserting a position in a particular controversy affects its overall tax enforcement and administration efforts. Consequently, in order to promote voluntary compliance with the tax laws, the Service may need to forego pursing an issue in a particular controversy (even if there is a real likelihood that the Service would be successful if it litigated the issue) to further overall tax administration goals. However, the Service is an institution composed of thousands of employees scattered geographically across the country and interacting with taxpayers on a daily basis. Consequently, the Service must develop internal procedures and practices to ensure that its employees are making such determinations in a uniform and fair manner that appropriately balances the institution's tax administration concerns against the factual equities inherent in particular cases.[73]

A crucial element in creating an institutional environment that produces the desired uniform and balanced results is the adoption of a comprehensive set of position guidelines applicable to the entire

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Council, Inc., 467 U.S. 837 (1984). This type of broad judicial deference based on an inferred Congressional delegation of authority should logically apply to most Service interpretations of the Code. *See* Kristen E. Hickman, *The Need for* Mead*: Rejecting Tax Exceptionalism in Judicial Deference*, 90 MINN. L. REV. 1537, 1538 (2006).

71. *See, e.g.*, Mitchell M. Gans, *Deference and the End of Tax Practice*, 36 REAL PROP. PROB. & TR. J. 731, 758 (2002) (expressing concerns about Service anti-taxpayer bias); Irving Salem et al., Am. Bar Ass'n Section of Taxation Task Force on Judicial Deference, *ABA Section on Taxation Report of the Task Force on Judicial Deference*, 57 TAX LAW. 717, 724-25 (2004) (questioning Service's motives and willingness to push statutory boundaries).

72. *See supra* note 19.

73. The Service has already issued a great volume of directives to guide employees regarding various operating procedures and internal policies. Such directives are compiled in the voluminous, if poorly organized, Internal Revenue Manual (I.R.M.). As discussed *infra* at Part IV.C., the purpose of this article is not to replace such practical guidance but to add to it a set of guiding principles to serve as a general framework for Service employees involved in controversy matters.

institution so that all employees are aware of the institution's overall goals.[74] This permits employees to place their own particular roles in context and assists them in monitoring their phase of the controversy process to ensure that their actions are in fact furthering the institution's interests. Unfortunately, the Service's current controversy guidelines are in disarray.[75]

Once the institution's overall goals are defined and announced, the relevant guidelines must be further refined to fit the various roles and skill sets of particular types of employees. The review of a tax return can produce a variety of potential issues ranging from simple mathematical errors or information matching discrepancies to nuanced judgments regarding the proper taxation of complex structured financial transactions. It makes institutional sense to conserve resources by allocating various tasks in the review process to different employees based on their expertise, knowledge, and authority. Today, returns are initially reviewed by sophisticated computer programs to identify and resolve run of the mill errors and to assist in selecting returns that should be subjected to a more comprehensive audits.[76] Examining agents are then assigned based on their knowledge and expertise in light of the estimated complexity of the audit.[77]

However, once a competent agent is assigned to review a tax return, what rules should govern the agent's decisions regarding the issues raised? Should the agent be charged with appraising the systemic policy concerns implicated by a particular issue or should that task be reserved

74. However, merely announcing a set of standards by itself may be of little use without sufficient internal trainings on the guidelines and a demonstrated commitment to the new guidelines at the highest levels of the Service. In this regard a number of studies have indicated that employee compliance with announced ethical codes of conduct increases dramatically if employees perceive that management believes in, and is in fact adhering to, the announced policies. *See, e.g.*, LINDA KLEBE TREVIÑO & GARY R. WEAVER, MANAGING ETHICS IN BUSINESS ORGANIZATIONS: SOCIAL SCIENTIFIC PERSPECTIVES 117-18, 141 (2003); Linda Klebe Trevino et al., *Managing Ethics and Legal Compliance: What Works and What Hurts,* 41 CAL. MGMT. REV. 131, 142 (1999); Gary R. Weaver et al., *Corporate Ethics Programs as Control Systems: Influences of Executive Commitment and Environmental Factors,* 42 ACAD. MGMT. J. 41, 41 (1999); Gary R. Weaver et al., *Integrated and Decoupled Corporate Social Performance: Management Commitments, External Pressures, and Corporate Ethics Practices,* 42 ACAD. MGMT. J. 539, 539 (1999).

75. *See* discussion *supra* Part II.B.

76. For a detailed discussion of the means by which tax returns are screened by the Service and selected for further review, see MICHAEL I. SALTZMAN, IRS PRACTICE AND PROCEDURE § 8.03 (2d ed., rev 2003).

77. I.R.M. 4.19.1.2.3 (2001) (explaining how returns selected for further review are allocated among different categories of examining agents based "upon the complexity of issues involved, the degree of accounting and auditing skills required to perform the examination, and whether it can be effectively done by correspondence").

for some subsequent internal review? Even with respect to determining whether an issue should be raised on the basis of the particular taxpayer's situation, should the examining agent be permitted to resolve the merits of a nuanced legal issue that, despite her experience as an auditor, she may be ill-equipped to evaluate?[78] Phrased more directly, what limits in applying the Service's announced controversy position guidelines should be applied to examining agents?

The traditional standard that the Service has applied in this context is that examining agents are supposed to raise all meritorious issues presented by a tax return and are prohibited from settling or compromising the issues identified.[79] To this end, examining agents are provided with guidelines for performing their audits, including advice regarding issues that may be present for particular types of taxpayers.[80] They also have the ability to request guidance from the Service's National Office regarding the appropriateness of raising a particular issue. But, primary authority to settle issues identified by an examining agent is vested in the Service's Appeals Division.[81] Consequently, the paradigm is for an examining agent to gather the relevant facts and raise the issues presented by a tax return and for an Appeals agent to weigh the legal merits and attempt to compromise the contested issues after taking into account the hazards of litigation. In fulfilling this role the Appeals Division will often consult with attorneys in the Service's Office of Chief Counsel.

Despite this dogma, which suggests that examining agents have little discretion in whether issues are raised, the reality has always been quite different.[82] In the first instance, if an examining agent can be

78. While the Service's examining agents dealing with complex cases are typically quite experienced, most are not attorneys.

79. Rev. Proc. 64-22, 1964-1 C.B. 689; I.R.M. 4.10.7.5.3.1 (2006) ("Examination personnel have the authority and responsibility to reach a definite conclusion based on a balanced and impartial evaluation of all the evidence. . . . This authority does not extend to consideration of the hazards of litigation.").

80. Much of this guidance is contained in the Internal Revenue Manual, which contains guidelines of general application (I.R.M. 4.10.3 (2003)) as well as separate guidelines for the examination of individual, corporate, partnership, estate, and employment tax returns. Further, directives on particular issues are developed at various levels of the Service, in particular through the Service's Coordinated Examination Program for large corporate taxpayers and through its Industry Specialization Program for specific industries. *See generally* SALTZMAN, *supra* note 76, at § 8.07; James E. Merritt, *Administrative Procedures: Large Case Audits; Industry Specialization Program; Coordinated Examination Program ("CEP"), in* HOW TO HANDLE A TAX CONTROVERSY AT THE IRS AND IN COURT 63, 87-88 (ALI-ABA Course of Study 1997), *available at* SC24 ALI-ABA 63 (Westlaw).

81. *See supra* note 48 and accompanying text.

82. Ronald Stein, *Settling With The IRS: The Importance of Procedure*, 107 TAX NOTES

convinced of the strength of a taxpayer's position, then the agent will typically not raise it despite some potential that the Service might succeed if the issue were litigated.[83] Further, even though examining agents lack the formal authority to settle issues, they often engage in informal settlements by issue swapping.[84] Consequently, this practical reality must be reflected in the position guidelines adopted for the institution.

Finally, even once clear standards are developed and their application to different controversy functions determined, the problem of lowest denominator decision making must be faced. The institutional reality is that no Service employee acts in isolation regarding significant decisions. When any particular employee evaluates an issue under the relevant position standard, their decision most likely will be reviewed by a number of supervising employees with increasing authority. As a practical matter, only if all these reviewers agree regarding the strength of the Service's position and the appropriate application of the relevant position guidelines will the Service ultimately pursue an issue.[85] As a result, the ultimate institutional decision typically reflects the view of the employee having the *lowest* assessment of the strength of the Service's position and the strictest view of the application of the controversy position guidelines to that issue.[86] Consequently, this lowest assessment

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1675, 1676 (2005) (Even though barred from considering the hazards of litigation, "in practice, the agent may choose to forego potential issues in recognition of concessions by the taxpayer. . . .").

83. Thomas D. Terry, *ABA Committee Submits Comments on Expansion of IRS Examination Division Settlement Authority*, TAX NOTES TODAY, Apr. 6, 1995, LEXIS 95 TNT 67-44 ("Further, the normal discretion that Exam exercises in the audit process necessarily carries with it some latitude related to settlement authority. Thus, by deciding which issues to raise, Exam implicitly concedes others.").

84. Since an agent cannot settle an issue based on the hazards of litigation, there is no justification or ability to effect split dollar settlements where the taxpayer agrees to pay a percentage of the total alleged tax deficiency based on the Service's chance of success on the issue. However, agents frequently will achieve a similar settlement effect by agreeing with the taxpayer to not raise one issue in exchange for the taxpayer's agreement to concede liability on a different issue. This type of issue trading is often used by agents to avoid the need for detailed factual development on the conceded issue. As a practical matter, such issue trading occurs frequently, although agents are specifically instructed not to raise an issue merely for the purpose of trading it away. Rev. Proc. 64-22, 1964-1 C.B. 689.

85. That is, if any employee decides the issue is not a meritorious one, the likely result is that the Service will concede the issue. The reality is that decisions to pursue issues are the most likely ones to be passed on to the next level for review.

86. This would not be the case if the Service were less hierarchical in its structure. In many instances, an argument can be made that group or institutional decisions tend to be more extreme than that of judgment of the individuals contributing to the decision ("Groupthink"). Groupthink is "a mode of thinking that people engage in when they are deeply involved in a cohesive in-group, when the members' strivings for unanimity override their motivation to realistically appraise alternative courses of action." Irving L. Janis, VICTIMS OF GROUPTHINK: A PSYCHOLOGICAL

bias must also be factored into crafting any controversy position guidelines for the Service.

D. Evaluating a Position's Strength

The primary function of any controversy guideline is to determine whether or not a legal issue should be pursued. While, as discussed above, there may be situations where the disposition of an issue is ultimately controlled by overriding policy concerns, in all cases a key factor in deciding to pursue an issue is the perceived strength of the Service's legal position. While evaluating the strength of any legal position is more akin to a skill than a mathematical science, some system of measurement still must be used to quantify the relative strength or weakness of a legal position.

As discussed above, in appraising the merits of an issue from the taxpayer's standpoint, a continuum of catch phrases has developed to gauge a position's strength.[87] While the authorities from which these terms are derived typically do not assign percentage probabilities to them, in practice the tax bar does. Under that scale the relevant thresholds and approximate associated probabilities (from least to most likely) are: frivolous (10% or less), reasonable basis (at least 20%), realistic possibility of success (at least 33%), substantial authority (at least 40%), more likely than not (more than 50%), should (at least 66.7%), and will (at least 80%).[88]

The use of percentage probabilities to assess the merits of a legal issue can be criticized on the ground that it is misleading to use percentage probabilities since they imply exactitude in an assessment that actually represents only a general expectation regarding the outcome.[89] A conclusion regarding the legal strength of a position represents a reasoned and considered judgment rather than a mathematical certainty.[90] Since it is based in no small measure on the experience and knowledge of the appraiser, assigning a specific percentage probability to such an assessment arguably misleads the

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STUDY OF FOREIGN-POLICY DECISIONS AND FIASCOES 9 (1972). However, groupthink is typically a problem only in small, cohesive groups of decision-makers where relieving tensions and creating cohesion within the group overrides deliberative decision making. Indeed in such groups the most extreme positions may be adopted as the members with such views are more likely to forcefully present them and leave the other decision-makers with the impression that everyone else must be in agreement given the lack of criticism voiced in the group deliberations.

87. *See* discussion *supra* Part II.A.

88. *See* discussion *supra* Part II.A.

89. *See supra* note 19.

90. *See supra* note 19.

client regarding the underlying basis and actual certitude of the appraisal.

However, this criticism misperceives the rationale for using percentage probabilities to quantify the chances of various outcomes in a legal analysis. Such percentages are really just used as an easily grasped shorthand to identify the basic probability plateaus intended by the verbal formulations. Phrased differently, practitioners using such percentages do not believe, or mean to imply, that they are in fact absolute and precise strength assessments. In reality practitioners do not come up with a percentage assessment of say 49% and conclude that therefore the issue fails to meet the more likely than not standard. Rather, they undertake their reasoned appraisal of whether the taxpayer will succeed and then use the percentages as a short hand to succinctly convey that assessment to others. Viewed in this light, it makes little difference whether words or percentages are used to express these probability assessments.

Consequently, this article will use a percentage probability formulation as the relevant metric for the controversy guidelines proposed in Part IV. Using such percentages has several benefits. First, as discussed above, percentages are easy to grasp intuitively and less cumbersome than a verbal formulation. Second, using percentage guidelines provides a common base of understanding between Service employees and tax practitioners since practitioners routinely evaluate a client's legal issues by assigning such percentage probabilities to various outcomes.[91] And third, using percentage evaluations reflects the reality that such percentages are often used in gauging the appropriateness of a settlement proposal.

However, even once an acceptable metric is agreed upon, reasonable persons will often reach divergent appraisals regarding the strength of a position in any given situation. Differences in evaluations can arise from variations in the experience and training of the evaluators as well as from divergent perceptions of the relevant facts and the meaning of the relevant law. In order for a set of controversy position standards to have their desired impact in an institutional setting, the institution must take steps to minimize such divergent appraisals. The goal is not to create rigid interpretive rules that are strictly enforced, but rather to foster an interpretive community where, on the same facts, most reviewers would reach essentially the same conclusion regarding

91. This commonality in approach also is beneficial since it is not uncommon for practitioners to leave private practice for positions at the Service and vice versa.

the strength of the Service's position based on their common training and analytical approach. Consequently, a key part of any system of controversy guidance must be a setting forth of a clear framework for analysis and providing the necessary training of employees to promote uniformity in results.

IV. CRAFTING NEW STANDARDS FOR GOVERNMENT POSITIONS

In light of the foregoing considerations relevant to developing an effective controversy paradigm for the Service, this Part will present a set of proposed controversy guidelines that address the noted considerations.

A. The Proposed Controversy Guidelines

As discussed above, a taxpayer can legitimately take a non-frivolous position in litigation (or a disclosed reasonable basis position on a tax return) even if the taxpayer does not actually believe his position should be upheld.[92] While reasonable arguments exist supporting such a taxpayer right,[93] the basic premise of the controversy guidelines proposed here is that the Service generally should not assert claims it does not believe will be upheld.[94] More precisely, the Service should only pursue issues when the Service's position reaches the correct tax policy result *and* has a significant chance of prevailing in litigation. Thus, the Service should be held to a significantly higher standard in controversy matters than would apply to a taxpayer. The remainder of this Part IV.A. explains the proposed controversy guidelines in more detail. The goals and operation of the proposed approach is further discussed in Part IV.B., *infra*.

1. General Controversy Guidelines

The proposed controversy guidelines take a two step approach. First, the Service would determine the correct tax policy answer for any

92. *See supra* note 34 and accompanying text.

93. The primary argument for allowing a taxpayer to file a tax return based on a less than certain position is that the taxpayer should be able to litigate uncertainties in the law prior to actually paying the uncertain tax liability. *See, e.g.*, BERNARD WOLFMAN, JAMES P. HOLDEN & KENNETH L. HARRIS, STANDARDS OF TAX PRACTICE § 202.2 (6th ed. 2004).

94. As discussed above, the Service is not a monolith. It operates only through its employees. However, for purposes of setting forth the general goals those employees should be striving for on behalf of their institution, this Part will generally phrase the proposed controversy guidelines in terms of rules to which the Service should adhere.

issue presented (the "Policy Threshold"). If, and only if, the relevant tax policy considerations support pursuing the issue, would the actual probability of success in litigation be considered to determine if it meets the minimum level set forth in the guidelines for pursuing the matter (the "Probability Threshold"). Absent unusual circumstances, the Service would only pursue issues satisfying *both* thresholds and would completely concede all other issues.

Satisfying the Policy Threshold requires a determination that the Service's asserted position on a contested issue represents the correct tax policy. In this context the "correct" tax policy means a determination by the Service that their position reaches the proper result from the vantage point of fostering a fair tax system and furthering sound tax administration.[95] The goal of the Policy Threshold is to force the Service to analyze each situation and truly conclude that pursuing the matter is in the best interests of the tax system as a whole. This is a multi-faceted analysis examining issues of fairness, equity, uniformity, tax theory, and tax administration in addition to the potential tax revenue impact. In this context, the Service should evaluate the Policy Threshold in light of the policy and purpose behind the relevant statutory provisions even if a court might refuse to consider such authorities.[96]

It is important to note that the Policy Threshold determination is made without reference to the actual likelihood of success in litigation. Thus, even if the Service would have a very high probability of success (say greater than 80%) if it were to pursue an issue, the issue should not be pursued if doing so would be counter to sound tax policy.[97] Of course, the Service's view of sound tax policy must be informed by Congressional views and in the case of a direct conflict, the Congressional determination would need to control. For instance, if Congress were to adopt a tax provision to address a specific situation, then the Service would not be permitted to avoid enforcing that statute against taxpayers in such situation on the ground that pursuing the issue would be contrary to sound tax policy since the Congressional adoption of the statute has conclusively fixed the proper tax policy in that instance. However, assume that the same statute, if read literally, would also apply to a situation apparently not considered by Congress. Here, the Service should be permitted to forego enforcing the literal words of

95. *See* discussion *supra* Part III.A.

96. Even if one accepts the premise that the judiciary should not "make law," an administrative agency is not as fully subject to such prohibition. *See supra* note 70.

97. Conversely, this threshold could be satisfied even if the Service had almost no chance of successfully pursuing its position in litigation.

the statutory provision if it determines that doing so is in the best interests of the tax system as a whole.[98]

If the Service concludes that the Policy Threshold is not met, then the issue should be conceded by the Service. If the Policy Threshold is satisfied, then the Service must examine the Probability Threshold to determine whether, despite being on the tax policy high ground, the contested issue nevertheless should be settled with the taxpayer or dropped, rather than being asserted against the taxpayer and eventually litigated.[99] Depending on the percentage probability of success on the merits, one of four results would be obtained under the Probability Threshold Guidelines. (1) If the Service has an 80% or greater probability of success (the "80% Threshold"), then the Service would always continue to pursue the issue if the taxpayer refused to completely concede the issue. (2) If the Service has a greater than 50% (but less than 80%) probability of success (the "50% Threshold"), the Service should attempt to reach a fair[100] settlement of the issue with the taxpayer, but would assert a deficiency and ultimately litigate the matter if no settlement is reached. (3) If the Service's probability of success is between 33% and 50% (the "Gray Zone Threshold"), then the Service should attempt to reach a settlement with the taxpayer that yields the Service at least 50% of the tax liability at stake in the issue. If such a settlement cannot be reached, then the Service must decide either to entirely concede the issue or to assert the full deficiency against the taxpayer and ultimately proceed to litigation. The decision to concede or proceed would be based on an analysis of all relevant considerations, including, the tax policies involved, the actual percentage probability of

98. Whether the Service has such power can well be debated. *See, e.g.*, Gregg D. Polsky, *Can Treasury Overrule the Supreme Court?*, 84 B.U. L. REV. 185 (2004) (arguing that the Service's "check the box" regulations for entity classification, while a great aid to taxpayers and tax administration, are nevertheless invalid since not supported by the statute as previously interpreted by the Supreme Court).

99. As a procedural matter, it is the taxpayer that typically decides whether or not an issue will be litigated in civil tax cases. If the Service and the taxpayer fail to reach agreement on an issue raised by the Service, the Service can either concede the issue or, more typically, assert that the taxpayer has underpaid his tax liability as a result and demand immediate payment. At that juncture the taxpayer can either petition the Tax Court to review the issue or pay the asserted tax liability and subsequently sue the government for a refund of the amount paid in the federal district courts or the court of federal claims. However, while the taxpayer technically commences the litigation, a decision by the Service to continue asserting a position after settlement negotiations with the taxpayer have failed generally ensures that the matter will be raised by the taxpayer in litigation.

100. Typically a fair settlement would be one roughly in accord with the Service's perception of the strength of its position, but in no event would a concession of more than half the proposed deficiency amount of the issue be considered fair under the proposed guidelines.

success, the underlying equities of the case, the dollar amount of the tax liability at issue, the cost of litigating the case, and the potential harm to the tax system that would result from an adverse judicial determination on the issue. It is expected that a substantial number of cases in this category would in fact be dropped by the Service as a result of this facts and circumstances review. (4) If the Service's probability of success is less than 33% (the "33% Threshold"), then the Service would concede the issue despite the fact that the Policy Threshold was satisfied.

2. Institutional Adjustments

As discussed above, any set of controversy position standards must be tailored to fit their institutional context. A crucial purpose of the proposed controversy guidelines is to promote both the perception and the reality of the Service as an impartial guardian of the tax laws charged with working with taxpayers to ensure a fair tax system. To facilitate this goal, all members of the institution must act accordingly. Consequently, the proposed guidelines need to be disseminated and explained throughout the Service. Stressing the institution's commitment to the proposed guidelines will help employees internalize this overall goal and prevent them from treating taxpayers as adversaries intent on attacking the fisc. In this way, the proposed controversy guidelines are intended to act as a type of moral compass guiding employees in their everyday activities whenever they find themselves unsure of what action should be taken in a particular situation.

Beyond making the proposed controversy guidelines generally known to all Service employees, the guidelines must be adapted to account for differences in the functional roles of Service employees. In this regard, the proposed guidelines would generally retain the traditional limitation on the settlement authority of examining agents and leave the existing rules regarding internal operations unchanged. However, under the proposed guidelines, examining agents would not be charged with applying the Policy Threshold. Instead, examination personnel would focus on making factual determinations and making the initial Probability Threshold review. The role of the examining agent would be to assert any issue with a probability of success greater than 33%, unless other Service directives identified the issue as one for which the Policy Threshold would not be met. Such identified issues would not be settled by the examining agent, and would either be agreed to by the taxpayer or protested to the Appeals Division for further consideration and possible settlement at that level. Issues with a

probability of success below 33% would be conceded conclusively at the examination level.

With regard to issue swapping as an informal means of settlement at the examination level, the proposed guidelines would accept that, while examining agents are not generally charged with settlement authority, trading issues often constitutes the most efficient means of satisfactorily resolving controversies with taxpayers. Examining agents typically have the best perspective on weighing factual and proof issues presented in a taxpayer's return. Consequently, issue trading based on the examining agent's weighing of such factual matters is appropriate. Issue trading based on legal uncertainties is less optimal and generally should not be undertaken by examining agents. The greatest temptation to issue swap legal issues will be on matters that the examining agent believes have little merit and is willing to concede to obtain immediate agreement on another issue where the agent feels the case is strong. An examining agent would generally be less willing to trade away one issue for agreement on another when he believes the Service has a substantial chance to succeed on *both* issues if litigated. Consequently, as a practical matter, the creation of the 33% Threshold and the 80% Threshold should serve to dramatically decrease the number of legal issues on which an agent is willing to even consider issue swapping. In those instances where an examining agent nevertheless does engage in issue swapping based on legal uncertainty, the agent should keep the general intent of the proposed guidelines in mind, including making an evaluation of the Policy Threshold (which would normally not be invoked in examination determinations) since it is unlikely that the policy considerations of such swapped issues will become subject to consideration by the Appeals Division.

B. Goals of the Proposed Controversy Guidelines

The central requirement for any set of Service controversy position standards is that they promote compliance with the self-assessment system by demonstrating to taxpayers that the Service is aggressively pursing tax cheats without overreaching in ordinary cases. The proposed position guidelines attempt to promote this perception and reality in several ways. First, the Policy Threshold ensures that the Service will not assert claims that it does not truly believe are appropriate from a tax policy and administration standpoint. While the Service is permitted under the proposed guidelines to raise issues even if its chances of success on the merits are as low as 33%, such Gray Zone issues are only

pursued if the Service believes the entire tax system benefits from pursuing the issue.[101] Additionally, with respect to issues falling within the Gray Zone Threshold, reasonable minds could differ regarding the proper appraisal of the strength of the issue. Therefore, allowing the Service to pursue Gray Zone issues helps hedge against the Service's institutional tendency to appraise the merits of issues more restrictively.[102] For both these reasons, taxpayers should gain faith that the Service is acting rationally to enforce the tax law in the interests of the entire tax system when it pursues issues on audit.

Another key goal of the proposed guidelines is to promote the fair and efficient resolution of tax controversies. The Probability Thresholds promote this goal in several ways. These Thresholds help narrow the real issues for discussion by eliminating debate about controversies at each end of the probability spectrum. The 33% Threshold frees the taxpayer from having to defend against claims on which the taxpayer's claim is quite likely to be sustained under the currently applicable law. Similarly, the 80% Threshold dissuades taxpayers from asserting extreme positions to obtain nuisance settlements from the Service. Since extreme positions on both sides are dissuaded by the proposed controversy guidelines, the Service and taxpayers can focus more effort on evaluating and addressing issues where legitimate uncertainty exists regarding the proper resolution of an issue.

Further, the Gray Zone Threshold operates to force both taxpayers and the Service to honestly evaluate their probability of success in litigation (as well as other considerations) when weighing their settlement options. It is fairly common for tax practitioners to overestimate their chance of success on the merits.[103] An overly optimistic appraisal, even if employed as a mere negotiating technique with a less optimistic assessment provided confidentially to the client, may create unrealistic client expectations and impede settlement. Under the proposed controversy guidelines, the Service would not accept any

101. While an examining agent will raise Gray Zone issues without first examining the Policy Threshold, the taxpayer always has the ability to protest such issues to the Appeals Division where the Policy Threshold will be considered. Consequently, any taxpayer who feels the Service is inappropriately pursing an issue will be afforded the full benefit of both the Policy and Probability Thresholds. Conversely, if a taxpayer agrees with the deficiency determined by the examining agent without resorting to Appeals consideration, then it strongly implies that the Service's assessment of the issue as being in the Gray Zone was inaccurately low in any event.

102. See supra text accompanying notes 85-86.

103. *See* Elizabeth F. Loftus & William A. Wagenaar, *Lawyers' Predictions of Success*, 28 JURIMETRICS J. 437, 437 (1988) (finding that "in general lawyers were overconfident in their chances of winning, especially so in cases in which they had been highly confident to begin with").

settlement less than 50% on the theory that the Service believes its position is the correct one from a policy viewpoint even if its chances of succeeding in court might be somewhat lower. If a 50% settlement cannot be reached, then the Service has to decide, based on all the facts and circumstances, whether to concede the issue or to proceed with asserting the tax deficiency and ultimately litigate the matter.

This combination of a percentage settlement coupled with the uncertainty of an all or nothing consequence upon rejection presents taxpayers (and their advisors) with a complex decision. If a taxpayer is wrong in its appraisal of its chances, then the Service may be forced into an all or nothing choice that may ultimately prove detrimental to the taxpayer. Similarly, taxpayers with perceived chances within the range of reasonable doubt around the 50% level will be more likely to acquiesce to a 50% settlement offer since it will be clear that that is the best result obtainable short of litigation. Consequently, while making any settlement decision requires an understanding of the merits of the case, the downside for miscalculation is increased when the Service's options below a 50/50 settlement are limited to a simple proceed or concede decision. This encourages taxpayers to be very honest with themselves in appraising their actual chances of success on the merits and promotes the acceptance of any settlement within the reasonable range of appropriate compromises.

An example will help illustrate the dynamic. Assume a taxpayer initially believes her position has a 60% chance of success if litigated (i.e., she believes the Service has only a 40% chance). In a normal negotiating strategy the taxpayer might first assert that a 75/25 split settlement would be appropriate in hopes of reaching an ultimate settlement of 60/40 or better. The only downside to such a strategy is the risk that the Service would conclude from the initial offer that there was simply no middle ground on which to negotiate. Under the proposed guidelines, since the Service's chances exceed the 33% Threshold, the taxpayer knows that the Service will not automatically concede this issue. The taxpayer also knows that the Service cannot accept a 40% settlement. The taxpayer's choice is to accept a 50% settlement or to reject it in the belief that the Service ultimately will either (1) concede the issue based on a facts and circumstances review or (2) lose in litigation. In a close case, a taxpayer will probably discount the likelihood of the Service conceding the issue since the Service will have a substantial chance of success and will already have determined that their position is appropriate from a policy standpoint (i.e.,

determined that the Policy Threshold is satisfied).[104] Therefore, the taxpayer must closely consider whether the theoretical 10% "loss" from accepting a 50% settlement warrants taking the risk of obtaining nothing in a potentially costly litigation.[105] Thus, in situations where a 50% settlement is in the range of potentially acceptable ones, taxpayers will be encouraged to more readily accept settlements at the lower end of their settlement range. A rational taxpayer should only reject a 50/50 settlement if such settlement is truly outside of its acceptable settlement range. As an added advantage, the rejection of such a settlement offer will prompt the Service to honestly reevaluate its own appraisal of the merits since the taxpayer's insistence on the strength of their position has real consequences and is no longer just posturing as part of their negotiating strategy.

C. Anticipating Certain Criticisms of the Proposed Controversy Guidelines

While the proposed controversy guidelines are intended to facilitate the fair enforcement and sound administration of the tax system, it is likely that any number of criticisms could be raised regarding particular aspects of the proposed guidelines. Many of these will represent divergent policy approaches rather than frailties with the proposed guidelines per se. For instance, the 33% Threshold could be challenged as being too generous to taxpayers since it prevents the Service from litigating a matter even when the Policy Threshold has been met. The 33% Threshold is justifiable if one believes that there should be a level where, even though legitimate arguments could be made for the Service's position in court, the Service should be forced to pursue their tax policy goal by seeking legislative change rather than asserting a strained interpretation of the existing law. However, not all would agree.

Other criticisms may fall into the category of attacking the proposed guidelines as generally unworkable for various reasons. So,

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104. This is especially true because the taxpayer will realize that reasonable minds can differ regarding the merits of an issue. So, while the taxpayer's view is that the Service only has a 40% chance of success, the taxpayer must realize that the Service could view itself as still having a more than 50% chance on the merits, in which case from the Service's perception of the case would fall into the 50% Threshold (rather than the Gray Zone Threshold) and would never concede the case if no settlement is reached.

105. While there is a chance that the Service might concede the issue if the settlement is rejected, a taxpayer in a case fairly close to the 50% line would typically assume that the Service would continue to contest the issue given its fairly strong position.

some may assert that the proposed guidelines are (1) too vague given their reference to percentage probabilities that are often guesswork, or conversely (2) too rigid given their reference to specific percentages probabilities, or perhaps just (3) too simplistic given the reality of a large institution and the myriad situations to which the guidelines must be applied. Such arguments miss the point of this article. As discussed above, any set of controversy position standards must use some metric for measuring a position's strength.[106] The specific percentage probabilities used in this article could be substituted for another formulation expressing such relative strengths. Further, the proposed controversy guidelines are neither inflexible precepts written on stone tablets, nor are they intended to replace all existing internal operating procedures. The goal of this piece is not to replace the thousands of pages of internal directives and employee guidelines already adopted by the Service, but rather to suggest that the Service should have some overall guidelines that would imbue a "guiding spirit" into those existing directives. Further, the proposed guidelines are just that, guidelines. It is expected that in appropriate circumstances the Service should and would violate a guideline if it was determined to be in the best interests of the tax system. For instance, the National Office could identify a specific issue where a test case was desired and instruct the Examination Division to consult with it whenever that issue presents itself regardless of the examining agent's perception of the various Thresholds.

Finally, the proposed guidelines could be criticized as a usurpation of Congress's legislative power. As discussed above, a fierce debate exists regarding the proper approach to statutory interpretation.[107] Similarly, reasonable minds differ regarding the scope of quasi-legislative actions by administrative agencies.[108] Consequently, the appropriateness of using the Policy Threshold (which sanctions an all inclusive approach to statutory interpretation as well as a large role for the Service in independently developing tax policy through its enforcement activity) could be reasonably debated and those whose beliefs tend toward strictly textual statutory construction would likely have serious concerns regarding the proposed controversy guidelines. Again, this is not a problem with the proposed controversy guidelines per se, but a reflection of broader issues relating to the scope of legislative power that should be granted to administrative agencies.

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106. *See* discussion *supra* Part III.D.

107. *See supra* notes 65 & 66.

108. *See supra* notes 70 & 71.

V. CONCLUSION

Creating fair enforcement policies is a key element in maintaining an equitable and efficient tax system. Unfortunately, the standards by which the Service weighs its enforcement activity have never been clearly articulated. This article has proposed a set of controversy guidelines aimed at rationalizing the Service's enforcement decisions and promoting taxpayer faith that the Service is dedicated to enforcing the tax laws in the best interests of all taxpayers without unwarranted over-reaching in its normal audit activities. The proposed guidelines are intended as a basic framework to guide the actions of all Service employees and promote less adversarial relations between taxpayers and the Service. Given the current uncertainty regarding the appropriate Service position standards, it is hoped that the Service will consider the issues discussed in this article and adopt a formalized set of controversy guidelines in the near future.