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# The Administrative Phase of Tax Practice

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# THE ADMINISTRATIVE PHASE OF TAX PRACTICE

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## 1. FROM THE GOVERNMENT'S VIEWPOINT

While fervent lip service is frequently paid to the *subject* of tax equity, the orators and the average citizen alike generally overlook the importance of able *administration* in achieving tax equity. Despite his lack of interest in the subject from a positive point of view, however, the average citizen is embittered by evidence that taxes are being administered unfairly. The weight of public opinion bears heavily upon any administrative agency which acquires the reputation of being discriminatory or arbitrary. The average citizen not only resents unfair treatment for himself but resents it for his neighbor as well and he resents preferential treatment toward others.

Efficient administration must necessarily be based upon the degree of reasonable objectivity which will create and sustain the confidence and approval of the public. This is particularly true in the complex field of federal tax administration. It should be remembered at all times that administrative agencies are essential features of our complex economic society and it is idle to rebel against them or to protest what is so readily condemned as "red tape". Likewise, it should be kept in mind that for an agency such as the Bureau of Internal Revenue to sustain the confidence of the public generally, it must function objectively and it is foolish, generally speaking to expect to settle a tax case through "personal" contacts.

On paper the Bureau of Internal Revenue is merely a part of the Treasury Department, but it is now larger than many departments of the Federal Government. Without doubt its operations affect directly more individuals and more businesses than any department. In these tax-heavy times efficient administration takes on added significance. Because of the increasing expenditures of our Government it is not likely that taxes can be decreased much, if at all. They should, however, be collected as equitably and as conveniently as possible.

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This can only be done by an adequate and well-trained staff.

As recently pointed out by the Tax Institute, the Government and the taxpayer are going to have to live with each other for a long time and in a very intimate manner. It is important that a smooth working relationship be established between them. There is no real conflict of interest between the administrative official and the taxpayer. It is the responsibility of the administrative official to collect from each taxpayer as expeditiously and painlessly as possible the exact amount of tax obligation that is due under the law. It is no less to the advantage of the honest taxpayer that this be done. Delays, uncertainty, friction, and tax exasion are mutually injurious.

It is worthy of notice in this connection that the first rule of instructions to the Technical Staff reads as follows:

> "The Staff conferee shall bear in mind that an exaction by the United States Government, which is not based upon law, statutory or otherwise, is a taking of property without due process of law, in violation of the fifth amendment to the United States Constitution. The conferee, in his conclusions of fact or application of the law, shall hew to the law and the recognized standards of legal construction. It shall be the duty of the conferee to determine the correct amount of the tax, with strict impartiality as between the taxpayer and the Government, and without favoritism or discrimination as between taxpayers."

It is to the interest of the Government and the public generally that this basic rule of practice be followed.

On January 27, 1948, the Advisory Group, appointed by the Congressional Joint Committee on Internal Revenue Taxation, pursuant to Public Law 147 of the 80th Congress to investigate the Bureau of Internal Revenue, rendered its report. After commending the Bureau generally for its high standards of integrity the letter of transmittal concluded with this pertinent paragraph:

> "Bureau-taxpayer relations can be improved by deemphasizing additional revenue as a criterion of proper enforcement and making correct determination of tax liability the goal of all investigational effort. The Bureau of Internal Revenue is the most vital direct link between the citizen and his Government. Standards of integrity, competence, absolute fairness, and performance should

> nowhere in the Government service be higher than in the Bureau. The attainment and maintenance of those standards cost money—a great deal of money. The alternative, however, cheap tax administration, costs, in the long run, more than any nation can bear."

While this Advisory Group recommended various reforms in the organization and methods, it strongly urged a substantial increase in appropriations in the belief "that a substantial increase in over-all enforcement activities of the Bureau is clearly in the interest of the country". The Section of Taxation of the American Bar Association has endorsed similar proposals in the recent past.

Perhaps the first tangible result of the Advisory Group's report was the announcement by the Treasury Department on July 2, 1948, of a committee to direct management studies of the Bureau with the view of improving its efficiency. At the present time the committee is composed of top career men within the Bureau. The Committee on Bureau Practice and Procedure, Section of Taxation, of which the author is a member, has recently advised the chairman of the Bureau committee that our organization is "anxious and willing to cooperate and work with the Bureau's committee".

### 2. From a Practitioner's Viewpoint

Generally speaking, the initial phase of a tax controversy arises when the Revenue Agent begins to audit the return. If the matter is at all complicated the client should be properly represented at this early stage. Full cooperation with the Revenue Agent is highly advisable. Oftentimes what initially appears to the Agent to be a serious diversion from the path of tax righteousness may be rather thoroughly dissipated when the full picture is presented. It is important not only to furnish the Agent with books and records specifically requested but also to encourage the Agent to talk over the problems as his audit progresses. It is often possible to work out a satisfactory solution with the Agent before a formal report is submitted. Bear in mind that if a contest is anticipated it is only natural to assume that the Agent will resolve all doubts against you and place upon you the burden of disproving a much more substantial deficiency than might otherwise have been asserted.

If no agreement is reached with the Agent in the preliminary stage, his report will be submitted and in due course a letter will be forwarded by the Internal Revenue Agent in Charge, stating the amount of deficiency proposed, together with a copy of the Agent's Report, and a specified time, generally 30 days, will be allowed within which to file a protest.

A. *The Protest—its Purpose, Preparation and Presentation* *

The first purpose served in preparing a protest, in point of time, is that the one who prepares it in a thorough manner learns the strength and weakness of his own case. It is surprising how often you may think that you have a poor case and then after getting all the facts down in black and white and a carefully prepared argument in support of your position, you find that you have a strong case. Of course, this works both ways. Sometimes you find that the case does not look so good when stated in bold type. Whichever way it may go, it is advisable for the attorney to know how strong his position really is. It is only then that he is able to appraise the litigating value of his case and it is absolutely essential to make such an appraisal before going into a conference with the Bureau of Internal Revenue on any case.

The second and most important purpose to be served by the protest is to present to the Conferee, designated by the Internal Revenue Agent in Charge, a positive statement of the taxpayer's position, a clear and concise, but at the same time a complete, statement of the facts, and a statement of the principles of law in support of the taxpayer's position, with citations of the authorities relied upon.

The third purpose to be served by the protest is to make a record to support any favorable action which the Conferee may take on the issue presented. It should always be borne in mind that the Conferee who initially decides the issue must support his decision by a proper record. His decision will be reviewed not only by his superiors in the Office of the Internal Revenue Agent in Charge, but also by the reviewers in Washington, including the lawyers in the Review Division of the Chief Counsel's office in cases involving refunds of more than $75,000. The record must be such as to satisfy these reviewers,

* The material in this section is taken from an address recently delivered by the partner of the author, Claude W. Dudley, before the Western Railroads Income Tax Accounting Conference at St. Paul, Minnesota.

otherwise the case will be returned for reconsideration. Long delay will be encountered and perhaps an initially favorable decision will be overturned.

In the preparation of the protest these purposes should always be kept in mind. In order to serve adequately the purpose of giving the Conferee a clear picture of the issue, it is necessary to state at the outset the question involved. This is best done by first stating the Revenue Agent's position, with reference to the pages in the Revenue Agent's Report where that position is stated, followed by a statement of the taxpayer's position. It sometimes takes courage to make a clear-cut statement of the issue. Sometimes you feel like straddling. Sometimes you feel that you would like to beat around the bush with the Conferee and find out what he thinks before you ever take a position. This may be advantageous in an occasional situation, but as a general proposition it is advantageous to come to the point. We do not enhance our reputation with the Conferee or the Revenue Agent, or increase the possibility of success, by evading the issue. That makes their work more difficult and they do not like it.

The Conferee is entitled to an exact statement of the facts. First, a reference should be made to the statement of facts in the Revenue Agent's Report and a summary of the facts as there stated should be included in the protest. Special attention should be directed to any error there may be in the Revenue Agent's statement of facts. There should also be presented a clear and concise statement of any additional facts upon which the taxpayer relies. The Conferee is entitled to know your exact understanding of the facts and to have from the Revenue Agent his comments upon your statement of facts as it is set out in the protest. The Conferee may then readily see whether the taxpayer and the Revenue Agent are in accord as to the facts, in which case he may give undivided attention to the principles of law and accounting involved, or whether there is a serious difference of opinion as to the facts which requires a careful, independent analysis and appraisal by the Conferee as well as further exploration on his part before he can reach a conclusion as to what the basic facts really are.

The Conferee is entitled to have a full and frank statement of the facts. Whenever the Conferee finds that the facts have been trickily presented he is likely to make a mental note to watch that taxpayer's presentation of other matters. Nothing

is more valuable to a taxpayer than a reputation for reliability in presenting facts. If the Conferee has the feeling, based on prior experience, that he can rely on the statement of facts presented in the protest without making a detailed independent investigation, the first step toward a successful conference has been accomplished.

After presenting the facts involved in an issue, the next step is a statement of the principles of law applicable to the question presented and the citation of authorities in support of the position taken by the taxpayer. While the obligation to make a complete statement of the law is not as specific as in the statement of facts, it is wise to call attention to all rulings or decisions directly pertinent to the issue even though they may be adverse to some extent. If they appear to militate against you an effort should be made to distinguish them or to limit their scope. If they have a direct bearing on the issue and can not be distinguished, an effort should be made to show why they are wrong or how they produce an inequitable result in your case. This might arouse the sympathetic interest of the Conferee, which will likely prove beneficial in the disposition of other issues of a borderline nature. Generally speaking, it is advisable to meet the problem squarely.

During World War I, and its tax aftermath, it would perhaps have been a waste of effort to have filed a 200-page protest. The Bureau was not then adequately staffed and the Conferees could not give the time required to make a real study of such a protest. Now the situation is quite different. Capable Conferees are usually assigned to these cases. In a complicated case they not only read the protest but they study each issue thoroughly. They come to the conference prepared to discuss the issues in the case.

Needless to say, the preparation of a protest in this manner requires a lot of work. It requires cooperation between the legal, accounting and engineering staffs. Preliminary conferences between these people as to each item to be protested and the formulation of an outline of its presentation, prior to the preparation of detailed schedules and evidence to be submitted, will reduce to the minimum unnecessary or unprofitable work. Even though useless work is minimized in this manner, it still is true that the job is a large one. Experience demonstrates that it is worthwhile to do this kind of a job. If this is done, there is a good chance that a settlement may be reached in the

Bureau without ever going to the Tax Court and it is certainly advantageous to the taxpayer to effect a settlement in the administrative stage if it can be done.

In the oral presentation of the protest it is of primary importance to create the feeling that you are in the conference for the purpose of accomplishing something and that you are not merely going through the motions. If the Conferee feels that you are presenting the case with the expectation that a settlement will be reached, he is more likely to make a real effort to meet you half-way than if you create the impression that the skirmish is really preliminary to a presentation to the Technical Staff and the Tax Court.

In presenting a case to a Conferee, it is always well to bear in mind that he is a part of a large organization and that he is bound not only by the law but by the rules and regulations of the Treasury Department. He is not bound by court decisions other than Supreme Court decisions, unless the Commissioner has acquiesced in such decisions. But the rules and regulations are the law so far as the Conferee is concerned. He can do nothing contrary to them and even though you should be so forceful in your argument as to convince him, which is practically equivalent to convincing a man that black is white, it would still avail you nothing because his decision would be reversed by the reviewer. In other words, if the regulations of the Bureau are definitely against you, it is a waste of time to argue that the Conferee should disregard them. In such a situation one of two things should be done. You should either make an effort before the proper authorities to get the regulation changed, or you should present the matter to the Conferee merely for the purpose of creating sympathetic interest which might cause the Conferee to be more liberal in his consideration of other issues in the case.

There are many items on which a Conferee has discretion. In considering whether a debt has become bad in the year in which claimed, or whether stock has become worthless, or whether an item is a capital or expense item, or a question of obsolescence, or loss of useful value, or a question of valuation, including the valuation of capital stock for invested capital purposes,—these are some of the important questions on which the Conferee has discretion. His decision on such questions as these in analogous to the determination of a trial court on a question of fact. As you know, the Appellate Court

will not reverse the trial court on a question of fact if there is any substantial evidence to support the findings of fact by the trial court. Likewise, the reviewer in the Bureau of Internal Revenue will not reverse a Conferee on a question of fact unless the decision appears to be absolutely wrong. But let a Conferee make a mistake as to Bureau policy or the application of an established Bureau ruling or a regulation, and the case will be sent back almost invariably. Consequently, one should spend his time in making a thorough presentation of those matters as to which the Conferee has real discretion to act. It is possible in many cases to get sufficiently attractive settlement on the points on which the Conferee has discretion that you can afford to make a settlement of the case and forget the points as to which the regulations are against you. It is much more likely that this result can be obtained if you are content merely to create the feeling that the regulations work a hardship in the case and arouse the Conferee's sympathetic interest rather than to dwell too long on the inconsistencies and inequities of the regulations. It is also often possible to settle satisfactorily with the Conferee the points on which he has real discretion and leave to be litigated by the claim for refund procedure questions on which the rules and regulations are against you but as to which you think you may get favorable court action.

B. *The Technical Staff*

If the case can not be settled in the office of the Internal Revenue Agent in Charge one further opportunity is afforded before the institution of judicial action. Ordinarily, at the conclusion of a stalemated conference a form will be made available whereby the taxpayer or his representative may indicate a desire to have the case considered by the Technical Staff.

While this step gives the taxpayer another chance to advance his cause without direct cost, it is not a step to be taken as a matter of course. In fact, many experienced tax practitioners forego this opportunity as a general rule. The Technical Staff is made up of the Bureau's top men and it may well be that a case is weakened as a result of the informal type of conference at this formative stage. The Technical Staff representative, being more experienced, may, during the course of the conference, develop an effective defense, technical or

otherwise, which had hitherto been overlooked by the Government representatives, or he may develop a new theory or ground for denying relief and incorporate it in the statutory 90-day letter.

In making the decision on this step it should be remembered that the case can still be presented to the Technical Staff for purposes of settlement after the issuance of the 90-day letter and the filing of a petition with the Tax Court. The issuance of the statutory letter and the filing of the pleadings crystallizes the issues and limits the scope of the burden of proof rule. If, at that later stage, a new theory is developed by the Technical Staff, calling for departure from the position previously taken by the Commissioner, it may well be that the Commissioner rather than the taxpayer will carry the burden of proof to that extent.

Under the present procedure the Technical Staff representatives have more authority to act in settlement conferences than the representatives of the Internal Revenue Agent in Charge. While a settlement reached in the latter's office is subject to review in Washington, a Technical Staff settlement is accorded finality. By reason of this delegated authority to bind the Commissioner, an agreement with the Technical Staff can be so worded as to close the case and preclude either side from reopening under ordinary circumstances. Compare *Guggenheim v. United States,* 77 F. Supp. 186 (Ct. Cls.), and *Joyce v. Gentsch,* 141 F. 2d 891 (C.C.A. 6th).