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THE TAX CUTS AND JOBS ACT

DESPERATELY SEEKING GUIDANCE

An Open Letter to the IRS

Re: The next chapter of U.S. tax administration—observations and recommendations

Dear Commissioner [Charles P.] Rettig and Chief Counsel nominee [Michael J.] Desmond:

As you assume your new roles, we would respectfully like to convey our recommendations for the improvement of tax administration. These recommendations are based on our own experiences interacting with the agency, as well as detailed discussions with numerous senior tax officers at leading corporations about their perspectives.

As a general observation, you inherit responsibility for an agency that most believe does its job remarkably well, especially with shrinking budgets and constant political pressures. We believe that the vast majority of IRS officials are dedicated to obtaining proper outcomes and treating taxpayers fairly. Nonetheless, we would like to discuss four principal concerns impacting tax administration that we think could be improved—and that you possess the power and credibility to improve—during your tenure. Those are:

1. providing, in a timely manner, further administrative guidance explaining the complex provisions of the Tax Cuts and Jobs Act of 2017 (TCJA), especially those without analogs in prior law; and, in the absence of such guidance or in the case of subsequently revised guidance, temporarily ameliorating any penalties related to good-faith failures to comply with the provisions of the TCJA;
2. eliminating administrative measures that abrogate the ability of taxpayers to go to IRS Appeals, or that could call into question the independence of IRS Appeals or limit its effectiveness;
3. implementing a mechanism permitting taxpayers to address those rare situations where the standards set forth in the Internal Revenue Manual that ostensibly govern the conduct of IRS examination teams and their members are violated; and
4. increasing transparency in the handling of IRS examinations, including specifically identifying the key decision makers who have the authority to resolve campaigns and issue-focused audits, as well as clarifying how campaigns and issue-focused audits are intended to work and, in fact, do work in practice.

We discuss each of these suggested improvements in turn.

TCJA Guidance

First, nearly all senior corporate tax personnel with whom we spoke suggested providing further administrative guidance regarding the TCJA as quickly as possible, especially for those provisions without analogs in prior law. The efforts of the individuals at the IRS and Treasury who have been and currently are working diligently to prepare guidance in this area are commendable, but additional timely guidance on many additional aspects of the TCJA is imperative given this period of great uncertainty. We would, of course, caution against sacrificing sound tax law for speed. But undoubtedly additional efforts could be undertaken, including temporarily redeploying more people to assist with the numerous TCJA guidance projects and, budget permitting, hiring additional tax professionals. The probable and beneficial impacts of such measures, as one corporate tax executive noted, are increased efficiency of the overall tax administration system and improved tax certainty and accuracy.

Importantly, in the absence of guidance in a particular area, or in the case of guidance that is subsequently revised, we recommend providing administrative relief for taxpayers by temporarily ameliorating any penalties that result from uncertainties in the law. The inequity of imposing penalties on taxpayers that adopt reasonable interpretations of new and complex provisions during such a time is self-evident. Similarly, in the event that proposed or temporary regulations provide the ability to elect a particular treatment, if the final regulations adopt a different interpretation of that provision or otherwise change taxpayer expectations, we suggest providing flexibility for taxpayers to withdraw their elections.

Administrative Measures

Second, we urge eliminating administrative measures that abrogate the right of taxpayers to go to IRS Appeals. The opportunity for taxpayers to present their disputes before an independent and impartial

appeals officer serves important, fundamental interests that underlie sound and fair tax administration, including equal treatment under the law, efficiency, and economy. These principles benefit both taxpayers and the government alike, and IRS Appeals works well to resolve fairly the large majority of cases it considers. Our experience shows that appeals officers are typically capable, conscientious, and fair in their consideration of issues and achieve the Appeals mission of resolving cases without the need for costly and disruptive litigation.

Consistent with these principles, the general practice of designating individual cases for litigation should be dramatically circumscribed. Preventing some taxpayers from accessing IRS Appeals based on the taxpayer's particular facts and because of the Service's desire to create what it hopes will be favorable legal precedent, while allowing other taxpayers to go to IRS Appeals, including taxpayers who are situated similarly to those who have been denied access,[1] is contrary to the Service's mandate to treat all taxpayers equally and fairly. Denying select taxpayers a right to IRS Appeals is incompatible with fair tax administration and may undermine the taxpayer confidence that underlies voluntary compliance. A particular taxpayer should not be forced to bear the costs and risks of litigation because the Service believes its case is the best vehicle for establishing some broader tax principle in the courts. Moreover, the practice of designation is inefficient, costly, and wastes limited resources that could be expended elsewhere, for both taxpayers and the government, despite the Service's justifications to the contrary.[2] The Service will nearly always have alternative litigation vehicles available to it, based on the simple fact that not every case is resolved at IRS Appeals.

Relatively recent administrative changes further threaten to undermine the mission of Appeals by potentially increasing the number of cases that are effectively designated for litigation, unfairly denying even more taxpayers review by IRS Appeals.[3] Thus, in addition to circumscribing the general practice of designating cases, the procedures expanding the use of designation should be revoked. If the practice of designating cases is used at all, it should be limited to cases involving plainly frivolous positions and clearly abusive tax transactions.[4] Alternatively, in lieu of largely eliminating the practice of designation, we recommend at a minimum imposing stricter and clearer designation procedures.

We also suggest doing away with recent administrative changes that increase the participation of IRS examination team members in the IRS Appeals process. For a number of years, appeals officers have had the discretion to invite IRS Compliance personnel to Appeals conferences, but that discretion was rarely exercised. The Service's initiative makes IRS examination team attendance "routine for certain cases."[5] Those changes, however, threaten to compromise the independence of IRS Appeals by subjecting IRS appeals officers to continued and potentially undue pressure by IRS colleagues and increasing the risk of *ex parte* communications.

Moreover, appeals officers are not judges, are not trained as judges, and lack the tools judges possess to impose order, limit interruptions, and allow parties to present their positions. Further, they are not empowered to decide cases, but rather to negotiate resolutions. Likewise, as capable as IRS agents are, representing the Service in quasi-judicial proceedings is not their forte. Thus, while the theoretical goal of allowing Exam and taxpayers to debate issues in front of a neutral appeals officer may seem reasonable, it is inconsistent with the structure of Appeals. Some conferences invariably will devolve into unproductive free-for-alls, preventing the careful presentation of arguments and reasoned discussion between taxpayers and appeals officers that are the hallmarks of the process. Additionally, despite their independence from Exam, appeals officers are still IRS employees who view themselves, as least to some degree, as responsible for protecting the fisc. The proposed structure effectively creates a "two-on-one" situation, which is neither fair nor designed to instill faith in the process in taxpayers. Prohibiting IRS Exam from participating in Appeals proceedings after the *ex parte* conference unless the taxpayer consents will obviate these concerns and will help to preserve IRS Appeal's valuable independence and impartiality.

The IRS Manual

Third, we propose implementing a mechanism that would permit taxpayers and agency management to address those rare but troubling situations where the standards set forth in the Internal Revenue Manual (the Manual) and elsewhere that govern the conduct of IRS examination team members are clearly violated. Although currently largely aspirational, the provisions in the Manual and other IRS guidance direct Exam personnel, for instance, to determine the "substantially correct" tax liability on a return and to apply the law to the facts in a fair and impartial manner.[6] If the law is unclear, the examination team must weigh the various legal authorities to determine the merits of the issues.[7] Agents are instructed to raise issues only when they "have merit, never arbitrarily or for trading purposes."[8] And no IRS employee may adopt a "strained construction in the belief that he or she is 'protecting the revenue.'"[9] Likewise, the Manual provides detailed instructions on how to conduct examinations, including the new Information Document Request procedures. No mechanism, however, presently exists for taxpayers to combat situations where those standards are ignored. The taxpayer community is unaware of a system for either retraining or disciplining agents whose positions are chronically unreasonable, who violate procedural guidelines or are abusive to taxpayers, or who generally fail to uphold the agency's standards.[10] In contrast, taxpayers must self-report their tax liability and, for example, are subject to accuracy-related penalties for underpayments of tax attributable to negligence or the disregard of rules or regulations. Similarly, IRS Circular 230 governs the conduct of tax professionals who represent taxpayers before the IRS, and the IRS Office of Professional Responsibility investigates and punishes ethical violations by those practitioners. Taxpayers complain that this creates an asymmetry of standards, in that they are held to rigorous requirements for reporting positions and their representatives are subject to discipline for their behavior during an examination, whereas IRS agents lack similar constraints.

In our experience, the overwhelming majority of IRS employees act in good faith, treat taxpayers fairly, and comport themselves in accordance with high ethical standards. But most large taxpayers have witnessed or are aware of instances where one or more members of an examination team violated the standards of conduct set forth in the Manual, resulting in or contributing to a difficult, prolonged, and needlessly expensive examination. The biggest problem as we perceive it therefore continues to be not the absence of standards governing IRS employees, but the absence of a mechanism to ensure that those basic standards of conduct are followed during the examination. A parallel regime imposing an internal review process on agents that addresses failure to comply with the modest standards imposed on IRS employees to ensure that both sides of the examination behave in good faith and with integrity would promote sound and fair tax administration. For example, an agent who repeatedly raises issues that end up being fully conceded by Appeals should receive some sort of retraining. Taxpayers need not know when an agent has been subject to such review, but the simple awareness that an internal review process exists will enhance faith in the system.

Increasing Transparency

Fourth, we suggest increasing transparency in the handling of IRS examinations, including clearly delineating the key decision makers who have the authority to resolve issues in campaigns and in issue-focused audits. Those decision makers often are difficult to discern in practice, despite the fact that the Large Business & International (LB&I) examination process encourages the examination team and the taxpayer to "work together in a spirit of cooperation, responsiveness, and *transparency*."[11] The current process for resolving issues in campaigns and in issue-focused audits may contribute to the lack of clarity, given that both case managers and issue managers are simultaneously "expected to demonstrate their leadership" during the examination, and although case managers ostensibly have overall responsibility for the audit, they are not afforded principal control over the case.[12] In the event that "disagreements occur within the issue team(s) that cannot be resolved between the case and issue managers," the matter must be "elevated to the next level of management."[13] That next level decision maker is not always apparent to taxpayers or may not be readily accessible. Clearly setting forth at the commencement of an audit and then making available during the audit the key decision makers who possess the authority to resolve issues may facilitate a more expeditious and satisfactory resolution of examinations. There are few things that frustrate taxpayers more than not knowing whom they must convince or not having access to that person to present their positions themselves.

We also recommend further clarifying how campaigns and issue-focused audits are intended to work and disclosing how they are working in practice. This information and data are helpful both to the public and the Service in evaluating the merits and efficacy of campaigns and issue-focused audits.

Thank you for your consideration of these suggestions, as well as for your commitment to public service.

Sincerely,
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Matthew Lerner and **Nathan Clukey** are partners at Sidley Austin LLP.

Editor's note: This submission has been prepared for informational purposes only and does not constitute legal advice. This information is not intended to create, and the receipt of it does not constitute, a lawyer-client relationship. Readers should not act upon this submission without seeking advice from professional advisors. Its content does not reflect the views of the firm.

Endnotes

1 IRM 33.3.6.1.3 (stating that the designation of an issue in a case will not preclude "Appeals from settling the same issue in other cases within its jurisdiction").
2 IRM 33.3.6.1.1.
3 Rev. Proc. 2016-22 (denying referral to IRS Appeals in cases docketed in the U.S. Tax Court that were not previously considered by IRS Appeals, "if Division Counsel or a higher level Counsel official determines that referral is not in the interest of sound tax administration").
4 *See, e.g.*, Announcement 2004-46, 2004-21 I.R.B. 964.
5 Appeals Team Cases Conferencing Initiative FAQ, available at *www.irs.gov/pub/irs-utl/atclfaqs.pdf*.
6 IRM 4.10.3.2.1, IRM 4.46.5.2.2(1).
7 IRM 4.46.5.2.2(3).
8 Rev. Proc. 64-22, 1964-1 C.B. 689.
9 IRM 32.2.1.1.
10 Matthew Lerner, Kevin Pryor, and Katharine Funkhouser, "Sauce for the Goose: Standards Applicable to Taxpayers, Practitioners—and the IRS," *Tax Executive* (August 24, 2016), *http://taxexecutive.org/sauce-for-the-goose-standards-applicable-to-taxpayers-practitioners-and-the-irs/*.
11 IRS Publication 5125 (emphasis added).
12 IRM 4.46.1.1.5, IRM 4.46.1.1.2, IRM 4.46.1.3.3.1.
13 IRM 4.46.1.4.3.4.