Current Issues and Trends in Tax Practice

By Lawrence B. Gibbs and Claudia A. Hill

Lawrence B. Gibbs and Claudia A. Hill share some insights into current issues and trends that emanate from the relationship among the Treasury, the IRS, Congress and the media.

Editor's Note. Lawrence B. Gibbs has a general tax practice in Washington, D.C. in which he counsels large corporations and other businesses on how to solve their domestic and international tax problems, including those involving planning, compliance and controversy matters; administrative and legislative matters; and litigation—issues similar to what we all experience in our tax practices.

Larry served as Commissioner of the IRS from August 1986 to March 1989. As Commissioner, he turned his fellow tax professionals into "partners" and "stakeholders" and the U.S. taxpayer into a "customer." He brought civility and accountability back into vogue. In 1987, I was fortunate to serve on his Advisory Group. Now we find ourselves facing some of the same issues addressed back then and facing a few new ones primarily associated with technological changes over the past two decades.

In the interview that follows, I ask Larry to share some insights into current issues and trends that emanate from the relationship among the Treasury, the IRS, Congress and the media—trends that ultimately affect our own practices, our clients and our relationship as practitioners dealing with the IRS.

HILL: What is the focus and mood in Washington, D.C. today with regard to tax administration by the Internal Revenue Service?

GIBBS: Some emphasis is still being given to taxpayer service, such as Acting Commissioner Linda Stiff's recent praise for various IRS partnerships with private sector organizations to increase taxpayer education and assistance, including the National Disability Institute that has been providing free tax return preparation and other assistance to the disabled. The bulk of the focus, mood, and emphasis these days is on IRS's efforts to increase taxpayer compliance, and such emphasis on tax compliance is at both ends of Pennsylvania Avenue. The IRS continues to ramp up to deal with tax noncompliance, even in the waning days of promoted tax shelters. The Congress is encouraging the IRS to do so by passing laws that can be counted as revenue raisers to pay for other things the Congress wants to do, like repeal the alternative minimum tax.

HILL: How large is the IRS today compared to its size when you were Commissioner, and how does the IRS workload today compare to the size of its workload when you were Commissioner?

GIBBS: The IRS today is about the same size as it was when I was Commissioner about 20 years ago, around 100,000 people. The workload at the IRS, measured by returns filed, has gone up each year for the last 20 years.

HILL: In view of what you just told us, can the IRS really be effective in dealing with tax noncompliance, and if so, how is it trying to do so?

GIBBS: In my opinion, the IRS has been surprisingly effective in dealing with tax noncompliance in the form of promoted tax shelters, largely by leveraging

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its own resources, using tougher sanctions, and pushing much of the identification of tax noncompliance to the private sector taxpayers and practitioners, including:

- Using the organizational changes made by the 1998 Tax Reform Act, IRS efforts were coordinated out of the National Office with listed transactions and issue champions.
- IRS attorneys were more deeply involved in individual cases.
- Penalty policies were changed to require tougher sanctions to be used.
- Promoters and taxpayers were required to self-identify listed transactions.
- Relying on technology changes, information flow was facilitated by OTSA (Office of Tax Shelter Analysis).
- Tax practitioners, who acted as promoters and facilitators, became targets.

The IRS is using many similar techniques to deal with tax noncompliance today in the post-shelter era.

HILL: Can you provide some examples of how IRS is using similar techniques today in non–tax shelter cases to deal with tax noncompliance?

GIBBS: One of my handouts, a reprint of my article in The Tax Executive entitled *Tax Controversy in the Post-Shelter Era,* analyzes what LMSB is doing, which is a pretty good example:

- LMSB is using Industry Issue Focus program to identify tax compliance issues at greatest risk, with the National Office appointing Issue Owner Executives who, like prior Issue Champions, are directing issue development by LMSB audit teams on Tier I and Tier II issues.
- IRS Field and National Office attorneys continue to be heavily involved in LMSB audits.
- Penalty threats continue to be used by LMSB auditors to not only sanction what they perceive as overly aggressive behavior but also to encourage LMSB taxpayers to self-identify soft spots in their returns.
- Schedule M-3 changes, the FIN 48 rules, and the continuing review of the traditional restraints on IRS auditor requests of tax accrual work papers continue as examples of developments putting more pressure on LMSB taxpayers to identify soft spots in their returns.
- Electronic filing of large corporate returns offers increased opportunities for IRS to use its technology to facilitate identification of noncompliance by LMSB taxpayers.
- The Office of Professional Responsibility through Circular 230 and the use of sanctions against practitioners, as well as the IRS participation in OECD's Tax Intermediaries Project to encourage practitioners to become part of tax compliance, are two examples of the continued IRS attempts to focus on practitioners who, for one reason or another, are perceived by the IRS as part of the tax noncompliance problem. OPR also is studying the impact of pending legislation to regulate the tax preparer community, should that legislation be enacted.

HILL: While there may be some practitioners who are part of the problem, I am convinced that practitioners are definitely part of the solution. I fear that the intensity of IRS, Treasury and Congressional media focused on the bad acts of a few practitioners is driving a wedge between the vast majority of honest practitioners and the Service. We have heard a lot about the tax gap over the last year or so. What role is the tax gap playing and what impact is it having on the issues and trends in the IRS response to tax noncompliance today?

GIBBS: My perception is that, at least to some extent, the tax gap is attracting attention because, after 20 years since the last tax gap report was published, the IRS last year put out another report estimating that about $300 billion in taxes was not being collected every single year.

That caught the politicians' attention because, with the re-introduction of the pay-go rules that require Congress to propose legislation to pay for the cost of any new legislation Congress wishes to pass, the politicians are always looking for revenue sources. And the idea of being able to propose ways to collect that much revenue has been irresistible.

The media too have been fascinated by the tax gap. Between the media and the politicians, the tax gap story has developed legs and continues to be a major item of interest in the tax area.

The bulk of the tax gap is in the small business area, but the politicians instead have focused primarily on noncompliance by large corporations.

Many of the proposals to reduce the tax gap have proposed additional withholding and enhanced information reporting. This is another way of shifting the cost and burden of policing tax noncompliance to the private sector.

This, in turn, raises the issue of balancing the cost to private sector companies affected by the new withholding and information reporting against the

revenue raising benefits of these proposals.

What is not being suggested, at least by the politicians, is giving the IRS more resources. Instead, there have been suggestions about how the IRS can do more with its existing resources.

My handout entitled "Administrative Options to Close the Tax Gap" spells out some of the ways IRS has worked smarter with existing resources to try to address the tax gap. The IRS has used carrot and stick programs to encourage better compliance. The CAP program, LIFE audits, Fast Track, Pre-Filing Agreements are used to benefit compliant taxpayers.

The new IRS Whistleblower Office is being used to provide leads to IRS compliance functions about potentially noncompliant taxpayers. IRS also has enhanced its relationship with states and foreign governments to detect potential noncompliance.

On the other hand, IRS has improved its telephone assistance to provide better taxpayer education and assistance to those who are trying to comply. IRS also has expanded its Tax Counseling to the Elderly and Volunteer Income Tax Assistance programs and made greater use of private sector tax clinics to improve taxpayer compliance.

Some of the IRS administrative responses to the tax gap have been intrusive and, therefore, less agreeable and acceptable to taxpayers and practitioners. That is the nature of the response to the tax gap because there are no easy answers to how to close the tax gap. That is why you and your clients need to pay attention because how the federal government decides to respond to the tax gap can affect you and your clients.

HILL: With tax noncompliance and compliance being the focus of the IRS, are you seeing an increase in tax controversies and litigation?

GIBBS: We are seeing an increase in tax controversies before the IRS, but not an increase in litigation, at least not among the larger companies. One reason is that although some companies are willing and able to litigate their tax issues if they disagree with the IRS, some companies are not able to litigate and many more are not willing to litigate, even if they are able to do so. The impact of the risks and costs of tax litigation itself, the prevalence of investigative business reporters and the possibility of adverse publicity and their attendant reputational risks, and the threat plaintiff lawyers and potential cost of shareholders' derivative suits—all of these factors have had an impact upon the willingness of corporate senior executives and boards of directors to litigate.

HILL: I can understand why a company might not be willing to litigate, but what did you mean by a company might not be able to litigate?

GIBBS: As indicated in my third handout, in IRS audits today we increasingly are encountering—in the midst of real business deals—highly complex transactions that were planned by tax professionals who had little or no experience with tax controversies or litigation. Although there often are more-likely-than-not opinions stating that the transactions will prevail, there often are no credible witnesses and very few documents to be able to explain and defend the non-business purposes of the transactions.

The complexity often is attributable to attempts to structure around or otherwise avoid various anti-tax avoidance rules. Government attorneys are relying on decisions like *Coltec* and *Black & Decker*[1] to attack these portions of real business transactions that appear to have been done to either maximize tax benefits or minimize tax risks inherent in the business deals. Sometimes we see tax planning portions of overall transactions that simply have been added, or forced into, the business transaction with relatively little concern over whether or how the tax portion fits with the rest of the business transaction.

The result is we are seeing highly complex tax planning transactions that are often difficult to explain to skeptical IRS auditors and equally difficult to explain and defend to generalist judges, who often see the transactions as tax avoidance attempts. This often leads to penalty assertions by the IRS auditors. The resulting cases are more difficult to defend and more risky for clients to pursue.

The IRS is getting better at using the complexity of these cases to argue that the transactions were primarily tax motivated. In the face of this, we find more clients willing to try to settle rather than litigate their cases.

HILL: Are you suggesting that more tax practitioners are becoming too aggressive in their tax planning for clients?

GIBBS: No, to a large extent, this phenomenon appears to be a by-product of narrower specialization in the tax area. It is increasingly the norm for us in tax controversies to deal with the product of tax planners who have not had significant exposure to tax controversy work. Often it appears that the tax planners were more focused on the applicable law than attuned to the importance of relevant facts and the ability to credibly prove how the tax planning portion of the transaction

related to the business needs and purposes of the overall transaction.

A lack of concern with admissible evidence in the form of business documents and credible business witness testimony often makes the defense of tax planning portions of business transactions difficult to establish, much less to defend. E-mail exchanges during the tax planning process have become the bane of tax controversy attorneys in an increasing number of cases.

Finally, in a tax controversy, the simpler the explanation of the background and steps in a transaction, the better in terms of explaining the transaction to IRS auditors and attorneys. A transaction that can be simply explained is easier to understand and accept.

I have no crystal ball. The tax shelter years recently concluded were not the finest hours for many so-called tax professionals.

Complexity is the foe of those responsible for defending a client in a tax controversy. Complexity seems to be the friend of many tax planners who not only appreciate the subtleties and nuances of the tax law in their area of specialization but also occasionally appear to be mesmerized by the sheer beauty of a complex tax planning transaction that "works," in the sense of addressing each of such subtleties and nuances. While this may be understandable on the transactional planning level, it is real detriment when the transaction is subjected to the scrutiny of suspicious IRS auditors and their attorneys in the post shelter era.

HILL: During your administration we worked to reduce the number of taxpayer penalties that had grown like mushrooms through the IRC. We also looked at the philosophy and purpose of penalties and concluded they should not be imposed simply as revenue enhancers. Our work lead to the IMPACT legislation of 1988. Lately we've seen Congress tinker with penalties solely to raise revenues—like the corporate underpayment of estimated tax penalty. Clearly the 4x and 5x increase in return preparer penalties in legislation earlier this year were aimed at revenue enhancement—both from the penalty itself and from the hope preparers will become extremely conservative in their preparation efforts and insist their clients re-evaluate risky positions. Is this a trend we can expect to continue? Is there any activity toward consolidating and re-evaluating penalties as was done 20 years ago?

GIBBS: The 1988 legislation was developed by the IRS and enacted because the penalty system in many instances was not being used by the IRS. The penalties often had become so draconian that IRS employees either felt it was not appropriate to assert them or asserted them in situations in which the courts refused to sustain them. Although I know of no activity to review and re-evaluate penalties, I would hope that might be done. Some may say that it will be difficult to modify or repeal the new penalties because of the potential revenue loss under the new pay-go regime in Congress. I urge the IRS to keep track of how many times the new penalties are asserted, sustained, and abated in order to demonstrate what any actual revenue loss might be. There are times when it is appropriate for the IRS to impose penalties, and the penalties should be tailored to permit that to occur. The new penalties are but another example of how bad policy can become law if revenue raising considerations overly influence the structure of the penalty provisions.

HILL: I think the post-Enron and post–Arthur Anderson era has seen a number of positions advanced by the Service and sustained in the courts because of the egregious behavior of a limited number of bad actors. For over four years we have been trying to restore the reputation of ourselves and our peers as "trusted professionals." How long will so many continue to pay for the bad acts of so few? Do you have a crystal ball on that one?

GIBBS: I have no crystal ball. The tax shelter years recently concluded were not the finest hours for many so-called tax professionals. Far too many accounting and law firms—large and small—developed, marketed, and opined upon tax shelters or prepared returns based on such transactions. While it is true that many today may be paying a price for the prior activities of a minority, it is also true that the legal and accounting professions (and we as individual members of such professions) did not step forward as strongly as they (and we) perhaps should have to deal with the phenomenon that many of us knew was taking place. Until we as individuals and our professional organizations are willing to become more accountable and, for example, to criticize and urge the IRS to deal harshly with activities and

transactions that are too aggressive in the tax area, I suspect we may continue to see state and federal officials, as well as the courts and the media, take a dim view of the work of tax professionals. If we treat the practice of tax as a business that is subject to the laws of the market place instead of as a profession that has real, enforceable professional standards that subsume what the market will bear, we are likely to continue to pay the price.

Endnotes

[1] *Coltec Industries, Inc.*, CA-FC, 2006-2 USTC ¶50,389, 454 F3d 1340; *Black & Decker Corp.*, CA-4, 2006-1 USTC ¶50,142, 436 F3d 431.