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### The Role of Litigation in the Federal Tax System

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## THE ROLE OF LITIGATION IN THE FEDERAL TAX SYSTEM

by  
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**Chief Counsel**  
**Internal Revenue Service**  
**April 23, 1979**



[Introductory note: Stuart E. Seigel has been Chief Counsel of the Internal Revenue Service since 1977. Prior to that he was, for eight years, a partner in the Washington, D.C., law firm of Cohen and Uretz. He also served as Tax Legislative Counsel in the Treasury Department.

Mr. Seigel earned his bachelor's and law degrees from New York University and a Master of Laws in Taxation from Georgetown University.

He has served on the faculties of Antioch School of Law and the Law School of George Washington University.

Mr. Seigel is a member of New York and District of Columbia Bars. He is also a member of numerous other legal associations.]

Litigation of tax cases in the courts plays a central role in the federal income tax system.

The purpose of the courts in handling tax disputes is, of course, to resolve controversies over tax liability between the Government and tax-payers. In this respect, the courts serve the practical and necessary function of reaching a specific conclusion with regard to an individual or corporation's tax liability, as well as providing a forum for the settlement of disputes which remain unresolved through the administrative process.

A by-product of that function and an important role of the litigation process is the interpretation of tax issues which have significant impact. This process helps shape the law and is a touchstone for guidance in planning transactions and in legislative and regulatory development.

Litigation of income tax cases, as structured today, presents what is to many a confusing and perplexing array of alternative judicial procedures and options.

There are three trial forums available to taxpayers -- the United States Tax Court, the United States District Courts, and the United States Court of Claims. The District Courts and the Court of Claims are, as I will elaborate more fully, only available if the taxpayer has paid the tax in controversy and is seeking a refund. The Tax Court offers the only trial court available where a dispute can be aired without prepayment of the tax involved.

Obviously, every tax dispute has its origins in a tax audit or examination initiated by the Internal Revenue Service. If the taxpayer does not agree with the agent's determination, and the matter remains unresolved, in whole or in part after administrative appeals are exhausted, a formal notice of the deficiency in the tax determined to be due must be sent to the taxpayer. This notice of deficiency -- or

so-called ninety-day letter -- affords the taxpayer the opportunity to file a petition within ninety days. If that option is chosen the case, if not settled before trial, will be heard by a judge of the court in one of the many cities throughout the country where the Tax Court holds trial sessions. Although the Tax Court is head-quartered in Washington, D.C., its judges travel throughout the country to hear cases. The Government is represented in these proceedings by attorneys of the Chief Counsel's Office of the IRS. Among the statutory duties of the Chief Counsel is the responsibility to represent the Commissioner of Internal Revenue in proceedings before the Tax Court. IRS lawyers are located in 45 field offices throughout the country, handling, among other matters, cases pending in the Tax Court. No jury trial is available in the Tax Court, and the losing party -- the taxpayer or the Government -- has an automatic right of appeal to one of the 11 United States Courts of Appeals. Further review of the case can be had in the United States Supreme Court if that Court, in its discretion, chooses to hear the case upon application by the losing party in the Court of Appeals. Obviously, only a very limited number of cases originating in the Tax Court are ultimately presented for decision to the Supreme Court.

If a taxpayer chooses to pay any additional income tax claimed by Government, whether before or after receipt of a notice of deficiency, he or she has the right to file a claim for refund of the tax within a limited period prescribed by statute. If that claim is denied by the Government, or not acted upon within six months, a suit to recover the amount may be brought in the United States District Court for the judicial district within which the taxpayer is located, or in the United States Court of Claims.

In the District Court, either the taxpayer or the Government can demand a jury trial and, as in Tax Court proceeding, there is a right of appeal to the appropriate United States Court of Appeals, with the further possibility of review by the Supreme Court. The Government is represented by the Department of Justice, although IRS lawyers will be involved in recommending the position to be taken in the case and in determining the acceptability of settlement offers. The lawyer handling the case for Justice may be one of the attorneys in the Tax Division in Washington, D.C., who travels to the trial site as necessary, or, in some larger areas, a local Assistant U.S. Attorney.

The Court of Claims employs a bifurcated procedure. The evidence is received and the initial decision rendered by a special trial judge, without a jury. The court is located in Washington, but evidence will be taken by the trial judge at such place or places as may be most convenient. The trial judge's decision will be reviewed by judges of the Court upon application, in an appellate type proceeding. Unlike the Tax Court or district court, no right of appeal exists from a final decision of the Court of Claims to the United States Courts of Appeals. The only appellate review is to the Supreme Court, where the case will be heard only if the Court, in its discretion, decides to hear it. Because so few tax cases are heard by the Supreme Court, the likelihood of any appellate review of a final decision of the Court of Claims is remote. The Government is represented by a lawyer from the Tax Division of the Department of Justice in Washington, with little participation and assistance of IRS lawyers as in district court cases.

As you can see from this summary, trial jurisdiction in federal income tax cases offers a wide range of alternatives. Counsel for a taxpayer must consider carefully the choices and make appropriate recommendations to the client on how to proceed. This is a classic example of forum shopping, where the choice of forum itself may influence or even control the disposition of the case.

To illustrate -- if the dispute centers about a factual matter which may be more sympathetically received by a lay jury rather than a trained jurist, it may be advantageous to pay the disputed sum and seek recovery in a federal district court -- the only forum available with the right to a jury trial. Of course, if the taxpayer cannot pay the amount involved without current adverse financial consequences, the choice may be limited to the Tax Court, even though a jury trial might be deemed preferable.

If the issue is legal, not factual in nature, and the arguments best comprehended by a judge who specializes in tax matters, going to the Tax Court may be the best way to proceed.

Another example -- if the Court of Claims has decided the legal issue in the taxpayer's favor, and the

decisions in other courts are adverse or nonexistent, the Court of Claims becomes the forum to litigate in.

This complex jurisdictional scheme breeds conflicts among the trial courts and leads to uncertainty in the predicting of the legal result in many tax issues, since it is highly unlikely that the government will be able to effect an appeal seeking to overrule the court's position. The anomalies of the system are evident. A jury trial can be secured only by prepaying the tax. Tax Court and district court cases are subject to review and are bound by decisions of the Court of Appeals. However, since the Tax Court is a national court, it need not follow the decision of one court of appeals in deciding a case in which appellate jurisdiction lies in another court of appeals which has not ruled on the issue. The Court of Claims, although it may be influenced by decisions of other courts, is bound only by precedents of the Supreme Court.

If you litigate your case in the Tax Court, an IRS lawyer in or near the taxpayer's geographical location will handle the case, whereas if you litigate in the district court or in the Court of Claims, the case will likely be handled by a Department of Justice lawyer in Washington.

In attempting to treat taxpayers similarly throughout the country, close coordination is not only required within the technical and litigating functions of the Service but between the Service and the Justice Department.

If you are in the Tax Court your case will be heard and decided by a judge whose background and judicial functions are tax-oriented -- a specialist. In the district court and the Court of Claims, the judges have wider and more generalized jurisdiction.

Should the system be reformed? Most observers would say we could probably devise a more rational, plainer, and less confusing system without much difficulty. Will reform of trial jurisdiction likely occur in the near future? Probably not. There have been long standing impediments to dealing forthrightly and in a meaningful way with the problems.

There are institutional barriers. IRS and Treasury officials tend to believe that trial responsibility can be most effectively discharged by IRS lawyers. The Service is highly decentralized, so it is argued that taxpayer convenience and expense can be best served by IRS lawyers who are on or close to the scene. Also, their day-to-day involvement and close working association with IRS agents and administrators should expedite and make more efficient the handling and disposition of the cases.

On the other hand, it is suggested that representation by Department of Justice lawyers creates more institutional independence and objectivity than can be expected of agency lawyers. One of the rebuttals to that notes that the Chief Counsel of the IRS, and the lawyers within the office, are not organizationally subject to the control of the Commissioner of Internal Revenue. The Chief Counsel is responsible to the Secretary of the Treasury through the General Counsel of the Treasury Department, and is able, therefore, to promote and exercise independent legal judgment.

Another issue which must be faced to eliminate the triple forum trial system is whether it is better to have specialist or generalist trial judges. Much has been written and voiced on that subject, with division and sincerity abundant.

There are those who argue that the present system takes account of the various situations and concerns of taxpayers and is responsive to their needs -- a primary and overriding factor. Many tax lawyers also favor the existing structure, since more than a single trial forum maximizes their opportunity to succeed.

I am hopeful that an objective and searching inquiry into this subject could produce a consensus either in support of the present system, or for change. It is a subject worthy of professional concern, since its impact on taxpayers and tax administration is substantial.

Although the IRS initiates the tax audit and the resulting claim for additional taxes, the IRS does not make the initial determination to litigate a tax case. That decision is made by the taxpayer who decides whether to agree with the Government's assessment, or to litigate the controversy in the courts, and, if so, in which trial court.

Each year there are thousands upon thousands of tax controversies. Last year, for example, the IRS examined approximately 2.3 million returns, resulting in approximately \$6.3 billion in recommended additional tax and penalties. Out of those examinations, about 62,000 proposed deficiencies were unagreed to by taxpayers, thus setting the stage for efforts at administrative and judicial resolution of the issues.

Our tax system is designed to dispose of the vast majority of these cases through administrative appeals within the Service. Over the last 10 years, we have been able to close about 97 percent of all disputed tax matters without a trial. Obviously, if most of these controversies were not handled in that manner, an intolerable burden would be placed upon the courts.

Most litigated tax cases involve disputes over the facts, rather than disputes over the law. For example, an agent may have disallowed deductions claimed as ordinary and necessary business expenses under section 162 because of a lack of substantiation as to the amount of the deduction, or the business purpose for the deduction. In such cases there may be no uncertainty as to the legal standard to be applied -- only whether the facts can be demonstrated to support the deduction.

In general, cases which present issues of a significant legal nature should be distinguished from those which are essentially factual in nature. It is the former category which requires special consideration and review by the Service in determining our litigation position. A number of factors are taken into consideration in deciding whether settlement on a reasonable and equitable basis is possible, or whether the case will likely have to be tried.

Settlement is based upon a review of the facts and the law taking into account the hazards of litigation. The exercise is necessarily judgmental and requires analysis, based upon training and experience, of the probability of success in the courts.

There are certain issues which are more difficult to compromise than others. A challenge to the constitutionality of an Internal Revenue Code provision will likely pose substantial impediments to settlement, since we will ordinarily presume the constitutionality of congressional enactments and defend the case. If one is claiming that a regulation issued by the Treasury is invalid, settlement probably again is not on the high side -- although the service is not always right, the validity of regulatory provisions is carefully analyzed during the promulgation process. Settlement of a case contrary to a published Revenue Ruling is also generally somewhat more difficult, although the hazards of litigation will be taken into account.

The decision to litigate a particular issue is therefore often determined by the existence of a published Service position on that issue. In establishing litigating positions, our office makes every effort to insure that the positions taken conform with National Office policy as expressed in the regulations, published rulings, and positions taken in decided cases on similar issues. Our field lawyers have procedures available to make access to technical guidance from the National Office a reality. Hundreds of requests for such guidance are handled each year.

If a published legal position of the Service is held invalid by a trial court, the matter will be carefully reviewed. An appeal will be taken if we believe that the reasoning of the court is in error. If the issue is lost on appeal, an evaluation of whether to continue to litigate the Service's position in other cases must be made. We may litigate an issue in more than one appellate court where we believe the issue was wrongly decided although most often two appellate losses will result in conforming our position to the judicial verdict. Taxpayers also are free to, and will with more frequency than the Government, continue to litigate issues lost in one or more appellate courts.

Another type of case where the Service may be more prone to litigate than settle is a case which would be an important test case on an issue of significant administrative or legal importance. There are always many unresolved questions of interpretation of the Internal Revenue Code. Often a case will arise which we perceive to be an important "test" case of an issue having significance beyond the tax liabilities involved in that particular case. For example, the Supreme Court recently rendered an important decision in the *Thor Power Tool Company case*. The main issue involved an accounting practice whereby the taxpayer, a tool manufacturer, in accordance with generally accepted accounting principles, "wrote down" its excess spare parts inventory to their scrap value, but continued to hold the goods for sale at their original prices. The Service took the position that the write down did not clearly reflect income, notwithstanding conformity with good financial accounting, and the Supreme Court upheld the Service's position.

What is important in a case like *Thor* is the opportunity to resolve an issue with important ramifications in the development of the tax law. Here it was the relationship between financial inventory and tax inventory -- should GAAP prevail. An important fundamental issue was addressed in the words of Mr. Justice Blackmun:

... the presumption (taxpayer) postulates is unsupportable in light of the vastly different objections that financial and tax accounting have. The primary goal of financial accounting is to provide useful information to management, shareholders, creditors, and others properly interested; the major responsibility of the accountant is to protect these parties from being misled. The primary goal of the income tax system, in contrast, is the equitable collection of revenue; the major responsibility of the Internal Revenue Service is to protect the public fisc. Consistently with its goals and responsibilities, financial accounting has as its foundation the principle of conservatism, with its corollary that 'possible errors in measurement [should] be in the direction of understatement rather than overstatement of net income and net assets.' In view of the Treasury's markedly different goals and responsibilities, understatement of income is not destined to be the guiding light. Given this diversity, even contrariety of objectives, any presumptive equivalency between tax and financial accounting would be unacceptable.

This is a landmark case on the issue of tax versus financial accounting, and one of importance which the Service believed warranted testing.

We are more likely to litigate and less likely to settle an issue involving significant questions of law on which there is doubt as to the correct substantive position; cases which would appear to be of substantial precedential value on issues which would affect a substantial number of tax-payers; and cases involving important jurisdictional, procedural, or evidentiary questions.

Along these lines, in the mid 1960's we instituted a litigation procedure known as the prime issues program. This program established a list of issues -- "prime issues" -- which the Service believed needed resolution by the courts and, therefore, would not generally seek to settle. These were important but unanswered questions of importance to tax administration. In cases involving these issues, field offices were instructed to develop the facts fully in preparation for a trial, and we attempted to make our most complete presentation of our legal position on brief in the first case to be tried.

The prime issues program was designed to help develop judicial guidance on important tax questions. From the beginning, however, the program had difficulties. We found, for example, that the prime issues program did not significantly contribute to Supreme Court and Courts of Appeals review of those issues. We also found that issuance of regulations, or rulings, were often a more effective and speedy means of resolving problem issues and furnishing guidance to the public. The prime issues program has essentially been dormant for several years, and we are now in the process of considering its termination.

The IRS is, as I have mentioned, settlement oriented, and our administrative and litigation procedures are designed to encourage and facilitate settlement. In recent years, however, it had been apparent that many of these procedures were not working as well as they might and we recently made significant changes in our settlement procedures.

In the past few years, the case load in the Tax Court has increased dramatically. At the end of fiscal 1973, there were approximately 13,500 cases pending in the Tax Court. At the end of fiscal 1978, this inventory was over 23,000 cases. In 1973, 9,624 petitions were filed; in 1978, 13,284. At the same time, there was statistical evidence indicating that an increasing number of taxpayers were bypassing the administrative appeals system within the IRS and going directly to the Tax Court -- needlessly, in many cases, invoking judicial procedures without adequately testing the possibility for administrative settlement.

Last year we instituted two changes in the handling of disputed cases. These changes are the movement to a single level of administrative appeal, and the clarification of settlement authority in cases docketed in the Tax Court.

The old system of administrative appeal dated back to the early 1950's. Under that system, first, the taxpayer could appeal his case to District Conference. The District Conferee could resolve factual disputes, but did not have settlement authority based on hazards of litigation, except in cases involving \$2,500 or less.

Second, the taxpayer could go from District Conference, if the case was not settled at that level, to the Appellate Division. The Appellate Conferee had full authority to take hazards of litigation into account in all cases. A Third available alternative was to take the case directly to the Appellate Division, without consideration by District Conference. A fourth possibility was to go to District Conference and, if the case remained unsettled, file a petition in the Tax Court without further protesting the case to the Appellate Division.

Yet a fifth alternative existed -- a taxpayer could by-pass both District and Appellate Conferences and take the case directly to the Tax Court.

Settlement of a case pending in the Tax Court required the approval of both an Appellate Conferee and the Regional Counsel's Office except that, after the calendar call in the Tax Court, Regional Counsel had sole settlement authority. This dual settlement authority applies to all cases -- those which Appellate had considered in nondocketed status as well as those which had been brought to the Tax Court without Appellate consideration.

Whether Appellate would have sole jurisdiction to consider settlement in a case depended on which option was selected by the taxpayer. If the taxpayer protested the case to Appellate in nondocketed status, Appellate had sole settlement authority. If the taxpayer by-passed Appellate and filed a petition in the Tax Court, settlement of the case was a dual responsibility of Appellate and Counsel.

There were other anomalies in the system. For cases involving less than \$2,500, the taxpayer could have his case considered at two separate levels of administrative appeal, each with full settlement authority taking into account litigating hazards, whereas for larger cases there was only one forum with full authority to settle -- the Appellate Division.

These procedures were duplicative, time consuming, and expensive.

After careful consideration, we recently took two steps which we hope will simplify, expedite, and make more rational the system for disposing of disputes between the IRS and taxpayers.

First, under the new single level of appeal system, which went into effect last October, a Regional Director of Appeals is in charge of all appeals within each of the seven IRS regions. This new appeals

organization will have jurisdiction over all appeals, including those arising from collection matters and those involving employee plans and exempt organization cases. The District Conference procedure is eliminated.

Taxpayers will continue to enjoy all rights and opportunities previously afforded under the two-tiered appeals system, except of course for the elimination of the District Conference. In any case in which a taxpayer was previously afforded a District Conference, the taxpayer may now have a conference with an Appeals Officer who can exercise full settlement authority. Appeals conferences are offered to taxpayers at the same locations where District Conferences were previously offered.

One of the advantages we hope to realize through the single level of appeal is greater uniformity. We believe that having all appeals under a central managerial system and a uniform reporting system will promote uniformity in appellate-type decisions. This system will also emphasize the separateness and independence of the administrative appeals function of the IRS from its examination and collection functions, which is an appropriate and necessary aspect of an effective administrative appeals mechanism.

We believe the single level of appeals system will provide significant benefits both to taxpayers and to the IRS. For both the IRS and for tax-payers, the system saves time, effort, and money previously required to participate in two conferences. The merged system will provide all tax-payers the opportunity to obtain full settlement of their disputes at the first conference. For the IRS, the merged system will eliminate duplicate utilization of limited resources; resources that can be used more effectively in the administration of the tax laws.

Revenue Procedure 78-9 is the second part of our efforts to improve the procedures for resolving tax disputes. While the new single level of appeal is designed to limit taxpayers to a single administrative appeal, Revenue Procedure 78-9 is designed to help assure that disputes are considered solely by the Appeals Division at some point. As I have noted, formerly a taxpayer could preclude Appellate from having an opportunity to settle a case on its own by docketing the case in the Tax Court prior to an Appellate hearing.

Revenue Procedure 78-9 is also designed to eliminate duplicative Appellate consideration of the same case -- once before docketing and once after docketing with the participation of Regional Counsel.

As I stated, the case load in the Tax Court has increased dramatically in recent years. This, in part, is attributable to taxpayers increasingly by-passing the administrative appeals system. Last year over 80 percent of the cases filed in the Tax Court had not been submitted to the Appellate Division before bringing the case to court. Forty-four percent had been neither to District Conference nor to the Appellate Division. This meant that less than 20 percent of the cases filed in the Tax Court had been subject to a settlement process where the Government's representative had authority to settle the case taking into account litigating hazards. The Tax Court had, to some extent, become a *de facto* extension of the administrative appeals process. This result is contrary to basic concepts of orderly administrative practice -- that judicial proceedings ordinarily should be invoked only after administrative settlement processes have been exhausted. An effective and efficient administrative appeals mechanism is central to the orderly handling of disputed matters.

Appellate has consistently resolved about 75 percent of the cases it handles in non-docketed status.

It appeared sensible and reasonable to afford the Appellate Division the sole opportunity to settle every case at some point in the process under its relatively informal settlement procedures. This step would put primary settlement authority where it properly belongs and, at the same time, allow Counsel lawyers more time to devote to cases that are more likely to be tried.

Furthermore, under the old procedure, if a case had been subject to Appellate Division consideration before docketing, continuing jurisdiction of Appellate jointly with Counsel once the case was docketed

interfered with the timely preparation of cases for trial. Taxpayers frequently operated on the principle that they had little or nothing to lose by docketing a case. It was likely that the best settlement proposal worked out in nondocketed status would always be available, since the same appeals officer would continue to be involved in the settlement process after the case was filed in court. This meant that some cases were filed in the Tax Court primarily for the purpose of utilizing that forum as a mechanism to test the possibility of a better settlement.

Moreover, because of Appellate's continuing role after docketing, the emphasis continued to be on settlement. Emphasis should be on further development of the case under the normal judicial procedures designed to elicit information from both parties to aid in the preparation for trial.

Our experience was that in too many cases Counsel got into trial preparation too late. This encouraged late settlements and hampered the proper development of the case for trial.

Revenue Procedure 78-9 is designed to deal with these concerns. Its objectives are to utilize the administrative appellate process effectively and to provide for earlier and more thorough development of cases from a litigating standpoint. We hope the result will be both earlier settlements and better presentation to the court of those cases that go to trial.

Under Revenue Procedure 78-9, if a case had been to Appeals before the notice of deficiency was issued, Counsel will have exclusive jurisdiction of the case from the time it is filed in court. If the case had not been to Appeals, Counsel will refer the case to Appeals, which will have sole settlement authority over the case for a stated period, subject to extensions with Counsel's concurrence.

This means that, unlike the former procedure, Appeals will have sole settlement authority over every case at some time. Since the Appeals organization is viewed as the primary settlement mechanism for all cases, there will be no difference in settlement authority achieved by docketing a case. Taxpayers and their representatives are therefore encouraged to bring their case to Appeals first and not to invoke unnecessarily the processes of the Tax Court. Appeal's record of settlement is enviable and I think the overwhelming majority of cases can be disposed of fairly and justly without the necessity of bringing the case to the Tax Court.

When Counsel acquires sole jurisdiction over the case under Revenue Procedure 78-9, the initial emphasis will be on trial preparation -- not settlement. While settlement of the case is always possible, and is desirable, our lawyers will take a fresh look at the case, and by utilizing the court's informal discovery process, develop and exchange relevant facts and evidence. This process will enable Chief Counsel lawyers to be in a better position to consider independently, and against a different background, the advisability of settlement. Only when this process is complete can we then determine whether the case is susceptible to settlement. We will not be bound by any prior settlement proposals that Appeals may have considered and will approach the range of settlement in a given case *de novo*.

Our procedures provide for Counsel to have available the views of Appeals prior to concluding any settlement of a case, which we believe will enhance and strengthen the process.

The new procedures have great potential for stemming the ever increasing tide of cases being brought to the Tax Court. They also have potential for the earlier settlement of cases that are filed with the court, and for the better presentation and development of cases that are tried.

These changes greatly expand the role of the Appeals Division. It becomes the primary organization to resolve disputed cases by settlement. It will have sole settlement authority over all disputed cases at some point. It will handle all disputes -- collection, and Employee Plans and Exempt Organizations as well as all tax disputes. We hope the result will be the fair, uniform and expeditious disposition of most disputes. Generally speaking, Appeals should settle cases -- Counsel should be viewing cases from their litigation posture.

Since the initial portion of my remarks dealt primarily with trial jurisdiction in tax cases, I would like to close by discussing current developments affecting appellate jurisdiction. As I have mentioned, there are 11 Courts of Appeals and the Court of Claims which can render conflicting decisions resolvable only by the Supreme Court or Congress.

Final resolution of issues affecting taxpayers and the efficacious planning of business transactions may be delayed for years while courts struggle with difficult issues. Not infrequently final resolution can come only if the Supreme Court hears and decides a case involving an issue which has created a conflict in the decisions of the Courts of Appeals. A conflict in the circuit courts which have considered the issue is the most certain basis upon which the Supreme Court will accept cases for consideration.

Often, legislation in important areas will only be forthcoming when a final judicial opinion has been established. For example, in the area of corporate taxation, the *Chamberlin* case (1) gave rise to section 306 to prevent preferred stock bailouts of corporate earnings. The decisions in the *Court Holding* (2) and *Cumberland Public Service* (3) cases led to enactment of section 337, to permit tax free sales of corporate property in liquidation, rather than have the incidence of taxation depend upon whether the sale was implemented by the corporation or its shareholders.

Yet, the conflicts in decisions can proceed for years until Congress or the Supreme Court acts to resolve the matter definitively. This causes uncertainty for both taxpayers and tax administrators alike.

Over the years there have been a variety of proposals to cure the problem by restructuring or modifying the present appellate system for handling tax appeals. The objective has generally been the same -- to provide for earlier resolution of disputed issues and thereby enhance uniformity -- although the suggested means to the desired end have varied.

The subject is again of current vitality. It has been the subject of recent discussion within the administration, and Senator Kennedy, Chairman of the Senate Judiciary Committee, has put forward a specific legislative proposal.

Senator Kennedy's proposal would provide for a single court of appeals to hear tax cases brought from the Tax Court or from federal district courts. Under this bill, the Court of Claims would no longer have jurisdiction over tax refund suits. The Court would be composed of judges, selected on a rotating basis for stated periods of service, from among the judges of various United States Courts of Appeals.

By creating a single court of tax appeals, the uncertainty generated by litigation ensuing after an initial appellate court has heard and decided an issue would be ended. The potential for conflicting decisions among the courts of appeals, with resulting nonuniformity in treatment among similarly situated taxpayers, would also be terminated.

That uncertainty has had adverse effects for taxpayers and for tax administration. Conflicting decisions lead to uncertainty in undertaking business transactions which have significant tax implications. This can inhibit economic activity and also cause concern over the equity and efficiency of a tax system whose consequences are not predictable. On the other hand, lack of finality in appellate decisions encourages noncompliance and intensifies incentives for arcane tax planning schemes and devices.

A concern expressed, however, is that good jurisprudence is an evolutionary process, where consideration and reconsideration of complex issues yields, in the end, a more mature and reasoned result. Concern is also expressed that resort to only one appellate proceeding on an issue can result in an erroneous decision without prompt, effective recourse. The sparse opportunities for Supreme Court review leaves legislative correction by the Congress as the only effective remedy in most cases -- an uncertain and frequently time consuming alternative. Single appellate review in tax cases is also said to put a premium on the quality of the representation in the first proceeding. Perhaps a case will be lost which might have been decided differently if better presented and analyzed. Under the existing system the opportunity for correction exists, since another appellate court may not concur with the earlier

finding, either because it brings new or more sophisticated analysis to bear, or has the advantage of a better presentation and discussion of the relevant legal authorities and reasoning.

There is much to appeal to a lawyer's desire for the best legal result to lead one to favor the reflective qualities of the present system. Yet, on balance, I believe the practical benefits to tax administration of a single court of tax appeals outweighs those concerns, assuming such a court is properly structured.

To merit the confidence of taxpayers, affected Government agencies, and the bar, the court must be composed of judges of competence and stature. Moreover, the court must be able, through its procedures and structure, to build a permanent body of decisional law which will serve as precedents among the panels of its judges who will hear cases, and which will guide the lower courts in the discharge of their judicial functions.

This can be accomplished by having the court composed of judges appointed for life, as is the case in most federal judgeships. The recent increase in the number of federal judges authorized by Congress, however, may make any approach which involves the creation of additional judgeships politically uncertain.

Since the workload of a court of tax appeals will be drawn from the existing courts of appeals, it can be argued with reason that, along with the cases, should come a corresponding number of judges. Since many present appellate judges may not wish to serve permanently on a court where jurisdiction is limited to tax cases, it may be necessary to rotate judges for set terms. I think a court composed of a permanent chief judge, with some permanent and some rotating circuit judges, sitting for set periods during which they devote their full time to the work of the court, would be viable and productive. It may present the mix of generalists and specialists that could assure quality and confidence in its decisions.

Change is always difficult and there are many who are concerned with upsetting a traditional system which has functioned for many years. Where change has the promise of substantial improvement, the risk is worth taking, and I believe Senator Kennedy's proposal deserves careful and thoughtful consideration. Clearly the Kennedy proposal has much to commend it, and we will be following its progress closely in the next few months. Hearings on this proposal will be held by the Senate Judiciary Committee in early May.

I believe it is widely recognized by tax practitioners, the Courts, the Government, and other interested parties that some changes are needed in the structure of our tax litigation system. The primary issue to be decided today is what changes would be most appropriate to correct problems. In the meantime, government, taxpayers, and taxpayers' representatives must work effectively within the present system. I believe we all have a responsibility to try to reduce unnecessary litigation by pursuing settlement negotiations fully and expeditiously. I am also hopeful that tax practitioners and other interested parties will support appropriate efforts to eliminate many of the abuses and problems with the present system.

Tax litigation occupies an important role as the ultimate resolver of differences of opinion between the Government and individual citizens. Tax litigation serves, perhaps, an even greater role, however, in furthering the development of the tax law. We need to be concerned about the structure of the system and its potential improvement.

(1) *Chamberlin v. Commissioner*, 207 F.2d 462 (6th Cir. 1953), *cert. denied* 347 U.S. 918 (1954).

(2) *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945).

(3) *United States v. Cumberland Public Service Co.*, 338 U.S. 451 (1950).

## QUESTIONS AND ANSWERS

**Question:**

My question relates to generally accepted accounting principles, and I was wondering, you mentioned a case, the Thor case, and I believe you said that it went to the Supreme Court. I was wondering if you could explain where along the line of these levels, the generally accepted accounting principles would be reviewed, and why. You said that that was a landmark case and there were some others coming up.

**Answer:**

In the inventory area, there is a rule in the code which, in effect, defers to the best accounting practice in the industry. However, in this particular case, the regulations took a position different than the accepted financial accounting practice in writing down inventory. There are many other areas where good financial accounting practice conflicts with tax accounting. For example, there was an issue which went to the Supreme Court dealing with whether a taxpayer who receives advance payments of income must include that amount in income for tax purposes when received, or whether it could be accrued over the years in which earned. Good accounting practice would match the income with the period in which it was earned. Under tax accounting principles, in the other hand, you have economic control over the disposition of the funds, and are in a position to pay the tax presently. Those are the kinds of issues which have generated continuing conflict and discussions between accountants, Government officials, academicians and others concerned about the inter-relationship between tax accounting and generally accepted accounting principles. Should generally accepted accounting principles, take precedence because they do tend to match income with expenses in a more consistent manner than tax rules would? The Thor case clearly faced the issue squarely. It was clear that in the ordinary case, good tax accounting for inventories would follow the best accepted practice in the industry. And yet, here was a situation where the Treasury regulations differed from that practice. The Supreme Court decided the issue in favor of the government in language that I quoted to you from Mr. Justice Blackmun which, in effect, recognized very clearly, and I think for the first time, in a succinct and orderly way, the different purposes of Financial accounting and tax accounting. Now, that does not mean to say that there are not situations where the two should be consistent and complement one another. What it does say is the fact that good accounting practice dictates one result, does not, in fact, mean that the tax treatment will follow the generally accepted accounting practice. You must look deeper into the issue. As the quote explained, financial accounting rules tend to be conservative because they are designed not to mislead affected parties, whereas tax rules are looking to economic realities. The importance of the case no longer is that the write-down of excess spare parts below original prices may not be done, but rather that there is now precedent in the Supreme Court, which will be applicable to other disputes in the future, where generally accepted accounting principles and tax principles conflict. That's the kind of case where settlement of the case, itself, is not terribly important. What is useful is getting an important issue with broad ramifications resolved for the guidance of the government and taxpayers in the future.

**Question:**

Mr. Seigel, I'm sorry that you determined to reiterate Mr. Justice Blackmun's observation with respect to financial accounting, where he referred to the fact that we are committed to, quote "Conservatism," close quote. I'm afraid that he just hasn't had any good financial statements recently. At the outset, I respectfully submit that we, like the tax collector, are supposed to be committed, at least conceptually, to economic reality, and that there is this dichotomy, looking to exact whatever tax is appropriate. It turns out to be somewhat nonsensical if you look at the United States Steel Corporation report for 1978, for example, which just comes to mind. If you look at it, the accountants with conservatism, calculated a pre-tax income, of exactly \$250.0 million, with conservatism, mind you. And then they calculated the amount of tax owing to his tax collector with liberality, mind you of \$8 million. And without a calculator I can figure that very easily at 3.2%. In short, I recognize the need for differences, serious differences, between tax accounting and generally accepted accounting principles. But I believe to label one as conservative and the other as being somewhat different, I'm afraid it's an over simplification of the situation and is inclined to be misleading to those who read those cases.

**Answer:**

Your view of the label which Mr. Justice Blackmun uses may be well taken. It may be an

oversimplification. I think that it's a matter of personal opinion based upon personal knowledge, and I recognize that yours is widely respected. On the other hand, I'm not sure that your example of reporting a large financial income and a small tax income is attributable necessarily, to differences in tax accounting and generally accepted accounting principles. More likely than not, the lower taxable income is attributable to specific provisions of the Internal Revenue Code which provide incentives for investments that result in diminishing the incidence of Taxation.

**Question:**

True, right off hand, but I'm merely trying to distinguish conservatism from liberality. Depreciation is different, straight-line versus accelerated. The point I'm making is that with conservatism, you say, we straight-line on the financial statements and then rip-off tax collectors with accelerated depreciation. Second, you look at the US Steel report and they defer, for accounting purposes, give it at cost, but write it off for the tax collector. Again, I understand the Justice's decision in thought, but somehow or other it creates this kind of a generalization of a dichotomy that produces misleading results.

**Answer:**

Well, the decision is there, and it obviously will have broad impact in the future. However, as you know, there is an evolutionary process in court cases. Perhaps, at some future time, that particular issue may be reconsidered, and perhaps somewhat different results may result. But I think for the short turn it has made clear, perhaps in an over-simplified way, perhaps not, that tax accounting need not tract the best financial accounting principles.

**Question:**

Mr. Seigel, this is an historic moment for me because I have never spoken at one of these lectures. But I think that you can very simply reconcile the accounting and the tax accounting in the *Thor* case. In the *Thor* case, although they wrote the inventory down, they kept the selling price. And normally, when you write an inventory down to scrap value, you write it down and then sell it at that price, plus a reasonable addition for the normal profit and administrative expenses. And I doubt that the Treasury or the Government would have prosecuted that case any further if the Thor Company had adopted that procedure in respect to the selling price at which these things were held. So I don't perceive that there is a difference here between Financial accounting and tax accounting.

**Answer:**

I think the issue was presented and, commented upon as a basis for the decision by the Court. So the language of Mr. Justice Blackmun, in a unanimous decision of the Supreme Court makes its precedential value significant. Having framed the issue that way, and having made the distinction as I have quoted, it will have an effect in the future in determining, when conflicts arise, as to which set of principles should take precedence.

**Question:**

President Carter, when he ran for office, described the tax laws as a national disgrace, and I can't help but feel that part of the litigation problems that you talked about this evening stem from this, so-called, national disgrace. What is your view as to the prospect of tax simplification in the future?

**Answer:**

Tax simplification requires some definition. Simplification means different things to different people. For example, some people talk about tax simplification in terms of a simple tax form to fill out. If the form became substantially easier for individuals to cope with, they would be satisfied that we had made a significant advance in tax simplification. Others speak with reference to the technical provisions of the Internal Revenue Code and Regulations. Their view is, can't we simplify the language somehow, can't we make these complex provisions, which require intellect and enduring patience to understand, somehow easier to digest. I think, on the first point, simplification of the form, there has been improvement in the last couple of years. There was redesign of the Form 1040-A, and we find that its use has increased substantially, both last year and during this year's filing season. With some additional

work, it can become even less complex. When you talk about simplification of the technical provisions of the Code, however, I think we face a much more difficult problem. The Internal Revenue Code is complex because society is complex, business is complex. People want their particular situations reflected when the laws do not seem to operate fairly. I can give you one illustration from personal experience. In 1966, I was in the Treasury Department, and I was working on a proposal that you may remember, to suspend the Investment Tax Credit. We drafted a proposal that was on four pages, double spaced. A complete legislative proposal to implement suspension of the Investment Tax Credit, and it had in it all the essential rules. It had a binding contract exception, and additional basic rules that could be the basis for more detailed interpretation by regulation and rulings. As the bill passed through the legislative process industry after industry, not necessarily without justification, demanded more specific rules to be sure that harsh rules would not operate against them. The provisions dealing with the suspension of the Investment Tax Credit as enacted covered pages upon pages of fine print. There's a completed contract rule, there's a building and equipment rule others. They merely reflect that society and business is sophisticated and tax laws cannot be simple if they are to operate in a way that will satisfy the concerns of those affected by the tax system. And everybody is for tax simplification, and tax reform, unless in the process you take away some tax benefit they now enjoy. I think there's much that can be done in terms of trying to weed out of the Code, certain provisions which are no longer of general use. If time ever permitted, it could probably be rewritten in some respects in more understandable prose, but I don't have much hope, myself, for significant advances in simplification in terms of the need for a layering of complex rules, for the reasons that I stated.

**Question:**

Mr. Seigel, you seem to endorse the proposal by Senator Kennedy, to make one Appellate Court, in lieu of the eleven Circuit Courts which we now can go to from the Tax Court and District Court. By using one Appellate Court, would you not eliminate, really, completely from the picture, the Supreme Court of the United States. And is that a desirable thing to eliminate them from the tax litigation picture?

**Answer:**

The Supreme Court would not in fact, be eliminated from reviewing decisions of this Appellate Court. What would likely happen is some reduction in the number of cases in the tax area that the Supreme Court hears, because there would no longer be conflicts among Circuit Court decisions for taking cases to the Supreme Court and it would be limited to issues of administrative importance or impact upon a broad number of taxpayers. Now you can read that two ways. Sometimes the conflict cases are really not all that important, and because the Court tends to favor resolving conflicts, to attain order in the judicial system, they may bypass more important cases where there is no conflict. There are many situations where we would like to take a case to the Supreme Court because it is important, and yet we know that the probability of the Court taking the case in the absence of a conflict is so remote that is not really worth the trouble. One case which is illustrative up to that point was the recent decision of the Seventh Circuit Court of Appeals in the Lester Crown case. That's a case which involved family loans of \$18 million, interest-free. In other words a father would loan substantial sums of money to his son, and not charge interest. The Government took the position that there was a gift, and therefore a gift tax due, on the interest factor involved in the loan -- the interest that would otherwise have been paid in an arm's-length transaction. We lost the case in the Seventh Circuit, 2 to 1. We were able to get a rehearing in the Seventh Circuit by the entire court, and again we lost by one vote. This is an issue of tremendous importance to the tax system, much more important, I would say, than many issues that the Supreme Court has heard in recent years, because it is a glaring loophole, in my judgement, one that is now being widely used by tax practitioners. In light of the case, practitioners should advise their clients of the possibility of using this device as a form of making tax-free gifts. And yet, because it is known that there is a great difficulty in getting a case like that to the Supreme Court in the absence of a conflict, the ultimate decision made by the Solicitor General was not to take the case to the Supreme Court. So I think, perhaps, this system might well work to our benefit. By eliminating conflicts, the cases that the Court would take might tend to be the cases which are of greater importance to taxpayers and the Government, and are not just heard because of a judicial conflict. I share your concern because I think it is important that there always be recourse to the Supreme Court in appropriate tax cases. The

question is, will this system develop a better class of cases than the existing system? I think the question of a single appellate court is a question on which reasonable people can come out either way. My own judgement is, on balance, that it would be better to proceed with a proposal along those lines. It has great potential for doing away with much of the uncertainty in the tax laws. But I would only be in favor of it, as I indicated, if it were structured in a manner that I thought would permit the confidence of the tax bar and taxpayers, and also, only if there were recourse to the Supreme Court.

