CHIEF COUNSEL’S SUBTLE IMPACT ON REVENUE: REGULATIONS, LITIGATION, AND ADMINISTRATIVE GUIDANCE

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This essay examines the Chief Counsel’s role in the tax system and attempts to assess the ways in which it may affect revenue. The essay specifically discusses the revenue impacts of regulations and litigation led by the Office of Chief Counsel. Ultimately, the essay calls on Congress to systematically require analyses of revenue impacts of tax legislation and the administrative response to such legislation.

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I. BACKGROUND

This essay examines the Chief Counsel’s role in the tax system and attempts to assess the ways in which it may affect revenue, focusing on the revenue impacts of regulations and litigation led by the Office of Chief Counsel. Ultimately, the essay calls on Congress to systematically require analyses of the revenue impacts of tax legislation and the administrative response to such legislation. Questions of how much revenue the tax system should generate and from whom and the effects of tax reform on the economy are perennial hot topics. No less hotly debated, albeit in somewhat narrower circles, is the revenue impact of any given tax proposal.

Since passage of the Congressional Budget Act of 1974, the Joint Committee on Taxation (JCT) has been required to provide revenue estimates for all tax legislation considered by the House or Senate. In addition, any Member of Congress may request a revenue estimate for a tax proposal. JCT economists begin with a revenue baseline created by the Congressional Budget Office (CBO) — the 10-year projection of Federal receipts. The baseline assumes that present law remains unchanged during the 10-year window. The revenue estimate reflects changes to revenue relative to the baseline resulting from the legislative proposal.

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Present law, of course, includes not only the Internal Revenue Code (IRC) but also regulations and case law. The JCT economists use microsimulation tax models as well as individual panel-based models. The primary source of tax data for the models comes from tax return data collected by the Statistics of Income Division of the Internal Revenue Service (IRS). Taxpayers and their representatives use various forms of guidance in preparing tax returns. They look not only to the IRC, the U.S. Department of the Treasury (Treasury) Regulations, and case law, but also to administrative guidance like revenue rulings and procedures. Sophisticated tax preparers pay close attention to the administrative practice of the IRS in determining return positions; a recent example is provided by the volume of commentary on proposed changes to Circular 230, which sets standards for professional practice before the IRS, including standards for advising with respect to tax return positions (Gallagher, 2008; Blattmachr, Gans, and Madden, 2008; Raby and Raby, 2007). Thus, the revenue baseline inevitably reflects, to some extent, the effect of the administrative practices and published guidance of the IRS.

Legislative changes may also produce changes in regulatory guidance, case law, and administrative practice. The JCT takes into account potential compliance, administration, and enforcement issues that could affect the timing or amount of revenue collected (Joint Committee on Taxation, 2005). However, unanticipated changes in regulations, case law, and administrative practice that occur after the legislation is enacted can have significant revenue impacts that go unmeasured. As the law firm for the IRS, the Office of Chief Counsel likely plays a large role in determining the nature of this unmeasured revenue impact. The purpose of this essay is to examine the Chief Counsel’s role in the tax system and to attempt to assess the ways in which it may affect revenue.

The Office of Chief Counsel is a large law firm with only one client — the IRS — whose mission is to “[s]erve America’s taxpayers fairly and with integrity by providing correct and impartial interpretation of the internal revenue laws and the highest quality legal advice and representation for the Service.”1 As a law firm, it is comparable in size to the largest multinational law firms, with approximately 1,650 attorneys. About 60 percent of the attorneys work in field offices, representing the IRS in Tax Court litigation. Most of the other 40 percent are specialized subject matter tax experts working in the National Office in Washington, DC. In a recent interview, Chief Counsel Bill Wilkins identified the three main tasks of the Office of Chief Counsel: (1) “building the regulatory structure that is needed to make the system work”; (2) “dealing with conflict resolution in the tax system”; and (3) “working with I.R.S. leadership on policy initiatives” (Cummings and Swirski, 2010, pp. 6–7). Chief Counsel activities in any of these three tasks can have a significant revenue impact, which may or may not be measured by JCT estimates. This essay will review a sampling of regulations projects, court cases, and administrative guidance, focusing on their potential revenue impact.

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II. REGULATIONS

IRC § 7805 grants the Treasury broad authority to “prescribe all needful rules and regulations for the enforcement of” the IRC. Some tax regulations arise out of more specific authority within the governing section itself, like the consolidated return regulations under IRC § 1502. Much has been written about the appropriate level of judicial deference to agency regulations (Hickman, 2006; Lederman, 2012; Smith, 2011), and that debate will not be renewed in this essay. However, choices made by Treasury and Chief Counsel in drafting regulations and the procedures followed in promulgating the regulations may affect whether those regulations ultimately have the desired effect.

A cursory reading of IRC § 7805 would lead one to believe that the Assistant Secretary (Tax Policy) is responsible for developing and reviewing regulations and rulings. However, the Internal Revenue Manual (IRM) puts the focus clearly on Chief Counsel, stating, “[t]he Office of Associate Chief Counsel is solely responsible for issuing published guidance,” conceding, however, that Treasury attorneys “provide assistance in developing published guidance.”2 In practice, Chief Counsel attorneys work closely with attorneys from Treasury in writing regulations.

The consolidated returns regulations contain a cautionary example about judicial deference. The regulations denied a deduction for a “duplicated loss,” defined as loss with respect to subsidiary stock that is duplicated by the subsidiary’s operating losses or built-in losses with respect to its assets.3 The regulations used a complicated mechanism to determine duplicated loss. The loss disallowance regulations were designed to back up the repeal of the General Utilities doctrine, enacted by the Tax Reform Act of 1986, which required the recognition of corporate level gain on the distribution of an appreciated asset to a shareholder. Rite Aid Corporation challenged the loss disallowance regulations. The Federal Circuit Court of Appeals found that the regulation exceeded the authority granted by Congress and was invalid.4 The loss disallowance rule, if found valid, would seem likely to have raised revenue over a pre-loss disallowance baseline, as the pre-loss disallowance consolidated returns regulations facilitated avoidance of General Utilities repeal. However, regulations do not require revenue scoring, and the authorizing provision, IRC § 1502, was enacted decades before Congress mandated legislative revenue scoring. In the American Jobs Creation Act of 2004, Congress reaffirmed the Treasury’s authority to draft rules like the loss disallowance rules by adding a sentence to IRC § 1502 allowing promulgation of “rules that are different from the provisions of Chapter 1 that would apply if such corporations filed separate returns.”5 The JCT scored that provision as having negligible revenue effect

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4 See Rite Aid Corp. v. United States, 255 F.3d 1357 (Fed. Cir. 2001).
(Joint Committee on Taxation, 2004). The original loss disallowance regulations have been replaced by the unified loss rule, which is even more complicated. Perhaps the original scoring of General Utilities repeal took into account the potential compliance and enforcement issues faced by the IRS in conforming the consolidated returns regulations, although the actual level of resistance encountered would be difficult to predict.

The consolidated returns regulations are so-called “legislative” regulations in long-used tax parlance (Aprill, 1996). IRC § 1502 specifically calls for the consolidated returns regulations. Interpretive regulations, issued under the general authority of IRC § 7805, present a different form of revenue leakage. Rather than directly implementing Congress’s intent, interpretative regulations frequently ease statutory language to enhance administrability. The “small issuance exception” regulations under IRS § 382 loosened the loss transfer restrictions, probably at the cost of some revenue. Under IRC § 382, a loss corporation issuing stock generally must treat less-than-five-percent shareholders acquiring stock in the issuance as a separate public group from any public groups existing before the issuance. The less-than-five-percent shareholders who are part of this new public group are presumed not to be members of any existing public groups (“presumption of no cross-ownership”). As the preamble to the proposed regulations notes, the segregation rules impose significant administrative burdens on loss corporations. For example, corporations frequently issue small amounts of stock as incentive compensation or otherwise. Under the segregation rules, these issuances create new public groups, which must be tracked separately. The “small issuance exception” regulations probably did not cause much revenue leakage because, as noted in the preamble, “issuances of stock to less-than-five-percent shareholders result in a shift of ownership to persons who, because of the relative size of their ownership interest, generally have little incentive to undertake transactions to enhance the use of the loss corporation’s losses.” The revenue loss, if any, could be justified as balancing administrability and reasonable compliance.

The check-the-box (CTB) regulations relating to entity classification represent a high point in the history of taxpayer-favorable regulations (Field, 2009). The regulations replaced the Kintner regulations, which employed a corporate resemblance test. The CTB regulations were warmly greeted by tax practitioners, who embraced the flexibility of the new rules (Nott and Razook, 1997). Under the former Kintner regulations, a business entity would be treated as a corporation for tax purposes if the entity had a majority of the following characteristics: (1) centralized management, (2) continuity of life, (3) free transferability of interests, and (4) limited liability. The growing popularity of limited liability companies (LLCs) under state law and the lowering of individual tax rates by the Tax Reform Act of 1986 completely changed the landscape for entity classification. The preamble to the proposed CTB regulations explicitly recognized that entities could now choose their classification at will and that continuing to attempt to enforce the Kintner regulations would cost the IRS considerable resources. Despite

their apparent favorability toward taxpayers, the CTB regulations have not been immune to taxpayer challenge, but the regulations have so far survived. The ability to freely elect entity classification undoubtedly reduced tax bills for organizations. Whatever the revenue loss from the CTB regulations, it could not be avoided, as entity classification could not be the immovable object against the inexorable progress of lower individual tax rates and state law changes.

The ability to freely choose entity classification put additional pressure on partnership taxation, already a notoriously complex regime. The partnership anti-abuse regulations were promulgated in 1995, shortly before the CTB regulations.\(^8\) The partnership rules permit flexible tax allocations to allow the partnership agreement to reflect flexible economic sharing arrangements. However, flexible tax allocations also may be used to “minimize the collective tax liabilities of the partners, to the detriment of the Treasury and all other taxpayers” (Yin, 1997). Again, no data appear to quantify the revenue losses from partnership tax abuses or to show whether the promulgation of the anti-abuse regulations stemmed the revenue loss. The partnership anti-abuse regulations could be viewed as one of the tools in the IRS arsenal against tax shelters, a long-running battle perhaps forced to a truce by application and codification of the economic substance doctrine.

III. LITIGATION

Congress codified the economic substance doctrine in 2010, but the courts, taxpayers, and the IRS created the economic substance doctrine over many years. The economic substance doctrine and its close cousin, sham transaction theory, have been litigated since before the famous spin-off transaction examined in *Gregory v. Helvering.*\(^9\) In that case, the Supreme Court, affirming a Second Circuit decision in favor of the government authored by Judge Learned Hand, stated, “the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended.”\(^{10}\)

The transaction in *Gregory* was cloaked in the guise of a corporate reorganization, but the doctrine espoused by the case has been used to analyze many types of transactions. As taxpayers over the years tested the envelope with transactions such as sale-leasebacks,\(^{11}\) the circular flow of nonrecourse debt,\(^ {12}\) and basis shifting strategies,\(^ {13}\) the government’s success in arguing the objective test of economic substance and the subjective test of business purpose has been key to stemming revenue loss.

Whether an economic substance doctrine case arises in Tax Court, District Court, or the Court of Federal Claims, Chief Counsel is involved. Chief Counsel attorneys

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\(^8\) See Treas. Reg. § 1.701-2.

\(^9\) See *Gregory v. Helvering,* 293 U.S. 465 (1935), in which the taxpayer sought to avoid dividend tax treatment on a distribution of subsidiary stock from her wholly-owned corporation.

\(^{10}\) See *Gregory,* p. 469.


\(^{13}\) See, e.g., *ACM Partnership v. Commissioner,* 157 F.3d 231 (3d Cir. 1998).
litigate in Tax Court. Refund cases (all cases other than Tax Court cases) are argued by Department of Justice (DOJ) attorneys. The DOJ Tax Division employs more than 350 attorneys in fourteen civil, criminal, and appellate sections. Interestingly, the DOJ Tax Division website boasts of the revenue impact of its work, stating, “The monetary impact of the Tax Division’s affirmative litigation efforts is far-reaching in scope. During fiscal year 2010, Tax Division attorneys successfully defended lawsuits against the United States representing claims of over $714 million, and, through affirmative litigation, collected $566 million.”

Chief Counsel’s involvement in non-Tax Court cases stems from its role as the law firm for the IRS. The IRM contains detailed guidance on the Chief Counsel’s role in refund cases as well as appeals and certiorari requests. First, the IRM sets out general principles for handling legal work: “[T]he role of the Office of Chief Counsel is to ensure the correct and uniform application of the tax laws.” To ensure that cases litigated by DOJ uniformly apply the tax laws, a Chief Counsel attorney must send a defense letter to DOJ within a short period of time after a taxpayer files a refund suit. The defense letter classifies the case as either “Settlement Option Procedure” (S.O.P) or “Standard,” sets out the legal issues, and recommends defense, concession, or settlement. If the Chief Counsel attorney classifies the case as S.O.P., meaning a suit that presents only commonplace issues of fact, legal issues that do not substantially affect the collection of revenue, or the application of well-established legal principles, DOJ may settle the case without further input from Chief Counsel.

Appellate cases similarly receive Chief Counsel review and recommendations. The IRM notes “[t]he Office of Chief Counsel’s interest in litigation continues even after a trial court’s decision: to ensure a correct and administrable interpretation of the IRC and related statutes.” Specifically, the Chief Counsel attorney assigned to the case must prepare a recommendation for appeal and/or settlement, monitor the status of the case while on appeal, and prepare a recommendation for certiorari when appropriate. On occasion, DOJ and Chief Counsel may disagree on the appropriate disposition of the case. The IRM does not clearly identify who wins the coin toss in the event of a disagreement with DOJ, but it is clear that Chief Counsel’s views continue to play a large role in the decision.

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In 2003, a General Accounting Office (now the Government Accountability Office (GAO)) report found that abusive tax shelters represented “a potentially significant, although imprecisely understood, loss in tax revenues” (Brosteck, 2003). In 2006, former Assistant Treasury Secretary for Tax Policy, Pam Olson, reported that “[t]he tax shelter war is over[, t]he government won” (Fleischer, 2006). The government won the war, with Chief Counsel on the front lines in many cases arguing economic substance. However, as the GAO noted, it is difficult to determine how much revenue was involved.

Returning to codification of economic substance, JCT scored that provision as raising $4.5 billion over 10 years (Joint Committee on Taxation, 2010). At first, it is hard to understand how the codification of economic substance could raise any revenue. IRC § 7701(o) provides that a transaction will be treated as having economic substance only if (1) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer’s economic position; and (2) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction. The provision applies only to transactions “to which the economic substance doctrine is relevant.” The definition of “economic substance doctrine” and the determination of whether the economic substance doctrine is relevant are specifically unchanged from prior law. As noted above, the revenue baseline reflects current law, including case law. Thus, the only significant change from prior case law appears to be that the codification has settled the courts’ inconsistent application of the two aspects of the test: whether economic substance requires that the transaction have both economic substance and a business purpose, or whether economic substance or business purpose alone would suffice. It is hard to imagine that requiring the courts to apply a conjunctive test rather than a disjunctive test would raise $4.5 billion in revenue. Jackel (2010) wrote that further guidance would be key to administering the provision. In particular, Jackel seeks definition of the term “transaction” and argues for the publication of an “angel list” of transactions that would not be subject to the law. Would such guidance change the amount of revenue collected? The $4.5 billion estimate includes an enhancement to the substantial understatement penalty in IRC § 6662. The new law increases the penalty for non-disclosed transactions lacking in economic substance from 20 percent of the underpayment to 40 percent of the underpayment. Disclosure of the transaction will reduce the penalty to 20 percent. Moreover, the new penalty is a strict liability provision — there is no exception for reasonable cause and good faith. It seems likely that a good portion of the revenue increase stems from this revised penalty provision, although it is impossible to tell because the two provisions are combined in the revenue estimate.

IV. POLICY AND ADMINISTRATION

The Office of Chief Counsel produces significant amounts of guidance each year in a variety of forms, including revenue rulings, revenue procedures, notices, private letter rulings, technical advice memoranda, chief counsel advice memoranda, and other types
of guidance more or less ephemeral in nature. Revenue rulings describe how the IRS will apply the law to a specific set of facts. Taxpayers in similar factual circumstances may rely on revenue rulings, but generally courts view revenue rulings as simply statements of the IRS’s position and not as law (Galler, 1995). While theoretically taxpayers can ignore revenue rulings that are contrary to their interests, as a practical matter the taxpayers would be inviting litigation. It is not clear whether revenue rulings are on balance revenue raising or revenue losing. Revenue procedures are instructional in nature and probably do not have a significant revenue impact. Notices may be used to announce forthcoming proposed regulations or to provide guidance in anticipation of delayed regulatory action. Over the last three years, the Internal Revenue Bulletin index shows the publication of 103 revenue rulings, 169 revenue procedures, and 292 notices.

Each year, the Office of Chief Counsel issues its priority guidance plan, which is developed with input from taxpayers, tax practitioners, and industry groups and is periodically updated during the year. For example, current Chief Counsel Bill Wilkins set out several key areas to consider in drafting the plan, including issuing critical guidance, carrying out key IRS initiatives, dealing with new legislation, and easing the burden of taxpayer compliance (Coder, 2012). Wilkins particularly noted that audit guidance on application of the economic substance doctrine would have influence beyond the audit setting. The IRS, presumably with Chief Counsel assistance, issued the audit directive on July 15, 2011. The directive contains lists of factors for auditors to consider in determining whether application of the economic substance doctrine is appropriate or not. Practitioners and commentators alike have expressed concern that this directive will reduce the effectiveness of the law (Coder, 2011). In particular, Sheppard (2012) describes the directive as amounting to an IRS repeal of the economic substance statute, noting that the directive discourages IRS agents from asserting the penalty against large business taxpayers. Is this guidance repeal of IRC § 7701(o) and thus a revenue loser to the tune of $4.5 billion over 10 years? Or is it simply a reflection of the reality of administering a difficult, complex statute that requires a factually intensive inquiry? In either case, no one will measure the revenue impact of this administrative guidance or any one of the many other items of administrative guidance issued each year.

V. CONCLUSION

This essay has raised many questions and provided few answers. One hopes that it has provided at least some food for thought. Revenue estimates are just that — estimates. It is probably unreasonable to expect estimates to take into account future actions like

21 Note that guidance seems to disappear whenever Tax Analysts wins a Freedom of Information suit compelling its disclosure (Parvez and Stratton, 2004).

22 Coder cites former Treasury official Michael Desmond’s statement that IRS hesitation to issue more guidance on economic substance helps deterrence efforts because uncertainty diminishes taxpayers’ willingness to enter into aggressive transactions.
interpretative regulations and litigation decisions to any greater extent than the JCT does now. This essay does not find any fault in JCT’s current ex ante approach to potential future Chief Counsel reactions to legislation. However, the essay does highlight a concern long held by this author (Mann, 2009; Mann and Hymel, 2006). Congress should require some systematic ex post analysis of tax legislation and the administrative response to such legislation. Systematic ex post analysis could provide the basis for meaningful reform or at least a method for assessing current reform efforts relative to past reforms.23

REFERENCES


23 During the presentation of this paper at the 2012 Annual NTA-ATPI Spring Symposium, Pamela Moomau noted that ex post analysis of tax provisions would require proving a counterfactual. Whereas some researchers caution against making counterfactual arguments (Dawid, 2000), others have embraced use of counterfactuals (Shpitser and Pearl, 2007). As a non-technical professional, I merely hope that government can obtain the information necessary to make wise decisions.


Joint Committee on Taxation, 2005. *Overview of Revenue Estimating Procedures and Methodologies used by the Staff of the Joint Committee on Taxation, JCX-1-05.* Joint Committee on Taxation, Washington, DC.


