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AGENCY ACTIVISM AS A NEW WAY OF LIFE: ADMINISTRATIVE MODIFICATION OF THE INTERNAL REVENUE CODE THROUGH LIMITED ISSUE FOCUSED EXAMINATIONS

by

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I. INTRODUCTION

The IRS has begun to get more aggressive. Contrary to what one might expect, however, this new stance has greatly benefitted taxpayers. Due to a lack of proper funding, the agency has found itself in an impossible situation when it comes to enforcing the tax laws. This problem is not new, however, as the IRS has historically never had enough resources to provide for completely effective administration of the tax laws. It knows full well that it cannot audit taxpayers quickly and thoroughly with the resources it currently has. Although the problem is a familiar one, what the IRS has recently been doing about it is cause for concern.

In the name of increasing efficiency and better utilizing limited resources, the IRS has begun to adopt audit policies that overly favor taxpayers and greatly hinder the IRS's ability to perform thorough audits. Highlighting this trend is a relatively new audit technique used by the Large to Mid-Size Business Division (LMSB), which "serves corporations, subchapter S corporations, and partnerships with assets greater than \$10 million."¹

When faced with the conflict between currency and thoroughness, the LMSB has chosen to focus primarily on improving audit currency.² The LMSB believes that improved currency will have several positive effects:

- A. Taxpayer records will become more easily accessible and available on current years;
- B. Taxpayer personnel familiar with transactions selected for examination will still be available;
- C. There will be the ability to eliminate issues from future examinations by using resolution tools;
- D. There will be the ability to enter into pre-filing actions for future returns; and
- E. There will be the improved employee and customer satisfaction.³

The LMSB has considered several techniques to improve audit currency, such as limited scope audits, skip-cycle examinations, multi-year examinations,

1. Large to Mid-Size Business Division Homepage, at <http://www.irs.gov/business/article/0,,id=103401,00.html>.

2. See I.R.M. 4.45.7.2 (2004).

3. I.R.M. 4.45.7.2(1) (2004).

LMSB sweeps, and accelerated examination plans.⁴ One of the LMSB's more imaginative initiatives for improving audit currency is the audit technique known as the Limited Issue Focused Examination (LIFE) Process.⁵ Under LIFE, the LMSB has attempted to involve taxpayers in the audit process by sharing responsibility for timely completion of the audit and has attempted to streamline the audit by reducing the scope of issues examined and applying materiality thresholds to limit scope expansion.⁶

Although the LMSB has had success improving audit currency through the use of LIFE, it is paying too high a price for this result. By instituting LIFE, the LMSB has exceeded the audit authority congressionally granted to the IRS. Furthermore, the IRS is doing so without full disclosure to the public of how LIFE is implemented. In other words, the IRS is in effect legislating without any political accountability. In addition, although the LMSB believes that it will not be sacrificing much in the way of quality, this claim does not hold up, especially when one considers the potential for taxpayer abuse of the program. The fact that corporate America views tax departments as profit centers almost assures that LMSB "customers" will be able to exploit the lack of audit thoroughness to engage in questionable if not outright fraudulent activity. LIFE also greatly undermines the rule of law because the program misuses discretion and arbitrarily treats similarly situated taxpayers unequally.

This paper will examine LIFE and whether the LMSB has given up too much in the name of improving audit currency in a world of insufficient enforcement resources. Part II will discuss some of the recent budget and enforcement problems that the IRS has been having. Part III will examine LIFE and explain the program's specifics. Part IV will analyze whether the IRS has exceeded its authority in implementing LIFE. Part IV will also address the IRS's unwillingness to explain fully critical aspects of LIFE to the public. Part V will explore whether or not LIFE, even if legitimate, is good public policy. Finally, Part VI concludes that the IRS is indeed sacrificing too much for improving audit currency through LIFE. By implementing LIFE, it has both changed the historical relationship between taxpayers and the tax collector, and it has done so in a manner that it must know that neither Congress nor the public would sanction.

4. I.R.M. 4.45.7.2(4) (2004).

5. I.R.M. 4.45.7.2(5) (2004).

6. I.R.M. 4.45.7.2(5) (2004).

II. THE IRS'S RECENT BUDGETARY PROBLEMS PREVENT EFFECTIVE ENFORCEMENT

During at least one of the years from 2001-2003, eighty-two of the nation's largest corporations did not pay federal income taxes.⁷ While there are several causes for such an astounding number,⁸ the IRS's failing ability to conduct effective audits of a large number of corporate taxpayers is certainly one of them.

In recent years there has been a marked decline in corporate audit activity.⁹

Only about a third of very large businesses are audited every year, down from more than half as recently as 1995. Audit rates for businesses with assets of between \$10 million and \$250 million, . . . plunged to 10% to 15% in 2001 from 20% to 30% in the early 1990s.¹⁰

As one commentator has observed:

Tax experts agree that corporate tax avoidance has become a serious problem. Corporate tax receipts – already in a long, steady decline – fell to \$132 billion in the fiscal year that ended Sept. 30, [2003] the lowest since 1993, even before adjusting for inflation. Expressed as a percentage of total tax receipts or as a share of the economy, corporate tax receipts this year will

7. Kurt Ritterpusch, [CTJ Tallies Corporate Tax Boon Under Bush; 82 Corporations have had a Tax-Free Year,] 184 BNA Daily Tax Rep. G-8, G-8 (Sept. 23, 2004). The rebate checks that were owed to these eighty-two corporations actually totaled \$12.6 billion.

8. Factors like a slower economy, an increasingly complex set of tax structures, ease of S corporation formation, and the proliferation of stock options have also contributed to the recent decline in corporate taxation. IRS: Speeding Corporate Tax Audits, Glass Jacobson's E.Perspective, at <http://www.glassjacobson.com/index.php3?page=270> (Jan. 2004) (hereinafter Glass Jacobson).

9. Albert B. Crenshaw, IRS Putting LIFE on Line in Bid to Improve Corporate Audits, Chi. Trib., Jan. 6, 2003, at 10.

10. Id.

be at their second-lowest level since the Great Depression. Only 1983's receipts were lower.¹¹

“With corporate tax receipts at record lows, IRS Commissioner Mark W. Everson recently declared that corporate audits, which now take an average of 38 months, should be completed in less than half that time.”¹² The IRS's hope is that improved audit efficiency will increase audit risk and thereby present a more constant audit threat to the corporate taxpayer that will in turn lead to greater compliance.¹³ This push for increased efficiency has been the driving force behind recent IRS internal procedures.¹⁴

The IRS has been relying on an increased budget to accomplish its goals of improving audit times while maintaining quality.¹⁵ To support its argument for increased funding, however, the IRS has been trying to show that it was doing as much as it could with its resources. Commissioner Everson has stated “that improving the agency's efficiency gave him more ammunition when it came time for him to plead his case to Congress for a funding boost. In the meantime, . . . greater efficiency has enabled the agency to cope when it doesn't

11. Glass Jacobson, *supra* note 8 (brackets added).

12. *Id.*

13. *Id.* As will be discussed in more detail in Section V, *infra*, however, there is legitimate concern that steps taken to increase audit efficiency may lead to a greater potential for tax fraud. *Id.*

14. Allen Kenney, [Official Says IRS Audit Process Still Needs Work,] 105 Tax Notes 27 (Oct. 4, 2004):

On a larger scale, [Deputy IRS Commissioner for Services and Enforcement Mark E.] Matthews said in his conference speech that IRS Commissioner Mark Everson's mantra that “time matters” has reached all corners of the agency, pushing his charges to “ruthlessly prioritize” their use of resources.

“Nobody feels in the IRS that they are not under the gun in terms of thinking about how they function and what kind of efficiencies they can bring,” Matthews said. “It's not a message that we don't seek excellence – it's about making right decisions about resources and about risk.”

Id. (brackets added).

15. *Id.* at 28. Even without such funding increase, however, the IRS still planned on moving ahead towards “pursuing its goals of increased enforcement and improved service.” *Id.*

get the money it asks for.”¹⁶ Everson’s funding fears have turned into reality, and the IRS will thus have to hope that it can continue to increase efficiency without additional resources in order to make up for funding shortfalls.¹⁷

However, funding problems are nothing new to the IRS. Hoping to compensate for these problems through increasing efficiency is a laudable goal. Taking this stance to the point at which efficiency increases are being achieved by giving away the entire farm, however, and subverting the rule of law, is not justifiable. Nevertheless, this is what the LMSB is doing with LIFE.

III. THE LMSB’S SOLUTION TO A LACK OF RESOURCES: LIMITED ISSUE FOCUSED EXAMINATION (LIFE)

A. General Overview of LIFE

Because the IRS did not expect to receive additional resources for enforcement, the LMSB implemented LIFE on December 4, 2002.¹⁸ The IRS’s press release summarizes LIFE’s basic structure:

This initiative will involve a formal agreement, a Memorandum of Understanding (MOU), between the IRS and

16. Allen Kenney, *Everson Strong on Enforcement Despite Bleak IRS Funding Outlook*, 105 Tax Notes 503, 503 (Oct. 25, 2004).

17. See Allen Kenney, *Everson Evaluates State of IRS, Pledges Strong Agenda for 2005*, 106 Tax Notes 40 (Jan. 3, 2005). President Bush had requested a 5% IRS budget increase in 2005 (which comes out to about \$490 million). *Id.* at 41. While Everson wanted a “10% increase of \$134 million over the previous year’s budget from the requested \$300 million increase set aside for enforcement:”

Congress, however, appeared to have other plans. When all the politicking was said and done, the IRS was left with \$10.3 billion in the fiscal 2005 omnibus appropriations bill, a nominal increase of \$134 million over the previous year’s budget and \$356 million less than Bush requested.

Id.; see also Stephen Joyce, *Everson Letter Says IRS Will Forfeit Billions, Lack Auditors Unless FY2005 Request is Met*, 189 BNA Daily Tax Rep. G-8 (Sept. 30, 2004) for a discussion of Everson’s concerns over how funding problems could drastically reduce the amount of the revenue that the IRS was able to collect.

18. IRS News Release IR-2002-133 (Dec. 4, 2002); IRS LIFE Training Video, received pursuant to FOIA request.

taxpayer to govern key aspects of the examination. The MOU will contain dollar-limit thresholds, established on a case-by-case basis, below which the IRS will agree not to raise issues and the taxpayer will agree not to file claims. This will create, with the taxpayer's assistance, an atmosphere where the examination process is less difficult, less time-consuming, less expensive and less contentious for all involved.¹⁹

In addition, an initial risk analysis will significantly restrict the number of issues to be examined, resulting in situations in which only a small number of issues are examined while the IRS in effect concedes all others prior to examination.²⁰ According to the LIFE Training Manual, after identifying as many as fifty issues "warranting examination," the auditor might work only the top few that are "most material to the transaction as a whole" thereby conceding almost all of the other issues warranting examination:

For example, if you had identified 50 areas warranting examination in your risk analysis, use of the LIFE process might result in raising the bar to perhaps the 10 or 15 of the most significant issues. If you had classified your issues as priority A, B and C for your traditional audit plan, LIFE might result in only the "A" issues being examined. Depending upon the circumstances of your examination, LIFE might involve working only the top few "A" issues. You will use the principles of risk analysis to isolate those issues that are *most* material to the tax return as a whole.²¹

Also, under LIFE, the auditor has the authority to waive certain steps considered so important in traditional examinations that they are normally mandatory.²² LIFE resulted from the IRS establishing "best practices" for scope

19. IRS News Release IR-2002-133 (Dec. 4, 2002). See also LMSB LIFE Training Manual, at 26-7, 32 received pursuant to FOIA request (may not be cited as official authority) (hereinafter LIFE Training Manual); I.R.M. 4.51.3 (2004).

20. LIFE Training Manual, supra note 19, at 32.

21. LIFE Training Manual, supra note 19, at 32 (emphasis in original). "However, LIFE does not impact the depth to which issues are examined." I.R.M. 4.51.3.3.6(9) (2004).

22. I.R.M. 4.51.3.3.6(4) (2004). The steps that may be waived are:

- A. The mandatory income probe;
- B. Minimum Inventory Checks;

limitation from its former practice of informally agreeing with certain corporate taxpayers to limit audit scope.²³ The LMSB did not develop these best practices solely based on internal feedback; it also relied on the input from the private sector.²⁴

The LMSB has established guidelines for determining when a LIFE audit is appropriate. These guidelines provide a mechanism to allow the LMSB to maximize its resources while not applying the taxpayer friendly LIFE limitations to taxpayers whose behavior does not indicate that a limited audit

C. Mandatory Compliance Checks (the requirement to verify filing of and reviewing payroll, excise, and pension returns, verify filing information returns and Forms 8300, Cash Transaction Reports.);

Id.

23. Jennifer Corbett Dooren, Tax Facts: IRS to Streamline Corporate Audits, Dow Jones Newswires, at http://www.salestax.org/news/thisweeksnews_12-6-02.html.

24. The LIFE Training Manual describes how the LMSB consulted with private interest groups in developing the “best practices:”

After securing information on best practices from within LMSB, we contacted outside stakeholder groups including the Tax Executives Institute (TEI), the American Bar Association (ABA), and the American Institute of Certified Public Accountants (AICPA). In seeking their input, we crafted nine questions covering specific problem areas of the examination process. We also invited them to share examination success stories and best practices they believed to be important. Surprisingly, many of the key elements in their “success stories” mirrored those expressed by the examination teams, including increased communication and participation in the planning process.

LIFE Training Manual, *supra* note 19, at 3. Because of the role that these groups were permitted to play in designing LIFE, taxpayers’ enthusiasm for LIFE, as discussed in Section V.A, *infra*, is unsurprising.

would be appropriate.²⁵ Despite these guidelines, the LMSB believes that the application of LIFE should be considered in every audit.²⁶

25. I.R.M. 4.51.3.2.1(1) (2004) provides the following factors as supporting the use of a LIFE audit:

- A. The risk analysis identifies a limited number of material items (no specific number since this will vary based on the facts and circumstances);
- B. Prior experience indicates the taxpayer is both capable and willing to meet the commitments required in the MOU;
- C. Workload demands exceed resources available and require scope limitations;
- D. Special project cases where the primary issue is identified;
- E. Out-of-cycle returns when there is an issue requiring examination for tax administration purposes;
- F. There is no prior examination history of the taxpayer, but the interaction to date indicates the taxpayer is both capable and willing to meet the commitments required in the MOU, or
- G. Improved currency is a primary concern and the taxpayer is reasonably compliant, even if there have been issues in the past.

See also LIFE Training Manual, *supra* note 19, at 5-6 for a more specific breakdown of the factors supporting a LIFE audit, in which the LMSB establishes separate criteria depending on whether the audit is an industry case or a Coordinated Industry Case.

IRM 4.51.3.2.1(2) (2004) lists the factors that, either individually or together, could make a LIFE audit inappropriate:

- A. A history of substantial noncompliance, such as aggressive positions or the use of marketed tax products;
- B. A history of failing to consistently meet agreed upon information Document Request (IDR) response times (including completeness);
- C. Average IDR response times that will most likely impede an efficient examination;
- D. A tax shelter transaction that was not properly disclosed as required by any Notice, Revenue Procedure, Revenue Ruling or Treasury Regulations;
- E. A large number of material issues which render scope limitation unreasonable;
- F. An indication of fraud on the part of the taxpayer, or
- G. The taxpayer is unable or unwilling to meet the commitments required in the MOU.

See also, LIFE Training Manual, *supra* note 19, at 5-6.

26. I.R.M. 4.51.3.2.1(1) (2004).

Larry Langdon, the LMSB Commissioner when LIFE was announced, emphasized that LIFE was meant to be used for cooperative taxpayers.²⁷ Driving LIFE, however, was a desire to reduce audit times and maximize the use of limited resources.²⁸ In an interview about LIFE, Langdon stated that:

As is true of our corporate taxpayers and their practitioners, the IRS realizes that we also have limited resources. There are only about 6,000 employees in LMSB to deal with 150,000 taxpayers with assets exceeding \$10 million. Because our current audit process only allows us to deal with a small number of our mid-sized taxpayers, we need to revise these audit procedures to properly increase our audit coverage. The LIFE Program and our other initiatives will allow LMSB auditors to do this.²⁹

27. See, e.g., IRS News Release IR-2002-133 (Dec. 4, 2002). As a result of reducing the audit times of compliant taxpayers, the IRS hopes through LIFE to be able to focus on issues often found in non-compliant taxpayers like tax shelters. Terry Carter, *The IRS Wants to save you Time and Money . . . Seriously: Bigger Businesses With Good Records Get to Determine Audit Issues in Advance*, 2 No. 2 A.B.A. J. E-Rep. 6, (Jan. 17, 2003). Furthermore, the IRS hopes that LIFE will allow it to focus on more mid-size businesses by reducing audit times of large corporations. *Id.*

28. Carter, *supra* note 27. Langdon indicated that the IRS was auditing returns that were five years old, and that he was hoping to reduce that number to three years. *Id.* In fact, Langdon stated that one of his reasons for leaving the private sector, where he had been a Hewlett-Packard Vice President and a former president of the Tax Executives Institute, was to change the LMSB's audit process to result in less documentation and increased coverage. See Biography of Larry Langdon, at <http://www.mayerbrown.com/lawyers>; Interview with Larry Langdon on Frontline, Nov. 5, 2003, at <http://www.pbs.org/wgbh/pages/frontline/shows/tax/interviews/langdon.html>.

29. Larry R. Langdon, 81 *Taxes* 279 (Mar. 1, 2003). The IRS training manual providing instruction on how to administer LIFE echoes this need for increased efficiency: "With finite resources, LMSB can only [streamline the process]. . . by reducing the resources we devote to some of our traditional examination areas." LIFE Training Manual, *supra* note 19, at 1 (brackets added); See also LIFE Training Manual, *supra* note 19 at ii. See also, IRM 4.45.7.2(1) (2004). Increased efficiency will allow it to focus more on its highest enforcement priorities, which include "[a]busive tax avoidance transactions, . . . executive compensation, offshore tax avoidance transactions, flow-through entities, special purpose entities, and financial vs. tax reporting discrepancies." LMSB Compliance Priorities, at <http://www.irs.gov/businesses/article/0,,id=121348,00.html>.

Langdon summarized the problem that these figures present to the IRS:

That means there are about 148,000 that are not covered as extensively as we'd like." "We haven't decreed a number, but we hope that at least a quarter of new case starts use . . . [LIFE] principles, and we will be pleased if it's more than that. Then, we'll have resources to be able to touch more taxpayers, for lack of a better term, and focus on what's material.³⁰

B. Differences Between Traditional Limited Scope Examinations and LIFE

Although any audit procedure is inherently discretionary in terms of the examination's scope, LIFE is distinguishable from other audit procedures in several critical respects. While some auditors prior to the implementation of LIFE may have been limiting examined issues to post-LIFE levels, through LIFE the LMSB is attempting to get all their "agents to leave their comfort zone and to take some risks in the process," by greatly reducing the number of issues examined.³¹ The LMSB is asking taxpayers to do the same thing by agreeing to leave certain claims off the table and to "share in the responsibility for timely completion of the examination."³² More specifically, the LMSB established six factors that distinguish LIFE from traditional full scope audits:

- A. The examination plan is more issue-driven than resource driven;
- B. The scope of the examination is limited based on materiality concepts;
- C. Some mandatory compliance checks and mandatory steps may be waived;
- D. Once the scope is set, it is not necessary to comment on other LUQ [large, unusual, and questionable] items;

30. Carter, *supra* note 27. (brackets added).

31. LIFE Consolidated Frequently Asked Questions, Aug. 1, 2003, at 4, received pursuant to FOIA request (hereinafter LIFE Consolidated FAQ). In providing an example to its auditors, the LMSB stated that "maybe you will only be able to focus on category A (will work) issues when in the past you focused on category A and B (would like to work) issues. In some cases, you might even limit the scope to only some of the 'A' issues." *Id.*

32. *Id.*

- E. Once the scope is set, managerial approval is required to expand it, and
- F. LIFE requires the taxpayer to commit to actions specified in the LIFE MOU.³³

One of the factors, issue limitation, is nothing new as the IRS has for some time used traditional limited scope examinations.³⁴ Traditional limited scope examinations, however, provide much more discretion in issue expansion than LIFE does.³⁵ As a result, the LMSB believed that these traditional limited scope examination procedures were not consistently being applied to LMSB audits, and the LMSB implemented LIFE, in part, to establish more consistency with these limited audits.³⁶ The LMSB listed three primary factors of traditional limited scope audits that distinguish them from LIFE audits:

- A. The examiner may only waive gross income and inventory checks;
- B. The limited scope examination can involve only one or two issues, and
- C. There are only a few instances or circumstances where the traditional, limited scope examination is appropriate, such as whipsaw issues and other related returns.³⁷

Thus, through LIFE, the LMSB hopes to provide more uniformity as well as a broader application of limited scope examinations, which is consistent with the IRS's stated goal of maximizing the use of its decreasing resources.

33. I.R.M. 4.51.3.1.2(2) (2004) (brackets added).

34. See I.R.M. 4.10.2.6.1 (1999) et seq. for a description of the traditional limited scope examinations.

35. See I.R.M. 4.10.2.6.1.2(1) (1999) which states at the outset that "[e]xpanding the scope of the examination is based on the examiner's judgment;" see also I.R.M. 4.10.2.6.1(3) (1999), which also establishes that "[e]xaminers are expected to continually exercise judgment throughout the examination process to expand or contract the scope as needed." This discretion is very different from a LIFE examination, in which the established materiality thresholds greatly restrict the examiner's discretion to expand the audit's scope. See Section III.C, *infra*, for a more detailed discussion of how the initial risk analysis and subsequent materiality thresholds impact an examiner's ability to expand a LIFE audit.

36. LIFE Training Manual, *supra* note 19, at 4-5.

37. I.R.M. 4.51.3.1.2(3) (2004); see also LIFE Frequently Asked Questions, at 1, received pursuant to FOIA request (hereinafter First LIFE FAQ).

Despite the IRS's attempts to create more uniformity and consistency, LIFE's very nature will result in inconsistent taxpayer treatment, as discussed in Section V.B.3 further. This inconsistency results from LIFE's overly discretionary methods of issue selection and determining materiality thresholds.

C. Issue Selection and the Materiality Thresholds

While LIFE consists of many procedural intricacies, at its heart are two questions: (1) how are issues selected and (2) how are the materiality thresholds determined. This section will explore what little guidance there is for how the LMSB makes these determinations.

At the conception of LIFE, the initial plan was to use materiality thresholds to govern issue selection and scope expansion.³⁸ After getting feedback from the field, however, the LMSB changed this procedure to remove the consideration of any materiality thresholds in issue selection.³⁹ As will be discussed further, although specific thresholds are not used in issue selection, materiality concepts still play a pivotal role in the determination of the examination's initial scope. What resulted is a process consisting of two independent steps.⁴⁰ The first step consists of performing a risk analysis, without regard to any dollar thresholds, to determine which issues will be examined.⁴¹ The second step involves setting the materiality thresholds for scope expansion by either the IRS or the taxpayer.⁴² "The thresholds may be the lowest dollar value selected in the LIFE exam plan or another amount based on the examiner's professional judgment."⁴³ To understand how the LMSB makes its issue and threshold selections, analyzing these two steps separately is helpful.

1. Issue Selection – Initially, "[t]he examiner will perform a risk analysis in the same manner as in a traditional, full scope examination."⁴⁴ In this

38. Interim Review Produces Changes to the LIFE Process, at <http://www.irs.gov/businesses/article/0,,id=103618,00.html> (hereinafter Interim Review); LIFE Consolidated FAQ, supra note 31, at 7.

39. LIFE Consolidated FAQ, supra note 31, at 7.

40. Id.; I.R.M. 4.51.3.3.6(1) (2004).

41. Interim Review, supra note 38; LIFE Consolidated FAQ, supra note 31, at 7; I.R.M. 4.51.3.3.6(1) (2004).

42. Interim Review, supra note 38; LIFE Consolidated FAQ, supra note 31, at 7-8; I.R.M. 4.51.3.3.6(1) (2004).

43. LIFE Consolidated FAQ, supra note 31, at 8.

44. I.R.M. 4.51.3.3.3(1) (2004). This provision refers the reader to I.R.M. 4.10.2.4.1 (1999) and I.R.M. 4.45.7.2 (2004) for a discussion of risk analysis.

risk analysis, auditors are expected “to effectively manage their workload by prioritizing the issues so that the issues with higher audit potential are examined over those with lower potential. Issues with little or no audit potential should not be selected for examination.”⁴⁵ The most important issues are generally the large, unusual, and questionable (LUQ) items.⁴⁶ Materiality issues are commonly used to identify these LUQ items.⁴⁷ Thus, although specific materiality thresholds are not being used to govern issue selection, materiality⁴⁸ does come into play at the issue selection step. In fact, according to the Internal Revenue Manual, materiality considerations are the most important ones in limiting an audit’s scope.⁴⁹

Several factors come into play in determining materiality. The first and most basic is the dollar amount of an item – the higher an item’s dollar amount, the more likely it is to have a significant affect on tax liability and thus be

45. IRM 4.10.2.4.1(1) (1999). The LMSB has attempted to come up with a few examples of factors that might be used to conduct an effective risk analysis:

- The outcome of issues from prior years (was it agreed, unagreed, or how was the issue ultimately resolved?)
- Is the issue a “must work” item such as a Coordinated Issue or tax shelter?
- Is the issue an emerging issue?
- Is the item one with a high probability of error? (Some accounts are inherently more prone to errors than others) consideration of the resources needed to address the item
- Estimated time to complete the examination of an item
- Materiality

LIFE Training Manual, *supra* note 19, at 8-9.

Note also that it is unclear from the Internal Revenue Manual whether “high audit potential” means items in which the IRS is likely to prevail or items that will result in a high adjustment of tax liability.

46. I.R.M. 4.10.2.4.1 & 4.10.2.6 (1999); LIFE Training Manual, *supra* note 19, at 8-9. While the auditor is generally expected to examine all LUQ items, an exception to this general rule is made when the scope of an examination is to be limited. *Id.*

47. LIFE Training Manual, *supra* note 19, at 8-9.

48. “Materiality is an accounting concept which does not exist, for the most part, in tax law. Materiality is both a qualitative and quantitative concept used in identifying those items most relevant and consequential in determining the correct tax liability.” I.R.M. 4.51.3.3.4(1) (2004).

49. I.R.M. 4.51.3.3.4(3) (2004).

material.⁵⁰ A second critical materiality question is, in the case of two equal dollar amount items, which item will have the more permanent effect on tax liability (thus becoming more material)?⁵¹ Timing also plays a key role in materiality, and timing adjustments that affect a larger deferral/acceleration period are considered to be the more material timing adjustments.⁵² More qualitative factors, such as “significant transactions involving a tax haven entity,” or even the absence of an item, can also be factored into a materiality analysis, even if quantitative numbers cannot be attached to them.⁵³

2. *Materiality Thresholds* – After the risk analysis has been performed and the issues have been selected, the auditor must establish the materiality thresholds⁵⁴ that will determine whether the IRS or the taxpayer will be permitted to add any other item discovered during the audit to the agreed audit

50. I.R.M. 4.51.3.3.5(1) (2004). Note that “[c]ertain transactions or events may be of such a nature that it is difficult to associate a dollar amount for materiality without significant audit work. The fact that there is no specific dollar amount associated with an issue should not exclude it from consideration under LIFE.” I.R.M. 4.51.3.3.5(7) (2004). Also note that high dollar amount might not always be indicative of an item that would have a material effect on tax liability. For example, if an item had a very high dollar amount but a very low profit margin, it might not involve a significant amount of taxable income.

51. I.R.M. 4.51.3.3.5(2) (2004).

52. I.R.M. 4.51.3.3.5(3) (2004). Changes in accounting should be considered in regards to certain timing issues. I.R.M. 4.51.3.3.5(4) (2004). In addition, even an issue that might not be material from a timing perspective could be material if it involves a large enough amount. I.R.M. 4.51.3.3.5(5) (2004).

53. I.R.M. 4.51.3.3.5(7) & (9) (2004). Examples of other qualitative factors include:

- A. A taxpayer who has experienced a number of mergers and acquisitions during the cycle;
- B. Non-deductible personal expenses or shareholder distributions;
- [and]
- C. Employment tax compliance

I.R.M. 4.51.3.3.5(7) (2004).

54. The plural “thresholds” is used because one materiality threshold does not necessarily apply to all items. For example, in the IRS’s Instructions for Completing the MOU, the IRS states that a different threshold could be established for each item. See Instructions for Completing the MOU, Revised Aug. 1, 2003, at http://www.irs.gov/pub/irs-utl/mou_8_1_03.pdf.

scope.⁵⁵ The LMSB implemented the concept of materiality thresholds to combat “scope creep,” which many LMSB field teams said often contributed to prolonged audits.⁵⁶ The auditor must state these thresholds as a specific dollar amount, which “may be based on the lowest dollar value for each type of issue included in the LIFE plan or another amount based on the examiner’s professional judgment.”⁵⁷ These thresholds can apply to issues as well as to “any tax return line item, tax attribute, or a combination of any of the above.”⁵⁸ The scope can be expanded to include certain high priority issues, however, regardless of whether or not they fall within the materiality thresholds.⁵⁹ These high priority issues are: “tax shelters, coordinated issues, fraudulent items, items contrary to public policy, worker classification issues, executive compensation, and LMSB Field Directive issues.”⁶⁰ These thresholds do not have to be the same for the entire audit period, and it is conceivable that the auditor might have to establish different materiality thresholds for different taxable years.⁶¹

If the auditor does plan on expanding the audit’s scope, he must obtain managerial approval.⁶² This approval is required regardless of whether the expansion satisfies the materiality thresholds.⁶³ This is because the LMSB has decided that for scope expansion there should be virtually no professional discretion allowed to the audit team.⁶⁴ Even if scope expansion is possible, a manager may decide not to expand the audit’s scope if other perceived resource considerations indicate that the scope should not be expanded.⁶⁵

As can be seen, LIFE both dramatically limits the number of issues that will be audited and, in effect, concedes many other issues even when the auditor has established that they warrant examination. This institutionalized, severe

55. Note, however, that if an item is selected for audit, the materiality thresholds will not affect the depth to which that item is audited. I.R.M. 4.51.3.4.5(7) (2004).

56. LIFE Training Manual, *supra* note 19, at 20.

57. I.R.M. 4.51.3.4.5(2) (2004).

58. I.R.M. 4.51.3.4.5(4) (2004).

59. I.R.M. 4.51.3.4.5(8) (2004).

60. I.R.M. 4.51.3.4.5(8); I.R.M. 4.51.3.4.5(11) (2004). Note also that certain “obvious computational/mathematical or accounting errors/omissions” can be corrected without regard to materiality thresholds. I.R.M. 4.51.3.4.5(9) (2004). The LMSB can also expand the scope without regards to the materiality thresholds if the taxpayer has not followed a “stated accounting policy or practice.” I.R.M. 4.51.3.4.5(10) (2004).

61. First LIFE FAQ, *supra* note 37, at 7.

62. I.R.M. 4.51.3.4.5(12) (2004).

63. LIFE Training Manual, *supra* note 19, at 20.

64. *Id.*

65. *Id.*

audit constraint is hardly conducive either to assuring compliance by the taxpayers under audit or to instilling in those not under audit the proper respect for the system. LIFE is not just a new technical way of auditing; it represents a radically different approach in the philosophy and goals of auditing. One is left to ask whether the IRS can enact such an entirely different approach without prior congressional approval and oversight.

IV. IS LIFE A LEGITIMATE USE OF THE IRS'S AUDIT AUTHORITY OR AN ILLEGITIMATE SECRET LAW?

A. LIFE is an Inappropriate Use of the IRS's Statutory Audit Authority.

In analyzing LIFE's implications, the first issue that must be addressed is whether the IRS even has the authority to conduct a LIFE audit. Generally, the IRS derives its authority to conduct an audit from IRC section 7602(a). This Code section's language is critical in determining exactly what the IRS is authorized to do. Specifically, the Code states, in relevant part:

A. Authority to Summon, Etc. – For the purpose of ascertaining the correctness of any return, . . . determining the liability of any person for any internal revenue tax . . . or collecting any such liability, the Secretary is authorized –

(1) to examine any books, papers, records, or other data which may be relevant or material to such inquiry⁶⁶

The Code on its face limits the IRS to examining only documents that are "relevant and material" to "ascertaining the correctness of any return." Congress has not required the IRS to examine every taxpayer for every item for every year nor has it explicitly outlawed any examination that did not result in "ascertaining the correctness of any return." Congress emphasizes this point further by preventing any "unnecessary examinations or investigations" as well as providing a general limitation of one examination per taxable year.⁶⁷

LIFE, however, is an illegitimate expansion of the IRS's audit authority. LIFE, by definition, cannot lead to "ascertaining the correctness of any return." In LIFE, the IRS is not just limiting the scope of its examination to the items

66. IRC § 7602(a). The IRS's general authority to issue regulations is found in IRC § 7805.

67. IRC § 7605(b).

that are relevant to “ascertaining the correctness of any return.” By limiting the scope of an audit and establishing a materiality threshold below which items are ignored, it is intentionally ignoring information that may very well be highly relevant in “ascertaining the correctness” of a corporate taxpayer’s return. Indeed, the IRS admits that LIFE would result in the examination of only a few of potentially fifty issues that warranted examination.⁶⁸ Such an acknowledgment inherently recognizes that LIFE cannot ascertain “the correctness of any return” because both the IRS and the taxpayer are intentionally leaving issues worthy of audit off the table. The IRS’s stated justification for the vast reduction in the number of issues examined as well as the strict restriction on issue expansion is only one of improved efficiency rather than one of better “ascertaining the correctness of any return.” Thus, LIFE does not fall within the IRS’s congressional authority to examine all information that is relevant to “ascertaining the correctness of any return.”

The Code gives no grant of authority to the IRS to avoid relevant information intentionally in the name of efficiency. The IRS, however, has inappropriately given itself authority to conduct LIFE through the regulations under IRC section 7602. In Treasury Regulation section 301.7602-1(a), the IRS slightly but significantly changed the statutory language that grants its audit authority. Rather than stating that the IRS is “authorized” to examine the information described in the statute, the regulation states that the IRS “may” examine this information.⁶⁹ By making this language much more permissive, the IRS has given itself authority to choose not to examine materials that may very well be relevant to “ascertaining the correctness of any return.” Surely Congress did not intend to authorize the IRS to intentionally ignore relevant tax liability. Such an authorization would give the IRS an enormous amount of power to decide arbitrarily to audit relevant information in one taxpayer and ignore the same relevant information in another taxpayer. If Congress truly did intend this result, it would have made this intention plain.

Furthermore, Congress certainly knows how to state directly that it is willing to allow the use of thresholds similar to those used in LIFE. For example, IRC section 6051(a)(13) requires an employer to furnish to its employees who participate in nonqualified deferred compensation plans a written statement showing “the total amount of deferrals for the year.” The flush language to IRC section 6051(a), however, states that “the Secretary may (by regulation) establish a minimum amount of deferrals below which” such statement is not required. In this example, Congress has specifically authorized

68. See example from LIFE Training Manual discussed in Section III.A, supra.

69. Regs. § 301.7602-1(a).

the IRS to employ the use of a threshold. In the unlikely event that Congress wanted to allow the IRS to establish thresholds below which errors in computing tax liability could be ignored, it is perfectly capable of granting Treasury this authority. If Congress felt that, having established a reporting rule, it also had to establish an exception to the rule, one can imagine that, having authorized the IRS to audit taxpayer returns to determine their correctness, it would certainly reserve the right to establish an exception to the rule, particularly an exception that in effect eviscerated the rule.

In addition to knowing about how to authorize Treasury's use of thresholds, Congress also knows how to provide a broad grant of authority clearly permitting the establishment of thresholds through the regulations. In a recent Notice, the IRS has requested comments on the potential use of thresholds for reporting of taxable acquisitions under IRC sections 6043(c) and 6045.⁷⁰ These Code sections state explicitly that the filing of information under these sections shall only occur to the extent that the Secretary requires it.⁷¹ Thus, for these Code sections, the Secretary has regulatory authority to establish thresholds for the reporting requirement. This could be why the IRS actually felt confident promulgating regulations for establishing thresholds under these taxable acquisition code sections as opposed to establishing the thresholds without promulgating regulations. Had Congress desired to provide similar authority to the IRS in the context of LIFE, it could have easily done so. Its failure to do so does not give the IRS the right to circumvent the regulatory process by initiating the program administratively.

The IRS's justification for establishing LIFE through questionable legal authority is that it needs to compensate for the fact that it does not have the resources to follow Congress' authorization to examine information to ascertain the correctness of a taxpayer's return. Gregg Polsky has argued that the Treasury Department has increasingly been trying to achieve positive policy results even if they contradict direct legal authority.⁷² Polsky argues that Treasury has three options if it perceives a difficulty in tax administration: "(1) propose legislation to Congress to fix the problem, (2) promulgate regulations that fix the problem in a taxpayer-adverse manner, or (3) promulgate regulations that fix the problem in a taxpayer-friendly manner."⁷³ Polsky

70. IRS Notice 2005-7, 2005-3 I.R.B. 340.

71. IRC §§ 6043(c); 6045(a).

72. Gregg D. Polsky, *Can Treasury Overrule the Supreme Court?*, 84 B.U. L. Rev. 185 (2004) (arguing that the check-the-box regulations contradict established Supreme Court authority in *Morrissey v. Comm'r*, 296 U.S. 344 (1935)).

73. *Id.* at 188-9.

correctly argues that a congressional solution is the only valid one, but “[t]he Treasury, however, has recently shown a tendency to choose option number (3) (fix the problem in taxpayer-friendly manner).”⁷⁴ Polsky’s argument resonates regarding LIFE. LIFE is extraordinarily taxpayer-friendly because of the restrictions on issue selection and audit expansion.⁷⁵ Treasury is apparently trying to solve the problem of its insufficient resources by creating a program that is unlikely to trigger any taxpayer complaint.⁷⁶

The IRS is aware of these arguments against LIFE. In fact, the IRS directly contemplated whether it had congressional authority for LIFE early on when it was developing its internal guidelines for LIFE. In response to the argument that LIFE directly conflicts with provisions of the Code that

74. *Id.* at 189.

75. The IRS would likely argue that the application of materiality thresholds to taxpayers’ claims as discussed in Section III.A, *supra*, counteracts any overly taxpayer-friendly effects. This aspect of LIFE likely does little to lessen LIFE’s pro-taxpayer effects. In the audit context, it is the IRS that is much more likely to want to raise additional issues. Taxpayers, especially profit-minded corporations with sophisticated tax advisers, have most likely already taken all of the deductions that they believe are even remotely available and have excluded all items that might remotely be argued not to be income.

76. See note 24 for a discussion of the private interest groups that LMSB consulted with in designing LIFE. Such consultation is akin to the farmer consulting with the fox on appropriate ways to guard the hen house, and thus the taxpayer-friendly nature of LIFE is easy to understand.

In addition to the fact that taxpayers would likely not complain about the program, the IRS knows that taxpayers will be unable to challenge LIFE, even if the program is invalid. Gregg Polsky argues a similar idea with regards to the check the box regulations:

A more cynical explanation is that the Treasury was aware of the regulations’ invalidity yet issued them anyway because it severely discounted the likelihood of any judicial challenge. Under this view, the Treasury intentionally promulgated invalid regulations but determined that the regulations were insulated from a challenge due the very restrictive taxpayer standing doctrine discussed below. If, however, the Treasury had this troubling view, it was short-sighted because, although a taxpayer with standing to challenge the regulations might be hard to find, it is inevitable that such taxpayers exist.

Polsky, *supra* note 72, at 238-9.

specifically treated how taxpayers should handle certain items, the IRS stated in an early version of an internal frequently-asked-questions document: “It is the IRS’ obligation to efficiently utilize its resources. We do not think that Congress would dispute comparing potential benefits from examining an area to the resources required to perform the examination.”⁷⁷ Merely stating this, however, does not make it so. The IRS is basically assuming congressional support for its actions rather than directly asking Congress for authority to implement LIFE. The IRS is, thus, justifying taking on a legislative function based solely on its questionable assertion that Congress would approve. Such action is legally inappropriate even if one believes that the IRS is adopting LIFE as a good way to deal with the very real problem of diminishing enforcement resources.⁷⁸ In

77. First LIFE FAQ, *supra* note 37, at 10. The full question and answer reads:

Based on information presented to me, it is my impression that if the taxpayer had expensed an item that has normally been capitalized over a 3-year life, I would not propose an adjustment. Is this correct? If I am correct, isn’t this in direct conflict with the IRC and the intent of Congress?

In most cases, a timing issue such as the one described in your question would not result in a material impact on the returns as a whole. There may be instances where the size of a short-term timing item would cause it to be material, in which case the item would be selected for examination. In addition, agents cannot ignore requirements involving a Change in Accounting Method.

It is the IRS’ obligation to efficiently utilize its resources. We do not think that Congress would dispute comparing potential benefits from examining an area to the resources required to perform the examination. Yes, you have found the issue without having to perform much examination work. However, the compliance impact of spreading the deferral over the three years may not be material enough to support the time spent.

78. See Polsky, *supra* note 72, at 187 (arguing that invalidity of the check-the-box regulations was not eliminated by the fact that they represented sound tax policy). A recent example involving the IRS’s desire to assist victims of the 2004 hurricane season also illustrates this point. In response to the devastating property losses in Alabama, Florida, and Ohio, the IRS issued several notices in which owners of property that qualified for the low-income housing credit could provide temporary housing to individuals displaced by the hurricanes. Notice 2004-74, 2004-48 I.R.B. 875; Notice 2004-75, 2004-48 I.R.B. 876; Notice 2004-76, 2004-48 I.R.B. 878. The property owners

fact, the IRS has sensed the weakness of its justification, as the question about whether LIFE exceeds the IRS's congressional authority is conspicuously absent from the final version of the frequently-asked-questions document.⁷⁹

B. The IRS's Unwillingness to Disclose Certain Aspects of LIFE Raises a Presumption that the IRS is Exceeding its Audit Authority through LIFE.

By acting on its own and without affording the public any opportunity to be heard, the IRS has in effect created a secret law applicable to a limited group of taxpayers. The IRS has compounded the problem by its unwillingness to disclose certain key components of LIFE to the public. As can be seen from the discussion of issue selection and materiality thresholds discussed earlier, the IRS has provided general guidelines as to how these processes are accomplished. The IRS, however, has not provided any clear indication of (i) the amounts of the materiality thresholds it is establishing, (ii) how it establishes these thresholds, or (iii) how it will determine which issues to examine and which to ignore. In fact, in a speech on February 1, 2001, Larry Langdon stated that he was "frankly surprised at how large" the materiality thresholds being used were, but he refused to say what these thresholds were.⁸⁰ Rather, the IRS has chosen to cloak these specifics behind general statements that each taxpayer's differences make it impossible to come up with any specific, meaningful guidelines for determining materiality thresholds.

Even finding the guidelines is not easy. Apart from what was available in the Internal Revenue Manual, most of the information discussed in this article was obtained through a document request to the IRS under the Freedom of Information Act (FOIA).⁸¹ That request asked for all IRS documents, including

could provide this temporary housing regardless of income, without fear of losing their low-income housing credit under IRC § 42 (2004). *Id.* No one could doubt the benefits of helping those displaced by hurricanes. Nevertheless, this action provides yet another example of the IRS changing a section of the Code without congressional authority. It is for the legislative, not the administrative, branch to change the law and to decide whether the government should be helping hurricane victims through the tax code.

79. See LIFE Consolidated FAQ, *supra* note 31.

80. Larry Langdon, (Feb. 1, 2001), ABA-177 IRS's New Toolbox to Resolve Tax Disputes: Pre-Filing Technical Guidance and Other Initiatives.

81. 5 U.S.C.A. § 552 (West 2004). The FOIA request to the IRS, submitted on November 1, 2004, requested the following documents:

1. All Memoranda of Understanding ("MOUs") entered into between the IRS and taxpayers pursuant to the Limited Issue Focused

MOUs, that might shed light on how the IRS conducts issue selection and materiality threshold determinations under LIFE. While the IRS produced a variety of documents, it refused to provide copies of completed MOUs. These documents would provide data on the specific materiality thresholds that the IRS used for corporate taxpayers from July 1, 2003 to December 31, 2003. In refusing to produce the MOUs, the IRS stated in its response:

Examination (“LIFE”) program in the Large and Medium Sized Business (“LMSB”) division from July 1, 2003 through December 31, 2003.

2. All documents prepared or used by the IRS to determine the scope and the materiality thresholds for MOUs, as these concepts are described in sections 4.51.3.3 and 4.51.3.4 of the Internal Revenue Manual. For your convenience, a copy of these sections of the Internal Revenue Manual is attached. This request includes, but is not limited to, a request for any general guidance, policies, or procedures that the IRS has prepared or used to determine the scope and materiality thresholds in the LIFE program as a whole as well as the specific documents relating to scope and materiality thresholds established in the MOUs provided pursuant to Request No. 1.

3. All documents prepared or used by the IRS to determine which taxpayers will be offered to have their audits conducted under the LIFE program. This request includes, but is not limited to, a request for any general guidance, policies, or procedures that the IRS has prepared or used to determine which taxpayers generally are offered to have their audits conducted under the LIFE program as well as the specific documents relating to how the taxpayers who entered into the MOUs provided pursuant to Request No. 1 were determined to be eligible to have their audits conducted under the LIFE program.

4. All training materials prepared or used by the IRS to train its personnel to administer audits under the LIFE program, including, but not limited to, training materials prepared or used by the IRS to train its personnel to determine selection of taxpayers for participation in the LIFE program and/or to establish the scope and/or materiality thresholds in the LIFE program (described in requests 2 and 3).

Letter from Walter Edward Afield to Maureen Saperro, FOIA Disclosure Manager, (Nov. 1, 2004).

All documents are being released to you in their entirety with the exception of the deleted information that is being withheld in accordance with subsection 5 U.S.C. (b)(3) and (b)(6) of the Freedom of Information Act. The statute for the (b)(3) exemption is 26 U.S.C. 6103. The documents contain taxpayer identifiers and information that would constitute a clearly unwarranted invasion of personal privacy.

LIFE memoranda are part of a taxpayers examination file and therefore, “return information” which is not releasable in accordance with subsection 5 U.S.C. (b)(3) of the Freedom of Information Act. However, we have enclosed a copy of the LIFE MOU template for your information.⁸²

In withholding the MOUs, the IRS is preventing the public from having any significant knowledge about which specific return items will meet the criteria for audit under LIFE and what amounts of potential tax liability will be ignored under the materiality thresholds. Under case law discussed further in this section, whether the IRS has the authority to withhold this information in the face of a FOIA request depends on whether a court would consider the information to be useful in allowing taxpayers to circumvent audits or would consider disclosure of the information as serving a positive public purpose.

Under FOIA and IRC section 6103 (which prohibits the disclosure of return information), the IRS would likely argue that the withheld information is analogous to discriminant function scores (DIFs), an investigatory technique that the IRS uses internally to select tax returns for an audit.⁸³ Courts have routinely held it permissible for the IRS to withhold these DIF scores under 5 U.S.C. section 552 and IRC section 6103⁸⁴ because “[r]elease of this information could compromise the integrity of the IRS and its regulatory function by allowing individuals to manipulate their DIF scores and possibly

82. Letter from Maureen Saperio, Manager HQ Disclosure Office to Walter Edward Afield (Jan. 28, 2005) (hereinafter Response).

83. See *Buckner v. IRS*, 25 F.Supp.2d 893, 898 (N.D. Ind. 1998).

84. FOIA contains a list of exceptions in 5 U.S.C. § 552(b) (2004). Specifically, 5 U.S.C. § 552(b)(3) protects documents that are exempt under another statute from disclosure. IRC § 6103 is one such statute, as this section of the Internal Revenue Code protects taxpayer return information from disclosure. For a full discussion, see the cases cited in note 85.

avoid a well-deserved audit.”⁸⁵ Courts have extended this reasoning outside of the DIF score context and have applied it to other internal IRS practices and procedures that taxpayers could use to avoid audit selection.⁸⁶ Furthermore, under IRC section 6103, the IRS can legitimately withhold information that constitutes taxpayer “return information.” Courts have even held that redaction of certain portions of a document containing “return information” (such as redacting a taxpayer’s name or tax identification number) will not necessarily allow the IRS to disclose the redacted document.⁸⁷

These cases do present strong arguments for the IRS to withhold the MOUs. The IRS would likely argue that the MOUs contain corporate taxpayer information that is protected and that even redaction of the corporate taxpayer identities would not remove this protection. In addition, the IRS would likely argue that disclosure of MOUs containing a list of the issues selected for examination, as well as the materiality thresholds used, would allow taxpayers to manipulate their returns to avoid detection of certain items that should be subject to audit.⁸⁸

Authority does exist, however, that could be used to support disclosure of MOUs, or at least a statistical compilation of what issues are audited and

85. *Buckner*, 25 F.Supp.2d at 898 (citations omitted); e.g., *Gillin v. IRS*, 980 F.2d 819, 822 (1st Cir. 1992); *Long v. IRS*, 891 F.2d 222, 224 (9th Cir. 1989); *Pully v. IRS*, 939 F.Supp. 429, 438 (E.D. Va. 1996); *Lamb v. IRS*, 871 F.Supp. 301, 304 (E.D. Mich. 1994).

86. See e.g., *United States v. Imbrunone*, 379 F.Supp. 256 (E.D. Mich. 1974) (protecting from disclosure numerous documents relating to IRS investigatory techniques and selection of taxpayers for audit); *Flamingo Fishing Corp. v. United States*, 22 Cl. Ct. 625, 630 (1991) (protecting disclosure of “the IRS’s past practices in determining through specific audits over an 8- to 10-year period that crew members of a scalloper were subject to income taxes because the normal size of the crew was not fewer than 10.”).

87. See e.g., *Long*, 891 F.2d at 223-24; *Church of Scientology of Texas v. IRS*, 816 F.Supp. 1138, 1150 (W.D. Tex. 1993) (citing *Church of Scientology of California v. IRS*, 484 U.S. 9, 19 (1987)). These cases hold that, while mere redaction is not sufficient to allow disclosure, if the information was compiled into some sort of statistical data analysis, it could be produced.

88. Note that the IRS has not, as of the writing of this paper, raised this argument in response to the author’s FOIA request. See Response, supra note 82. Were this issue to actually be litigated, however, this argument could potentially be available to the IRS. Note, however, that this argument is based on taxpayers’ inherent desire to buck the system, while LIFE is premised on taxpayers’ honesty. See infra Section V. The IRS appears to have a flexible view of taxpayers’ ethics..

what materiality thresholds are used.⁸⁹ Should the IRS ever prepare a statistical compilation of the materiality thresholds and issues selected in a series of MOUs, as discussed earlier, the IRS would probably not be able to rely on its privacy argument to prevent disclosure. Thus, the IRS would likely have to rely on the argument that disclosure of such a compilation would allow taxpayers to avoid being audited.

An older case out of the Sixth Circuit presents a potential solution to this argument. In *Hawkes v. IRS*,⁹⁰ the Court stated that certain IRS guidelines relating to audit selection should be produced. One of the documents made available to the public was section 6.051 of the Return Classifier's Handbook, which listed "the average ratio of officers' salaries to gross income in various types of businesses."⁹¹ The IRS argued against disclosure "presumably on the ground that knowledge of the table's specific ratios would encourage corporations not to report salaries in excess of the averages, with the hope of avoiding an audit concerning the reasonableness of their deductions for officers' salaries."⁹² Holding that the information should be available to the public, the Court stated:

Information which merely enables an individual to conform his actions to an agency's understanding of the law applied by that agency does not impede law enforcement and is not excluded from compulsory disclosure Far from impeding the goals of law enforcement, in fact, the disclosure of information clarifying an agency's substantive or procedural law serves the very goals of enforcement by encouraging knowledgeable and voluntary compliance with the law. . . .

Disclosure . . . would give the public a rough notion of what salaries may be unreasonable for corporate deduction purposes, in the view of the enforcing agency – the IRS. The sole effect of disclosure of this information would not be easier evasion of the tax laws. Rather, companies taking unreasonable deductions would be encouraged to reduce their officers' salaries to within the ranges specified . . . , and companies wishing substantially to exceed the average range would be on

89. See *supra* note 87.

90. 507 F.2d 481 (6th Cir. 1974).

91. *Id.* at 484 (quoting Return Classifier's Handbook § 6.051).

92. *Id.*

notice that proof of the reasonableness of the higher salary deductions would probably be required by an IRS auditor.⁹³

The *Hawkes* rationale could be applied to support production of the MOUs. *Hawkes* could be applied on a broader scale to stand for the proposition that disclosure should occur if there is a significant public interest favoring disclosure and minimal to zero risk of abuse. Cases analyzing FOIA's provision protecting internal agency records from disclosure further support this view.⁹⁴

Applying this rationale, a taxpayer arguing for IRS disclosure could make the argument that the materiality thresholds and selected issues will not help taxpayers circumvent selection for audit because a taxpayer has already been selected for audit when LIFE is employed. Granted, knowing the issues that are selected and knowing the materiality thresholds could still allow a taxpayer to keep items from being included in a LIFE examination. However, if the IRS is correct in its assertion that taxpayer differences prevent application of uniform materiality thresholds to all taxpayers,⁹⁵ then the taxpayers will not be able to avoid audit by knowledge of the thresholds that have been applied to other taxpayers because the thresholds will not be the same.

Furthermore, the IRS is essentially creating a secret law in which material relevant to an audit is intentionally ignored for certain taxpayers without any type of congressional approval, oversight, or opportunity for the public to be heard. All of the guidelines that the IRS has created to determine issues and materiality thresholds under LIFE basically boil down to the IRS providing general guidance to its personnel and stating that actual determinations have to be made under the auditor's discretion on a case-by-case basis. Therefore, if examples of what these issues or thresholds are remain secret, the IRS will have succeeded in fundamentally changing the law relating to taxpayer audits without the public's knowledge. Such secrecy creates a political accountability problem and inherently compromises LIFE's integrity. Full disclosure is the only solution to these problems so that the people and their elected representatives can know what new law the IRS has created without

93. Id. (citations omitted).

94. *Church of Scientology*, 816 F.Supp. at 1148-49 (citations omitted) (discussing "Exemption 2" of FOIA found in 5 U.S.C. § 552(b)(2), which protects internal agency records, and stating that "[r]ecords are exempt under Exemption 2 if they are internal records that (1) relate to trivial agency matters of which the public does not have a legitimate interest or (2) if disclosure would risk circumvention of an agency regulation.").

95. See *infra* Section V.B.3.

authorization and can make their own decisions about whether this program is sound policy. Therefore, while the IRS might be able to withhold individual MOUs based on privacy concerns, it should disclose any statistical compilation of MOU data it has because of this high public interest and the fact that taxpayers cannot avoid audit selection with this knowledge.⁹⁶ Although encouraging greater disclosure is important, this analysis naturally leads to a broader question of whether LIFE is in fact good public policy, regardless of any legitimacy concerns that exist.

V. EVEN IF LIFE IS LEGITIMATE, IS IT GOOD POLICY?

A. Public Arguments Supporting LIFE

The IRS has taken an aggressive approach in claiming LIFE's advantages. Commissioner Mark Everson has stated publicly that he believes that decreasing audit times will lead to more revenue because corporations will realize that they will be more likely to be audited because the IRS will be able to perform more, though less comprehensive, audits.⁹⁷ Everson expressed

96. Note that whether the IRS possesses any such statistical compilations is unclear. It did not produce any as responsive to the FOIA request nor did it acknowledge whether they exist or, if they exist, whether it viewed them as part of the protected "return information" it withheld. See Response, *supra* note 82.

The IRS's refusal to produce all of the requested documents is consistent with a recent culture of secrecy that has pervaded the IRS. See Federal Lawsuit Filed Today Against IRS is Part of Broad Effort to Provide Information About Agency's Audit Activities to the Public, Apr. 14, 2005, at <http://trac.syr.edu/foia/> (last visited Jun. 6, 2005) [hereinafter Federal Lawsuit]; see also Dangers Posed by IRS Secrecy, at http://trac.syr.edu/tracirs/latest/current/include/side_1.html (last visited Jun. 6, 2005). Susan B. Long, a co-director of Transactional Records Access Clearinghouse (TRAC) and one of the plaintiffs currently suing the IRS for its refusal to comply with a TRAC FOIA request, argues: "Because a fair, effective and open tax system is so important to the nation, the IRS's new wave of secrecy about its operations is deeply disturbing and if left uncorrected could well undermine public confidence along with taxpayer compliance." Federal Lawsuit *supra* note 96. *Id.* Her co-director and co-plaintiff in the action against the IRS, David Burnham, adds: "From my research, it appears the IRS is reverting to its habits in the 1950s and 1960s, when secrecy was the norm and the problems of corruption and political abuse were later uncovered by the Congress." *Id.* A copy of TRAC's complaint in Long v. IRS, No. 05-0756 (D.D.C. Apr. 14, 2005) can be found at <http://trac.syr.edu/foia/complaint.pdf>. *Id.*

97. Jonathan Weisman, IRS Speeds Corporate Tax Audits; Fast-Track Method May Miss Fraud, *The Wash. Post*, Dec. 29, 2003, at A01.

disgust with the fact that because of the historically slow pace of audits, the IRS could not be a key figure in discovering the wave of the 1990s corporate scandals.⁹⁸ Everson hoped that LIFE would help combat the “atrocious” statistic that a mid-size company usually faces one audit every twenty years.⁹⁹ Former IRS Commissioner Charles Rossotti agreed that the historical audit pace was in dire need of improvement to increase the overall amount of collected revenue: “Does it make sense spending literally five or six years auditing routine matters that won’t produce much when there are people out there promoting billion-dollar shelters in the open market?”¹⁰⁰

Recent data seems to support the IRS’s claim that LIFE is increasing audit currency. The current Commissioner of the LMSB, Deborah Nolan, has stated that “[t]he overall [audit] currency rate has increased from 37% in 2003 to 47% in 2004. . . .”¹⁰¹ Although Nolan did not single out LIFE as the cause of this improvement, “[s]he attributed much of that success to the issue management tools the LMSB has developed to reduce its aging inventory of cases.”¹⁰²

LIFE’s benefits are more evident when one compares the audit rates of LMSB taxpayers with the audit rates of small businesses:

The overall audit rate for [corporations with \$10 million or more]. . . rose almost 40% from a record low of 7,125 in 2003 to 9,500 in 2004. The Service also increased its examination coverage of the country’s largest corporations, those with assets of at least \$250 million, from 30% in 2003 to 40% in 2004.¹⁰³

This increase in audit rate for LMSB taxpayers contrasts with the decrease in audit rate for small businesses (which do not qualify for LIFE by virtue of not being covered by the LMSB) which “fell from 0.58% in 2003 to 0.32% in 2004 – a 45% drop.”¹⁰⁴ How much of this increase in LMSB audits is

98. Id.

99. Id.

100. Id.

101. Kenneth A. Gary, Enforcement Remains Priority for LMSB, Nolan Says, 105 Tax Notes 504, 504-5 (Oct. 25, 2004).

102. Id.

103. Allen Kenney, Everson Evaluates State of IRS, Pledges Strong Agenda for 2005, 106 Tax Notes 40, 40-1 (Jan. 3, 2005).

104. Id. at 41.

directly attributable to LIFE, however, is unclear as TRAC has credited the numbers to an increase in correspondence audits over “face-to-face” audits.¹⁰⁵

Unsurprisingly, LIFE has received high praise from the taxpayers that are eligible for the program. An IRS survey of LMSB audited taxpayers whose cases the LMSB closed between October 2002 and September 2003 revealed that taxpayers were very satisfied with LIFE.¹⁰⁶ In addition, Deputy LMSB Commissioner Bruce Ungar has pointed out that LIFE’s popularity has increased from 2002 to 2004.¹⁰⁷

Tax Executives Institute (“TEI”), whose members are almost entirely assigned to the LMSB, has been a strong advocate of LIFE.¹⁰⁸

105. Id.:

One study, published following the IRS’s release of the 2003 enforcement data, noted that most of the ballyhooed boosts in audit coverage were attributable to the agency’s growing use of correspondence audits. . . .

TRAC called correspondence audits, which are conducted through the mail, “comparatively superficial” to audits conducted in person.

Id. Indeed, a recent audit conducted by the Inspector General for Tax Administration’s office stated that “[a]s of September 2004, approximately 4.2% of the examinations initiated for large businesses involved the LIFE process.” Memorandum from Pamela J. Gardiner, Deputy Inspector General for Audit, for Commissioner, Large and Mid-Size Business Division (Feb. 18, 2005), *in* *The Limited Issue Focused Examination Process Has Merit, but its Use and Productivity Are Concerns*, Ref. No.: 2005-30-029 (Feb. 2005), at <http://www.ustreas.gov/tigta/auditreports/2005reports/200530029fr.pdf> (hereinafter LIFE Audit Memo). Of course, even if correspondence audits played a significant role, they represent a similar audit policy to LIFE – namely to sacrifice thoroughness in the name of efficiency.

106. Alison Bennett, *Taxpayer Satisfaction With Larger Audits Relatively High, but Tied to Time*, IRS Finds, 154 BNA Daily Tax Report G-2, G-2 (Aug. 11, 2004).

107. Kurt Ritterpusch, *Ungar Details Programs to Accelerate LMSB Audits, Adaptation to New Tax Law*, 213 BNA Daily Tax Report G-9, G-9 (Nov. 4, 2004).

108. Statement of Timothy J. McCormally, Executive Director, Tax Executives Institute, Inc., Testimony Before the Subcommittee on Oversight of the House Committee on Ways and Means, (Mar. 30, 2004), at <http://waysandmeans.house.gov/hearings.asp?formmode=view&id=1318>.

An informal survey of TEI members recently confirmed that LMSB's LIFE initiative – which focuses on materiality of issues and risk analysis of issues to be audited – is streamlining the examination process. We understand that LMSB's interim review of LIFE validates this conclusion, and accordingly strongly recommend that future initiatives be designed to complement and supplement these programs, not replace or supplant them.¹⁰⁹

The fact that both the IRS and the taxpayers have such a positive opinion of LIFE could be viewed optimistically as rare agreement by the government and the taxpayers that a government program can fairly tax citizens while improving government efficiency. Pessimistically, and more realistically, such agreement could signal that one of the sides is not correctly perceiving the program's consequences. One must ask the question: if faster audit times really result in fair collection of revenue as well as an increased frequency of audits, why would such a program excite taxpayers? The answer to this question must be found in some of the criticisms that have been leveled against LIFE.

B. Public Arguments Attacking LIFE

While the IRS and LMSB taxpayers have gone to great lengths to tout LIFE's advantages, the program has several problems that take the petals off the rose. Contrary to the IRS's belief, LIFE inappropriately sacrifices audit quality for reduced audit time. That sacrifice can directly lead to taxpayer manipulation. Second, LIFE's inappropriate use of discretion irreparably damages the rule of law. In addition, LIFE violates the IRS's duty to treat taxpayers consistently. Finally, LIFE is premised on a faulty assumption that there are morally good corporate taxpayers and that the IRS can identify them.

1. LIFE Sacrifices Thoroughness and Enables Taxpayer Manipulation

– Although the IRS's top officials have been touting LIFE's successes, voices from IRS auditors have raised several concerns regarding LIFE. These auditors state that LIFE provides a much too rigid audit formula that results in a vastly increased potential for fraudulent taxpayer activity to go undetected.¹¹⁰ One auditor quoted in the Washington Post summarized this complaint:

109. Id.

110. Weisman, *supra* note 97; Glass Jacobson, *supra* note 8, at 1-2.

“There used to be a point of no return, where when you found something wrong, you were there, and you were going to stay there,” said one corporate tax auditor, who spoke only on condition of anonymity out of fear of being fired. “There was no way they were going to get you out, and you had the power of the IRS behind you.

“Now, even if you find the adjustment, find actual fraud, management is still throwing you out of the building,” the auditor said.¹¹¹

In addition, some IRS officials have complained “that accounting firms and corporate tax offices are too plugged in to what the IRS is focusing on. . . . Focusing on particular issues simply changes the behavior of tax cheats.”¹¹²

Even LIFE’s creators are questioning its current use. Larry Langdon believes that Commissioner Everson’s focus on using LIFE as a sword to cut down audit times so drastically is a misuse of the program.¹¹³ Langdon stated that he originally intended LIFE to be used on around 25% of LMSB audits, which would decrease the time of those audits but would not affect the overall time of LMSB audits.¹¹⁴ According to Langdon, to achieve Everson’s goals, the LMSB would have to use LIFE on nearly 75% of its audits, defeating Langdon’s original goal only to use LIFE on taxpayers with a good track record of compliance.¹¹⁵

B. John Williams Jr., the former IRS chief counsel, echoed Langdon’s concerns about the overuse of LIFE. Williams stated that “[b]y declaring that audits should take 15 to 18 months, Everson is virtually guaranteeing that IRS auditors will miss tax dodges, fail to explore suspicious transactions, or even walk away from audits that are on the verge of finding wrongdoing.”¹¹⁶

111. Weisman, *supra* note 97.

112. *Id.*

113. *Id.*

114. *Id.*

115. *Id.*

116. *Id.* These misses and failures could have profound economic effects:

[T]he statistics show LIFE cases are generating less additional recommended taxes than other large business examinations, which could impact tax revenues. [O]ur analysis indicates [if the IRS allocated] 5% of the available examinations [of large businesses to the LIFE process] over the next 5 years, the amount of recommended

Indeed, because of the IRS's new policy of secrecy, it is impossible for the public to determine if LIFE is playing a significant role in achieving Everson's efficiency goals, especially in light of a recent Inspector General for Tax Administration audit indicating a more limited use of LIFE.¹¹⁷ In its quest to demonstrate increased audit rates, the IRS may be hiding something. To know for sure whether LIFE is the cause of the efficiency increase is currently not possible because the IRS has been withholding some of the information necessary to attribute the reported increase to LIFE.

The Transactional Records Access Clearinghouse (TRAC) has gathered data indicating that:

While the overall audit rate for corporations has continued to decline, the FY 2004 rates for the larger corporate returns with assets of \$10 million or more increased for the first time in many years. Still the FY 2004 rates for these are only a fraction of what they were a decade ago.¹¹⁸

TRAC, however, indicated that it was having difficulty explaining this recent increase in LMSB audit rates because of the IRS's refusal to provide TRAC with all of the information it needed to conduct an informed analysis:

The reality behind this very recent increase in the audits of larger corporations is not clear, partly because the IRS currently is withholding essential data. Because the IRS has refused to make public supporting details to back up Commissioner Everson's official statements or to provide other material about a wide range of other IRS enforcement activities, fully documenting what the agency is doing, and not doing, has become more and more difficult. The agency's

additional taxes could drop an average of \$349 million a year (\$1.7 billion over 5 years).

LIFE Audit Memo, *supra* note 105, at 6, 7. One shudders to estimate what the impact if Langdon's goal of 25% use of LIFE were implemented, much less if LIFE were used in 75% of the audits, the number Langdon anticipated would be necessary to achieve Everson's goals. See Section V.B.1.

117. Life Audit Memo, *supra* note 105.

118. Corporate Audit Rates – Wide Disparities Found in Different Industries, at <http://www.trac.syr.edu/tracirs/latest/current/> (last visited Jun.6, 2005).

current closed-door policy reverses information practices that have been generally followed for the last three decades.¹¹⁹

Such limited disclosure combined with the IRS's refusal to disclose all of the documents in this author's FOIA request supports the conclusion that the IRS is creating a secret law through LIFE without any accountability.¹²⁰

Some insight can be obtained by a TRAC analysis performed on data from the first half of 2004. "The group said IRS data showed a 10% decline in the time spent on examinations of moderately sized corporations in the first half of FY 2004, while time spent on audits of the largest companies dropped by 33%, TRAC said."¹²¹ TRAC believed that such a decline in thoroughness of the audits of large corporations could have greatly contributed to the fact that the IRS concluded that substantially less additional taxes discovered through corporate audits were due in the first half of 2004 than in 2003.¹²² TRAC concluded that the LMSB "has tried to hold the line on audit coverage by allowing the time allocated for each audit to slip."¹²³ Thus, this data contradicts the IRS's claim that it can decrease audit times while maintaining audit thoroughness.

The IRS has summarily dismissed many of these complaints against the program with little acknowledgment of their possible merit. The Internal Revenue Manual states succinctly that "[t]he establishment of a materiality threshold(s) will not impact the examiner's responsibility to verify the proper computation of tax liability."¹²⁴ The Internal Revenue Manual, however, does not say how an auditor can ascertain the correctness of any return while ignoring all but a few items that warrant audit.

Other IRS officials have offered a better answer to the negative comments. They have argued that "their analytical techniques, along with their knowledge of the company's history, will prevent taxpayers from using the LIFE process to divert attention from scams and abuses."¹²⁵ This statement is,

119. *Id.* See Section IV.B, *supra*, for a more detailed discussion of the information that the IRS has withheld regarding LIFE.

120. See *supra* Section IV.B.

121. Alison Bennett, TRAC Says Pace of Corporate Audits Headed Toward New Low in Fiscal 2004, 211 BNA Daily Tax Report G-2, G-3 (Nov. 2, 2004). Note that the IRS has criticized TRAC's arguments because the IRS does not believe that accurate conclusions can be derived from data that only reflects six months. *Id.*

122. *Id.*

123. *Id.*

124. I.R.M. 4.51.3.4.5(5) (2004).

125. Crenshaw, *supra* note 9.

of course, tacit recognition of the fact that LIFE offers taxpayers new opportunities to cheat. In the first place, LIFE requires one to ignore all but a few issues that warrant audit. LIFE is premised on the fact that many items that warrant audit will be intentionally ignored. Furthermore, how can the auditors have a strong knowledge of a company's history if it has been audited only once in twenty years? Deborah Nolan has also relied on the LIFE audit procedures as an inherent obstacle to abuse of LIFE because these procedures "allow auditors to follow trails off audit plans if solid evidence indicates problems."¹²⁶

One of the more telling statements that the IRS has made regarding these complaints occurs in an internal, frequently-asked-questions document that the IRS prepared regarding LIFE. In response to the question of whether it would be possible for the auditor to "determine the issues that will have substantial noncompliance without getting into the books and records of the taxpayer," the entire answer was as follows:

The LIFE process may change the way you conduct your examination. After conducting your full risk analysis, LIFE involves increased communication and interaction with the taxpayer as well as materiality considerations in setting/narrowing your initial scope. Inherent in the process is examining issues with the greatest compliance risk in a shorter timeframe due to increased involvement of the taxpayer. Once you have identified an account or a transaction, you should be communicating with the taxpayer, having them explain the transaction to you, rather than issuing a series of IDRs. The examination techniques that you use to determine that the taxpayer has reasonably complied with the law do not change.¹²⁷

This double-speak makes it clear that the IRS understands the problem, has no answer, and has determined to ignore its implications. By merely stating that the audit process will change, the IRS has managed to answer the question without answering it at all. Nothing in the above statement actually addresses the concern over whether the shortened audit process could have drastic thoroughness ramifications.

¹²⁶ Weisman, *supra* note 97. Also see Section III.C.2, *supra*, for a discussion of how an audit can be expanded without regard to materiality thresholds if the auditor discovers certain types of abuse.

¹²⁷ First LIFE FAQ, *supra* note 37, at 3 (emphasis in original).

The IRS is not convincingly addressing the merits of these arguments against LIFE. The IRS's attitude seems to be "trust us, we can handle it." Merely stating that the complaints are without substance is not an answer to them. The IRS needs to be much more persuasive in explaining how it is effectively handling the concerns over LIFE leading to a lack of thoroughness and potential taxpayer abuse. Imagining how the IRS can do this, however, is difficult because it defies logic to argue that limiting the issues to be addressed and utilizing materiality thresholds to curb audit scope expansion will not compromise the thoroughness of those audits.

2. *LIFE Hurts the Rule of Law* – Although LIFE involves very little discretion once the issues are selected and the materiality thresholds are set, the decision of whether or not to use LIFE as well as the issue selection and threshold determination are highly discretionary. Larry Langdon recognized this when he instituted LIFE, and he stated in an internal memorandum in the LIFE training manual:

I recognize that the LIFE Process is not appropriate for all examinations. I also realize that there will be instances when we have agreed to conduct a LIFE examination but circumstances require that it be terminated. I will be relying on your judgment to determine when the use of this process should be employed, as well as when the process should be terminated.¹²⁸

This discretion over which taxpayers should be eligible for LIFE, as well as the discretion in issue selection and materiality threshold determination, present significant problems if one assumes that the tax system should favor rule of law values.

Edward Morse has argued that "[r]ule-based constraint is likely to enhance efficiency in tax administration and protect taxpayer rights to a greater degree than a discretionary approach to justice."¹²⁹ Although discretion cannot be completely removed from the tax system, it must be contained to preserve the rule of law.¹³⁰ Too much discretion in a rule-based system is problematic

128. Memorandum from Larry Langdon to LMSB Employees (Oct. 21, 2002), reprinted in LIFE Training Manual, *supra* note 19, at ii.

129. Edward A. Morse, Reflections on the rule of law and "Clear Reflection of Income:" What Constrains Discretion?, 8 Cornell J.L. & Pub. Pol'y 445, 451 (1999).

130. *Id.* at 448.

because it creates distrust in a decisionmaker's ability to apply rules consistently and fairly.¹³¹ In addition, "[d]iscretion also threatens the internal morality of law by undermining the notice and publicity requirement of rules."¹³² LIFE exemplifies these destructive characteristics of an audit system that has too much uncontrolled discretion.

An audit is inherently discretionary. It is properly up to Treasury to determine which taxpayers and what issues should be audited consistent with ascertaining a tax return's correctness. While such discretion might injure the rule of law, it does not destroy it entirely.

LIFE, however, greatly and inappropriately expands this discretion. In LIFE, the LMSB has created an audit program that it will apply to taxpayers on a discretionary basis. In addition, the program's authorization of an auditor to select only a few of many identified issues for audit provides the IRS with the discretion to intentionally ignore information relevant to ascertaining the correctness of a return. Thus, with this system, the discretion that the IRS has solely on the basis of its own authority now directly conflicts with the IRS's legislatively granted authority to examine relevant information (and not to ignore it intentionally) to ascertain the correctness of a return.¹³³ The problems with such discretion are compounded by the fact that the IRS is not enacting LIFE through the promulgation of regulations. As Morse points out:

Deference to agency interpretations embodied in prospectively applicable regulations does not present a significant threat to rule of law values. Changing the locus of rulemaking from the Legislative to the Executive branch may implicate other concerns, but regulations with rule-like characteristics provide taxpayers with notice of their obligations and facilitate planning. Moreover, they facilitate consistent treatment of taxpayers by announcing the official agency position to those who must enforce those rules.¹³⁴

Not only does LIFE signify an increase in the IRS's discretion with questionable legislative support, it does so without Treasury adopting the program through specific regulations that could lessen its damage to the rule of

131. *Id.*

132. *Id.*

133. See Section IV, *supra*, for a more complete discussion of whether or not the IRS has the authority to conduct LIFE.

134. Morse, *supra* note 129, at 485-86 (citations omitted).

law.¹³⁵ Furthermore, it has determined to keep secret two critical elements of the program – the issues it is selecting and the manner in which materiality thresholds are determined.¹³⁶ Thus, LIFE effectively gives auditors discretion to secretly change the law as it applies to a particular taxpayer.

3. *LIFE Violates the IRS's Duty to Treat Taxpayers Consistently* – Another problem with LIFE is that it violates the government's duty to treat taxpayers consistently.¹³⁷ While there is some debate as to the extent of the duty of consistency,¹³⁸ the general rule appears to be, unless there is a rational basis to treat taxpayers differently, they should be treated similarly.¹³⁹ Even a publication by the Tax Executives Institute, an organization that enthusiastically supports LIFE, stated that there could be a potential duty of consistency problem because “[o]ne examiner may establish more stringent materiality limits and audit more items than another examiner who is more liberal with the threshold.”¹⁴⁰

In response to this concern, the IRS believes it can treat taxpayers consistently regarding the use of materiality thresholds without establishing any specific guidelines. In establishing its materiality guidelines both for issue and threshold selection, the IRS has stated that producing specific guidelines for

135. The only apparent regulatory authority is the permissive language in Regs. § 301.7602-1(a) discussed earlier in Section IV. This general regulatory language is not specific enough to satisfy the uncertainty that threatens the rule of law.

136. See *supra* Section IV.B.

137. This problem is ironic considering that the IRS's press release announcing LIFE stated: “LIFE is an effort by LMSB to institutionalize best practices and provide consistency in the treatment of taxpayers.” IRS News Release IR-2002-133 (Dec. 4, 2002).

138. See Molly Moses, *Uphill Battle Predicted for Glaxo on APA Discrimination Claim*, 94 BNA Daily Tax Report J-1, J-3 (May 17, 2004) (comparing recent cases indicating a duty of consistency with those that indicate that the IRS is not required to treat current taxpayers consistently with prior erroneous treatment).

139. *Sherwin-Williams Co. v. U.S.*, 403 F.3d 793, 797 (6th Cir. 2005) (citing *Oshkosh Truck Corp. v. U.S.*, 123 F.3d 1477, 1481 (Fed. Cir. 1997)).

140. James A. Dougherty & Rona M. Faust, *IRS Instills New ‘Life’ Into its Audits -- limited issue Focused Examinations*, *Tax Executive*, (Jan.-Feb. 2003), at http://www.findarticles.com/p/articles/mi_m6552/is_1_55/ai_98416259. Of course, perhaps because of TEI's enthusiasm over the program, the authors tempered their concern by mentioning several mitigating factors: “The first is that the examiner should seek input in determining the thresholds from IRS specialists and the taxpayer. Furthermore, if the taxpayer disagrees with the materiality level, the taxpayer should ask to speak to the team manager.” *Id.*

determining materiality is impossible.¹⁴¹ Nevertheless, the IRS has stated it can provide equal treatment to taxpayers by applying a consistent process in determining materiality.¹⁴² Despite this emphasis on consistency, the IRS states that an auditor's discretion is essential in determining materiality.¹⁴³ In fact, when compiling its initial frequently asked questions about LIFE, the LMSB responded to the question of whether or not it was attempting to create blanket materiality thresholds for all taxpayers as follows:

Absolutely not! No two taxpayers are identical. The differences in location, size, business practices, industries, etc., make it impossible and impractical to set one standard. For this reason, provided [sic] examples to demonstrate different ways to establish materiality and encourage agents to use professional judgment in conjunction with a methodology that they believe is appropriate.¹⁴⁴

What the IRS perhaps does not realize in its response, however, is that the use of materiality thresholds will, by definition, result in the inherent inconsistent treatment of taxpayers. The fact that taxpayers are not identical does not mean that they cannot be treated relatively equally. The more discretion that is given in an audit process, however, the more unlikely it is for this consistent treatment to occur. Thus, LIFE's discretionary side creates as many problems as its overly rigid aspects, indicating that LIFE does not integrate necessary discretion properly into the audit process. Furthermore, the IRS's response does nothing to address the fact that taxpayers outside of the LMSB's jurisdiction are not even eligible to participate in LIFE. If LIFE is so beneficial and does not result in the problems already discussed, what rational basis could there be for not applying it to all audits?

141. I.R.M. 4.51.3.3.4(2) (2004).

142. See, e.g., I.R.M. 4.51.3.3.4(2) (2004); LIFE Training Manual, *supra* note 19, at 8-9; First LIFE FAQ, *supra* note 37, at 7, 9; LIFE Consolidated FAQ, *supra* note 31, at 8.

143. I.R.M. 4.51.3.3.5(10) (2004); LIFE Training Manual, *supra* note 19, at 10-12, 18.

144. First LIFE FAQ, *supra* note 37, at 9-10 (emphasis in original). The Internal Revenue Manual echoes this statement: "A threshold(s) set for one period or taxpayer should not be automatically extended to either another taxpayer or another period for the same taxpayer. A separate risk analysis must be performed for each examination." I.R.M. 4.51.3.4.5(6) (2004).

4. *LIFE is Premised on a Faulty Assumption Regarding Taxpayer Honesty* – If the rule of law suffers in the tax system, “citizens lose faith in the fairness of the tax system and are less inclined to honor it.”¹⁴⁵ Richard Lavoie argues that today “[t]he rule of law is flagging as the system struggles with its own mind-numbing complexity and revelations that many profitable corporations and wealthy individuals pay little or no tax.”¹⁴⁶ As a result, while taxpayers in the 1970s considered the tax system to be fair, today, after the increase of corporate tax shelter activity in the 1990s, most taxpayers believe that the system is unfair.¹⁴⁷

Lavoie argues that this failure of the rule of law has contributed to the modern taxpayer rarely taking moral or ethical considerations into account when deciding the taxpayer’s level of compliance with the tax laws.¹⁴⁸ The government should not expect taxpayers to rely on their own internal sense of right and wrong as they consider their tax liability.¹⁴⁹ Rather, the government should understand that taxpayers’ behavior will be much more heavily influenced by issues such as the taxpayer’s determination of the likelihood of being caught and punished.¹⁵⁰

For corporations, this failure of morality in tax planning is even starker than for individuals. According to Lavoie, for the corporate tax planner “[e]thical considerations about the moral appropriateness of playing games with the tax system generally do not enter the calculus.”¹⁵¹ Maximizing profits to shareholders is much more likely to drive corporate executives making tax

145. Richard Lavoie, *Subverting the rule of law: The Judiciary’s Role in Fostering Unethical Behavior*, 75 U. Colo. L. Rev. 115, 176-77 (2004).

146. *Id.* at 181.

147. *Id.* at 181.

148. *Id.* Lavoie points out that:

For some the very concept that ethical considerations could impinge on tax planning may seem absurd. After all, the appropriateness of tax planning has long been accepted. Additionally, certain provisions of the Internal Revenue Code (the “Code”) were adopted with the express goal of harnessing tax planning as a means of modifying taxpayer behavior. However, while tax planning is permissible, tax evasion is not. The gray area between the two falls under the domain of tax ethics.

Id. at 175-76 (citations omitted).

149. *Id.* at 121-22.

150. *Id.* at 121-22.

151. *Id.* at 186.

compliance decisions, especially if the corporations are publicly traded. Such profitability would necessarily include minimizing the corporation's tax liability. This mindset has enormous implications for LIFE.

As discussed in section V.B.1, when LIFE was created, the LMSB intended that it should only be used for a small number of LMSB taxpayers that had good compliance histories and were therefore trustworthy. LIFE, however, appears to be based on a faulty premise.¹⁵² Assuming that any corporate taxpayer can be trusted to pay its fair share is risky because of the non-ethically based motives that drive taxpayer decisions today. Just because a corporation has a good past track record does not mean that the government can trust that corporation not to take advantage of the LIFE system. The more realistic presumption is that if corporate taxpayers determine either through observation or conversations amongst themselves that there are ways to manipulate the lack of thoroughness inherent in the LIFE system without being caught, they will do so. For example, if corporations determine that the IRS tends to look at similar issues across the board or tends to set similar materiality thresholds, it will not be difficult for those corporations to manipulate their transactions to take advantage of this knowledge. Despite the government's contention that different materiality thresholds will be used for each taxpayer, its reticence in disclosing any hard data about what materiality thresholds are being used strongly suggests that a discernible pattern applicable to a number of taxpayers exists. Although the government technically states that it can terminate the LIFE audit if there is an indication of fraud, there is only a slim chance of the government even detecting this fraud because of the restrictions on looking outside specific issues.

152. At least one other division of the IRS recognizes the faultiness of this premise. Martha Sullivan, the director of the IRS Exempt Organizations Division, in describing her division's recent initiatives, stated: "It's important to understand that a balanced enforcement program has to have some across-the-board coverage. If you don't, then the good taxpayers will start to become bad because they will start to think we're not looking." Stephen Joyce, *IRS Shifting Enforcement Actions Regarding Tax-Exempt Groups to Crack Down on Abuses*, 98 BNA Daily Tax Report G-12, G-12 (May 23, 2005).

The IRS is not the only taxing entity that is operating from this faulty premise. France has recently unveiled a plan to reform corporate audit procedures and improve taxpayer response time. Lawrence J. Speer, *France Unveils Blueprint for Simplifying Return Filing, New Corporate Audit Limits*, 213 BNA Daily Tax Report G-2 (Nov. 4, 2004). In commenting on the new plan, the French Finance Minister Nicolas Sarkozy stated that "[o]ur idea is that taxpayers are honest, and that only a slight minority are committing fraud." *Id.* at G-2.

This potential for taxpayer abuse of LIFE undermines LIFE's goal of relying upon increased audit coverage to lead to greater corporate compliance and in increased revenue. LIFE will likely result in decreased, rather than increased, corporate compliance as taxpayers manipulate their participation in the program to their benefit. As a result, any increase in revenue obtained by increasing the audit rate will be more than offset by the decreased revenue resulting from the taxpayer abuse.

VI. CONCLUSION

Although having insufficient resources is not a new problem for the IRS, the agency is getting much more aggressive in its solutions to this problem through a new policy of administrative activism. The expanded use of LIFE reflects the IRS's clear vision to make the most of its very limited resources by reducing audit times to perform as many audits as possible. This vision is also evident in the fact that timesaving techniques are beginning to spread to other IRS divisions.¹⁵³ The IRS cannot solve this problem by unilaterally

153. For example, the IRS is launching a pilot program in 2006 in which virtually real-time audits will be used to detect abuse trends and provide better advice to taxpayers. John Herzfeld, IRS to Launch Pilot Project to Speed Audits, Guidance Process, Official Says, 188 BNA Daily Tax Report G-1 (Sept. 29, 2004). Furthermore, the IRS has experimented with establishing artificial cutoff points on certain audit times: "Though auditors may prefer to hold out to complete the "perfect audit," [Deputy IRS Commissioner for Services and Enforcement Mark E.] Matthews said, "the return on investment for that last 50% or 70% of effort may not be that great.'" *Id.* at G-1. In addition, the LMSB is instituting other timesaving policies of its own to improve audit currency. See Kenneth A. Gary, IRS Evaluating Comments on Enhancing Audit Currency, 104 Tax Notes 887, 887 (Aug. 30, 2004); Glass Jacobson, *supra* note 8, at 3-4.

In fact, the only sign that use of LIFE might be diminishing comes in the form of it being potentially replaced by a "currency initiative" announced in 2004 that takes an even more aggressive stance to emphasizing audit speed. Molly Moses, Practitioners Say Hurried Audits Under Currency Initiative Leading to Incomplete Analyses in Large, Complex Transfer Pricing Cases, 64 BNA Daily Tax Report J-1, J-1 (Apr. 5, 2005):

We found, for example, the progress of implementing the LIFE process was hindered by a new initiative, the Currency and Cycle Time Improvement Initiative (Currency Initiative), that overlapped with the implementation of the LIFE process and was more aggressive in holding examiners accountable for closing examinations. As a result, examiners gave the Currency Initiative a

implementing procedures that possibly exceed its congressionally granted audit authority. To do so would greatly damage the rule of law that is essential to the tax system.

In addition, while LIFE is reducing audit times, it is doing so at too great a price. LIFE has allowed too much discretion where none should exist and limited discretion where more should be used. The very nature of the system creates enormous problems due to a drastic decline in audit thoroughness. As a result, the LMSB is giving corporate taxpayers an opportunity to take advantage of LIFE to hide fraudulent activity. Even if LIFE were just applied to “good” taxpayers as it was originally intended, such taxpayers, especially at the large corporate level, probably do not exist. Despite the IRS’s efforts to prevent taxpayers from discovering detailed information regarding how issue selection and materiality threshold determination are established, corporate taxpayers will eventually learn from sharing information with each other whether there is a discernible pattern that could aid in predicting how the IRS determines these issues. Compounding these problems is the fact that the IRS’s lack of full disclosure regarding the program basically allows the agency to create a secret law without any meaningful political accountability.

The solution is a simple one. The IRS needs to go to Congress. Either Congress needs to increase the amount of resources going to the IRS so that the LMSB is not forced to disregard information that could be highly relevant in determining tax liability or Congress needs to give the IRS direct authority to use techniques like LIFE. While congressional approval of LIFE would not remove its problems, at least it would indicate that the people, through their elected representatives, had consented to the trade-offs that accompany LIFE. Congressional approval of LIFE is unlikely, however, because such approval would lead to a negative reaction from the public and the media because of its favorable treatment of large corporate taxpayers.¹⁵⁴ Thus, increased resources

higher priority than the LIFE process, which had the effect of reducing the number of LIFE cases.

Id. (quoting from a Feb. 18, 2004 Treasury Inspector General for Tax Administration Report).

154. Of course, direct congressional disapproval of LIFE could be equally as unlikely because Congress might not want to be seen as opposing a program that is so popular with corporate America. This would not be the only example of Congress doing nothing while the IRS gives too much to corporations.

For example, the Senate Finance Committee recently investigated the IRS’s Advance Pricing Agreement Program (“APA”), “wherein the IRS cuts transfer pricing deals with large corporate taxpayers.” Lee A. Sheppard, Draft Senate Finance APA

for IRS enforcement is the only solution that makes practical sense. Without either of these solutions, however, the IRS has greatly overstepped its function. A society that values the rule of law cannot tolerate this result, even if done with the best of intentions, because these intentions can pave the road to a place where we dare not go.

Report Shows Incompetent IRS, 2005 Tax Notes Today 119-21, (June 22, 2005). The APA is somewhat similar to LIFE in the sense that both programs involve an advance agreement between the taxpayer and the IRS. "An APA is a binding contract between the IRS and a taxpayer by which the IRS agrees not to seek a transfer pricing adjustment under IRC § 482 for a covered transaction if the taxpayer files its tax return for a covered year consistent with the agreed transfer pricing method." Advance Pricing Agreement Program, at <http://www.irs.gov/businesses/corporations/article/0,,id=96277,00.html>.

The investigation resulted in a draft report that "points out . . . that the program is badly managed, and the IRS is giving away the store." Sheppard, *supra* note 154. According to the draft report, rarely are taxpayers actually kicked out of the APA, and some taxpayers are not paying tax because of transfer pricing. *Id.* Furthermore, there was considerable movement of APA officials into the private sector, which resulted in "some back scratching." *Id.* Although the specific revenue loss under the APA is unknown, it is predicted "to be massive." *Id.* "Yet the report was widely expected to be a whitewash, since senators on both sides of the aisle like the APA program because business likes it. The Court of Appeals for Aggrieved Business is not about to kill a program that business is happy with." *Id.*