1991

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Coping with the New IRS Exam Initiatives

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Prepared for the William & Mary Tax Conference
December 7, 1991

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The audit and enforcement process, particularly as it relates to the 1500 or so large corporations subject to the Internal Revenue Service's Coordinated Examination Program (CEP), has become a significant issue, culminating in an Executive Committee Decision Document on July 20, 1990, announcing a number of broad changes to the program. This outline covers the history of and reasons for changes to CEP (and the related Industry Specialization and International programs), suggests strategies and planning techniques, and offers predictions as to further evolution in the programs. Nearly all of the CEP directions, strategies, and techniques are or will become equally applicable to the regular Examination process. Consequently, an understanding of the process will be important even to those not representing CEP taxpayers.

I. FACTORS LEADING TO CHANGE

A. A legacy of the 1980's was an ever more complex law. Enormous additional complexity, and relative lack of guidance, put great pressure on the audit system and on corporate tax managers. Greater uncertainty means more error, more need for enforcement. It also means less ability of revenue agents to apply the law, and more need for training and assistance.

B. Pressure for revenue grew exponentially.

1. 1982 Act reversed course, sought to raise money.

2. 1986 Act purportedly shifted $100 billion of burden to corporate sector.

3. IRS continually was given additional money for enforcement. Example: Large case revenue initiatives in 1987-88, 1991.

4. Growing dollars in large case inventory beyond Exam level
   1978-7 billion
   1988-35 billion

5. Poor agreement rate and lengthening cycles in Exam meant slow collections. Agreement rate in Exam for large cases less than 25%.

C. Corporate Environment Changes

1. More mergers and acquisitions, more sophisticated transactions.

2. Growing number of multinationals

3. Larger and more complex corporate structures, more and more potential places of audit, created increasing difficulty in identifying material issues, completing audits.
D. Service Resource Problems

1. Agent salaries and grades falling further behind private sector. Serious personnel problem.

2. Budget problems - IRS systematically underfunded. [Note: This trend has been reversed in the last two years, which have seen IRS' budget go from 5.5 billion to 6.7 billion dollars.]

3. Emphasis on tax shelters absorbed scarce enforcement resources, and also contributed to a change in enforcement attitude.

E. Perceived Problems With Large Case Enforcement

1. Issues not raised

2. Facts poorly developed

3. Success rate poor - 15-25% in litigation, Appeals

4. Wrong issues frequently raised

5. Poor coordination, lack of consistency. Lack of knowledge of issues pending in system

6. Little coherent policy or operational control/management.

7. Alleged taxpayer procrastination

Result - A growing realization through the 1980's that the audit and controversy system must do a better job of identifying and dealing with the cases and issues that matter.

II. HISTORY OF CHANGE - A GRADUAL EVOLUTION

A. Industry Specialization Program

1. Begun in 1979

2. Gradual expansion of industries currently covers 22. The program provides oversight and coordination for key issues in key industries, but suffers from lack of resources, emphasis, expertise and support. Generally perceived within IRS as a good idea.
3. Chief Counsel/Appeals extensively involved as of 1985. For first time, attorneys begin to be formally involved with Exam during audit.

B. Special Trial Attorneys created - 1980. Program to assign most difficult cases to senior trial specialists.

C. 1982 Reorganization of IRS moved Technical and Appeals under Chief Counsel. Although there were many reasons for this restructuring, a central concern was creating a better ability to deal with and control the issues that matter.

D. 1983 North Atlantic Region study - identified most of problems enumerated above.

E. 1986 - International functions separated in both Chief Counsel and Commissioner. Creation of separate International functions was a reaction to many of the factors noted in part I, supra, as well as recognition of the growing importance and difficulty of international tax issues. International promptly began developing the sort of coordinated team approach to enforcement that will undoubtedly evolve in the rest of CEP. International has established a Field International Support Team, whose acronym (FIST) perhaps needs no further elaboration! But see part III, infra.

F. Sawyer\Blattner Report (February, 1987) - Exam undertakes comprehensive review of CEP.

G. SLA's (Special Litigation Assistant) created - 1988 - Senior lawyers to assist Exam, deal with most significant cases.


I. Exam, Appeals, Counsel proposals, April 1990.

J. New Program - July 1990

III. SPECIAL INTERNATIONAL CONSIDERATIONS

International enforcement has gained considerable additional attention over the period of the 1980's. Although it needs to be understood in the context of the entire large case enforcement program, there are special factors and considerations, as well as enforcement tools, in the International area.
A. International Enforcement Factors

1. Congressionally mandated Section 482 study of transfer pricing.

2. Growing International dollars.
   a. Foreign owned assets in U.S.
      - $306 billion in 1977,
      - $1.3 trillion in 1986
   
   b. Number of returns by foreign-owned corporation in U.S.
      - 14,351 in 1978
      - 44,862 in 1987
   
   c. U.S. assets abroad.
      - $379 billion 1977
      - $1.1 trillion 1986
   
   d. Income on U.S. investment abroad.
      - $32 billion 1977
      - $91 billion 1986
   
   e. Number of U.S. corporation returns with a Controlled Foreign Corporation.
      - 28,000 in 1982
      - 56,000 in 1986
   
   f. Number of International Examiners.
      - 150 in 1977
      - 490 in 1990

3. White Paper Compliance survey. As a part of its 1988 White Paper, the IRS conducted a compliance study. Highlights:
   a. No transfer pricing documentation in 75% of the cases.
   b. Long response times to information requests (68% of those over 1 year with no explanation).
c. Rare use of §982 (formal document request - see Part III(c)(1), infra.)

d. U.S. subsidiaries of foreign corporations report lower profits than similar U.S. controlled corporations. (The same conclusion was presented to the House Ways and Means Oversight Subcommittee Hearing by Commissioner Goldberg on July 10, 1990).

e. Foreign corporations and foreign-controlled corporations routinely frustrated audits of inbound transactions by refusing to produce documents.

B. International Functions as Laboratory.

Separate international organizations in both Chief Counsel and IRS have focused attention on international issues, and served as laboratories for many of the notions that now will pervade the rest of the Coordinated Examination Program, and ultimately the rest of the Examination program, at least as it relates to audits of any significant size.

1. Extensive use of lawyers, specialists, and technicians to assist Exam.

2. Centralized issue development, planning, and authority.

3. Extensive technical training.

4. Audit Guidelines (i.e., a paper explaining to international examiners a particular issue, the relevant facts, what to look for, how to conduct the examination, etc.).

5. Issue tracking throughout the system.

6. FIST

"FIST (Field International Support Team) was created to enhance the delivery of legal services by improving coordination with field counsel and International Examiners, and encourage the involvement of Counsel personnel during the examination process. FIST coordinators in the national office serve as the primary contact point for inquiries emanating from either International Examiners or Field Counsel, and coordinate substantive assistance. The FIST team will utilize the CEP report to identify national examination and litigation trends and encourage local Counsel assistance at the earliest stage of examinations which involve the potential for large proposed deficiencies or otherwise significant issues."

* From a paper prepared by attorneys in the International Function of Chief Counsel.
C. Special International Enforcement Tools.

Over the last few years, Congress has provided special tools for international enforcement.

   a. If the taxpayer fails to comply with a formal document request within 90 days after mailing, the taxpayer may not introduce into evidence in any civil tax providing any foreign-based documentation covered by the request.
   b. This provision is very broad, but seldom used so far.
   c. The new CEP program encourages use of §982.
   d. Examination has recommended the Service seek a domestic version of §982, but the recommendation was not adopted.

2. Section 6038A
   b. Very Broad. Essential provisions:
      (i) Prior to the 1989 Act, section 6038A only required the reporting of certain information annually on Form 5472 regarding transactions between a foreign-controlled domestic corporation or a branch of a foreign corporation and any related parties. The penalty for failure to file the form 5472 was $1,000 plus $1,000 for each additional 30-day period following 90 days after notice of such failure was mailed. The maximum additional penalty that could be assessed was $24,000, for a total maximum penalty of $25,000. Foreign control was defined as 50% or greater ownership.
      (ii) In 1989, changes made to:
         A. Apply section to foreign corporations doing business in U.S. and 25% foreign owned U.S. corporations;
         B. Require the maintenance of such records by the reporting corporation or another person as may be appropriate to determine the correct treatment of transactions with related parties, generally in the U.S. Regulatory authority is granted to the Secretary to prescribe such records, their location, etc. Final regulations were published on June 14, 1991. The regulations require that records "sufficient to establish the correctness of the federal income tax return" be maintained, but they may be maintained outside the U.S. if the foreign party can meet certain requirements, e.g., the
ability to produce originals or duplicates within 60 days of an IRS request, and translate them into English within 30 days of an IRS request. The regulations do not specify what records must be maintained, although there is a safe harbor listing 6 categories of records that will be deemed to be sufficient. The safe harbor, unfortunately, requires basic accounting records sufficient to produce material profit & loss statements, even if they must be created, and if they are not kept according to GAAP, material differences must be explained. The scope of the potential records required and the need to create them have drawn most of the adverse comments.

C. Require related foreign persons to designate the U.S. subsidiary as foreign person's agent to accept service of process in summonses enforcement.

D. Increase penalty to $10,000 per month with no cap.

E. Allow the IRS to determine in its discretion the deductions and costs of goods sold if the foreign corporation does not comply. (Another significant lack in the regulations is their failure to address the relationship between Sections 6038A and 982. Will formal document requests be used first? Or will the service use summonses, and apply the Section 6038A sanctions? Or both?)

F. Effective only for tax years beginning after July 10, 1989.

3. 1990 Act further extends section:

a. Extends the application of the 1989 amendments to future acts and failures to act after date of enactment (or, in the case of record maintenance, to records in existence after March 20, 1990), without regard to the tax year at issue.

b. New §6038C subjects related party transactions of all foreign corporations carrying on trade or business in U.S. to information reporting and record maintenance rules similar to §6038A rules for 25% - foreign-owned corporations. Gives Treasury broad authority to prescribe additional rules relating to items not directly connected to a related party transaction. Applies to future acts or failures to act without regard to the tax year at issue.


b. Requires reporting by a taxpayer benefitting from a treaty where the Internal Revenue Code and the treaty are in conflict.
c. Final regulations in March 1990 require taxpayers to disclose cases where they relied upon any tax treaty provision contrary to a Code provision to override the Code regardless of whether Code provision was before or after the treaty.

Disclosure is required if the treaty-based return provision effects or potentially effects a reduction of any Code tax liability incurred at any time.

d. Potentially very broad.

5. Extension of Overvaluation penalty to §482.


b. Applies section 6662(b)(3) overvaluation penalty (20% of understatement attributable to overvaluation) to any §482 adjustment (royalties, purchase price, fees for service, interests, rents, transfer prices).

c. Adjustment has to be at least $10 million of taxable income; or transfer price claimed has to be at least 200% or more (or 50% or less, depending upon the direction of the adjustment) of the adjusted price.

d. Penalty doubles if numbers above are $20 million, or 400% or 25%.

e. Conference agreement applies "reasonable cause" avoidance of penalty to any portions of the net increase due to prices arrived at in good faith. However, proposed accuracy penalty regulations published in March of 1991 reserve as to the §482 penalty, and specifically as to what would constitute "reasonable cause".

f. Applies to taxable years ending after date of enactment (e.g., calendar year 1990).

6. Designated Summons.

a. New section 6503(k) - 1990 Act.

b. IRS may designate an administrative summons as one that will suspend the running of the statute of limitations on assessment during the period required for judicial enforcement and 60 days thereafter.

c. Applies to domestic as well as foreign issues, exams, and documents.
d. Generally, only one may be issued per audit. But there is a very broad exception that treats as designated all related summonses issued within 30 days of the first designated summons.

e. Effective for any designated summons issued for any open year.

f. Very powerful tool. A substitute for proposals that the statute of limitation should remain open in international cases for 6 years. Will alter audit strategy, as discussed in Part V, infra.

7. IRS Appropriation - The Conference report on the IRS 1991 budget contains the following language:

   Provided, That additional amounts above fiscal year 1990 levels for international tax enforcement shall be used for the establishment and operation of a task force comprised of senior Internal Revenue Service attorneys, accountants, and economists dedicated to enforcement activities related to United States subsidiaries of foreign-controlled corporations that are in non-compliance with the Internal Revenue Code.

IV. NEW CEP PROGRAM

A. Document dated July 20, 1990 lists 10 recommendations, plus an expanded "Intent" as to each (Document is attached as Exhibit #1).

1. Establishment of a National Policy Board. The board has several high-level representatives from Exam, Counsel, Appeals, and International, and is intended to set policy and direction for the program, ensure proper coordination between functions, establish objectives for CEP, and ensure proper focus and management of the program.

   Observations

   - Although the document does not say so explicitly, ISP and International programs are included within the Board’s responsibilities.

   - The Board will not normally deal with "individual cases". But it is inevitable that it will deal with issues, which could cause delay if that issue is present in your case. Moreover, the Board will necessarily consider issues within the context of individual cases, and a further degree of centralized resolution will result.
2. Establishment of a National CEP Director, and regional CEP managers with support organizations. The regional officials will directly supervise Industry Specialists and Issue Specialists.

Observations

- The National Director is John Monaco, formerly Deputy National Director of Appeals, who served for many years as Chief of Exam in Chicago.

- The National Director does not have line authority over any Exam personnel in the field. He can lead and persuade, but not order. But he will have great power because he can issue directives requiring coordination or control of issues, establish programs to coordinate and control cross-functional matters (e.g., when and how must Exam coordinate with Counsel), establish guidelines for currency of audit cycles, and mandate audit guidelines for industries. He will also derive authority from the National Policy Board's directives.

- The regional officials have no direct line authority over local Exam, but presumably will wield the Regional Commissioner's authority. They will be very powerful individuals.

- Both Counsel and Appeals recommended their own establishment of such regional positions, and will now do so.

- There will also be a District ISP coordinator in most Districts. All of these new officials will become significant players in the resolution of individual cases, particularly where significant or coordinated issues are involved, or where ISP is a factor.

3. Use top management officials to plan the process, and improve support examination. These are the District Director and Chief of Exam primarily. They, with the Assistant Regional Commissioner (Exam) will also be responsible for improving support audits (timeliness and quality).

Observations

- District Director and/or Chief of Exam will be more in evidence when planning meetings conducted for individual CEP examinations.

- A significant emphasis is being placed on communication and planning. All Districts have been told to work more closely with taxpayers in planning the audit.
Emphasis on support audits probably will result in more attention to remote subsidiary matters, and a different auditor or team of auditors to deal with could significantly complicate the audit in some cases. Threshold for materiality on subsidiary returns is often lower, leading to more issues as well.

4. Increase managerial oversight and the use of available procedures to ensure taxpayer cooperation. Communicate service objectives, involve taxpayers in the CEP improvement initiatives, but manage so as to fully use the tools available to coerce taxpayer responsiveness (e.g., summons, Section 982 requests), and encourage involvement of higher level taxpayer and service management to resolve disputes.

Observations

- Premises for this set of recommendations are deeply disputed. Commissioner’s Advisory Group, for example, believes most perceived cooperation problems relate to overbroad or fuzzy information requests, agent misperceptions as to corporate ability to generate information, poor IRS case management, etc. There is little objective data, except the relative lack of use of administrative summons (4% of cases), and the rare use of §982 procedures.

- Notion that upper level taxpayer management will be interested in document disputes between service and tax department strikes some as naive, at best.

- Most controversial part of original Exam proposal, i.e., revise current policy and permit agents broad access to accountant’s workpapers, was summarily dropped. It is not expected to resurface.

- But note new 1990 Act provision for Designated Summons to keep statute open. Likely to be used by agents, at least to force agreements on statute extension.

- Extensive additional use of summons, §982 procedures not only risks increasing adversarial nature of audit process, but is arguably at odds with announced intention to improve timeliness of audits, promote early settlements, and enhance agreement rate in Exam. Use and enforcement of summons generally greatly lengthens time required to complete audit. Doubtful that agents will use routinely. But threats to use will escalate. Moreover, the International area could be the exception, given the Congressional focus, the amount of legislative attention to foreign-owned corporations, and IRS needs to show it is using the new tools Congress has given it.

5. Expand industry specialization program. Create new industries, or industry groups. Create issue specialists, teams of specialists.
Observations

- More experts on particular issues in the system is long overdue given complexity of the law. But where will they come from?

- More ISP will be created that cross industry lines. Current Examples: Leveraged Buyouts; Amortization of Intangibles. Thus, a team of people from Exam, Appeals, Counsel, will coordinate all issues relating to the category regardless of industry. Another likely candidate: Financial Products.

- Exam wants to expand controlled (as opposed to coordinated) issues. A controlled issue (e.g., many of the petroleum issues handled out of the Southwest Region) may not be settled except on the basis dictated by the individual specialist controlling the issue, who may be in Washington or a field office. A coordinated issue must be raised, but can be settled by individual agents on an individual basis upon notification to the industry specialist. Expansion of controlled issues is dangerous in terms of delay in the system, somewhat controversial. Recently, however, John Monaco appeared to reverse this trend by announcing that 27 of the 87 Industry Specialization Program industry coordinated issues would be released to the revenue agents, who would be permitted to settle them without any involvement of the Industry Specialist. This is a very welcome development. No list of the 27 issues has been released as of October, 1991.

Appeals is a different story. In Appeals there are Industry Coordinated Issues and "Appeals Coordinated Issues" (ACI's). The latter, of which there are now eight, are actually controlled issues. Recently, Appeals has moved to make its Industry Coordinated Issues controlled as well. Thus, on certain issues (e.g., amortization of customer based intangibles), a single Appeals coordinator will be required to approve all settlement offers before they are made. This trend will extend to other industries, and will almost certainly lead to delay and difficulty in settling coordinated issues in Appeals.

- Issue specialists will, if effective, be very powerful individuals in the system and a significant potential source of delay. But they will also be a significant potential source of issue resolution for taxpayers if properly approached.

6. Establish a CEP training program. Training would be cross-functional (involve Exam, Appeals, and Counsel), and would utilize outside sources.

Observations

- Potentially very valuable and much needed initiative, but must be carefully managed to avoid delays due to training down-time.

- Training may not be an entirely adequate solution for the problems created by low pay and grades.
- Training needs to include training on business and industry, modern corporate economics and practices. Few agents or attorneys have ever operated in a large corporate environment. There is a tendency for some to believe that corporate decision-making is invariably tax-driven, and that tax decisions play a greater role in corporate affairs than is often the case. Thus, some training needs to be provided by outsiders such as professional groups, industry groups, etc.

- Counsel is beginning to prepare and deliver professional quality technical videotapes for field use. Potentially very valuable training tool.

7. Develop effective communication systems to move technical information to front-line personnel. Would include issue tracking, audit handbooks and guidelines, electronic bulletin board.

Observations

- Big Brother is currently little brother insofar as information is concerned. The development of an effective issue tracking system will greatly enhance ability to coordinate issues currently in Exam. May facilitate settlement in some cases by identifying cases government considers "bad".

- Knowledge is power. Cumulative effect of recommendations is likely to further reduce role of revenue agent and case manager as decision-makers; on an increasing number of issues they will be information gatherers.

- Audit guidelines may have salutary effect in focusing agent inquiries.

8. Establish a program to provide legal and technical assistance to Exam on an expedited basis. Assign a lawyer to each CEP Exam at the outset. Role is not to prepare for litigation, but to insure access to technical and policy advice, help in developing adequate information.

Observations

- Formalizes a role Counsel has been adopting for some years (e.g., 1985 ISP expansion). But requires Exam to utilize services for first time.

- Lawyers should not control the Exam, but may wind up doing so depending on personalities involved and willingness of taxpayer to monitor situation and complain. See, e.g., Judge Goffe's recent opinion in Westreco, T.C. Memo. 1990-501, in which he found that a Special Trial Attorney was in charge of the audit of subsequent years and ordered that no information gathered in the audit be used in the Tax Court case covering earlier years.
Taxpayer access to government lawyers will be an important issue, as will the ability to determine who is giving advice and where it is coming from. The formal technical advice process may become a more necessary tool for taxpayers in order to overcome the informal advice agents are getting from lawyers/technicians.

Field lawyers are litigators and tax generalists, not expert tax technicians. It will be vital for the government to recognize this limitation, provide technical assistance from other sources.

Fear of additional litigation, or threat thereof, may seriously alter taxpayer approach to audit controversies. Neither the Service nor the Court system can stand significant additional large case litigation.

Counsel will often recommend the retention of an outside expert by Exam. Exam is receptive to this initiative. Taxpayers will need to be alert to such developments, consider whether early retention of an outsider is warranted on some issues to forestall or combat government movement in that direction.

9. Implement a quality assurance and quality measurement system using "peer review" concept. This would include development of additional goals and measurement systems for CEP to follow dispositions of cases, standardized measures of quality between Exam, Appeals, and Counsel, and the assessment of case management techniques, currency of cases and "customer satisfaction" indicators. Major goals would be to increase revenue, improve sustension rates in Appeals and Counsel, and reduce lapsed time.

Observations

A coordinated measurement system is vitally needed, as is attention to quality rather than quantity in the program. This is a promising initiative.

Peer review has limitations due primarily to reluctance to seriously criticize peers who may be criticizing you next year and with whom you have to work regularly. System will need to be augmented by outside review. At a minimum, functions should review each other (e.g., Exam reviews Counsel & Appeals, Counsel reviews Exam & Appeals).

10. Use early settlement offers and enhance coordination between Exam, Appeals, and Counsel. Includes delegating authority to Exam to settle "rollover" issues for which Appeals has already established a settlement practice. Exam and Counsel should have pre-Appeals conference meeting with Appeals to discuss issues, strengths and weaknesses, the protest and RAR, etc., and a post-settlement conference to discuss why Appeals settled as it did, provide tips to Exam for subsequent audits. Appeals required to have Discussion with Exam whenever taxpayer presents new information or arguments. Document asserts firm belief in necessity of preserving independence of Appeals.
Observations

- Settlement recommendations have been around for some time, will enhance disposition of some issues earlier in the process. But taxpayers may sometimes still need to preserve those issues until Appeals process if other issues cannot be settled at Exam.

- Delegation of "rollover" settlement authority was implemented in Del. Order 236, 1991-5 IRB 6, effective November 7, 1990. Generally, the authority extends to rollover and recurring issues, but only in the CEP program, and only where "a settlement on the merits has been effected by Appeals with respect to the same taxpayer in a previous tax period." Several conditions are imposed. Rollover issues are those that affect more than one tax period and that involve adjustments arising from the same legal issues in the same transaction or taxable event, (e.g., amortization or depreciation, inventory adjustments). Recurring issues are adjustments arising from the same legal issue in a separate transaction or a repeated taxable event in which the taxpayer advances the same legal position as it did in a prior tax period (e.g. method of depreciation for similar assets).

- Authority delegated should be broader, but service has traditionally feared the corruption potential in delegating great settlement authority to agents. This fear is misplaced, given already great ability of agents to resolve issues by not raising them, trading them, altering approach, etc. Moreover, the sheer number of agents and others involved in a CEP Examination would make hanky-panky difficult. Agents should be given more real settlement authority, possibly with review by Counsel or Appeals. Perhaps CEP should have special settlement rules. Note that one Exam suggestion was for assignment of an Appeals officer to a case at an early date to facilitate settlement before the need for a 30-day letter and formal referral to Appeals. This or a similar mechanism will probably be tried as a pilot program in one or more regions.

- An encouraging development has been continued emphasis from the National Office upon the need for agents and case managers to take more responsibility to settle disputes, particularly factual disputes. Case managers are specifically delegated authority to settle factual disputes, such as valuation and pricing issues, without referring them to Appeals. Both National and Regional offices have repeatedly stated as a goal the achievement of a greater agreement rate in Examination, which necessarily implies greater exercise by local examiners of their actual settlement authority and the techniques noted above that they have traditionally used.

- Functional coordination recommendations highly controversial, reflecting taxpayer and Appeals concerns that Appeals' ability to dispose of cases independently will be compromised. As a practical matter, this may relatively rarely occur given Appeals' fierce devotion to independence, but will certainly occur in some cases, and in any event taxpayer perception may be more important than actual facts. Neither taxpayers nor service can tolerate damage to functions Appeals currently performs.
- There will be a lot more discussion between Appeals and Exam, but the most controversial proposal, i.e., to require Appeals to confer with Exam after reaching a basis for settlement but before it settles, was dropped.

- Requirement that Appeals involve Exam when new information or arguments are presented will sometimes alter strategy during audit. Decisions as to what information to provide at Exam level or what arguments to make will be more difficult, and may require more consultation with advisors. Also, the process may delay resolution of appeals. But all three functions (Exam, Appeals, and Counsel) have long believed that Appeals sends too few cases back to Exam for further development.

IV. STRATEGY & APPROACH

A. General Observations

The new Examination initiatives represent an evolution of a number of prior IRS programs and strategies, and are likely to further evolve. For example, effective October 1, 1991, the Office of Chief Counsel was reorganized to consolidate National Office domestic litigation and technical functions under one official and to elevate the status of the office that manages large case coordination. This development, which mimics the pattern established earlier in International, is intended to further the same goals as the CEP reorganization in 1990.

Moreover, the new initiatives are not fully in place and, given the IRS' cumbersome decentralized structure that emphasizes local decisionmaking, will inevitably be implemented with some local variations. Thus, care should be exercised in reaching general conclusions as to appropriate strategies and responses, which may well vary with local conditions and personnel.

Nevertheless, it must also be recognized that very significant changes are coming that will surely affect every CEP taxpayer, and ultimately any taxpayer with significant dollars at stake. Some may find it tempting to dwell upon the defects in the new programs (and certainly there are defects), or upon the potential for additional delays, additional contentiousness, additional litigation, and damage to the Appeals process, as to all of which responsible cases can surely be made. But it will almost certainly be more productive to focus on the fact that the changes are upon us and to inquire as how they will affect us and what to do about it. For if anything is clear, it is that large taxpayers are targeted for additional revenue. Even Congress has joined in. The 1992 IRS appropriation provides that any amounts of funding for the information reporting program above 1991 levels (i.e., about $12 million) are to be used instead for the audit of high-income and high-asset taxpayers.

Further, IRS will succeed in more effectively coordinating its efforts and its issues, and a new structure will be in place that will have to be dealt with.
Therefore, like it or not, some thoughtful hatch-battening is in order.

B. Overall Strategy

Many of the elements of a successful overall audit strategy have not changed. But the new programs will undoubtedly require renewed emphasis and attention, and a few new thought processes. For example, a more coordinated IRS system suggests less emphasis on issue resolution with local agents and more attention to reaching and influencing others in the process. Yet the traditional strategy of developing and maintaining good relationships of trust and respect with local IRS personnel is just as essential as ever; it may just be more difficult to maintain in the face of occasional to frequent necessity to go over or around the agent or case manager.

The following are certainly prominent among the basic elements of good audit strategy:

1. Seek to avoid issues leading to litigation.

2. Try to achieve the earliest possible resolution of issues consistent with a prompt and reasonable overall settlement.

3. Identify the issues that matter to the government as early as possible (preferably before the audit) and develop strategies.

4. Know the people involved in the issues, who is managing them, who matters and doesn't matter in the resolution, and seek access to those who do.

5. Actively manage the audit, including documents, document requests, information, and timing.

6. Maintain effective working relations with local IRS personnel.

A summary discussion of each of these elements follows:

1. Avoiding Litigation

Litigation, like taxes, cannot always be avoided. But it is expensive, time-consuming, and uncertain of outcome, and therefore audit strategy should usually be oriented toward achieving the least likelihood of ending up in court. The IRS' new initiatives may in some cases enhance that objective, since one of the objectives is to identify those few best litigating vehicles and settle everything else. Nor does the Service have the personnel or the resources to litigate more than a small percentage of the cases even if it wanted to. Moreover, the IRS faces serious revenue pressure, a factor which is somewhat antithetical to the delay in receipt of ultimate tax revenue occasioned by extensive litigation.
Thus, taxpayers will certainly find it useful to carefully assess which issues might be litigation vehicles and spend time building a case as to why their own facts or situation would make a perfectly lousy vehicle for the government. Issues of timing and approach will also be important. Some factors to think about:

(a) Statute extensions - are you merely permitting the government to hold your case in reserve? Should you force an early resolution? Under some circumstances forcing a statutory notice and docketing the case may be effective in avoiding litigation by forcing government lawyers to make choices. But this is risky strategy. Forcing a statutory notice will generally result in the largest possible deficiency, more issues to deal with, and a poorer record for both sides. Moreover, a seldom-noticed rule allows the IRS to summarily assess and recover any tentative carryback refunds made in the years which are not being extended. Although this rule has no real relationship to the regular statute of limitations for the year, IRS agents sometimes threaten to invoke it if extensions are not given. The new "designated summons" procedures of the 1990 Act also may make it more difficult to force a 90-day letter by refusing to extend, particularly if information gathering is incomplete and has been contentious.

(b) Conversely, will delay be beneficial? Maybe a request for technical advice would be a useful tactic even if you don't think you need it, or a trip to Appeals.

(c) Is the issue coordinated? If so, how can you separate yourself from the herd? Even if the issue is not formally coordinated, is it one that is being raised or considered elsewhere? Maintain contact with others who have the issue. Do not view your issue in isolation; if there are good taxpayer vehicles in the system that will almost surely force a government reassessment of its situation, then delay may be advisable. Example: the Humana and Gulf issues in the area of captive insurance. On the other hand, on emerging issues such as those growing out of National Starch, it is a good idea to seek rapid settlement if you can get a reasonable deal.

(d) Does the local agent think he has settlement authority? If not, why not?

(e) Would an outside expert help? In some cases an early use of an expert will convince the agent to drop the issue or settle it favorably, or at least narrow the focus. But it is expensive and may risk giving the Service an early road map.

(f) Will it be necessary to go beyond the agent or case manager to the industry or issue specialists, regional official, national office, etc? To the lawyer involved? If so, when and to whom? Start building a case early for access to others.

(g) Appeals consideration - pre-90 day letter or not? If taxpayer goes to Appeals in pre-90 status, its access to technical advice procedures is preserved; more time may be available to resolve the issue or narrow the issues; information may be preserved
that might be discovered in litigation; and the procedure could be less costly. On the other hand, if the case is docketed in the Tax Court, Appeals will still consider it and discovery will be limited, as will the potential for new issues being raised. There are a number of other factors to consider as well, which are beyond the scope of this limited discussion.

(h) The ramifications of Westreco, supra and of the decision in Ash v. Commissioner, 96 T.C. 459 (March 11, 1991), should be considered. The Tax Court effort in Westreco to protect its limited discovery rules against information gathered through the administrative process for subsequent years might have dictated the most rapid possible docketing of a case if there were vulnerabilities that related to another cycle, or simply to try to wall off one cycle from another. But in Ash the Tax Court significantly limited the scope of Westreco, holding that ordinarily, unless an administrative summons is issued for the same taxpayer and taxable year as are before the court, the court will not intervene, except if the taxpayer can show that the Service lacked an "independent and sufficient" reason for the summons. The latter showing, which is akin to proving a negative, will rarely if ever be possible.

This is certainly not an exhaustive list, and individual cases will vary greatly. The essential strategy to avoid litigation may well be either enhanced or retarded by the new Examination procedures, depending in part upon the taxpayer's willingness to actively monitor and assess its situation and think ahead.

2. Achieve early resolution

Generally, push to narrow the issues as rapidly as possible, encourage the agent and case manager to exercise settlement authority.

This strategy should be enhanced by the new initiatives. Revenue and case management pressures, pressure to produce agreed cases in Exam, and encouragement of more settlement authority in Exam, will produce a climate favorable to early settlement. Moreover, Commissioner Goldberg has repeatedly stated that he wants case managers to exercise more authority to settle cases. Thus, taxpayers should ordinarily seek to narrow the issues early on and push toward settlement. On the other hand, the expected enhancement may not be realized if too many issues become prisoners of the new officials and structures, such as the National Policy Board, built into the system.

Having an IRS lawyer involved may be either a plus or a minus, depending on the issues and the personalities involved, and will have to be carefully assessed. Under the new rules, a lawyer or lawyers will almost certainly be involved, even if you don't see them. Or an issue specialist or some other technician or advisor somewhere. If the agent suddenly changes course on an issue, it is wise to question whether the District Counsel or someone else had anything to do with it. On the other hand, if no progress is being made with the agent, it may be wise to seek another arbiter, e.g., the District Counsel lawyer.
Other factors in the new system suggest the wisdom of seeking early settlement. Better coordination and knowledge of the issues will expose more issues to more service personnel. One of these may see something others missed, or decide this is a good issue.

Moreover, it is possible that the IRS will decide what position to take on some broad national issues more rapidly, putting a premium on getting emerging issues settled promptly.

Further, Appeals' initiative to send cases back to Exam if new information surfaces will make it less likely a taxpayer can hold its cards until Appeals, and the Service's stepped up efforts to enhance and target IDR's and other information requests may make anything but prompt audit resolution of issues dangerous.

Finally, the 1990 Act boosts the corporate interest rate on tax deficiencies by 2% for amounts attributable to periods after the 30-day or 90-day letter, providing an additional incentive to settle early and pay up.

All of this must, of course, be balanced against the traditional need to retain issues as bargaining chips if the taxpayer believes an overall settlement will not be achieved in Exam, or if the case overall is expected to be hard to settle. Nevertheless, it is usually wise to get as many potential substantive issues as possible off the table as early as possible. The least dangerous issues to retain are common factual issues with known parameters, e.g., T&E or depreciation. Further, it can often be the case that an offer in Exam establishes the Service high-water mark, and the taxpayer can do better in Appeals. Nevertheless, the new system puts a premium in some cases on getting a settlement early, and certainly should promote that objective unless too many cooks delay the broth.

3. Identify the issues that matter

Increasingly, there is a great deal of information available or obtainable about what the IRS is thinking about in terms of issues. For example, the industry coordinated issue papers are widely available, government officials are routinely interviewed or appear on programs, and tax advisors make it a point to monitor all sources of information about current issues of interest to the IRS. Under these circumstances, there is very little excuse for taxpayers not to be well-informed about many of the issues that will arise on audit.

The new initiatives will put a premium on taxpayers performing this analysis; the government will be better coordinated and up-to-speed, and advance thought by the taxpayer will pay dividends. For example, knowing that the government will invariably challenge amortization of intangible assets, a prudent taxpayer will certainly be careful to collect and retain all necessary information and analyses to support the deductions, rather than scramble to do so when challenged. Agents confronted with a well-organized and well-prepared taxpayer are far less likely to get dug in on an issue.
Knowing the tack the government will take, and its arguments in advance, a taxpayer can also consider what arguments or facts or approaches are most likely to be persuasive, and whether other pre-audit approaches such as retaining expert assistance might be productive.

Knowing that a particular issue is pending may also suggest an attempt to influence its resolution in the national office, rather than waiting for it to be raised on audit.

Knowing the issues well may also suggest minor changes to operations that will help prevent the issue being raised in the future.

Knowing the issues will also permit the appropriate thought to be given in advance to issues of information and document management, such as the creation of different or enhanced data, the appropriate presentation or format for data, and the elements to emphasize. Generally speaking, an agent is simply less likely to spend time on an issue if presented initially with a thoughtful and persuasive analysis, and the new system should offer more opportunities for that approach.

Further, knowing the issues enhances overall settlement strategy; you need to know which issues are the most dangerous if not disposed of.

Finally, don't forget acquired companies have issues too!

4. Know the people involved in the issues.

The new CEP, ISP and International programs all involve people. Lots of people, at all levels of the IRS, and in both field and national offices. While this may suggest danger (and indeed, if the IRS is correct, it will mean danger to those whose issues are better identified and more competently resolved), it also suggests opportunity; opportunity for issue management by using the system to advantage.

The well-advised taxpayer needs to be alert to nuances in the examination suggesting that others are involved. A lawyer, though assigned to the examination, may not necessarily be consulted on particular issues. Or the lawyer may be talking to national office technicians, or issue specialists, or ISP coordinators, or someone else. Nothing in the initiatives guarantees any taxpayer access to any of these individuals, but taxpayers should regularly and vigorously seek such access if there is any suggestion of outside advice. Service officials have been saying regularly that the taxpayer will be told the name of the lawyer involved, and will be able to meet with him or her. However, that policy is not in writing and is not always understood or applied at the field level. In some cases, a taxpayer may want to routinely ask that all Examination team members, including the lawyer, sit in at all meetings, depending on the circumstances. And knowledge of who is involved necessarily precedes access; thus, taxpayers should be alert to outside information as to individuals likely to be involved.
If the agent is heading down an erroneous path, suggest he ask his outside advisors. Put such requests in writing, and document them. It may provide a predicate for reaching someone else later; "you're my last resort - the agent won't seek advice".

Consider talking or writing directly to those you know are also involved. This is particularly important if the agent claims his hands are tied by advice from somewhere else. In many cases, your own outside advisors have access to others in the process. Don't be afraid to use it. The IRS has recently begun to try to limit informal taxpayer access to National Office lawyers, who are instructed to ask callers whether their case is pending in Exam, Appeals, or Litigation, and not to answer questions if it is. But this policy is still in a state of flux. Moreover, the apparent concern that taxpayers will obtain informal opinions and use them against the agent or Appeals officer can be overcome by involving the agent or Appeals officer or other IRS field personnel. Expect evolution and modification of this policy.

Finally, use your professional advisors to help identify the individuals involved for the government. Many advisors have continuing contacts with issues, industries, IRS personnel, and can help you predict with a high degree of certainty who is actually providing advice or working in your audit.

There is great danger in the amount of informal advice agents and case managers will be receiving. The person giving the advice is only hearing one side of the issue, and if the advice is not in writing (which will be the rule), may give it fairly short shrift. If direct access cannot be obtained, the formal technical advice procedure is another mechanism that may force the audit team and its advisors to confront the issues more formally. Indeed, if the policy seeking to limit taxpayer access to the National Office is rigidly enforced, it will put a premium on willingness to ask for formal technical advice. Sometimes, however, the submission to the agent of a request that he seek technical advice, or the suggestion that the taxpayer is about to do so, will provide an opening for informal discussion with the National Office with field concurrence.

5. Actively manage the audit.

Perhaps this is advice to do something you are already doing - if so, all the better. Or perhaps you don't think your audit can be managed (a point of view that, depending upon the audit team, can sometimes have some validity!). But like it or not, the new system puts a premium upon staying on top of the process at all times.

Paragraphs 1 and 3 have already discussed having a pre-audit strategy on issues. Presumably the taxpayer has already, as well, accumulated its adjustments and disclosures, if any, to present when the audit begins, and it certainly makes good sense to have some. But thereafter, it is not uncommon for taxpayers simply to react to the things the audit team does. You will be better served, particularly in the coming environment, by monitoring the audit team's activities more closely.
Again, this is a subject that could be the basis for a treatise, and there is a literature available (although somewhat outdated). See, e.g., Caplin, *Handling a Tax Controversy at the Internal Revenue Service*, 44 NYU Inst. on Fed. Tax'n §1.03 (1)(1986); Donaldson, *Techniques in Presenting and Settling a Case Before the IRS*, 27 NYU Tax Institute 1343 (1969); Heintz, *How to Improve Your Client's Chances of Success When the IRS Audits His Return*, 16 Taxation for Accountants 384 (1976). But a few suggestions follow:

(a) Seek to meet with the agent on a regular basis, to discuss anything he's looking at, what he's interested in, etc. If he won't meet, talk to the case manager.

(b) **Document** everything - conversations, meetings, correspondence. Consider establishing a timetable for your own use, and followup whenever the audit falls behind. Write the agent or case manager, setting forth expectations, notes of meetings, etc.

(c) Try to determine what other specialists, such as International Examiners, Engineers, Employee Plans Agents, Actuaries, Data Processing experts, will likely be needed, and make sure the agent or case manager has requested appropriate assistance. Determine who the assistants report to, in case you need to ask for assistance from their supervisors.

An ugly actual example: A taxpayer thought it had reached a settlement with the agent after 2 1/2 years of arduous audit, only to realize that the agent was required by the IRM to seek engineering assistance and hadn't done so. Two years later, the examination was still incomplete.

(d) Try to anticipate requests for information. IDR's can be very burdensome, but may also present opportunities to manage the audit. For example, consider giving the agent information voluntarily before he asks for it formally. This presents an opportunity to manage the information provided, and can be effective in resolving the issue if the information satisfies the agent.

If an IDR is issued, and is overbroad or burdensome, object promptly, and put the objection in writing. Do not let significant time pass before objecting. Seek to meet with the agent immediately to try to narrow the request. An example of an issue that may require negotiation is an IDR requiring the taxpayer to create new documents or formats for information. This issue has become more prominent since the Section 6038A regulations, which may require creation of profit & loss statements or other records not normally maintained by the taxpayer. In *United States v. Mobil Corp.*, 499 F. Supp. 479 (N.D. Tex., 1980), the Court held that the IRS could not require a taxpayer to create documents or alter the form of existing records for its convenience. But, the Court would permit the IRS to require the creation of necessary documents. In many cases, it may be to the taxpayer's advantage to comply with such a request. For example, the required documents or data display may help prove the taxpayer's point. But if not, this is a point worth raising and negotiating over.
IDR’S are inherently opportunities for negotiations that may shed light on the agent’s direction or approach, or offer a chance for the taxpayer to preliminarily suggest its own direction. Make use of the opportunity, if it would be useful. Also, the negotiation of time frames for response should be regularly undertaken.

Consider a partial or a narrow response. The agent may be satisfied. It is generally better to respond partially or narrowly, but promptly, than to respond fully but late.

Keep in mind, however, that a lawyer may well be reviewing the IDR and your response.

(e) Carefully assess extensions of time requested by the agent. View with suspicion claims that issue holdups elsewhere, or other matters outside the agent’s control, prevent completion. You may be able to use such claims to gain access to others, and you should usually document them by writing to the case manager. Subject to the need to maintain good relations it may often be good strategy to resist extensions; the request offers an opportunity to achieve agreements on time frames for completion. It can also sometimes be better strategy to refuse to extend if, for example, further delay may solidify the government’s position or expose additional information. But, the new designated summons procedures make this decision more complicated. Again, this subject is very complex and generalizations are dangerous. The essential point to remember, however, is that the negotiations for extension can be a significant opportunity for the taxpayer, and should be carefully managed.

An issue that frequently arises is whether to extend for a definite period (usually six months or one year), or to execute a Form 872-A, which keeps the statute open until 90 days after the consent is terminated in writing by the taxpayer (Form 872-T is used for this purpose). The IRS is somewhat reluctant to use form 872-A, but sometimes will offer it. The benefit to the taxpayer is that no further negotiations over extensions need to take place, and if the case is one in which delay would be beneficial, the open-ended extension will usually have that result. Since the consent can be terminated at will, some taxpayers say "why not?" The reasons "why not" boil down to three: The open-ended extension will deprive the taxpayer of the opportunities for negotiation occasioned by the IRS’ need to ask for a new extension; it will almost inevitably foster delay in concluding the audit; and in practice the taxpayer will find it difficult to terminate the extension without provoking a serious confrontation. Moreover, the Service has never been known to accidentally allow an open-ended extension to expire!

(f) Manage the documents and information you have. For example, keep records of documents supplied, or reviewed by the agents, and when.

None of these techniques is new, or surprising. But the new Examination program will put an enormous premium on managing and documenting the course of the audit because the risks of being targeted are so much greater, as is the need to build a case for
access to higher level officials. If, as many suspect, the agents and case managers increasingly become information gatherers rather than decision makers, it is crucial to manage the audit so as to insure that the taxpayer is well positioned to seek help outside the audit team. If, on the other hand, the new procedures result merely in a more effective audit team, the taxpayer itself needs to be more efficient in managing the course of that examination to keep it pointed in acceptable directions in acceptable time frames.

Bottom line: If, as many suspect, the agents and case managers gradually lose authority, it is crucial to manage your audit and document its course and progress to insure you are well-positioned to seek help outside the audit team.

6. Maintain effective relationships with the local IRS personnel.

This remains an essential ingredient of a successful audit, but may be more difficult than ever to achieve in view of the needs discussed in paragraphs 1-5 above to react more forcefully to the audit team and to reach others in the process. It is not unlikely that in some cases audits will in fact be more adversarial regardless of all attempts to make them otherwise.

Nevertheless, attempts should always be made to maintain good relationships. Explain to the agent whenever possible why you are asking questions about others. Never try to deal with someone else without exhausting all possibilities with the agent. Try to enlist his help in resolving problems; agents are often genuinely frustrated that issues and matters are tied up outside their control, and will readily condone or encourage taxpayer attempts to resolve them. Consider using outside advisors who have not been dealing with the agent to go outside the agent or case manager ("its not my fault - the company hired X and he called Y.")

Provide adequate heat, light and water! Note the testimony of some revenue agents at the recent Congressional hearings on transfer pricing issues related to foreign investors in the US that they were relegated to a former guard shed outside the building, without any creature comforts whatever. While it is usually good strategy to isolate the agents to some extent (example: a taxpayer claimed his son was a vice-president of the company, but an agent wandering about his building overheard the son ask a secretary directions to the restroom! Compensation deduction summarily denied), it is also possible to go too far. It would be instructive to know what sort of examination the taxpayer complained about at the hearings endured as a result of its isolation strategy.

None of the strategies or approaches discussed in these brief paragraphs will always be effective, and individual cases will vary significantly. But changes on the way require devoting substantial attention to them, and will clearly more often warrant the early retention of outside assistance, not necessarily to prepare for litigation, but to provide knowledgeable assistance in dealing with the nuances of a much more aggressive, coordinated, and confusing CEP/ISP/International audit controversy environment.
IV. NEW DIRECTIONS

How will the new programs further evolve?

The QIP report that precipitated the current changes recommended broader solutions, primarily a formal centralization of CEP, to be run out of Washington. That approach seems dead, having achieved no popularity either inside or outside the agency.

But there are a number of trends that may emerge.

A. Transactional Audits

Increasingly the IRS has come to believe that the current system of auditing a return of a participant in a larger transaction is an inefficient way of determining and isolating the issues inherent in the transaction. Leveraged Buyouts, for example, usually involve a host of parties, and numerous transactions between them. Thus, an approach under active consideration is to isolate the transaction at an early stage, assign a team of auditors, lawyers, etc., to it, and cut across the local and regional lines to reach all the parties at the same time.

B. Place Of Audit

An unresolved series of issues relate to the tendency of the current audit system to result in a place of audit different than the place where most of the issues arise. For example, a company may file its return in Dallas but have most of its actual operations, or its major subsidiaries, in Los Angeles. This results in cumbersome procedures that may or may not be to taxpayer’s advantage but are almost never to the Service’s advantage. Suggestions have been made to assign place of audit other than by place of filing, and may ultimately be adopted.

C. Settlement Authority

Numerous suggestions have been made for additional ways of getting settlement moved into Exam, discussed briefly in Part III above. Assignment of Appeals officers to review issues before the 30-day letter stage, or to offer settlement assistance to Exam, is very dangerous from Appeals point of view, and may accomplish little, but will almost certainly be tried as an experiment.

D. Swat Teams

A frequent suggestion has been the assignment of issue-oriented teams of auditors, lawyers, engineers, and others to roam the country engaging in audits where the issues arise (the "hunter/gatherer" theory of tax auditing?): The current structure could easily evolve in this direction, particularly the expanded ISP, or "FIST" in International. Note also the
money provided to IRS in the 1991 budget reconciliation bill to form a task force to work on international issues of foreign-owned corporations. A Swat team?

E. Corporate TCMP

A suggestion has been made that a few outside auditors or others be assigned to conduct the equivalent of a TCMP (Taxpayer Compliance Measurement Program) audit on a few large corporations. This would be enormously disruptive to the targets, but cannot be rejected out of hand.

F. Pre-settlement Conference in Appeals.

A rejected suggestion by Exam was to require Appeals to confer with Exam after it reaches an agreement with the taxpayer but before it settles the case. This is a very bad idea, but depending on the direction of the program, it could still resurface. The recent Commissioner's Advisory Group report notes that the role of Appeals is something requiring further study, and further evolution might occur. However, there is a widespread belief within the agency and elsewhere that Appeals essentially works well and that its ability to settle most of the cases is so essential to the system that any changes should be approached with extreme caution.

G. International issues

The burgeoning International program, upon which many of the current initiatives are modeled, will certainly spawn additional issues, including the implementation and uses of Sections 6038A and C, section 982 and the new Designated Summons. For example, Examination recommended that the Service seek a domestic version of § 982, a suggestion thankfully rejected, but pressure to lengthen the statute of limitations on assessment to 6 years originated with International issues and may easily come to pass. Legislative and Administrative vigilance will be required.