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AUGUST 26, 2013
Let's Get the Facts of the Couzens Investigation Right!
by George K. Yin

George K. Yin responds to Jay Starkman's letter, saying that some accusations regarding the Couzens investigation need to be reconsidered.
To the Editor:

I am sympathetic to Jay Starkman's criticism of the practice since 1998 of appointing persons without tax experience to be IRS Commissioner ("Practitioner Sees Need for Restructuring the IRS," Tax Notes, Aug. 19, 2013, p. 837). Given the principal mission of the agency, it is plausible that an outstanding tax professional would be better situated to energize the workforce, instill the importance of integrity and professionalism, and provide more meaningful scrutiny of the agency's activities. We have had many examples of past Commissioners with tax backgrounds who have had those qualities. Such a person would also likely have longstanding relationships with wise colleagues familiar with the tax system that could be drawn upon when the inevitable challenging situations arise in the Commissioner's office. Arguably, the change carried out since 1998 has been exactly backwards. Rather than filling the Commissioner's slot and Oversight Board with business/"management" experts (and others with unclear qualifications), it may have been better to place Commissioner-quality tax professionals in all of those positions. Unfortunately, as Starkman notes, it appears that the shift away from tax experience in the management of the agency is going to continue.

Starkman errs, however, in repeating stale charges that the 1924-1926 Couzens investigation showed the agency to be "corrupt" and exposed a large scandal involving "plain graft." On completion of the long investigation, the chief counsel of the investigative committee testified before the Senate Finance Committee and Senator Couzens that the investigation had not uncovered corruption at the agency. To be sure, the investigation questioned many of the agency's decisions and administrative practices. There were also isolated instances of fraud which the agency had uncovered and revealed to the investigative committee at the start of its work. But the widespread allegations of corrupt practices, including favorable treatment of companies associated with Treasury Secretary Mellon, were not established.

The reason the rumors repeated by Starkman have persisted so long is complicated, but part of the explanation is Starkman's reference to the agency issuing "questionable multi-million dollar tax refunds." That charge came up again and again in congressional debates and the popular press,
especially as it related to large tax refunds made to some of Mellon's companies. A close examination of the facts, however, reveals a number of factors contributing to this perception, including a not insignificant amount of congressional misunderstanding and posturing.

Beginning with the 1918 Act, Congress required the Treasury Department to request a specific appropriation each year for the gross amount of tax refunds to be paid, and to provide Congress with a list of any refunds authorized. As a result, the number and amount of refunds were quite visible to Congress and the public. In addition, beginning in 1919, to catch up on its auditing responsibilities and accelerate its collection of revenue, the agency began a policy of making "superficial audits" of most returns that generally resulted in the complete disallowance of hard-to-determine deductions for purposes of both the income and excess-profits tax. Since taxpayers at the time had no ability to contest the resulting deficiencies prior to assessment, the audit policy increased the number of tax controversies resolved through post-assessment procedures, including refund claims. Meanwhile, the applicable statutes of limitation were sufficiently long to permit refund claims to remain open many years after the tax year in question. The upshot was that throughout the 1920s, Treasury sought appropriation for large refund amounts (plus interest) that reflected to an important extent the gradual settlement of disputes relating to 1917 and 1918 -- high-tax years for which the determination of the proper amount of taxes had been especially problematic.

The specter of sizable amounts of money flowing out of the treasury year after year to large businesses active during the war, including some companies associated with Mellon, aroused the suspicions of Congress and the public. Unlike deficiency claims, which to some extent were passed on by the Board of Tax Appeals beginning in 1924, there was no independent review of the refunds authorized. Legislators frequently accused Mellon and the agency of possible favoritism (or worse) in carrying out their refund duties. Yet many of the refunds were completely innocuous. One example was a $6 million refund awarded to the estate of the father of then-Treasury Secretary (and former Congressman) Ogden Mills (R-N.Y.), for which Mills was the executor. Under the law at the time, estates were allowed a credit of up to 80
percent of their federal estate tax liability for any state inheritance taxes paid within three years of the federal estate tax return. The Mills estate had filed its federal return prior to paying its state taxes and therefore had not claimed any credit. Once it paid its state taxes, it claimed the credit on an amended federal return, and about 97 percent of the refund was due to the allowance of this credit. All of this information was clearly laid out for the legislators. Nevertheless, the improper appearance of a large refund being paid to the Treasury Secretary helped to persuade Congress to add a new statutory restriction on refunds, one that was vetoed by President Hoover as an unconstitutional violation of separation of powers.

Congress's fixation on refunds might be of mere historical curiosity but for the fact that it had clear policy consequences: Congress gave the Joint Committee authority to review all large tax refunds, a responsibility that continues to this day. The irony of this decision is quite evident. While it was true that the Board of Tax Appeals provided independent review of certain agency decisions prior to the assessment of taxes, the only ones considered by the Board were those unfavorable to taxpayers. Agency decisions improperly favorable to taxpayers were not appealed, and therefore never reached the Board or any other independent reviewer. Yet a taxpayer-favorable decision not to assert a deficiency was directly analogous to an unjustified refund that Congress was so suspicious about. Indeed, a failure to assert a deficiency was actually much more worrisome than a refund. Because a refund involved an affirmative act that went through several levels of agency review for approval, an illegal refund required the unlikely existence of widespread corruption throughout the agency. In contrast, a decision not to assert a deficiency conceivably could have begun and ended with the inaction of a single, rogue employee. Thus, if Congress was seriously concerned with possible, corrupt favoritism by the agency (rather than mere posturing to gain political advantage), it badly missed the mark.

Very truly yours,

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