

2023

## Where the Rubber Meets the Road: A View of the Tax System from a Tax Administrator's Perspective

Heather C. Maloy

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### Recommended Citation

Maloy, Heather C. (2023) "Where the Rubber Meets the Road: A View of the Tax System from a Tax Administrator's Perspective," *Ohio Northern University Law Review*. Vol. 39: Iss. 1, Article 1.  
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**Ohio Northern University  
Law Review**

**Woodworth Memorial Lecture**

**Where the Rubber Meets the Road: A View of the Tax System  
from a Tax Administrator's Perspective**

HEATHER C. MALOY\*

Good Afternoon. Thank you very much for allowing me the honor of presenting the 2012 Laurence Neal Woodworth Memorial Lecture. I did not have the good fortune of knowing Dr. Woodworth but have heard and read a lot about him. Dr. Woodworth, I understand, was concerned with having a rational tax system, one that both served the well-being of government and was fair to people.<sup>1</sup> He recognized that a fair tax system was “important in securing people’s trust in their government.”<sup>2</sup> As I was preparing my remarks for today, I reviewed a number of previous lectures given in Dr. Woodworth’s honor, and many of them since the lecture’s inception in 1995, including several recent lectures, have focused on tax policy.<sup>3</sup>

After perusing these lectures, I quickly came to the conclusion that there was nothing of interest I could add on the subject of tax policy here today. So, with your indulgence, I would like to give a different view of the tax system, the view of a tax administrator. And while I fully understand (and am quite resigned to the fact) that tax administration will never be as

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\* Commissioner, Large Business & International Division, Internal Revenue Service. This Article is a product of the Laurence Neal Woodworth Memorial Lecture, May 10, 2012, and retains the spoken character of the lecture. These remarks are solely the author’s made on her own behalf.

1. *Woodworth Lecture Series*, OHIO N. UNIV. CLAUDE W. PETTIT C. OF L., [http://law.onu.edu/about/lecture\\_series/woodworth](http://law.onu.edu/about/lecture_series/woodworth) (last visited Dec. 18, 2012) (quoting David Brockway).

2. *Id.*

3. *See id.* (lists several previous lectures).

glamorous as tax policy and that the nuts and bolts of translating brilliant tax policy into actual tax compliance can seem quite dull, I believe effective, efficient tax administration is critical and worthy of a bit of discussion.

Why is tax administration critical? Put bluntly, sound tax policy alone does not pay the bills. A system of tax laws that is grounded in voluntary self assessment must be backstopped by fair, efficient, effective tax administration—including robust compliance efforts. In my view, tax administration is where the rubber meets the road.

To bear this out a bit—it is informative to reflect on the commentary of statesmen, a jurist and even a comedian about the relationship between taxes and society.

Frederick the Great, an eighteenth century Prussian king stated, “No government can exist without taxation. This money must necessarily be levied on the people; and the grand art consists of levying so as not to oppress.”<sup>4</sup>

James Madison, one of our nation’s founding fathers and a U.S. president, recognized that “[t]he power of taxing people and their property is essential to the very existence of government.”<sup>5</sup>

Oliver Wendell Holmes, Jr., a U.S. Supreme Court Justice, in a quote that appears on the front of the IRS’s Washington, D.C. headquarters, famously said: “Taxes are what we pay for civilized society.”<sup>6</sup>

(This next quote is just for fun.) Comedian and entertainer, Arthur Godfrey, quipped: “I am proud to be paying taxes in the United States. The only thing is—I could be just as proud for half the money.”<sup>7</sup>

The last quote I would like to mention, and the one that I think is most on point for the topic today, is a quote from President John F. Kennedy who said:

For voluntary [self-assessment] to be both meaningful and productive of revenues, the citizens must not only have confidence in the fairness of the tax laws, but also in the uniform and vigorous enforcement of these laws. If non-compliance by the few continues unchecked, the confidence of the many in our self-assessment

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4. *Tax Quotes*, INTERNAL REVENUE SERVICE, <http://www.irs.gov/uac/Tax-Quotes> (last updated Aug. 1, 2012).

5. *Id.*

6. *Id.*

7. *Id.*

system will be shaken and one of the cornerstones of our government weakened.<sup>8</sup>

One only need look to our current global economy for examples of countries that are struggling economically, perhaps, in part, because they lack a robust tax administration system. One example that comes to mind is Greece.

In a May 2010 article, the *New York Times* reported on the staggering breadth of tax dodging in Greece.<sup>9</sup> This tax evasion, according to the article, has long been a way of life and is playing a significant role in the Greek debt crisis.<sup>10</sup> Various studies have estimated that the Greek government is losing as much as \$30 billion a year to tax evasion.<sup>11</sup> It is also interesting to note in this regard that in June 2011 the Greek Finance Minister stated, “Our top priority will be to implement a new tax system which will put an end to the provocative injustice that makes those who do not evade tax the ones who pay.”<sup>12</sup>

I think we can all agree that fair, efficient, effective tax administration, or what I will refer to as sound tax administration, is critical to the economic well-being of any country. And given my experience and current view of tax administration as the Commissioner of the Large Business and International Division of the Internal Revenue Service, I would like to focus today on the compliance aspects of tax administration, mainly related to business taxpayers. And while this will be my focus, I note that the other parts of tax administration, such as tax return processing and taxpayer service, are just as important if not more important than compliance.

A good place to start a discussion of the compliance aspects of sound tax administration is with the IRS’s mission with respect to its audit program. As stated by Commissioner Shulman, “our mission . . . is to collect the proper amount of tax and to use our compliance tools to foster

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8. John F. Kennedy, President of the U.S.A., Special Message to the Congress on Taxation (Apr. 20, 1961) [hereinafter Kennedy Remarks] (transcript available at <http://www.presidency.ucsb.edu/ws/print.php?pid=8074>).

9. Suzanne Daley, *Greek Wealth Is Everywhere but Tax Forms*, N.Y. TIMES, May 1, 2010, [http://www.nytimes.com/2010/05/02/world/europe/02evasion.html?\\_r=2&pagewanted=2&ref=ssuzanne-daley](http://www.nytimes.com/2010/05/02/world/europe/02evasion.html?_r=2&pagewanted=2&ref=ssuzanne-daley).

10. *Id.*

11. *Id.*

12. Harry Papachristou & Dina Kyriakidou, *Greece’s Top Priority is a New Tax System: Finmin*, REUTERS.COM (June 21, 2011), <http://www.reuters.com/assets/print?aid=USTRE75K5FS20110621> (quoting Evanelos Venizelos).

on-going compliance by all taxpayers, including our largest taxpayers.”<sup>13</sup> Commissioner Shulman’s view, which I share, is that:

[A]t the end of the day, taxpayers and tax authorities pretty much want the same thing out of the tax system. They want certainty regarding a taxpayer’s tax obligations sooner rather than later. They want consistent treatment across taxpayers. [And t]hey want an efficient use of government and taxpayer resources by focusing on the issues and taxpayers that pose the greatest risk.<sup>14</sup>

I will focus my remarks today first on a discussion of some of the most significant challenges I see to achieving sound tax administration in the compliance arena and then I will turn to a discussion of what I think needs to be done to meet these challenges.

There are a number of challenges to achieving sound tax administration, including improving technology, improving return selection processes, making our internal audit processes more efficient (and I could go on)—but today I would like to focus on two critical challenges that we currently face in LB&I—(1) the uncertainty of the tax law, and (2) achieving consistent treatment of similarly situated taxpayers.

First—uncertainty. Uncertainty in the law exists due to a number of factors. Uncertainty can be caused by complexity—either complexity in the law or in the facts. For example, a new law or a novel transaction could be extremely complex and as a result the proper treatment under the law is unclear. This leads to uncertainty for the taxpayer upon filing a tax return and uncertainty for the examiner during the examination of the tax return. Another way uncertainty can exist is related to simple, everyday market transactions governed by a set of tax laws that has not kept pace with the market. The 2008 financial crisis has brought to the surface a number of these types of issues.

Why is uncertainty a challenge to sound tax administration? First and foremost it is inefficient. Determining filing positions for issues that are uncertain under the tax law can be resource intensive for the taxpayer. Then, the subsequent audit of these issues by the government can and usually is as resource intensive or even more so.

Another reason uncertainty poses a challenge is that how the tax administrator chooses to deal with uncertainty can raise difficult issues

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13. Doug Shulman, Comm’r of the Internal Revenue Serv., Prepared Remarks to the New York State Bar Association Taxation Section Annual Meeting in New York City (Jan. 26, 2010) (transcript available at <http://apps2.irs.gov/newsroom/article/0,,id=218705,00.html>).

14. *Id.*

relating to fairness. Before I go more deeply into this point, let me pause here to state the obvious—the best solution to uncertainty would be to resolve most, if not all, of the uncertainty in the law before a tax issue arises or before a taxpayer files a return. While this approach would be ideal, and we are continually working to get there, realistically, the tax administrator needs to understand how best to deal with uncertain legal issues when they arise during an audit, because there is no way to avoid it.

One way to frame the discussion about uncertainty in the tax law is to define what we believe the parties' obligations are—both the taxpayer and the examiner—in dealing with the uncertainty. Let's start with the taxpayer's duty. My own view is that when the law is uncertain a taxpayer should take a position that lies well within the range of reasonable interpretations of the law as it exists and as it applies to the taxpayer's facts.

Some taxpayers may believe, however, that in the face of uncertainty, their interpretation of the law can come right up to the line as long as it does not cross the line of what a reasonable interpretation might be. Put differently, if the position is not clearly wrong it should not be challenged until the law is made clear.

Emily Parker, a former IRS acting chief counsel, gave a speech during her tenure discussing the so called "Wall Street Rule."<sup>15</sup> While not exactly on point with our discussion today, her remarks did deal with tax law uncertainty. As she stated at the time, "the failure of the IRS to issue published guidance on a transaction, and even the failure of the IRS to raise issues regarding a transaction in audits for many years does not prevent the IRS from questioning the tax treatment of the transaction."<sup>16</sup> She concluded that as a legal matter, "the Commissioner may challenge positions taken by taxpayers, however longstanding the tax treatment and however many dollars are at stake."<sup>17</sup>

I, of course, agree with these conclusions. But just because the IRS has the legal right to challenge a transaction or make an adjustment even when the law is uncertain, I believe a real question still exists related to when it is

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15. Emily A. Parker, Acting Chief Counsel of the Internal Revenue Serv., Remarks at the TEI/LMSB Financial Services Industry Conference (Sept. 22, 2003) (transcript available at <http://www.irs.gov/pub/irs-utl/tei-92203.pdf>) (Ms. Parker stated, "There are at least two accepted versions of the Wall Street Rule. One version is that the IRS cannot attack the tax treatment of any security or transaction if there is a long-standing and generally accepted understanding of its expected tax treatment . . . . The second version of the Wall Street Rule is that the IRS is deemed to have acquiesced in the tax treatment of any security or transaction if the dollar amount involved is of sufficient magnitude.").

16. *Id.*

17. *Id.*

in the best interest of sound tax administration for the Commissioner to challenge a position taken by a taxpayer when the law is uncertain.

So what would you tell an examiner to do in the situation where the law is uncertain on say a complex financial transaction from which the taxpayer is claiming a large financial benefit—the uncertain part is how much of a benefit, if any, the taxpayer is entitled to under the law.

Should the examiner take the most aggressive, pro-government position, whether or not the taxpayer's filing position is considered aggressive? Should the examiner take the position that is considered the "most reasonable" interpretation of the law and make an adjustment even if the taxpayer's filing position could be considered in the range of reasonableness? Should the examiner accept the taxpayer's treatment if the taxpayer's position is among the many interpretations that could be considered reasonable, even if we would all agree that it is very close to the line of what could be considered reasonable? Or should the examiner accept the taxpayer's position if it is within the range of what we would consider reasonable even if the "most reasonable" or "most aggressive" government position would yield more revenue?

You could imagine that an individual examiner, using his or her judgment, could reach different results on individual cases, not necessarily based on the facts or the law but instead based on a taxpayer's compliance history, level of cooperation and level of transparency. It has been suggested to me that, at a minimum, examiners should be bound to a "more likely than not standard" in raising issues. That is to say, an examiner should not raise an issue unless there is a more likely than not a chance that the position an examiner takes would prevail. I think this is an interesting idea and while I cannot say that it would ever be adopted, the possibility of such a rule can certainly contribute to the dialogue of what standards or principles an examiner should adhere to in making the decision of what arguments to raise on behalf of the United States Government.

One approach could be to have different principles or standards for different situations where the tax treatment of a transaction is in question and the law is uncertain. For example, take a transaction that is not in the ordinary course of a taxpayer's business and the taxpayer's tax treatment of the transaction produces results that seem too good to be true—a tax shelter—for example, the so called "Son of Boss" transaction. In this situation, perhaps the government should make the most aggressive arguments—"throw the book at 'em" so to speak—including penalties.

But what if the uncertain question of law is long standing and is related to a transaction that occurs in the ordinary course of the taxpayer's business? Imagine also that the taxpayer's interpretation of the law yields a very good result for the taxpayer, but that the treatment has never been

challenged on examination. Should the government in this situation make the most aggressive arguments available, including the assertion of penalties?

And while these two examples seem far apart—the tax shelter and the ordinary business transaction—real examples are often not this easy and the outcomes rest on the judgment of the examiner. Said differently, where a transaction falls on the continuum between tax shelter and ordinary business transaction is like defining beauty—it is truly in the eye of the beholder.

It also might seem that an examiner's individual judgment and a taxpayer's individual compliance history could help inform how to deal with the uncertainty, perhaps leading to different results for different taxpayers with respect to the same issue and similar facts.

This observation leads us to the discussion of the second challenge to sound tax administration—consistency. Achieving consistency, as reflected in President Kennedy's remarks, quoted earlier, is at the heart of fair and equitable enforcement.<sup>18</sup> If similarly situated taxpayers are not treated consistently by the tax administrator it erodes confidence in the system and ultimately could lead to a decline in voluntary compliance.

And while consistency is important, as Ralph Waldo Emerson wrote in his essay *Self-Reliance*, "A foolish consistency is the hobgoblin of little minds, adored by little statesmen and philosophers and divines."<sup>19</sup> Note that Emerson refers to "foolish" consistency. I believe sound tax administration demands not foolish consistency but wise consistency. Unfortunately, Mr. Emerson's essay does not give us any clues about the difference between wise consistency and foolish consistency.

I see two challenges that the principle of consistency brings to tax administration. The first is a significant management challenge. The second is the challenge of dealing with mistakes in interpretation, which, of course, should be minimized but are not entirely unavoidable—either by the government or by taxpayers.

First, what management challenges come from the requirement of consistency? Simply put, getting in place the basic mechanics of achieving consistency and ensuring they are working is a significant challenge. Anyone who has ever managed a large group of professionals, especially those who are hired for their judgment and expertise, knows that getting them to act consistently is difficult, to say the least.

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18. See Kennedy Remarks, *supra* note 8.

19. RALPH WALDO EMERSON, *Self-Reliance*, in *ESSAYS: FIRST AND SECOND SERIES* 27, 35 (2010).



For the IRS to achieve consistency in compliance results, the tax administrator must first decide what position its examiners should be taking on behalf of the U.S. Government on any particular issue. The first question that arises is who makes this decision—the individual examiner, a special team, a board of advisors and should it be different depending on the issue? Maybe more importantly how does this happen in a reasonable amount of time?

Once a government position is determined and is being consistently applied by examiners, what if more is learned about the issue and it is determined that the government's position is wrong? What does consistency tell the tax administrator to do in this situation?

What if the mistake benefits the taxpayer and the first audits on certain issues yield results that in hindsight for the taxpayer may be too good to be true. Should taxpayers that are audited later in time get the same “wrong” but favorable result in the name of consistency? Does it matter whether or not the taxpayers involved are direct competitors? Further still, if consistency requires the “wrong” but favorable result, does it ultimately motivate the government, when in doubt, to default to taking the most aggressive position? In thinking about these questions, you begin to see why Ralph Waldo Emerson may not have given us any clues about the difference between wise and foolish consistency . . . .

The opposite conundrum also exists—if the government determines the first position was wrong but pro-government, should the government continue to adhere to this position in the name of consistency? If consistency requires the government to continue to reach the same wrong, harsh result, does it ultimately motivate taxpayers, when in doubt, to default to un-agreed statuses on issues and leave them to an appeals officer or mediator to resolve?

So these are the challenges. My description of them, in the interest of time, has been designed to give just a flavor of the types of questions that arise in dealing both with uncertainty in the law and in attempting to ensure consistency of compliance results. In my view, these two challenges are among the most difficult faced by a tax administrator. I believe this is true because in dealing with these difficult questions it is impossible to provide a simple, easily administrable, one-size-fits-all answer. And while it would be tempting to do this, it has been tried before; unfortunately the way it turns out is that instead of one size fitting all—one size fits no one. Said differently, a one-size-fits-all solution provides a consistently bad answer for everyone.

So how do we meet these challenges? Ultimately, successfully dealing with these challenges requires judgment. But for that judgment to be fair and consistent, it must be exercised institutionally and with the benefit of

the collective knowledge and experience of the entire organization. The judgment also must be exercised with institutional perspective and a long view of tax compliance across the entire tax system and across time, not with a focus on the outcome in any one particular case at any one particular time.

And while there are no easy one-size-fits-all solutions to sound tax administration, I believe, the key to sound tax administration lies in some very basic principles. Foremost, it is important to understand and acknowledge that tax enforcement can be viewed as an adversarial process. This may seem obvious but there is nuance to it. While it is an adversarial process, the government should not behave as if it had the same freedoms as a private litigant. What I mean by this is that the government should not set its sights on an outcome—a result it wants at the end of the process—and then throw every available argument against the wall and see if anything sticks.

The government, in my view, has a higher duty than that of a private litigant. The government, represented by the tax administrator, should not pursue a particular outcome and then look for interpretations of the law that support it. The tax administrator should do nothing more or less than find the law and follow it, regardless of the outcome.<sup>20</sup> The separation of powers, a bedrock principle of our constitution, demands it.

So while the examination process can be considered adversarial, the goal of at least one party, the government, should not be to win but instead to find and follow the correct interpretation of the law.

This understanding of the tax administration process is important because, in my view, effective management of such a unique adversarial process requires adherence to certain principles: principles that may not be applicable or as important to success outside of this type of adversarial process. I have identified four such principles: (1) professionalism, (2) discipline, (3) transparency and (4) accountability.

For the tax administrator, professionalism simply means that taxpayers must be treated fairly and with respect.

The second principle, discipline, I believe, is even more important than professionalism and I would describe it this way. As citizens, we all have views about the fairness and efficacy of our country's tax laws. And most, if not all of us, could quickly think of at least one way to change the current tax law if we could. These views, however, have no place in decisions

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20. My friend and former colleague in the I.R.S. Office of Chief Counsel, Lewis J. Fernandez, is the one who first articulated the tax administrator's responsibility to me in this way. He is well known for saying, "My job is to find the law and follow it."

about how taxpayers file their tax returns and certainly should have no place in how examiners audit tax returns. As Commissioner Shulman has said, “Our responsibility is the same as the responsibility of our taxpayers—apply the law as it currently exists, not how we would like it to be, and do so with neither a thumb on the scale in favor of the government, nor in favor of the taxpayer.”<sup>21</sup>

Also a tax administrator may sometimes see his or her role as one of “protecting the revenue.” There can be no better view of this point than the one that was put forth in Revenue Procedure 64-22, which stated:

It is the responsibility of each person in the Service, charged with the duty of interpreting the law, to try to find the true meaning of the statutory provision and not to adopt a strained construction in the belief that he is “protecting the revenue.” The revenue is properly protected only when we ascertain and apply the true meaning of the statute.<sup>22</sup>

Human nature being what it is, however, I believe to achieve this, both examiners and taxpayers must be extremely disciplined and ever mindful to separate their personal views of the law from their professional deliberations and follow precisely what the law requires, even if the result is personally unsatisfying.

Transparency is the third basic principal that is essential to sound tax administration. In an adversarial process, transparency can be difficult to define. It is a concept that is often thrown around with respect to tax administration but I am not sure there is a uniform view of what it means. I will tell you what I think it means—first, with respect to audits, and then, with respect to the audit process in general.

With respect to audits, I think transparency means this—for the IRS, it means that taxpayers should know at the beginning, middle, and end of the examination the issues the examiner is considering raising, why they are being raised, what legal arguments the examiner is relying on and in turn what the examiner’s views of the taxpayer’s legal arguments are. If others in the organization are consulted to develop a position, that fact should be shared with the taxpayer and if the taxpayer wants to speak to those individuals, it should be arranged.

For taxpayers, I believe transparency means fully participating in the planning of an audit, discussing realistic timeframes for providing

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21. Shulman, *supra* note 13.

22. Rev. Proc. 64-22, 1964-1 C.B. 689.

information, being forthcoming with facts and legal arguments on a timely basis—presenting all relevant facts and arguments with respect to an issue during the exam phase of the process and holding nothing back for later phases of the process, for example in appeals.

With respect to the audit process in general, I think transparency means laying out clear expectations for examiners and taxpayers alike. As soon as we know our view on an issue it should be shared. An example of how we do this is the Field Directives that are issued in LB&I. These directives cover how the organization expects audits of a number of issues to be handled. Recent directives have provided guidance to examiners on subjects such as mark to market under section 475, economic substance, uncertain tax positions, and repairs versus capitalization.<sup>23</sup> These directives are public and therefore both taxpayers and examiners know how an audit of these issues should be carried out.

Another way we can make our views clear is by asking for advice from our counsel in a form that will be released to the public. I know there is sometimes a reluctance by examiners to ask for legal advice in writing and a reluctance by lawyers to put advice in writing. But I personally believe it can only benefit the process to do so.

The final basic principle related to sound tax administration is accountability. What does this mean? It means all parties to an audit need to be held accountable for how the audit is carried out. Through transparency a taxpayer should be aware of the issues being considered and aware of the processes or advice examiners should be following. If this isn't happening, it is incumbent on the taxpayer to raise the issue to the examiner or the examiner's management team. Likewise, if a taxpayer and an examiner discuss issues and agree to response times for providing information, if those timeframes are not met, taxpayers should be held accountable, if necessary through the summons process. In my view,

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23. I.R.S. LB&I Dir. Order LB&I-4-0711-015, *impacted* IRM 20.1.1, 20.1.5 (July 15, 2011), available at <http://www.irs.gov/Businesses/Guidance-for-Examiners-and-Managers-on-the-Codified-Economic-Substance-Doctrine-and-Related-Penalties>; I.R.S. LB&I Dir. Order LB&I-4-1110-033, *impacted* IRM 4.51.2.2 (Apr. 14, 2011), available at <http://www.irs.gov/Businesses/L.R.C.-475-Field-Directive-related-to-Mark-to-Market-Valuation>; I.R.S. Director's Dir. LMSB-4-0110-001, *impacted* IRM 4.51.2 (Jan. 22, 2010), available at [http://www.irs.gov/Businesses/Tier-I-Industry-Director's-Directive-on-the-Planning-and-Examination-of-Repairs-vs.-Capitalization-Change-in-Accounting-Method-\(CAM\)-%231](http://www.irs.gov/Businesses/Tier-I-Industry-Director's-Directive-on-the-Planning-and-Examination-of-Repairs-vs.-Capitalization-Change-in-Accounting-Method-(CAM)-%231); I.R.S. Director's Dir. LMSB-4-0110-002, *impacted* IRM 4.51.2 (Jan. 22, 2010), available at [http://www.irs.gov/Businesses/Tier-I-Industry-Director%E2%80%99s-Directive-on-the-Planning-and-Examination-of-Repairs-vs.-Capitalization-Change-in-Accounting-Method-\(CAM\)-%232](http://www.irs.gov/Businesses/Tier-I-Industry-Director%E2%80%99s-Directive-on-the-Planning-and-Examination-of-Repairs-vs.-Capitalization-Change-in-Accounting-Method-(CAM)-%232); Memorandum from Steven T. Miller, Deputy Comm'r for Serv. & Enforcement on Reporting of Uncertain Tax Positions (Sept. 24, 2010), available at [http://www.irs.gov/pub/newsroom/internal\\_directive.pdf](http://www.irs.gov/pub/newsroom/internal_directive.pdf).

greater transparency will bring greater accountability of all parties in the process.

In the final analysis, as Dr. Woodworth believed, we must have a rational tax system—one that both serves the well-being of the government and is fair to the people.<sup>24</sup> As he recognized, a fair tax system is important in securing people's trust in their government.<sup>25</sup>

This afternoon, I have tried to give you a perspective of some the challenges faced in providing a sound tax administration system. I have also shared with you the ways I believe we can best meet these challenges—with the principles of professionalism, discipline, transparency and accountability. And while creating and sustaining a sound tax administration system is a difficult task, I can assure you that the dedicated men and women in LB&I and the IRS as a whole will continually strive to achieve it. We must, in order to secure the people's trust in their government.

That concludes my remarks. Thank you very much for your kind attention.

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24. *Woodworth Lecture Series, supra* note 1.

25. *Id.*