HOW THE 1998 TAX ACT AFFECTS YOUR DEALINGS WITH THE IRS APPEALS OFFICE

The IRS Restructuring and Reform Act of 1998

January 22, 1999

Robert M. Kane, Jr.
LeSourd & Patten, P.S.
600 University Street, Ste 2401
Seattle, WA 98101
(206) 624-1040
rkane@lesourd.com

BOB KANE. Mr. Kane's practice is limited to resolving disputes with the Internal Revenue Service. He formerly represented the Internal Revenue Service in tax litigation as a trial attorney for the U.S. Department of Justice. Mr. Kane teaches a class on dealing with the Internal Revenue Service to accountants and lawyers at Golden Gate University's Seattle campus. He is a past president of the section of Taxation of the Washington State Bar Association and has an LL.M. in tax from New York University.

The assistance of Deborah Jaffe, formerly with IRS District Counsel in New Orleans, in the preparation of this outline is gratefully acknowledged.

rmk6\talks\012299.wpd

HOW THE 1998 TAX ACT AFFECTS YOUR DEALINGS WITH THE IRS APPEALS OFFICE

Bob Kane
LeSourd & Patten, P.S.
(206) 624-1040

I. OVERVIEW

Never before has Congress enacted so many taxpayer protections at one time as it did in the 1998 IRS Restructuring and Reform Act enacted on July 22, 1998. Many of the new provisions such as burden of proof are covered in greater depth in outlines prepared by others for this CLE program. In brief, the changes in Appeals include:

- Taxpayers may have additional leverage in Appeals when the IRS has the burden of proof.
- Taxpayers who have their settlement offer rejected in Appeals and then do better in litigation, may have their attorney fees and costs paid by the IRS.
- Taxpayers have the right to go to Appeals (and court if necessary) regarding Collection's decision to serve a levy or file a tax lien.
- Taxpayers have two additional means, mediation and arbitration, to resolve disputes with the IRS.
- Expanded Appeals coverage is mandated.
- There will be less ex parte communication between the Appeals Officer and the revenue agent who worked up the case.
- Taxpayers will be able to find out when an Appeals Officer has contacted a third-party to get information about the case.
- Taxpayers have the option of sending one or more issues to Appeals while Examination continues to work on other issues.

II. BACKGROUND

A. WHERE APPEALS FITS INTO THE PROCESS.

1. Opportunities to appeal agent's determination. After an examination, a taxpayer has numerous opportunities to resolve a dispute including with the revenue agent, the revenue agent's supervisor, the Appeals Office, and finally in the courtroom, with the last avenue of appeal being the U.S. Supreme Court.

2. Purpose of Appeals. The purpose of Appeals is "to resolve tax controversies with no litigation on a basis which is fair and impartial to both the government and the taxpayer."

3. High rate of settlement. Approximately 90 to 95% of all audit disputes brought to the Appeals Office in the Pacific-Northwest District are resolved at that level.

B. TYPES OF CASES HANDLED BY APPEALS.

1. Exam-related. Income, estate or gift tax deficiencies asserted by the Examination Division, either prior to the issuance of the statutory notice or after the case is docketed in Tax Court.

2. Collection-related. Collection disputes, including penalties asserted against responsible persons for trust fund liabilities and rejections of offers in compromise.

C. THE SETTLEMENT PROCESS IN APPEALS.

1. Procedures. If matters cannot be resolved at the Examination level, a 30-day letter normally will be issued, giving a taxpayer the opportunity to contest the audit determination with the IRS Appeals Office. Typically, a Protest is filed in response, putting the IRS on notice as to why the taxpayer feels that the agent's determination is erroneous. The process is informal and generally involves a conference at the Appeals Office attended by the taxpayer's representative and the Appeals Officer.

2. Hazards of litigation. Unlike the Examination Division, Appeals Officers are required to analyze and consider the hazards of litigation in the settlement process. To obtain a favorable settlement, the taxpayer's goal is to demonstrate that the IRS would lose in court if the matter were to go to trial.

D. RESULTS CAN BE FAVORABLE.

Statistics. Although not based on recent statistics, traditionally, on average, taxpayers have paid approximately thirty cents on the dollar by taking their case to Appeals. This does not mean that a taxpayer should expect to pay only thirty cents on the dollar simply by going to Appeals. Any settlement will depend on how the law is applied to the particular facts in question. Even if one were to assume that taxpayers are not faring as well in Appeals as in the past, these statistics suggest that a taxpayer is wise to consider whether a more favorable resolution can be obtained in Appeals than at the Exam level.

III. CHANGES IN APPEALS AFTER 1998 ACT

A. THE BURDEN OF PROOF ISSUE WILL SUPPLY TAXPAYERS WITH AN ADDITIONAL ARGUMENT DURING NEGOTIATIONS.

1. Burden of proof argument. The 1998 Act places the burden of proof on the IRS in any court proceeding as to factual issues if the taxpayer introduces credible evidence on the issue and meets four requirements:

   (a) Complies with substantiation requirements;

   (b) Maintains all required records;

   (c) Cooperates with reasonable IRS requests; and

   (d) Is not a corporation, trust or partnership with a net worth exceeding $7 million.

2. Increased leverage for taxpayer. If the Appeals Officer has doubts about the ability of the IRS to meet its burden of proof, the taxpayer acquires additional leverage. As a practical matter a procedural argument exists on top of any argument on the merits of the substantive issues. The taxpayer may be able to obtain a more favorable settlement by arguing that the litigation hazards of the IRS are increased because of its burden of proof.

3. Effective date. Effective for court proceedings arising in connection with examinations commencing after the date of enactment. If there is no examination, the provisions apply to court proceedings arising in connection with taxable periods or events beginning or occurring after the date of enactment.

B. IRS CONCERN ABOUT ITS ABILITY TO MEET THE BURDEN OF PROOF WILL RESULT IN MORE CASES BEING SENT BACK TO THE EXAMINATION DIVISION FOR FURTHER DEVELOPMENT.

Incomplete files. When an Appeals Officer receives a case file, the Appeals Officer will have to evaluate the burden of proof issue. Will the burden of proof be on the IRS in a court proceeding? If so, the Appeals Officer must ensure that the file is developed sufficiently that the IRS can carry its burden. If the information in the file is incomplete, the Appeals Officer must either develop the necessary information, send the case back to Exam for further development or settle the case for a lesser amount taking into account the IRS's problems in meeting its burden of proof. Given the reluctance of Appeals Officers to do work that is supposed to be done by agents, it would appear that more cases will be sent back for further development, perhaps lengthening the process in the long run.

C. TAXPAYERS HAVE ADDITIONAL LEVERAGE IN APPEALS BECAUSE OF A GREATER THREAT THAT THE IRS WILL HAVE TO PAY FEES AND COSTS.

1. Prior law. To obtain reasonable administrative and litigation costs, IRC § 7430 requires that the taxpayer show that the taxpayer was a "prevailing party." In addition, the taxpayer has to exhaust administrative remedies and not unreasonably protract the proceedings. In general, only an individual whose net worth does not exceed $2 million is eligible for an award, and only a corporation or partnership whose net worth does not exceed $7 million is eligible for an award. The taxpayer was not considered a "prevailing party" if the government could show that its position was substantially justified. It was the rare case where a court determined that the IRS position was not substantially justified.

2. 1998 Act. The 1998 Act provides that a taxpayer otherwise meeting the requirements for entitlement to fees or costs will be treated as a "prevailing party" if the liability determined in a court proceeding is equal to or less than what the taxpayer's liability would have been had the United States accepted a "qualified offer" made by the party. 1998 Act § 3101(e), amending IRC § 7430(c)(4)(E)(i).

    a. "Qualified offer" is defined as a written offer which:

        i. Is made by the taxpayer during the "qualified offer period."

        ii. Specifies the amount of the taxpayer's liability (without interest).

        iii. Is designated as a qualified offer.

iv. Remains open during the period beginning on the date on which it is made, and ending on the earliest of the date on which the offer is rejected, the date on which trial begins, or the 90th day after the offer is made.

b. The "qualified offer period" is defined as the period that begins on the date the IRS sends the first letter of proposed deficiency which affords the opportunity for administrative review with Appeals, and which ends 30 days before the date set for trial.

c. Therefore, offers made by taxpayers during consideration of their cases by Appeals could provide a basis for an award of attorney's fees and costs, if a court judgment determines a liability equal to or less than that of the liability which would have resulted had Appeals accepted the taxpayer's offer.

d. Reasonable administrative and litigation costs paid by the government shall include only costs incurred on and after the date of the qualified offer. Thus, the earlier the offer is made, the larger the potential recovery of costs.

e. If more than one qualified offer is made, it is the last one which controls.

f. The qualified offer rule allows the taxpayer to qualify as a "prevailing party" without substantially prevailing on the amount in controversy or the most significant issue. Taxpayers also will not have to argue about whether the position of the Service was substantially justified.

g. The Committee Reports state: "The Committee believes that settlement of tax cases should be encouraged whenever possible." This provision should provide incentive to both the taxpayer and the IRS to get cases settled.

h. The provision does not provide for payment of costs in a case which is settled nor does it cover cases in which no tax liability is in controversy (e.g., declaratory judgment and summons enforcement proceedings).

i. The "qualified offer" provision does not prevent a taxpayer from qualifying as a "prevailing party" under the old rules.

j. Taxpayers need to consider the amount of disclosure that they make in connection with a qualified offer so as not to run afoul of the exhaustion of administrative remedies rule or the prohibition on protracting the proceedings. For example, a fee award could be denied if the IRS were able to argue successfully that it would have settled the case for the qualified offer amount had the taxpayer disclosed certain information in its possession.

k. The provision is patterned after Rule 68 of the Federal Rules of Civil Procedure.

l. Because it is the taxpayer who controls the timing and the amount of the qualified offer, this provision should be particularly favorable to taxpayers. It is the IRS with the downside in rejecting an offer; not the taxpayer.

m. The pros and cons of whether to make a qualified offer in a particular case should be discussed with the client anytime a matter goes to the IRS Appeals Office.

3. Practical effect. IRS employees have lived in an environment in which the payment of attorney fees by the IRS is abhorrent because when such fees are paid, it suggests that an IRS employee did something wrong. Gentle reminders about the possibility of fees and costs being paid by the IRS should serve to keep IRS settlement offers realistic. The provision could be particularly useful when an Appeals Officer is taking an unrealistic position on a matter. More tax cases are likely to be settled as a result of this provision.

4. Effective date. This provision is applicable to costs incurred more than 180 days after the date of enactment. The date of enactment is July 22, 1998. Accordingly, it applies to costs incurred after January 18, 1999.

D. AN APPEALS HEARING IS AVAILABLE FOR LEVY AND LIEN NOTICES.

1. 1998 Act. Taxpayers will have an opportunity for an Appeals Office hearing prior to the IRS collecting the tax liability by levy and regarding the filing of a notice of federal tax lien by the IRS. 1998 Act § 3401, enacting IRC § § 6320 and 6330. These are significant due process rights.

2. Hearing before levy.

a. IRS must generally give written notice of its intent to collect taxes by levy at least 30 days before issuing the levy.

b. The taxpayer may then request a hearing before the Appeals Office within 30 days. If the request is not mailed within 30 days after the date of the IRS written notice, the taxpayer will be allowed a hearing but there will be no statutory suspension of collection action and the taxpayer will not have the right to go to court if the taxpayer disagrees with Appeals' determination.

c. The Appeals Officer conducting the hearing must be someone with no prior involvement in the matter, unless the taxpayer waives this requirement.

d. The Appeals Officer must first verify that required IRS procedures were followed, including:

    i. Revenue officer verified tax liability;

    ii. Estimated expenses will not exceed value of property to be levied on;

    iii. Revenue officer determined that there is sufficient equity in the property to yield net proceeds.

e. Any relevant issue relating to the unpaid tax or to the proposed levy can be raised, including:

    i. Spousal defenses (e.g., innocent spouse issues);

    ii. Appropriateness of collection actions;

    iii. Alternative collection methods;

    iv. Challenges to the existence or amount of the underlying tax liability, provided that the taxpayer did not receive a statutory notice or otherwise have the opportunity to contest the liability.

f. Issues previously raised in an administrative or judicial proceeding cannot be raised again if the taxpayer participated meaningfully in those proceedings.

g. IRC § 6330(c)(3) provides that in reaching a determination, the Appeals Officer must consider the verification made by the IRS, the issues raised by the taxpayer, and whether the proposed collection action balances the need for efficient tax collection with legitimate concerns that any collection action be no more intrusive than necessary. The Appeals Officer must prepare a written determination.

h. The Appeals Office retains jurisdiction over its determination, and further hearings may be requested, as for example where the taxpayer disputes whether the IRS is correctly interpreting the determination, or where circumstances change.

i. The determination may be appealed by the taxpayer within 30 days to the Tax Court, if it is a matter subject to Tax Court jurisdiction, or otherwise to the U.S. District Court.

j. In general, collection action will be suspended during the Appeals hearing and any ensuing court appeal; however, the running of any statute of limitations (i.e., collection or criminal) is also suspended.

k. Attachment 1 is a draft of a new IRS publication entitled "Hearing Available Under Due Process for Lien and Levy Notices."

3. <u>Hearing regarding filing of notice of federal tax lien</u>.

a. Under the new law, the IRS must give written notice of its intent to file a notice of federal tax lien not more than five days after it files such notice of federal tax lien.

b. The taxpayer will be entitled to a hearing regarding the notice of federal tax lien under rules similar to those governing the hearing before a levy. If both types of hearings are requested, they should, to the extent practicable, be held together.

c. Notice that the taxpayer is also entitled to appeal a decision to file a federal tax lien *prior to* the filing of the lien pursuant to the Collection Appeal Program, so theoretically taxpayer has two bites at the apple in Appeals on this issue.

4. <u>Effective date</u>. Effective for collection actions initiated more than 180 days after the date of enactment.

E. THERE WILL BE EXPANDED APPEALS COVERAGE, SOME OF WHICH CODIFIES CURRENT IRS PRACTICE.

1. <u>Collection</u>.

(a) The due process rights of a taxpayer include the ability to go to Appeals after receipt of a notice of levy or a notice of a tax lien filing. These procedures are described above.

(b) IRC § 6159(d) requires that the IRS develop administrative appeal procedures in connection with the review of terminations of installment agreements.

(c) IRC § 7122(d) codifies current IRS Appeals procedures regarding the appeal of rejections of offers in compromise.

(d) IRC § 7123 instructs the IRS to prescribe procedures for appeals of collection decisions. The Committee Reports express the intent that the IRS be statutorily bound to follow the procedures that have been developed through the Collection Appeals Program the IRS currently has in place. See Publication 1660, for a summary of the procedures.

2. Examination-related matters.

(a) In connection with a taxpayer exercising due process appeal rights regarding a Collection decision, IRC § 6330(c)(2) provides for the appeal of the underlying tax liability where the taxpayer has not had the opportunity to appeal on the merits previously.

(b) Act § 3105 requires that the IRS amend its administrative procedures to allow tax-exempt bond issuers examined by the IRS to appeal any adverse examination determination (i.e., a determination that interest on obligations of the issuer is not excludable from gross income under IRC § 103) to Appeals.

(c) Appeals will be involved in the appeal of innocent spouse determinations made under the new expanded innocent spouse rules.

F. EARLY REFERRAL OF UNRESOLVED ISSUES FROM EITHER THE EXAMINATION DIVISION OR THE COLLECTION DIVISION TO APPEALS.

1. 1998 Act. The new law permits any taxpayer to request early referral of one or more issues from either Examination or Collection to Appeals. 1998 Act § 3465, amending IRC § 7123.

2. Expansion and codification of program. This is an expansion and codification of an early referral program which previously had permitted early referral only in regard to limited categories of taxpayers or issues.

3. Taxpayer's option. Early referral is optional and initiated by the taxpayer.

4. Revenue Procedure. A revenue procedure is being developed which will describe the procedures to be used. Until it is issued, Appeals is supposed to consider the general guidelines in Rev. Proc. 96-9 (also, Announce-ments 96-13 and 97-52 for employment tax cases).

5. <u>Effective date</u>. Effective as of the date of enactment.

G. NEW SETTLEMENT PROCEDURES: ALTERNATIVE DISPUTE RESOLUTION.

1. <u>Mediation</u>. Under procedures to be prescribed by the IRS, either the taxpayer or Appeals can request non-binding mediation of issues remaining unresolved. 1998 Act § 3465(a)(1), amending IRC § 7123(b)(1).

   a. This is a codification and expansion of existing procedures in which mediation was available only where there was more than $10 million in dispute.

   b. It will take the IRS some time to develop procedures for mediation. In November, the Service expanded its mediation program to allow taxpayers to request mediation for factual issues involving an adjustment of $1 million or more that are already in the Appeals administrative process. Announcement 98-99, 1998 I.R.B. 1. This is part of a two-year test program the procedures for which follow.

   c. Under the mediation procedure the taxpayer and Appeals will continue to negotiate a settlement but an objective and neutral third-party mediator will assist them. The mediator has no authority to impose a decision.

   d. Factual issues include valuation, reasonable compensation and transfer pricing.

   e. The procedure may be used only after Appeals settlement negotiations are unsuccessful, and when all other issues are resolved but for the issue(s) for which mediation is being requested.

   f. Mediation under these procedures is not available for an issue designated for litigation or docketed in any court, an Industry Specialization Program (ISP) issue, an Appeals Coordinated Issue or an issue where taxpayer has filed a request for competent authority.

   g. The test of mediation procedures for Appeals seeks to include cases using both non-IRS and Appeals personnel as mediators. The procedures approve of the use of any local or national organization that provides a roster of neutrals in selecting a mediator.

   h. When an Appeals employee is selected as mediator, the person shall be from another Appeals region or the National Office of Appeals. If the parties select an Appeals mediator (or co-mediator), Appeals will pay the expenses associated with the mediator.

i. When the parties select a mediator from outside the IRS, the taxpayer and Appeals share equally the expenses associated with the mediator.

j. Although no formal procedure exists for the denial of a mediation request, a taxpayer may request a conference to discuss the denial.

k. Each party is to prepare a discussion summary of the issues (including the party's arguments in favor of the party's position) for consideration by the mediator. The discussion summaries should be submitted to the mediator and the other party no later than two weeks before the mediation is scheduled to begin.

l. The Announcement 98-99 procedures outlined above are effective for requests for mediation made during the two-year test period beginning November 16, 1998.

m. A Model Agreement to Mediate is included as an exhibit to Announcement 98-99.

2. Arbitration. The IRS is to establish a pilot program under which the taxpayer and the Appeals Office can jointly request binding arbitration on issues remaining unresolved. 1998 Act § 3465(a)(1), amending IRC § 7123(b)(2).

3. Effective date. Effective on the date of enactment.

H. CONVENIENT ACCESS TO APPEALS.

1. Access. An Appeals officer is required to be "regularly available" in every state.

2. Video conferences. In addition, the IRS is required to consider the use of video conferences when the taxpayer is located in a rural or remote area. 1998 Act § 3465(c).

3. Effective date. Effective on the date of enactment.

I. THE APPEALS OFFICE IS NOT TO COMPROMISE ITS INDEPENDENCE.

1. "No contact" rule. The 1998 Act includes provisions on restructuring the IRS. As part of the restructuring, the IRS is required to insure an independent Appeals function within the IRS. Therefore, the reorganization plan must prohibit ex parte communications between Appeals Officers and other IRS employees to the extent

that such communications appear to compromise the independence of Appeals Officers. 1998 Act § 1001(a)(4).

2. Effective date. Effective upon date of enactment.

J. MISCELLANEOUS.

1. Attorney fees and costs. Attorney fees may be awarded from the date of the 30-day letter, earlier than in the past.

2. Ten cardinal sins. Act § 1203 provides for termination of employment for any IRS employee who commits one of the ten described acts or omissions. Expect Appeals Officers to be particularly careful to disclose to taxpayers and representatives procedural options (and providing appropriate publications) such as with respect to statute extensions and to avoid any conduct that could be interpreted as retaliation or harassment pursuant to Act § 1203(6).

3. Customer service. The new IRS mission statement emphasizes customer service. Appeals now has a Customer Service Representative of its own in order to assist taxpayers and taxpayer representatives.

4. Tax Court petitions. Appeals, as well as other IRS functions, must include the deadline date for filing a petition in every statutory notice of deficiency that it issues. Where a joint return was filed, separate notices of deficiency will be mailed to each spouse even if they are at the same address.

5. Innocent spouse. IRC § 6015(g) provides that the IRS must prescribe regulations providing for the spouse other than the spouse electing relief to have notice of, and the opportunity to participate in, any administrative proceedings with respect to the election, presumably including Appeals hearings.