



Settling with the

IR



New avenues expedite conflict resolution



By Trevor Wetherington and Vincent Canciello

The length of time and resources required to resolve controversies with the Internal Revenue Service (IRS) has steadily increased in recent years. In response, the IRS has announced a number of procedures that either improve existing controversy resolution procedures or establish new alternatives to the existing procedures: pre-filing agreements, comprehensive case resolution, and industry issue resolution. Additionally, the IRS appeals division has emphasized and improved its ability to achieve speedy resolution of issues with the “mutually agreed appeals process,” the “early referral of issues” and mediation.

It is important for taxpayers to strategic vision that incorporates requests for early dispute

These new methods for resolving issues with the IRS, coupled with the reorganization of the IRS, have created procedural channels for resolution of issues or controversies that are significantly different than those just a few years ago. They also give taxpayers a chance to have issues reviewed by the IRS from fresh new perspectives and on an expedited basis if they are willing to invest the resources necessary to be involved.

This article describes the new or improved procedures in the context of the entire controversy resolution process and offers some analysis of their major advantages and limitations. The first section of this article describes the traditional process for resolution of issues and some relatively new improvements to that process. The second and third sections of the article detail procedures that operate outside the normal course of a controversy. The second section describes the procedures available to resolve the issue before the filing of a return. The third section describes alternative procedures that encourage the resolution of issues by aggregating one or more issues across many taxpayers or years.

Improvements to Traditional Methods of Resolving Controversies and Mediation

If during the course of a controversy, the taxpayer cannot resolve an issue with the examining revenue agent, the taxpayer is entitled to discuss the issue with the agent's group manager. If the issue is based on differing interpretations of law, the agent and the taxpayer can pursue a Technical Advice Memorandum (TAM),¹ which requests the IRS's national office to resolve the issue, based upon agreed facts. The TAM has been available to all taxpayers for some time, but it remains a potent tool for resolving issues where the taxpayer believes that the IRS is taking a legally incorrect position. While the determination by the national office is not binding on the taxpayer, the IRS will give the determination great weight.

FAST FACTS

- In addition to improving existing controversy resolution procedures, the IRS has implemented a number of new measures.
- These new methods give taxpayers a chance to have issues reviewed from a new perspective and on an expedited basis.
- New post-filing procedures will help resolve controversies comprehensively and efficiently.
- To be successful with these approaches, taxpayers should be well-prepared and proactive in managing potential audit controversy.

If there are unresolved issues after the examination is completed, the case or controversy will be closed out to appeals. This can generally be accomplished through the issuance of either a 30-day letter or a statutory notice of deficiency. Appeals takes jurisdiction of the case to settle the controversy "on a basis which is fair and impartial."² Traditionally, an appeals officer will engage in discussions with the taxpayer in an attempt to resolve the controversy. In Coordinated Examination Program cases, which are typically complex and time-consuming because of the issues involved, the IRS has implemented the Mutually Accelerated Appeals Process (MAAP) in an effort to expedite settlement. To expedite resolution, the MAAP initiative allows for the introduction of additional appeals officers to the appeals team responsible for the case, where the taxpayer also agrees to commit additional resources.³

Early referral to appeals is a process that allows taxpayers to take a contentious issue to appeals before the examination is concluded. It has been expanded beyond Coordinated Examination Program taxpayers. Any taxpayer may request early referral of one or more issues from the examination or collection division to appeals. These procedures allow taxpayers to request the transfer of a developed, unagreed issue to appeals while other issues in the case continue to be developed by the examination team. The purpose of early referral is to resolve cases sooner and to encourage taxpayers and the IRS to agree on other issues that are still being examined.⁴ Early referral eliminates the running of "hot" interest under Section 6621(c).

An attractive, if infrequently used, alternative to litigation is mediation. Appeals mediation, which is non-binding, is now available to more taxpayers unable to resolve an issue in the traditional appeals process. The IRS originally piloted the mediation program for issues involving more than \$10 million and expanded the program to include issues of more than one million dollars in 1998.⁵ In the Restructuring and Reform Act of 1998, Congress expanded the mediation program without respect to the dollar value of the issues, although the IRS has not yet incorporated that change into its internal procedures. The IRS will consider issues under one million dollars on an ad hoc basis, due to the change in law. Appeals mediation is most useful for intensely factual issues such as valuation and transfer pricing. It cannot be used for legal issues in dispute, appeal coordinated issues, or Industry Specialization Program issues.

In appeals mediation, the selection of mediators is left to the parties. If the parties choose an appeals officer as a mediator, then the appeals officer is selected from outside the local IRS office and there is no cost for the mediation. If the parties agree to use an outside mediator, which seems generally preferable, then the parties must share the cost. The concern with sharing costs with the IRS is that the government contracting process for purchasing services is very detailed and can take six or more weeks to complete. Consequently, the mediation process could be very protracted for administrative reasons. At least one author indicated that it was a year from an informal agreement to mediate with the IRS to the mediation hearing.⁶ The actual mediation process generally takes one or two days and the parties must have someone with authority to bind each party at the mediation.

approach potential controversy from a the application for, and timely execution of, resolution.

Taxpayer response to appeals mediation has been limited by exposure to the process, but the general view is that since it can be helpful and relatively inexpensive for factual issues, there is no downside to trying mediation on those types of cases. At the time of this writing, of the 66 mediation requests made under the pilot program, 31 have concluded. Of those, 27 were successfully concluded, and 4 cases were not resolved. Of the remaining 35 cases, 26 are in process and 9 were ultimately rejected as unsuitable.

Fast track mediation is a very new program being piloted in a few selected geographical areas around the country, but not in Michigan. The goal of fast track mediation is to very quickly resolve issues before the examination is closed out. The goal is to have a mediator from appeals assigned within a week of the request to mediate between the examination team and the taxpayer. The pilot limits the process to cases where the proposed tax is \$100,000 or less.

Resolving Issues Before Filing the Income Tax Return

At first look, it seems unlikely to resolve a tax controversy *before* the filing of the income tax return. However, the most interesting procedures for resolving controversies are pre-filing initiatives. The concept for these pre-filing initiatives is relatively simple: Some tax issues are so significant and so likely to generate controversy, such as transfer pricing, capitalization, or research and development credit, that they take a long time to resolve and often slow down the examination of the remaining issues. If the IRS and the taxpayer can agree to a resolution of those issues before the return is filed, resolving the remainder of the issues on a subsequent audit will be expedited. The three pre-filing initiatives discussed below are private letter rulings, advanced pricing agreements, and pre-filing agreements.

Most tax practitioners are familiar with private letter rulings, which are the IRS's response to a taxpayer's request for a ruling on the tax law consequences of a given set of facts.⁷ While private letter rulings are published, they are only precedential for the requesting taxpayer and only to the extent that the actual facts are consistent with the stated facts. The Office of Chief Counsel, IRS will not issue private letter rulings in certain areas.⁸ While clearly effective to give some comfort to a taxpayer regarding their understanding of the tax consequences of a proposed or completed transaction, private letter rulings are limited because they do not resolve issues involving disputable facts.

Advanced Pricing Agreements (APA) resolve transfer pricing issues between taxpayers and the IRS. This program is administered through the Office of Associate Chief Counsel (international).⁹ An advanced pricing agreement seeks prospective resolution of transfer pricing issues for three to five consecutive years. There are two types of

advanced pricing agreements, unilateral and bilateral. Unilateral APAs seek to resolve issues between the IRS and taxpayers by the implementation of certain agreements regarding transfer pricing. Bilateral APAs require the agreement of the taxpayer, the IRS, and the taxing authority of another country.

Since unilateral APAs merely require agreement between the IRS and the taxpayer, they are much easier to manage and resolve than the bilateral agreements. The IRS's goal is to conclude unilateral APAs within a year of filing. However, unilateral APAs do not directly address the most dominant issue in transfer pricing—double taxation on the same income in different countries.

Bilateral APAs generally take much longer to conclude because they require agreement by the "competent authorities" of both countries on the proposed transfer pricing methodology. The goal of the IRS is to have a recommended negotiating position forwarded to the U.S. Competent Authority within nine months of filing, at which point the competent authorities for each country can begin negotiation and finally conclude the bilateral agreement. In 1998, it was estimated that the average APA was concluded within 20 months of filing.¹⁰ While an APA is proposed and considered on a prospective basis, it is the IRS's policy to attempt to rollback the transfer pricing

methodology of the APA to resolve prior, ongoing controversies.¹¹ It may seem that it would be no easier to resolve a transfer pricing issue on a prospective basis (in an APA) versus a post-filing controversy. However, the involvement of the attorney/advisor from the office of associate chief counsel (international) as a "fresh look" and the lack of hindsight as to the actual results of the transfer pricing in a given year generally favors the APA process.

The latest development in the area of pre-filing procedures is the pre-filing agreement (PFA) program announced February 28, 2000.¹² The PFA program is a significant evolution of the pre-filing determination program, which still exists.¹³ The PFA program seeks to resolve difficult factual issues, under settled areas of the law, before those positions are reflected on a tax return. The IRS piloted the program with some success in 2000 and has adopted the program permanently for taxpayers under the jurisdiction of the large and mid-size business division.¹⁴

While the pre-filing agreement procedures are applicable to any issue except a short list of prohibited issues, they are clearly aimed at some of the most difficult issues, such as research and development credits, valuation of assets, and capitalization of expenses. Under the PFA procedures, the taxpayer submits the request to the IRS, locally if under examination, or in Washington. The taxpayer must submit it early enough that the IRS believes it can resolve the matter before the filing of the taxpayer return reflecting the transaction at issue. The IRS will generally utilize the examination team on site to evaluate the typically voluminous facts relevant to the issue and attempt to reach



resolution. The most significant benefit of the PFA is that the participant's recollections of the facts should be more complete and the documentation associated with the transaction should be more readily available, since the transaction at issue is very recent. Further, the resolution of the issue before filing of the return means that taxpayers can eliminate, for financial reporting purposes, the risk normally presented by large, disputed return issues. The procedure seeks to leverage the freshness of the information and the elimination of long periods of uncertainty into a quick, efficient resolution of the issue, which is memorialized in a closing letter.

Twelve taxpayers were accepted into the PFA pilot program. Seven taxpayers successfully resolved their issues and four had their issues still pending in February 2000. One taxpayer withdrew the request for a PFA after being unable to work out an agreement. With the establishment of a permanent PFA program, the IRS has stated its desire to resolve issues before controversy in order to expedite actual audits.

Comprehensive Resolution of Issues Across Many Years

The newest post-filing procedures for resolving controversies seek to resolve issues or controversies by aggregating them into larger groups that can result in the resolution of more than the issue in one cycle of examination. The hope is that this possibility will result in both parties being more flexible in the resolution of the issue in any one year. The new post-filing initiatives discussed below are "industry issue resolution," "accelerated issue resolution," and "comprehensive case resolution."

The Industry Issue Resolution program is a pilot that encourages all taxpayers in an industry to work with the IRS to resolve a common, frequently disputed issue.¹⁵ Any taxpayer or trade group can propose an issue for resolution. If selected, the IRS team focused on the issue will consist of both field and national office personnel, along with representatives from the field, office of chief counsel, appeals, and treasury. While the resulting resolution may be reflected in any suitable way, it is anticipated that the bulk of the issues will be resolved through the use of revenue procedure pronouncements. The pilot application period for submission of industry issue resolutions ended in February this year, but it is likely that this program will become permanent.

Accelerated Issue Resolution (AIR) agreements resolve a single issue across multiple years and/or cycles of a coordinated examination taxpayer.¹⁶ The AIR agreement is a closing agreement that resolves the issue for all years ending before the date of the agreement. If the resolution of the issue requires the consent of another agency or function within the IRS, the consent must be procured in order for the AIR to be effective. An example of this would be coordinated issues at either the examination or appeals level under the industry specialization



The most significant benefit should be more complete and more readily available, since

program. The examination team would be responsible for getting the acquiescence of the industry specialization personnel responsible for the coordinated issue. Since turf battles are prevalent in matters crossing the jurisdiction of more than one function within the IRS, one should be very careful in approaching the resolution of multi jurisdictional issues. In the right circumstances, an AIR agreement can be a very effective tool for managing a difficult, repetitive issue.

The Comprehensive Case Resolution (CCR) program is in its extended pilot phase.¹⁷ The CCR program is available to all large and mid-size business taxpayers and seeks to simultaneously resolve all open controversies, in examination, appeals, or tax court. The attractiveness of this program appears to lie in the fact that success results in a completely clean slate of tax issues. The CCR should take between six and twelve months to complete and will include IRS representatives from all of the involved functions: large and mid-size business, appeals, and possibly chief counsel. In order to be eligible for

the CCR program, the examination must be substantially completed for purposes of issue development. Appeals will be involved to provide an assessment of the hazards of litigation, and counsel will be involved for the same purpose, if there is a cycle in litigation. The taxpayer must waive the ex parte communication rule for appeals and, if the CCR is unsuccessful, the taxpayer has lost the right to further appeals consideration for all years subject to the CCR.

One of the major concerns with this program is that the mandatory ex parte waiver results in unfettered communication between appeals, the examination team, and/or counsel. Many worry that this will compromise the "fresh look" that appeals is designed to provide. Given that the CCR is the only shot at settlement in appeals, some practitioners have viewed this aspect of CCR as risky.

Conclusion

The IRS has identified the need to expedite the resolution of controversies and has put forth a number of procedures toward that end. Since they provide a new perspective on the controversies and take advantage of concepts like mediation, fresher documentation, and comprehensive resolution, these procedures are worthwhile and useful in the right circumstances. To be successful with these approaches, taxpayers need to be prepared to engage the IRS much earlier than traditional audit contests. They need to be proactive in managing potential audit controversy if they have industry issues, tax sheltered transactions, or any transaction that has traditionally been questioned by the IRS. These relatively new procedures provide an avenue for early resolution, but they are not for everyone, particularly the unprepared.

It is important for taxpayers to approach potential controversy from a strategic vision that incorporates the application for, and timely execution of, requests for early dispute resolution. Using these

of the PFA is that the participant's recollections of the facts the documentation associated with the transaction should be the transaction at issue is very recent.

procedures before and during the tax controversy cycle provides taxpayers an opportunity to have timely "fresh looks" at the issues in the hope of an effective resolution. The IRS has implemented various ways to resolve controversy, and taxpayers need to be attuned to all of these processes and apply them for maximum results. ♦



Trevor Wetherington is a senior manager in Ernst & Young's IRS Practice & Procedure group in Detroit. He represents clients in examinations, appeals conferences, and the United States Tax Court. Before joining Ernst & Young in 1999, he was a special assistant United States attorney and a senior trial attorney with Chief Counsel's Office, IRS in Detroit.



Vincent Canciello is a principal in Ernst & Young's IRS Practice & Procedure Group in the National Tax Department, Washington, D.C. He was nationally recognized and highly regarded as former National Director of Appeals for the IRS, where he worked for 33 years. Under his leadership, IRS Appeals instituted a number of taxpayer-friendly dispute resolution techniques, including mediation, collection, and bankruptcy appeals.

FOOTNOTES

1. Rev. Proc. 2001-2, 2001-1 IRB 79.
2. IRM 8131(2), MT 8-188 (Jan. 9, 1989) (Appeals Mission).
3. IR 2000-42 (June 27, 2000); IR 2000-57 (August 15, 2000).
4. Rev. Proc. 99-28, 1999-2 C.B. 109.
5. Announcement 98-99; 1998-2 C.B. 652; Announcement 2001-9, 2001-03 IRB 357.
6. David F. Rock, *A First Hand Look at Mediation with the Service: How to Make the Most of It*, 93 J Tax'N 69, August 2000.
7. Rev. Proc. 2001-1, 2001-1 IRB 1.
8. Rev. Proc. 2001-3, 2001-1 IRB 111.
9. Rev. Proc. 96-53, 1996-2 C.B. 375.
10. Steven C. Wrappe and George H. Soba, *A Practical Guide to the U.S. Advance Pricing Agreement Process*, 50 The Tax Executive 454, 455, November-December 1998.
11. Rev. Proc. 96-53, 1996-2 C.B. 375 § 3.06.
12. IRS Notice 2000-12, 2000-1 C.B. 727.
13. Rev. Proc. 2001-1, 2001-1 IRB 1; Rev. Proc. 2001-2, 2001-1 IRB 79; Rev. Proc. 2001-3, 2001-1 IRB 111.
14. Rev. Proc. 2001-22, 2001-9 IRB 1.
15. IRS Notice 2000-65, 2000-52 IRB 599.
16. Rev. Proc. 94-67, 1994-2 C.B. 800.
17. IRS Notice 2001-13, 2001-6 IRB 514 extending the pilot announced in IRS Notice 2000-43, 2000-35 IRB 1.