



*The Overall Independence of the Office of
Appeals Appears to Be Sufficient*

September 2005

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TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

September 9, 2005

MEMORANDUM FOR CHIEF, APPEALS

FROM: Pamela J. Gardiner
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – The Overall Independence of the Office of Appeals Appears to Be Sufficient (Audit # 200410035)

This report presents the results of our review to evaluate whether the Office of Appeals' (Appeals) modernized structure and processes provide the level of independence intended by the Internal Revenue Service (IRS) Restructuring and Reform Act of 1998 (RRA 98).¹ Independence from other IRS offices is critical for Appeals to accomplish its mission of resolving tax controversies, without litigation, on a basis that is fair to the taxpayer and the Federal Government. This review was requested by Appeals officials.

Synopsis

The overall independence provided by Appeals' structure and processes appears to comply with the intent of the RRA 98. Appeals survey results from taxpayers indicate there has been an improvement in the overall perception of Appeals' independence—taxpayer responses to questions about Appeals' independence from other IRS divisions show improvement from 3.43 to 3.70 (on a 5-point scale) from Fiscal Years (FY) 2003 to 2004. Representatives from the American Bar Association, the American Institute of Certified Public Accountants, the National Association of Enrolled Agents, and the National Society of Accountants advised us they believe the independence of Appeals is generally very high. Concerns these tax professionals have with independence are with specific programs and initiatives, primarily those involving high-dollar cases in which there appears to be coordination between Appeals and IRS compliance functions.

¹ Pub. L. No. 105-206, 112 Stat. 685 (codified as amended in scattered sections of 2 U.S.C., 5 U.S.C. app., 16 U.S.C., 19 U.S.C., 22 U.S.C., 23 U.S.C., 26 U.S.C., 31 U.S.C., 38 U.S.C., and 49 U.S.C.).



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The National Taxpayer Advocate expressed concern with Appeals centralizing many types of cases to the Appeals offices in the IRS campuses,² indicating the ability of Appeals employees to exercise independent judgment in the campus environment may be limited because the campus culture has traditionally been production oriented. Nonetheless, FY 2004 Customer Satisfaction Survey results indicate the perception of Appeals' independence was higher for the types of cases that had already been centralized at the campuses than for cases in the field offices. Appeals plans to monitor its campus operations and we plan to perform a review of this area in FY 2006 to further evaluate the effectiveness of Appeals' campus operations.

Another concern of the National Taxpayer Advocate is the IRS allowing "ex parte" communications³ in too many circumstances. One specific example is the IRS' requirement for taxpayers to waive the prohibition on ex parte communication in order to participate in a mediation program known as the Fast Track Settlement Program. In our discussions with tax professionals, they conceded that the waiver of prohibition against ex parte communications is necessary for this mediation program to work effectively; however, some expressed concerns that Appeals may be using these waivers to discuss and develop issues with IRS examination functions and Office of Chief Counsel personnel before starting the mediation process. As such, additional guidance is needed on what ex parte communications will be allowed before the start of the mediation process.

Some tax professionals are concerned that Appeals is not operating independently of IRS compliance functions and the Office of Chief Counsel in the development of coordinated tax issues. Part of the perception may be due to the wording in the Internal Revenue Manual that seems to indicate Appeals must follow Coordinated Issue Papers, which are developed by IRS compliance functions. The processes are actually set up so IRS compliance functions and Appeals can exchange information but develop and administer coordinated issues separately. Tax professionals were also concerned about the increase in the number of coordinated issues. We reviewed the number of coordinated issues and found it has increased by 14 (to a total of 99) since FY 2002 with the majority of new coordinated issues related to tax shelters for which the IRS has increased enforcement action. Tax professionals also want access to Appeals technical guidance coordinators because they believe these coordinators are dictating the terms of the settlements on coordinated issues. The Chief, Appeals, has indicated access will be granted in all cases for which it is requested.

Due to some of the recent IRS public announcements related to the effect of court cases on Appeals Settlement Guidelines, tax professionals believe Appeals is more likely to revise Appeals Settlement Guidelines when the IRS wins in litigation than when it does not. Based on Appeals guidance and the examples we reviewed, it appears Appeals reevaluates its Appeals Settlement Guidelines regardless of the outcome of litigated cases. Tax professionals were also

² The three major functions performed at the IRS campuses are responding to taxpayer inquiries, completing compliance actions, and processing tax returns.

³ These are communications between Appeals and other IRS functions when the taxpayer is not present.



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concerned that announcements stating Appeals will not provide a better settlement than that offered in a Tax Shelter Settlement Initiative⁴ indicate Appeals is working with IRS compliance functions and would not be fair or impartial. While these announcements may reduce the perception of Appeals' independence, in fact, the statements are based on the knowledge of IRS officials that a Tax Shelter Settlement Initiative offers a settlement to similarly situated taxpayers that is at least as advantageous as the Appeals Settlement Guidelines.

Tax professionals also took issue with the IRS approach of designating the Tax Shelter Settlement Initiative called the "Son of Bond Option Sale Strategy" (Son of BOSS)⁵ as a litigating vehicle.⁶ They indicated this approach pressured taxpayers into accepting unfavorable settlement terms by the IRS to avoid litigation. They believe the IRS should have let cases go to Appeals to allow Appeals to evaluate the merits of the taxpayers' positions. To address these concerns, the IRS Chief Counsel stated that, when Tax Shelter Settlement Initiatives are considered for designation as litigating vehicles in the future, the IRS will wait until Appeals has had a chance to review at least some of the cases in more detail.

The National Taxpayer Advocate used the Service-Wide Abusive Transaction Executive Steering Committee as an example of what should be considered an unallowable use of ex parte communications by Appeals. This Committee consists of executives from the IRS operating divisions, Criminal Investigation Division, Office of Chief Counsel, and Appeals with the objective of overseeing the IRS' response to abusive tax transactions, schemes, and devices. Revenue Procedure 2000-43,⁷ which details the circumstances under which ex parte communications are allowable, states that certain cross-functional meetings are allowable as long as specific taxpayers are not identified. Because this Committee was not formed to discuss the merits of specific cases, but to act as a steering function for the overall inventory of cases, we believe Appeals' participation on the Committee is permissible under Revenue Procedure 2000-43 and the RRA 98.

Recommendations

We recommended the Chief, Appeals, ensure taxpayers are informed of their rights and the conditions of the Fast Track Settlement Program before they sign a waiver of the prohibition on ex parte communications; revise guidelines to clarify the types of communication with other IRS operations that are permissible prior to an opening mediation conference; clarify procedures in the Internal Revenue Manual to establish that Appeals does not automatically follow compliance function Coordinated Issue Papers, but rather it uses this information and other sources of

⁴ The recent five Tax Shelter Settlement Initiatives have also been referred to as "Global Settlement Initiatives" or "Compliance Settlement Initiatives."

⁵ IRS Announcement 2004-46 (Son of BOSS Settlement Initiative), 2004-21 Internal Revenue Bulletin 964.

⁶ A litigating vehicle is a Tax Shelter Settlement Initiative which has been designated to bypass Appeals and requires a taxpayer to go to litigation in order to resolve the initiative issue.

⁷ Revenue Procedure 2000-43, I.R.B. 2000-43, 404.



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information to coordinate an Appeals approach to the issue; and revise procedures to clearly establish that taxpayer access to Appeals technical guidance coordinators will be honored, when requested, in all coordinated issue cases. With the exception of the IRS Commissioner and the Chief, Appeals, IRS officials should avoid discussing the impact of specific court cases on Appeals Settlement Guidelines. The Chief, Appeals, should consider the appropriateness of discussing changes to specific Appeals Settlement Guidelines in public statements or announcements and should revise policies and procedures to promote consistency.

Response

Appeals management agreed with our findings and recommendations. The application for the Fast Track Settlement Program will be revised and an explanation will be provided to inform taxpayers of their rights and expectations before the waiver of ex parte is signed. In addition, opening letters to taxpayers and their representatives will include an explanation of the taxpayers' rights in the Fast Track Settlement Program. Appeals will also revise guidelines to clarify the types of communication permissible prior to an opening mediation conference within the Fast Track Settlement Program and will issue a memorandum communicating this clarification to all IRS offices involved. The Internal Revenue Manual will be revised and interim guidance issued to clarify that compliance function Coordinated Issue Papers are not automatically followed and that a taxpayer's request for a technical guidance coordinator will be honored. Lastly, Appeals will reinforce the procedures regarding the reconsideration of Appeals' position for an issue based on any new court decision, ruling, or other significant occurrence. Management's complete response to the draft report is included as Appendix IV.

Copies of this report are also being sent to the IRS managers affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Daniel R. Devlin, Assistant Inspector General for Audit (Headquarters Operations and Exempt Organizations Programs), at (202) 622-8500.



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Background

The mission of the Internal Revenue Service (IRS) Office of Appeals (Appeals) is to resolve tax controversies, without litigation, on a basis that is fair to the taxpayer and the Federal Government. These controversies can be proposed tax assessments, tax collection, or other IRS actions. The Appeals process is less formal than that in court proceedings and is not subject to judicial rules of evidence or procedure. If the tax controversy cannot be resolved in Appeals, the taxpayer can seek a remedy from the courts. However, Appeals has historically been able to settle the majority of the cases that come within its jurisdiction.

Independence from IRS compliance functions is critical for Appeals to accomplish its mission. To resolve disputes effectively, it must show its ability to be objective, impartial, and neutral in fact as well as appearance. Furthermore, independence is necessary to ensure the Appeals process is fair to taxpayers. If taxpayers perceived they would not get a fair hearing in Appeals, more tax controversies would be litigated in tax court, which would increase the cost and burden to both the taxpayer and the Federal Government.

IRS Restructuring and Reform Act of 1998 (RRA 98)¹ Section (§) 1001(a) directed the IRS Commissioner to develop and implement a plan to reorganize the IRS by establishing organizational units serving particular groups of taxpayers with similar needs. It also specified that the reorganization plan should ensure an independent Appeals function within the IRS, including a prohibition of “ex parte” communications between Appeals officers and other IRS employees to the extent that such communications appear to compromise the independence of Appeals officers. Ex parte is a term used in legal proceedings to describe a one-sided or partisan point of view received on behalf of or from one side or party only. In the context of the RRA 98, ex parte communications are those that take place between Appeals officers and other IRS employees without giving the taxpayers/representatives an opportunity to participate in the communications. However, not all ex parte communications are prohibited; the Congress recognized that Appeals must have some communication (such as communication needed to determine workload demands and obtain workpapers, summaries, and reports for IRS decisions) with other IRS divisions to operate and to minimize additional requests to taxpayers for information already provided.

Some concerns have been expressed by tax professionals and the National Taxpayer Advocate that new policies, programs, and structures initiated by the IRS since enactment of the RRA 98 may be compromising the independence of Appeals. One area of concern relates to Appeals

¹ Pub. L. No. 105-206, 112 Stat. 685 (codified as amended in scattered sections of 2 U.S.C., 5 U.S.C. app., 16 U.S.C., 19 U.S.C., 22 U.S.C., 23 U.S.C., 26 U.S.C., 31 U.S.C., 38 U.S.C., and 49 U.S.C.).



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centralizing a significant portion of cases to the IRS campuses.² A number of factors related to this centralization cause concern. For example, if the process at the campuses is too standardized and focused on the speed of case closures, it could limit Appeals employees' ability to use adequate discretion to base their decisions on the facts and circumstances of each case. There is also a concern that the IRS is allowing ex parte communications in too many circumstances—to the extent that it is eroding the independence intended by the prohibition in the RRA 98. Furthermore, there is a concern that Appeals is coordinating and partnering with IRS compliance functions to a significant extent, especially in relation to specific issues (known as “coordinated issues”) and in developing Tax Shelter Settlement Initiatives,³ which could reduce the ability of Appeals to reach independent conclusions.

Appeals officials believe the Appeals structure and processes are necessary to accomplish their mission efficiently and effectively. They believe the structure and processes provide for adequate independence and are consistent with requirements of the RRA 98 as well as applicable regulations. Nonetheless, to ensure the careful and complete consideration of the concerns, Appeals officials asked the Treasury Inspector General for Tax Administration to review Appeals to determine whether the modernized structure and processes adhere to the intent of the RRA 98.

This review was performed at the Appeals offices in the IRS National Headquarters in Washington, D.C., and St. Louis, Missouri, during the period October 2004 through June 2005. We also interviewed representatives from the American Bar Association, the American Institute of Certified Public Accountants, the National Association of Enrolled Agents, and the National Society of Accountants, as well as several prior Appeals executives who currently work in private tax practices. The audit was conducted in accordance with *Government Auditing Standards*. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

² The three major functions performed at the IRS campuses are responding to taxpayer inquiries, completing compliance actions, and processing tax returns.

³ These are discussed in detail later in the report.



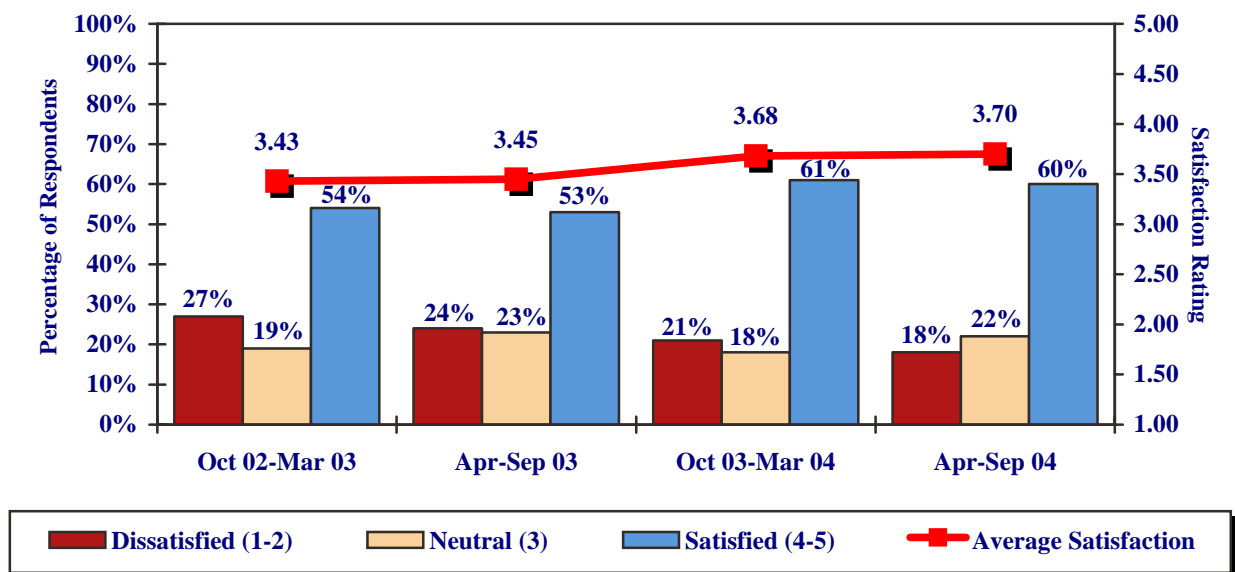
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Results of Review

Survey Results Indicate There Has Been an Improvement in the Overall Perception of the Office of Appeals' Independence

Appeals surveys taxpayers to monitor their satisfaction with the Appeals process. These taxpayer surveys are performed by an outside consulting group. Every 6 months, a sample of approximately 500 taxpayers who have completed the Appeals process are asked about their satisfaction with the process, including Appeals' fairness in resolving the case and independence from the other IRS functions. Survey results over the last 2 years indicate overall satisfaction with Appeals has increased from an average rating of 3.36 to 3.60 on the 5-point scale. Perception of fairness in resolving cases has improved from 3.27 to 3.48. Taxpayer responses to questions about Appeals' independence from other IRS divisions also show improvement from 3.43 to 3.70. Figure 1 shows the last four taxpayer survey results from Fiscal Years (FY) 2003 and 2004 for the specific question about Appeals' independence.

Figure 1: Taxpayer Survey Results for "How satisfied were you with the independence Appeals had from the people who proposed adjustments?"



Source: The Appeals semiannual customer satisfaction surveys from October 2002 to September 2004.



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The percentage of taxpayers surveyed who expressed dissatisfaction with Appeals' independence has also decreased significantly over the prior fiscal year. For those taxpayers who expressed dissatisfaction with the level of Appeals' independence, some comments from the recent survey are shown below.

- *I felt the Appeals Officer gave too much weight to the Examiner's position and didn't have an open mind to alternative arguments.*
- *I felt like Appeals was bending over backwards to approve the underlying actions of the IRS.*
- *Before the initial conference, discussions took place with the people who proposed the adjustment, which influenced the Appeals Officer's judgment.*
- *Appeals followed exactly what the original IRS agent determined. They didn't do any independent research.*
- *My impression was that they were working pretty close together, kind of like a rubber stamp.*

Because the taxpayers remain anonymous for this survey, we could not obtain the background information needed to evaluate the validity of specific negative comments. We did review the Appeals method to monitor case quality, including ex parte communications.

Appeals monitors case quality through the Appeals Quality Measurement System (AQMS), which randomly selects closed Appeals cases that reviewers evaluate for conformity with six standards of quality. From FYs 2003 to 2004, the AQMS reviews indicated a decrease from 83 percent to 79 percent in the overall standards of quality being met. This decrease was primarily related to a lack of adequate communication with taxpayers on some collection cases. While the AQMS does review the cases for inappropriate ex parte communication, the review is limited to the information documented in the case files. Possible ex parte communications were identified in less than 1 percent of the closed case files reviewed for FYs 2003 and 2004. Due to a lack of detail in some case workpapers, AQMS reviewers could not always determine whether communication was appropriate. If the information was incomplete, the case was rated on the standard of appropriate communications as "not met." It is also possible that inappropriate ex parte communications occurred that affected the outcome of cases for which there were no comments at all made in the case files, which would not have been identifiable by the AQMS process. In May 2003, AQMS staff issued an alert to Appeals officers restating the restrictions for ex parte communications and advising of the need to fully document all contacts.

We interviewed tax professionals to obtain their views of the adequacy of Appeals' independence. Representatives from the American Bar Association, the American Institute of Certified Public Accountants, the National Association of Enrolled Agents, and the National Society of Accountants advised us they believe the independence of Appeals, including compliance with the prohibition on ex parte communications, is generally very high. These tax



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professionals advised us that the concerns they have with independence are only with specific programs and initiatives, primarily those involving high-dollar cases in which there appears to be coordination between Appeals and IRS compliance functions. These are discussed in detail later in the report.

The Office of Appeals Plans to Closely Monitor Its Campus Operations to Ensure Quality and Independence

In an effort to reduce the inventory of cases awaiting appeal and the cycle time⁴ to complete those cases, Appeals has been shifting its focus from a traditional approach of a face-to-face contact on all cases to a more flexible model of campus correspondence reviews for certain cases. By the end of FY 2005, Appeals anticipates having a total of 350 employees in 6 campus locations⁵ that will specialize in Collection Due Process, Offer in Compromise, Penalty appeals, “S” docketed,⁶ and Innocent Spouse cases.

Because of the high level of inventory, the time it takes from the date a taxpayer requests a hearing by Appeals to the date Appeals concludes the case can be lengthy. Figure 2 shows Appeals cycle time from FY 2002 through March 2005. Appeals reports taxpayers have advised that a quicker resolution of their cases, as in the Campus operations, is more important than the need to have face-to-face contact on these types of cases.

Figure 2: Appeals Case Cycle Time

Case Type	Number of Days in Appeals			
	Fiscal Year			
	2002	2003	2004	2005 ⁷
Collection Due Process	274	253	241	237
Offer In Compromise	331	313	253	244
Penalty Appeals	166	194	166	115
Innocent Spouse	384	446	450	432

Source: Appeals Business Performance Reviews dated September 16, 2004, and April 26, 2005. These reviews did not include case cycle time for docketed cases.

The National Taxpayer Advocate stated in her 2004 Annual Report to Congress that the Campus operations are a concern because the independence and the quality of work performed by Appeals officers working at the campuses may not be as high as that of Appeals officers working in field offices. The concerns in this report included the following:

⁴ Cycle time is the total days from the receipt of a case in Appeals to the day of its closure from Appeals.

⁵ Brookhaven, New York; Covington, Kentucky; Fresno, California; Memphis, Tennessee; Ogden, Utah; and Philadelphia, Pennsylvania.

⁶ Docketed Tax Court cases from compliance issues less than \$50,000 under Internal Revenue Code § 7463 (2002).

⁷ Through March 2005 (the second quarter of FY 2005).



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- A lack of opportunity for a face-to-face meeting with an Appeals officer will decrease quality. Taxpayer representatives will more often request face-to-face meetings in local offices, which will provide the taxpayers they represent an advantage over unrepresented taxpayers.
- The ability of Appeals employees to exercise independent judgment will decrease in the campus environment because the IRS campus culture has traditionally been production oriented with limited employee discretion and decision-making.
- There is a risk that taxpayers assigned to Appeals campus sites will perceive that they are receiving “second class” treatment.

Appeals officials responded that Appeals employees receive the same training, oversight, quality review, and automation resources regardless of where they are located. Furthermore, if a face-to-face conference is requested, Appeals will provide it, either through video conferencing or by transferring the case to a local field office. Appeals statistics indicate taxpayers and their representatives often prefer to handle the Appeals process by telephone or correspondence.

Data collected by Appeals during Calendar Year 2004 indicate approximately 75 percent of conferences in its field offices were held through telephone or correspondence. If a taxpayer prefers a face-to-face conference, Appeals’ policy is to forward the case from the campus to a local office. We reviewed the contact letter sent to taxpayers who were assigned to the Appeals campus operations for Collection Due Process cases. Taxpayers are advised in the letter that they could request face-to-face conferences to be held in their local Appeals offices.

To evaluate the quality and independence of its campus operations, Appeals will compare campus performance and customer satisfaction to that of its field offices. Customer satisfaction surveys have been modified to identify campus and field operations. In the results of the FY 2004 Customer Satisfaction Survey, the perception of independence of Appeals was higher for the types of cases that had already been centralized at the campuses than for cases in the field offices. However, survey results for all types of cases that have been centralized more recently are not yet available.

Appeals plans to continue monitoring its centralization of campus operations and we plan to perform a review of this area to further evaluate the effectiveness of Appeals’ campus operations. In FY 2006, we plan to perform an audit to evaluate the quality of Appeals cases handled by the campuses and whether taxpayers are offered face-to-face meetings and provided these meetings when requested. We will also evaluate the processes Appeals has put in place to help ensure quality and independence in its campus operations.



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Additional Guidance on Ex Parte Communications in the Fast Track Settlement Program Would Be Beneficial

Two IRS programs, the Fast Track Settlement Program and the Fast Track Mediation Program, are designed to save time and reduce burden by facilitating resolution of tax disputes earlier in the examination process while the cases are still under the jurisdiction of IRS compliance functions. For both of these Programs, Appeals officers act as mediators between taxpayers and IRS examination functions to resolve tax disputes before the taxpayer is provided a formal notice of a proposed tax assessment. This mediation is nonbinding; taxpayers who do not resolve their disputes by using a Fast Track Program option still maintain the right to pursue the dispute later in the traditional Appeals process. Both Fast Track Programs are voluntary for the taxpayer, IRS compliance functions, and Appeals; therefore, each party can dissolve the Fast Track Program process for the case at any time. Members of Congress have indicated the IRS should consider offering nonbinding mediation processes to all taxpayers in advance of the formal Appeals process.

In the Fast Track Settlement Program, Appeals can use its delegated settlement authority based on hazards of litigation to help resolve disputes. Appeals has historically been able to settle the majority of cases that come within its jurisdiction by applying its unique authority to negotiate settlements using an analysis of the hazards of litigation. This process allows Appeals to determine the probability that the courts will agree with the IRS determination (based on similar cases) and then use this probability to reduce the proposed tax, when appropriate. The examination functions do not have this authority. In the Fast Track Settlement Program, Appeals uses the hazards of litigation procedures along with mediation when the case is still under the jurisdiction of the IRS compliance function.

Although there were only 114 cases closed in the Fast Track Settlement Program in FY 2004, these cases accounted for over \$10 billion in contested tax liabilities, which was a substantial portion of the total contested tax liabilities reviewed by Appeals that year. Of the 114 cases, 89 (78 percent) were resolved successfully using this mediation process. These 89 cases took an average of less than 120 days to complete, which is significantly fewer than the average number of days in which a case is completed in the traditional Appeals process.

In the Fast Track Mediation Program, Appeals also acts as a mediator between taxpayers and IRS examination functions but cannot use its delegated settlement authority based on hazards of litigation to help resolve a dispute. There were 122 cases closed in the Fast Track Mediation Program in FY 2004. The disputed tax liabilities for these cases were much lower than those for cases in the Fast Track Settlement Program. The Chief, Appeals, recently announced that the Fast Track Mediation Program will be cancelled and the Fast Track Settlement Program will be expanded into the general examination program.



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The National Taxpayer Advocate expressed concerns about the decision to reallocate resources away from the Fast Track Mediation Program.⁸ However, tax professionals we interviewed stated that the combination of settlement authority and effective mediation in the Fast Track Settlement Program is a superior benefit in resolving cases. As such, the future reallocation of resources will not necessarily result in an overall decrease in the use of pre-Appeals mediation.

The National Taxpayer Advocate has raised some concerns related to the waiver of ex parte communications in the Fast Track Settlement Program. Appeals is prohibited by the RRA 98 from participating in ex parte communications, to the extent that such communications appear to compromise the independence of Appeals officers. However, an element of successful mediation is the ability of the mediator to discuss issues with both parties jointly and with each party separately. A discussion with a party separately is, by definition, an ex parte communication. Therefore, for taxpayers to receive the benefit of having Appeals officers as mediators in the Fast Track Settlement Program, the IRS requires them to waive the prohibition on ex parte communications.

Tax professionals who have been involved in the process advised us the ability of the Appeals officers to discuss the merits and the hazards of both parties' positions with each party candidly and separately is essential to the early resolution of a case while it is still under the control of the examination functions. The same tax result might be obtained during the regular Appeals process; however, the benefit of the Fast Track Settlement Program is that it avoids the time-consuming and expensive process of completing the formal protests required for large cases to go to Appeals using the regular Appeals process. Additionally, tax professionals stated the negative publicity that can result if a corporation reports any contested liability, such as those in tax litigation, is an additional incentive for large corporations to resolve issues early in the process, which is made possible by the Fast Track Settlement Program.

We reviewed a judgmental sample of 59 program files of the 114 cases closed in FY 2004⁹ and found that taxpayers using this Program are generally represented by attorneys or Certified Public Accountants who understand the benefits and drawbacks of waiving the prohibition on ex parte communications to participate in the Fast Track Settlement Program. To date, the Fast Track Settlement Program has been used for high-dollar tax cases (averaging approximately \$90 million per case in FY 2004). Since the Chief, Appeals, has announced that the Fast Track Settlement Program is going to be expanded into the general examination program, it will be

⁸ See the Statement of Nina E. Olson, National Taxpayer Advocate, Internal Revenue Service, for the Joint Review of the Strategic Plans and Budget of the Internal Revenue Service before the Committee on Ways and Means, Committee on Appropriations, Committee on Government Reform, House of Representatives; and the Committee on Finance, Committee on Appropriations, Committee on Homeland Security and Government Affairs, United States Senate Convened by the Chairman of the Joint Committee on Taxation, May 19, 2005.

⁹ This sample included all 39 program files for cases having a customer satisfaction survey response and 20 additional program files.



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more important for Appeals to ensure all taxpayers fully understand their rights when agreeing to waive the prohibition against ex parte communications.

Although tax professionals agreed that the waiver of prohibition against ex parte communications is necessary during participation in the Fast Track Settlement Program, some expressed concerns that Appeals may be using these waivers to discuss and develop issues with IRS examination functions and Office of Chief Counsel personnel before starting the mediation process, without providing taxpayers the same opportunity. Tax professionals told us it has been apparent to them at some jointly held opening conferences that the Appeals officers have been briefed by examination functions and Office of Chief Counsel personnel on the IRS tax positions. The National Taxpayer Advocate also expressed concerns in this area in her 2004 Annual Report to Congress.

Part of the application process for entering the Fast Track Settlement Program is that the taxpayer must present his or her position in writing on each issue to be discussed in the mediation process. The Fast Track Settlement Program coordinator then reviews the issues to determine if the case is appropriate, given the limited resources of Appeals, and contacts the IRS examination functions and Office of Chief Counsel to determine whether:

- Examination issues are sufficiently developed for the IRS to briefly present its positions in writing.
- IRS experts and personnel are willing to participate in the process (the IRS is not required to participate) and are available within a reasonable time to complete the process.

While certain ex parte contacts with IRS examination function personnel are necessary in the preparation for the Fast Track Settlement Program, there is a risk that in addition to the necessary administrative contacts, Appeals is overstepping the intent of the waivers by discussing substantive issues with IRS employees in a manner that could bias, or appear to bias, the Appeals employees toward the positions of the IRS compliance functions. Additional guidance on the type of communication that is permissible at the beginning of the process will help to prevent inappropriate communications and will help taxpayers better understand the process before signing the waivers.

In some instances, Appeals employees can be involved in both the Fast Track Settlement Program and the traditional Appeals process

Tax professionals are also concerned about the possibility of the same Appeals employees being on the Fast Track Settlement Program case and then later being part of the traditional Appeals case if resolution was not achieved. Tax professionals stated this would prevent a fresh and fair review by Appeals and compromise independence. Taxpayers and IRS compliance functions have indicated concerns about this in the Fast Track Settlement Program survey results. Specific instances in the survey responses included the following:



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- A taxpayer stated an Appeals officer had advised the taxpayer to agree with the Fast Track Settlement Program resolution because that Appeals officer would be assigned the case in the traditional Appeals process and would not give the taxpayer a better offer.
- An IRS compliance representative stated an Appeals officer advised the IRS compliance function to agree with the Fast Track Settlement resolution because that Appeals Officer would be assigned the case in traditional Appeals and would give the taxpayer this offer.

The Appeals Fast Track Settlement Program coordinator contacted the taxpayer and the IRS compliance representative for these two cases to advise that the Appeals officers' statements in each case were inappropriate and that Appeals' policy is to assign a different Appeals officer in the traditional Appeals process, if possible, and to be fair and impartial. The Appeals officers involved were also advised of the complaints and of the correct policy. This policy comes from a Revenue Procedure¹⁰ which states that, when cases that were not successfully resolved in the Fast Track Settlement Program come to the traditional Appeals process, management will decide how to assign personnel to best provide a fair and impartial review. Ex parte communications restrictions will not be imposed on intra-Appeals communications. Fast Track Settlement Program guidelines state this policy should be made clear to the taxpayer at the beginning of the process and, if the taxpayer is unable to accept this policy, the taxpayer may decide to forego the Fast Track Settlement Program option and go through the traditional Appeals process.

The Appeals coordinator advised us the issues in the Fast Track Settlement Program are often so highly technical that there may be only one or two employees in Appeals who are experts in a specific area of the tax law; therefore, it is not always feasible to avoid having the Appeals employees who participated in a Fast Track Settlement Program mediation conference also be assigned control of the traditional Appeals process case. Our review indicates this is infrequent. Of the 114 Fast Track Settlement Program cases completed during FY 2004, 25 were not resolved. Only 11 of these 25 cases went on to the traditional Appeals process. In these 11 cases, we found only 1 in which an Appeals employee had been previously assigned to the Fast Track Settlement Program case. Nonetheless, Appeals needs to ensure this possibility is made clear to the taxpayer at the beginning of the process, as the current policy states.

Notwithstanding some specific concerns about the Program, overall, the tax professionals we interviewed who had been involved in the Fast Track Settlement Program agreed it is a very successful Program that they would like to see continue. Tax professionals stated they do not have a concern with Appeals officers being mediators because the officers operate fairly in that role and the tax professionals want Appeals' hazards of litigation authority to be considered during discussions. Responses to a specific customer satisfaction survey that Appeals uses to monitor satisfaction with the Fast Track Settlement Program also indicate a high level of satisfaction with the Program. Of the 114 cases completed during FY 2004, 39 taxpayers or their

¹⁰ Revenue Procedure 2003-40, I.R.B. 2003-25, 1044.



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representatives provided written responses.¹¹ On a 5-point rating scale, taxpayers responded with an average 4.13 rating for the statement, “The Appeals representative was fair and impartial.”

Recommendations

The Chief, Appeals, should:

Recommendation 1: Ensure taxpayers are informed of their rights and the conditions of the Fast Track Settlement Program before they sign a waiver of the prohibition on ex parte communications.

Management’s Response: Appeals will revise the application and provide an explanation to inform taxpayers of their rights and expectations in the Fast Track Settlement Program before the waiver is signed. In addition, opening letters to taxpayers and their representatives will include an explanation of the taxpayers’ rights in the Fast Track Settlement Program.

Recommendation 2: Revise the Fast Track Settlement Program guidelines to clarify the types of communication with other IRS operations that are permissible prior to an opening mediation conference.

Management’s Response: Appeals will revise guidelines to clarify the types of communication permissible prior to an opening mediation conference within the Fast Track Settlement Program. In addition, the Chief, Appeals, will issue a memorandum communicating this clarification to all IRS offices involved.

Some Tax Professionals Are Concerned About the Effect of Coordinated Issues and Tax Shelter Settlement Initiatives on the Appeals Process

To help ensure uniform treatment of taxpayers nationwide, the IRS develops guidelines to use in administering the tax laws. These guidelines may need to be coordinated within and between different IRS offices, including compliance functions, the Office of Chief Counsel, and Appeals, when an issue is not clearly defined by law and may affect many taxpayers. This coordination is also intended to avoid the practice of “shopping” by taxpayers and representatives for more favorable treatment of an issue by arranging for cases to be reviewed by different IRS employees or offices.

¹¹ We were told by some taxpayer representatives within large accounting and law firms that their policy is not to participate in surveys for a specific case; they leave the option of replying to the taxpayer’s discretion.



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Several sources have expressed concerns that Appeals is not operating independently of IRS compliance functions and the Office of Chief Counsel in the development of coordinated issues and settlement initiatives.

- Tax professionals told us Appeals can be biased by its requirement to consider the opinions and conclusions of IRS compliance functions on coordinated issues.
- The National Taxpayer Advocate stated in her 2004 Annual Report to Congress, “Appeals’ direct participation with IRS enforcement [compliance functions] in settlement initiatives compromises Appeals’ independence in both fact and appearance.”
- A prior Appeals executive stated the partnership among Appeals, the Office of Chief Counsel, and the IRS compliance functions to coordinate emerging issues in an attempt to create a “one-size-fits-all” approach to settlements may be reducing Appeals’ independence.¹²

Compliance functions and Appeals exchange information but develop and administer coordinated issues separately

When IRS compliance functions identify an issue not clearly defined by law, a team is assembled to coordinate the issue to ensure taxpayers are treated consistently while in the jurisdiction of IRS compliance functions. The team develops a Coordinated Issue Paper that requires review by the Office of Chief Counsel. IRS compliance function employees are then required to follow the guidance in the Coordinated Issue Paper. Although the team can obtain input from Appeals during development, the resulting Coordinated Issue Paper is not binding on Appeals.

Some taxpayers will appeal tax assessments related to these types of issues because of differing interpretations of the law. Therefore, once a Coordinated Issue Paper has been developed, Appeals prepares to receive cases with that issue. An Appeals technical guidance coordinator is assigned to develop an Appeals Settlement Guideline used to coordinate a nationwide Appeals approach to the issue to ensure all taxpayers requesting reviews receive similar treatment for similar facts. Taxpayers seeking a review by Appeals for an issue related to a Coordinated Issue Paper represented less than 1 percent of the total cases completed by Appeals in FY 2004; however, the contested liabilities accounted for \$12 billion or 36 percent of the total dollars.

To develop an Appeals Settlement Guideline, an Appeals technical guidance coordinator considers hazards of litigation and input from:

¹² Canciello, Vincent S. “Tax Shelter Resolution Initiatives and the Independence of Appeals.” *Journal of Tax Practice and Procedure* (May 2003, Vol. 5, No. 2): 23.



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- IRS compliance functions by reviewing the Coordinated Issue Paper and discussing the technical issue as needed for clarification. Appeals technical guidance coordinators should not discuss the specifics of cases in the jurisdiction of compliance functions which might later be assigned to Appeals.
- Taxpayers by reviewing cases in Appeals' jurisdiction. Appeals can also request input from interested taxpayer representative or advocate groups.
- The Office of Chief Counsel in the form of legal technical advice. To properly analyze the hazards of litigation, Appeals will need to know how the Office of Chief Counsel intends to litigate and its history of prior litigation.

If Appeals identifies a significant issue requiring coordinated treatment within Appeals, but IRS compliance functions have not issued a Coordinated Issue Paper for that issue, Appeals can identify the issue as an Appeals coordinated issue. An Appeals coordinated issue will have an Appeals technical guidance coordinator assigned and will also lead to the development of an Appeals Settlement Guideline.

Although there may be significant input from IRS compliance functions, taxpayers, and the Office of Chief Counsel, the final Appeals Settlement Guideline requires the approval of only Appeals. The Appeals Settlement Guideline may or may not match the compliance function Coordinated Issue Paper. The IRS Office of Chief Counsel provides advice on the proposed Appeals Settlement Guideline, but Appeals can disagree with that advice.

Tax professionals have pointed out that a section of the Internal Revenue Manual indicates Appeals is required to follow Coordinated Issue Papers, which limits Appeals' independence.¹³ This section states that, once an IRS compliance function issues a Coordinated Issue Paper, the Appeals officer must obtain the review and concurrence of the Appeals technical guidance coordinator before finalizing a settlement with the taxpayer. We discussed this concern with Appeals officials and determined this section of the Internal Revenue Manual was not intended to require Appeals technical guidance coordinators to follow a Coordinated Issue Paper when providing advice to Appeals officers but rather to coordinate an Appeals approach to the issue. The Appeals technical guidance coordinators may need to be in communication with Appeals officers who handle these types of cases to help develop an Appeals Settlement Guideline. The policy of requiring review and concurrence within Appeals on issues helps to ensure similarly situated taxpayers receive similar outcomes nationwide as soon as possible.

¹³ Internal Revenue Manual 8.7.3.2 (November 2004).



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Tax professionals are concerned about the number of coordinated issues and the lack of access to Appeals technical guidance coordinators

Tax professionals stated the increase in issues being coordinated by Appeals has given them the impression that they can no longer receive a determination based on an independent review of their facts and circumstances by an independent Appeals officer. Our review of coordinated issues developed since FY 2002 found that Appeals has not significantly increased the number of coordinated issues, except in the area of tax shelters. As of April 2005, Appeals reported having 99 active coordinated issues, with 70 initiated from Coordinated Issue Papers and 29 initiated from Appeals. Since FY 2002, Appeals has started the coordination of 31 new issues; 8 were initiated from Coordinated Issue Papers and 23 were initiated from Appeals. Twenty (65 percent) of these 31 new coordinated issues are related to tax shelters for which the IRS has increased enforcement action. During this same period, Appeals stopped coordination for 17 issues that were initiated by Coordinated Issue Papers. This resulted in a net increase of 14 coordinated issues.

Tax professionals also stated Appeals officers often tell them decisions involving a coordinated issue must be made by the Appeals technical guidance coordinators, who are perceived by tax professionals as collaborating with IRS compliance functions and who appear to be subjecting taxpayers to “one-size-fits-all” settlements. The tax professionals stated they would like the opportunity to present and discuss a taxpayer’s facts and circumstances directly with the Appeals technical guidance coordinators; however, they are not sure if they have the right to such a face-to-face meeting with the coordinators.

Appeals procedures are vague on this point. They require the Appeals technical guidance coordinators to be involved in settlement negotiations on an “as needed” basis. However, the Chief, Appeals, stated requests for discussions with Appeals technical guidance coordinators will be honored in all cases, and taxpayer access to a coordinator is not at the discretion of the Appeals officer. We believe this policy should be formally included in Appeals procedures and communicated to Appeals employees as well as to the public.

Appeals Settlement Guidelines are reevaluated based on the results of litigation

Appeals has received criticism that it has been too quick to publicize changes to an Appeals Settlement Guideline when the Federal Government won in litigation but slow to take similar action or to publicize a change when the Federal Government lost in litigation.



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On October 20, 2004, the IRS announced Appeals was tightening Appeals Settlement Guidelines based on an Office of Chief Counsel win in the Long-Term Capital Holdings case.¹⁴ Attorneys at an American Bar Association conference in October 2004 objected that there were several other similar cases still pending and that adjusting the Appeals Settlement Guideline within a month of one win made Appeals appear to be developing a party-line response in favor of the Office of Chief Counsel and the IRS Commissioner. One attorney stated “The announcement strips Appeals of its independence, judgment, and any real utility in these cases.”¹⁵

Within a few months, the IRS lost two contingent liability cases in litigation,¹⁶ for which no IRS announcement was made in relation to changing Appeals Settlement Guidelines. In addition, comments from IRS officials caused criticism about the appearance of Appeals’ independence. At a November 2004 District of Columbia Bar Taxation Section conference, the Chief Counsel stated the losses were “blips on the screen” but “in the long run we will prevail.” The IRS Chief Counsel’s senior shelter coordinator added that there are other contingent liability cases in the courts and “We’ll see how it comes out...”¹⁷

Appeals provided us with information about their reevaluation of the Appeals Settlement Guidelines as a result of the Long-Term Capital Holdings case win and the two contingent liability case losses. This information provided an adequate basis for the actions taken on the related Appeals Settlement Guidelines in reaction to the outcomes of these cases. Internal Revenue Manual procedures require Appeals technical guidance coordinators to consider revising Appeals Settlement Guidelines within 3 months after any new court decision or other significant event that would change Appeals’ settlement position for that issue.¹⁸ The Appeals Director of Technical Guidance provided us with examples of Appeals Settlement Guidelines that had been adjusted in favor of the taxpayer and others adjusted in favor of the Federal Government due to recent court rulings. Furthermore, we were advised that it is not Appeals’ policy to publicly announce its conclusions when it reevaluates the hazards of litigation in its Appeals Settlement Guidelines based on new court decisions.

While it appears to be appropriate for the IRS to discuss the strength of its legal position on issues based on the outcome of court cases, discussing how these cases will affect Appeals Settlement Guidelines for selected issues and court cases could harm the overall perception of Appeals’ independence. As such, we believe IRS officials should avoid this practice.

¹⁴ Long-Term Capital Holdings v. United States, 330 F. Supp. 2d 122 (D. Conn., 2004).

¹⁵ Stratton, Sheryl. “Appeals Tightens Screws on Shelter Investors.” 105 *Tax Notes* 487 (October 25, 2004).

¹⁶ Black and Decker v. U.S., 340 F. Supp. 2d 621 (D. Md. 2004) and Coltec Industries, Inc. v. U.S., 62 Fed. Cl. 716 (2004). Contingent liability tax shelter transactions involve transfers between corporations of high basis assets in exchange for stock and the assumption of liabilities.

¹⁷ Stratton, Sheryl. “IRS Officials Talk About Shelter Cases, Audits, and Appeals.” 2004 *Tax Notes Today* 224-4 (November 19, 2004).

¹⁸ Internal Revenue Manual 8.7. 3.3.1(4) (November 2004).



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Tax Shelter Settlement Initiatives¹⁹

With the approval of the IRS Commissioner, the compliance functions may establish a Tax Shelter Settlement Initiative which is intended to encourage taxpayers to come forward to settle tax issues with the IRS rather than wait to be audited by the IRS. These initiatives are normally used on what the IRS categorizes as abusive tax shelter transactions. There have been 5 such initiatives proposed by the IRS in the past 3 years. Tax Shelter Settlement Initiatives are generally proposed after the development of Appeals Settlement Guidelines. This helps the IRS compliance functions gauge what type of settlement to offer to make it attractive for taxpayers to opt for the Tax Shelter Settlement Initiative. Usually, these initiatives offer a settlement to similarly situated taxpayers that are at least as advantageous as the Appeals Settlement Guidelines.

The IRS may formally announce that if taxpayers do not opt for the terms of an initiative, they will likely not obtain a better settlement if they pursue the issue into the Appeals process. If taxpayers believed they could get a better resolution by proceeding to Appeals instead of accepting a Tax Shelter Settlement Initiative proposal, it would defeat the purpose of resolving abusive tax shelter issues at the lowest level possible. Appeals is not required to follow a Tax Shelter Settlement Initiative. Therefore, if a taxpayer chooses to request an Appeals hearing, there is a risk that the facts and circumstances of his or her case will result in a decision that is not as advantageous to the taxpayer as the settlement he or she would have received if he or she had opted to accept the proposal through the Tax Shelter Settlement Initiative.

Tax professionals have expressed concerns that announcements stating Appeals will not provide a better settlement than that offered in a Tax Shelter Settlement Initiative indicate Appeals is working with IRS compliance functions and would not provide a fair, impartial, and independent review for those who elect to go to Appeals. They provided the following examples of articles that imply taxpayers should not go to Appeals when a Tax Shelter Settlement Initiative is involved.

- Chief, Appeals, October 2002: “Taxpayers who do not avail themselves of these settlement initiatives should not expect a later administrative resolution of their case that is more advantageous.”²⁰

¹⁹ The recent five Tax Shelter Settlement Initiatives have also been referred to as “Global Settlement Initiatives” or “Compliance Settlement Initiatives.”

²⁰ Lupi-Sher, David L. “Abusive Tax Shelters Face Settlement Restrictions.” *2002 Tax Notes Today* 194-1 (October 7, 2002).



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- IRS announcement, February 2005: “Appeals has concluded that Executives and Related Persons should not expect a resolution of either the tax or penalty issues on terms that are more favorable than the terms of this settlement initiative.”²¹

While these announcements may reduce the perception of Appeals’ independence, in fact, the statements are based on the knowledge of IRS officials that the Tax Shelter Settlement Initiative offers a settlement that is at least as advantageous to taxpayers as the Appeals Settlement Guidelines.

Issues designated for litigation

A Tax Shelter Settlement Initiative may be designated, at the recommendation of the Office of Chief Counsel and with the approval of the IRS Commissioner, to be a “litigating vehicle.” This designation has been applied only in rare circumstances. When the designation has been applied, the scope of the tax issues were so significant that IRS officials believed it was important to settle or litigate the issue as quickly as possible. For an issue that is designated as a litigating vehicle, taxpayers are barred from seeking a review by Appeals and must go to court if agreement with the IRS cannot be reached. The Commissioner, Office of Chief Counsel, and compliance functions do not require the approval of the Chief, Appeals, to designate an issue as a litigating vehicle.²² Generally, the IRS will take this action only if there is a strong likelihood of the IRS prevailing in court on the issue. Otherwise, many taxpayers would litigate the issue rather than accept the settlement offer.

A recent example of a litigating vehicle is the tax shelter promotion called the “Son of Bond Option Sale Strategy” (Son of BOSS).²³ Appeals was in the process of developing an opinion on this issue based on a Coordinated Issue Paper at the time it was designated as a litigating vehicle in March 2004. However, Appeals could not complete an Appeals Settlement Guideline on the Son of BOSS issue because no cases had been received by Appeals to obtain the critical taxpayer position information—obtaining the taxpayers’ points of view is essential to the development of impartial Appeals Settlement Guidelines. In July 2005, the IRS announced approximately 1,200 taxpayers involved in the Son of BOSS promotion agreed to participate in the Tax Shelter Settlement Initiative, which resulted in the collection of over \$3.7 billion in taxes, interest, and penalties. The remaining taxpayers cannot go to Appeals. Any alternative remedy would be available to these taxpayers only through the courts. So far, more than 100 Son of BOSS cases are in court and the IRS expects the first cases to go to trial by early fall.

²¹ IRS Announcement 2005-19 (Executive Stock Option Settlement Initiative), 2005-11 Internal Revenue Bulletin (I.R.B.) 744.

²² Except for cases already in Appeals.

²³ IRS Announcement 2004-46 (Son of BOSS Settlement Initiative), 2004-21 I.R.B. 964.



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Tax professionals expressed concerns related to the approach taken by the IRS on the Son of BOSS initiative. They indicated this was a heavy-handed approach in which taxpayers were being pressured into accepting unfavorable settlement terms by the IRS to avoid litigation. They believe the IRS should have let cases go to Appeals to allow Appeals to evaluate the merits of the taxpayers' positions. To address these concerns, the IRS Chief Counsel stated that, when Tax Shelter Settlement Initiatives are considered for designation as litigating vehicles in the future, the IRS will take a different approach. He stated, "The IRS won't make the same mistake it did in the recent Son of BOSS settlement initiative of doing a global settlement initiative before Appeals has had a chance to review at least some of the cases in more detail."²⁴

Recommendations

Recommendation 3: The Chief, Appeals, should review and clarify procedures in the Internal Revenue Manual to establish that Appeals does not automatically follow compliance function Coordinated Issue Papers but rather uses this information and other sources of information to coordinate an Appeals approach to the issue.

Management's Response: Appeals will revise the Internal Revenue Manual and issue interim guidance to clarify that Appeals does not automatically follow the direction in compliance function Coordinated Issue Papers but rather uses this information along with other sources of information to coordinate an Appeals approach to the issue.

Recommendation 4: The Chief, Appeals, should revise procedures in the Internal Revenue Manual to clearly establish that taxpayer access to Appeals technical guidance coordinators will be honored, when requested, in all coordinated issue cases.

Management's Response: Appeals will revise the Internal Revenue Manual and issue interim guidance to clarify that a taxpayer's request for a technical guidance coordinator will be honored.

Recommendation 5: With the exception of the IRS Commissioner and the Chief, Appeals, IRS officials should avoid discussing the impact of specific court cases on Appeals settlement guidance. The Chief, Appeals, should consider the appropriateness of discussing changes to specific Appeals Settlement Guidelines in public statements or announcements and should revise policies and procedures to promote consistency.

Management's Response: Appeals will issue a memorandum to reinforce the procedures regarding the reconsideration of the appropriate settlement range or position of a coordinated issue based on any new court decision, ruling, or other significant occurrence.

²⁴ Stratton, Sheryl. "IRS Appeals, Audit Initiative Announcements Abound At Conference." *2004 Tax Notes Today* 192-4 (October 1, 2004, as clarified October 6, 2004).



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The Office of Appeals' Participation on the Service-Wide Abusive Transaction Executive Steering Committee Allows for Proper Workload Planning

The Service-Wide Abusive Transaction Executive Steering Committee is made up of executives from the IRS operating divisions, Criminal Investigation Division, Office of Chief Counsel, and Appeals. In her FY 2004 Annual Report to Congress, the National Taxpayer Advocate used the Service-Wide Abusive Transaction Executive Steering Committee as an example of what should be considered an unallowable use of ex parte communications by Appeals.

The objective of the Service-Wide Abusive Transaction Executive Steering Committee is to provide IRS-wide oversight for the IRS' response to abusive tax transactions, schemes, and devices. The guiding principles are:

- Understand the transaction.
- Get the right people to the table at the right time.
- Respect each function's role in the administrative process.
- Develop an IRS-wide strategy to address the abusive transaction or scheme.

Once the Committee has approved the development of a strategic IRS-wide response to a specific abusive tax transaction, an Abusive Tax Transaction Team is established. The Team is initially comprised of an executive champion and technical advisor who are both from a compliance function, and representatives from the Office of Chief Counsel and Appeals. One of the primary duties of all Team members is to identify the inventory of potential cases in their respective offices. As cases flow from IRS compliance functions to Appeals to the Office of Chief Counsel, the advance knowledge of how much staffing may be needed to handle the expected workload could be of enormous help to the receiving office. Understanding the potential workload that can be caused by tax issues and schemes is important even to the tax courts. For example, a United States Tax Court judge requested the Office of Chief Counsel to provide information on expected workload in anticipation of litigation for the Son of BOSS tax shelter.

In the guidelines developed by the Committee, the need for Appeals' independence in the process is highlighted by the following statements:

In accordance with the provisions of [the] RRA 98, Appeals is responsible for the independent assessment of the litigating hazards related to a particular tax issue. The success of any settlement initiative is based on the credibility of Appeals' independent assessment of the litigation hazards both in fact and appearance. This requires that the preparation of the Appeals Settlement Guideline by Appeals will occur only after the completion of the following actions:



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- *Development by Compliance [functions] of a full factual position for the issue in a Coordinated Issue Paper or equivalent document,*
- *Summation by [the Office of] Chief Counsel of the legal arguments that will be used if the issue proceeds to litigation, and*
- *Consideration by Appeals of the position of affected taxpayers.*

Revenue Procedure 2000-43 details the circumstances under which ex parte communications are and are not allowable.²⁵ This procedure states the prohibition against ex parte communications does not apply to cross-functional meetings as long as specific taxpayers are not identified. Although not specifically identified in Revenue Procedure 2000-43, the Service-Wide Abusive Transaction Executive Steering Committee falls within this exception's definition. In passing the RRA 98, the Congress specifically allowed for ex parte communications that do not impair the appearance of Appeals' independence. This Committee was not formed to discuss the merits of specific cases but to act as a steering function for the overall inventory of cases. As long as the Committee adheres to its stated principles of maintaining Appeals' independence throughout the process, and we did not find any evidence to indicate otherwise, we believe Appeals' participation on the Committee is permissible under Revenue Procedure 2000-43 and the RRA 98.

²⁵ Revenue Procedure 2000-43, I.R.B. 2000-43, 404.



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Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to evaluate whether the Office of Appeals' (Appeals) modernized structure and processes provide the level of independence intended by the Internal Revenue Service (IRS) Restructuring and Reform Act of 1998 (RRA 98).¹ To achieve the objective, we:

- I. Reviewed the legal requirements of an independent Appeals function as mandated by the RRA 98.
 - A. Researched tax law on the issue of the independence of Appeals, including prohibitions on ex parte communications.²
 - B. Researched IRS regulations, rulings, manuals, policy statements, and memoranda.
- II. Reviewed the historic and current structures of Appeals, including campus centralization, to determine whether Appeals' current structure meets the requirements of an independent Appeals function as mandated by the RRA 98.
- III. Evaluated whether the Fast Track Programs conflict with requirements to maintain Appeals' independence.
 - A. Reviewed program policies, procedures, and Internal Revenue Manual guidelines for the Appeals Fast Track Settlement Program and the Appeals Fast Track Mediation Program.
 - B. Interviewed key Appeals managers and analysts about the policies and procedures for these Programs, as they relate to the independence maintained by Appeals officers.
 - C. Reviewed all 39 of the 114 Fiscal Year (FY) 2004 Fast Track Settlement Program closed case files having a program customer satisfaction survey response to evaluate customer comments related to Appeals independence. These 39 case files along with a random sample of 20 additional files were also reviewed for possible ex parte communications. We limited the number of files selected because the sample was intended to identify whether there were indications of problems. We did not intend to project our results to the total number of cases.

¹ Pub. L. No. 105-206, 112 Stat. 685 (codified as amended in scattered sections of 2 U.S.C., 5 U.S.C. app., 16 U.S.C., 19 U.S.C., 22 U.S.C., 23 U.S.C., 26 U.S.C., 31 U.S.C., 38 U.S.C., and 49 U.S.C.).

² These are communications between Appeals and other IRS functions when the taxpayer is not present.



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- IV. Evaluated whether existing controls identify specific violations of Appeals' independence requirements.
 - A. Determined whether the Appeals Quality Measurement Program is identifying violations of the independence or prohibited ex parte communications rules.
 - B. Analyzed the Appeals Centralized Database System to determine whether Appeals officers assigned to the Fast Track Settlement Program cases have also been assigned to the related traditional Appeals cases for the same taxpayers.
- V. Evaluated instances of a perceived lack of independence in the Appeals process.
 - A. Researched tax practitioner publications to identify public concerns about Appeals' independence.
 - B. Interviewed representatives from constituent groups such as the American Bar Association, the American Institute of Certified Public Accountants, the National Association of Enrolled Agents, and the National Society of Accountants.
 - C. Interviewed prior Appeals executives, now working in private tax practice, to identify any concerns with changes to Appeals policies since enactment of the RRA 98.
 - D. Reviewed National Taxpayer Advocate reports and testimony to Congress.
 - E. Reviewed the results of the FYs 2003 and 2004 Appeals Customer Satisfaction Surveys to determine taxpayers' perception of Appeals' independence.
 - F. Interviewed the Chief of Appeals, key Appeals technical analysts, and the IRS Chief Counsel for their responses to instances of a perceived lack of Appeals' independence identified by tax professionals and the National Taxpayer Advocate.
- VI. Reviewed the structure, policies, and procedures of the Service-Wide Abusive Transaction Executive Steering Committee.



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Appendix II

Major Contributors to This Report

Daniel R. Devlin, Assistant Inspector General for Audit (Headquarters Operations and Exempt Organizations Programs)
Michael E. McKenney, Director
Aaron R. Foote, Audit Manager
Daniel M. Quinn, Lead Auditor
Mike Della Ripa, Auditor



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Appendix III

Report Distribution List

Commissioner C
Office of the Commissioner- Attn: Chief of Staff C
Deputy Commissioner for Services and Enforcement SE
Chief Counsel CC
Deputy Chief, Appeals AP
National Taxpayer Advocate TA
Director, Office of Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis RAS:O
Office of Management Controls OS:CFO:AR:M
Audit Liaisons:
 Chief, Appeals AP
 Chief Counsel CC
 Deputy Commissioner for Services and Enforcement SE



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Appendix IV

Management's Response to the Draft Report



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

AUG 25 2005

MEMORANDUM FOR TREASURY INSPECTOR FOR TAX ADMINISTRATION

FROM:

for Karen S. Ammons
David B. Robison
Chief, Appeals

SUBJECT:

Draft Audit Report - The Overall Independence of the
Office of Appeals Appears to Be Sufficient (Audit #200410035)

I have reviewed the draft report, and I appreciate your efforts in evaluating whether the Office of Appeals' modernized structure and process provides the level of independence intended by the RRA '98.

Appeals has been offering administrative case resolution services since 1927 - always with the primary goal of resolving disputes without litigation. To be successful for these nearly 80 years, Appeals has had to be fair and impartial to the interests of all parties - the government and the taxpayers. We are pleased your audit has found that the Appeals structure and processes provide the level of independence intended by Congress in RRA '98.

For many years the Appeals process was unchanged; however, in this era of uncertain resources, all of government - and the IRS is no exception - has had to find new ways to work smarter, faster, and with no diminution of quality. Appeals has been a leader at the IRS in creating innovative procedures and processes to meet this challenge. Your findings support that Appeals has recreated itself in a manner acceptable to Congress.

RRA '98 not only created a Congressional mandate for an independent Appeals, it also provided specific guidelines for its consideration of certain cases. Before RRA '98 the right to an appeal was a taxpayer right found in administrative regulations - not in statute. Such a significant change makes it clear that a fair and impartial case resolution process is of paramount importance to Congress.

Appeals has undertaken several significant changes to further its mission which you reviewed. These include creating:

- specialized campus operations devoted to particular issues and case types,
- new alternative dispute resolution options for taxpayers, and
- a supportive abusive tax shelter strategy allowing the IRS to quickly and effectively resolve these questionable transactions.



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All of these innovations have one thing in common - the Appeals' role in case resolution remains unchanged. The Appeals' mission remains "getting to the right answer" in every case, and that right answer must be fair and impartial to both taxpayers and the government. Appeals has developed innovations that let us get to that right answer quickly and efficiently, often while the case is still in Compliance.

Campus Operations

Creating specialized campus operations means that specific units are set aside to handle certain types of cases. Employees in those units become expert at identifying and resolving issues found in those case types. And we are pleased to note, taxpayers are expressing their confidence in these units with increased customer satisfaction ratings. Appeals is experiencing the planned improvement in overall cycle time for each case type it now considers in a campus environment.

At six different campus operations around the country, Appeals is now considering one or more of the following specialty areas: Collection Due Process, Offer in Compromise, Post Assessment Penalties, Innocent Spouse Claims, FOIA Appeals, and examination cases initiated by a campus Compliance activity. Appeals is creating processes that ensure access by all taxpayers - including informing them of their rights to a face to face conference at the Appeals office closest to them if requested.

Alternative Dispute Resolution

Through alternative dispute resolution (ADR) techniques, the IRS is expanding the taxpayer's opportunities to reach resolution. Such techniques include expanding fast track settlement to all of SBSE taxpayers and tailoring the ADR techniques to campus generated work as appropriate. By creating a flexible approach with a menu of options, taxpayers are able to select the option that best meets their needs.

Appeals is committed to holding the right kind of conference for each case. We believe easy and immediate access to Appeals - in a manner convenient to them - is what taxpayers have asked for and Congress has mandated. Some of these techniques include:

- Fast Track Settlement
- Fast Track Mediation
- Early Referral
- Post-Appeals Mediation

Communication both internally and externally is the key to the success of these ADR techniques. Appeals has undertaken a significant effort to inform all stakeholders of these programs. The variety and scope of these alternatives when coupled with the traditional Appeals process is significant.



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Tax Shelter Initiatives

Of particular importance in your report is your consideration of Appeals' direct participation with IRS compliance in its tax shelter initiatives. The concern has been that such participation compromises Appeals independence either in fact or appearance. Your findings clearly show that concern should not be overstated.

Appeals' participation in developing global tax shelter settlement initiatives does not prevent Appeals from maintaining its independence. The idea that independence and collaboration are mutually exclusive or that Appeals must maintain isolation from the rest of the IRS to protect that independence is incorrect. Appeals is a much more effective organization if it influences IRS decisions as they are being made and taxpayers have an early opportunity to avail themselves of the Appeals perspective rather than wait for long-delayed litigation. All parties benefit.

Especially in the shelter program, Appeals reaches out to all parties including the practitioner and industry leaders before it reaches its decision in creating a settlement guideline. As you noted in your report, Appeals is quick to alter that settlement guideline after litigation results call for it—whether for or against the government. This global settlement approach not only allows for early resolution, but it also promotes consistency of resolution for all parties involved.

It is important to note that Congress mandated an independent Appeals organization within the IRS not from the IRS. Your findings, particularly in the highly visible tax shelter arena, are very timely.

Regarding your report recommendations, we concur with all of them and will implement corrective actions to ensure we maintain our independence.

Recommendation 1

The Chief, Appeals should ensure that taxpayers are informed of their rights and the conditions of the Fast Track Settlement program before they sign the waivers of the prohibition on ex parte communications.

Corrective Action:

To ensure that taxpayers are well informed of their rights prior to executing the Application for Fast Track Settlement, Appeals will:

1. Provide all taxpayers with an explanation of their rights and expectations in all Alternative Dispute Resolution (ADR) processes.
2. Document this notice to the taxpayer in the Appeals Centralized Database System (ACDS) case activity record.
3. Revise the Application for Fast Track Settlement to inform taxpayers of their rights and expectations in the process before they sign the application.



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4. Include an explanation of the taxpayers' rights in the Appeals Fast Track Settlement opening letters to the taxpayer and their representative.

Implementation Date: December 31, 2005

Responsible Official: Director, Technical Services

Recommendation 2

The Chief, Appeals should revise the Fast Track Settlement program guidelines to clarify the types of communication with other IRS operations that are permissible prior to the opening mediation conference.

Corrective Action:

Appeals will revise all ADR Technical Procedures and Guidelines to ensure that all Operating Divisions are aware of the types of communications that are permissible prior to an opening mediation conference. A memorandum from the Chief, Appeals will be issued communicating this clarification to all parties involved.

Implementation Date: December 31, 2005

Responsible Official: Director, Technical Services

Recommendation 3

The Chief, Appeals, should review and clarify procedures in the Internal Revenue Manual to establish that Appeals does not automatically follow Compliance's Coordinated Issue Papers, but rather uses this information and other sources of information to coordinate an Appeals approach to the issue.

Corrective Action:

Appeals will revise Internal Revenue Manual (IRM) 8.7.3.2.1 and clarify that Appeals does not automatically follow the direction in Compliance's Coordinated Issue Papers. The IRM will further clarify that the Coordinated Issue Paper is to be used with other sources of information to coordinate an Appeals approach to the issue. Interim Guidance will be issued to all Appeals field employees by September 30, 2005, and changes to the IRM will be published by March 31, 2006.

Implementation Date: March 31, 2006

Responsible Official: Director, Technical Services



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Recommendation 4

The Chief, Appeals should revise procedures in the Internal Revenue Manual to clearly establish that taxpayer access to Appeals Technical Guidance Coordinators will be honored, when requested, in all coordinated issue cases.

Corrective Action:

Appeals will revise the IRM to clarify that the taxpayer's request for a Technical Guidance Coordinator will be honored. Interim Guidance will be issued to all Appeals field employees by September 30, 2005, and changes to the IRM will be published by March 31, 2006.

Implementation Date: March 31, 2006

Responsible Official: Director, Technical Services

Recommendation 5

With the exception of the IRS Commissioner and the Chief, Appeals, IRS officials should avoid discussing the impact of specific court cases on Appeals settlement guidance. The Chief, Appeals, should consider the appropriateness of discussing changes to specific settlement guidelines in public statements or announcements and should revise policies and procedures to promote consistency.

Corrective Action:

The Chief, Appeals will issue a memorandum to the Director, Technical Guidance reinforcing the provisions of IRM 8.7.3.3.1 regarding the reconsideration of the appropriate settlement range or position of a coordinated issue based on any new court decision, ruling, or other significant occurrence.

Implementation Date: September 30, 2005

Responsible Official: Director, Technical Services

If you have any questions, please have a member of your staff contact our GAO/TIGTA liaison, Nancy Talajkowski, at 415-744-9276.