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Appeals Restrictions in Cornyn Legislation Get Mixed Reaction

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Full Text Published by taxanalysts

New legislation introduced April 17 seeks to make several taxpayer-favorable changes to the IRS appeals process by giving small business taxpayers the option of free non-Appeals mediation, establishing harsher penalties for ex parte violations, and prohibiting Appeals from considering new issues. But practitioners who represent taxpayers in the appeals process questioned how effective the procedures would be if enacted.

Under the Small Business Taxpayer Bill of Rights Act of 2012 (S. 2291), sponsored by Senate Finance Committee member John Cornyn, R-Texas, violations of ex parte rules by IRS personnel could lead to termination. The bill would allow the IRS commissioner to remove employees who engage in prohibited discussions, but it also gives the commissioner discretionary authority to take personnel action other than removal. That discretion cannot be re-delegated by the commissioner, and no appeal rights are provided to dismissed employees. (For S. 2291, see *Doc 2012-8309*.)

That provision of the bill seems to be a legislative response to recently updated IRS guidance on ex parte practices. Practitioners have frequently commented that the guidance seems to lack effective enforcement when lapses occur. (For Rev. Proc. 2012-18, 2012-10 IRB 455, see *Doc 2012-3197* or *2012 TNT 32-9*. For prior coverage, see *Doc 2012-3202* or *2012 TNT 32-1*.)

Another proposed change in the bill is a prohibition on Appeals raising new issues or theories that were not in the initial deficiency or examiner's report. The proposed new section 7529 does not interfere with or limit a taxpayer's opportunity to raise new issues not in the scope of the initial determination. IRS Deputy Commissioner (service and enforcement) Steven T. Miller recently said that the agency was looking at the issue of new facts or theories being raised for the first time at Appeals, but was mainly concerned about it being prompted by taxpayers, not examiners. (For Miller's remarks, see *Doc 2012-7336* or *2012 TNT 68-54*.)

S. 2291 also adds new options for taxpayers seeking alternative dispute resolution by guaranteeing the right to ask for an independent mediator not employed by Appeals. While the costs in those mediation cases are typically split between the taxpayer and IRS, under the bill some qualifying individuals and small business taxpayers could have the entire cost paid by the government. The proposal makes the mediation or arbitration process available immediately once a case reaches Appeals, but it also allows the IRS to specifically exclude classes of cases from the process after issuing written notice.

The bill also contains provisions that increase compensation for IRS abuses (such as unauthorized return disclosure or return access by IRS staff), as well as changes

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to interest abatement procedures for small businesses and more equitable relief for innocent spouses.

In a fact sheet on the proposed legislation, Cornyn's office said the bill would allow for faster and less costly resolution of audits and that it would ensure Appeals is independent and acts as a neutral party. In an attached statement of support, former IRS Commissioner Mark Everson said the legislation "would provide meaningful tools to small business owners that will help them lower the costs and burdens of tax compliance across the board." (For the release, see *Doc 2012-7736* or *2012 TNT 72-17*.)

Ken Jones of Sutherland Asbill & Brennan LLP told Tax Analysts that the concern with new issues being raised at Appeals is long-standing and that practitioners often complain that Appeals seems to be conducting a new examination. "While Appeals has specific rules in place on when it can look at a new issue, those criteria often don't diminish the perception that Appeals is taking it upon themselves to correct mistakes in the exam process," he said. That Appeals officers are government employees makes it unlikely that they'll turn a blind eye to important issues that auditors overlooked, he said, adding that the problem of new issues is more likely to affect small business taxpayers than coordinated industry case taxpayers.

Diane Ryan of Skadden, Arps, Slate, Meagher & Flom LLP said that limiting Appeals' handling of new issues is important because otherwise taxpayers are exposed to more audit risk "for simply trying to exercise their appeal rights." While the proposed legislation tries to strengthen limitations on having new issues raised at Appeals, she said the bill would need further drafting to prevent circumvention of its intended goals. "For example, you would also need to ensure that cases are not returned back to Exam for new issue development," she said.

Part of the problem with consideration of new issues in the appeals process is that by the time a taxpayer gets to Appeals, it should be the end of the exam process, said Ryan, a former Appeals chief. "Restrictions in this area will streamline the back-and-forth that occurs, narrow the range of issues for Appeals to consider, and make the overall process more fair," she said.

Alex E. Sadler of Ivins, Phillips & Barker praised the proposed prohibition on raising new issues at Appeals, saying, "I generally regard this as a positive and needed change." When a taxpayer has fully addressed the issues raised during the audit, it is frustrating to reach Appeals only to have the appeals officer or examining agent raise new issues, he said. "The process works better when the assessment of the parties' respective litigating hazards is based on the issues developed during audit," he said.

One practical effect of the prohibition might be to prolong audits, because agents will be under pressure to raise every plausible alternative theory to sustain a proposed adjustment, Sadler said, adding, "As agents should be doing this already, I don't see this as a significant drawback."

Jones said he was concerned about the possibility of giving the IRS commissioner latitude to fire employees for ex parte breaches. "Giving the commissioner the ability

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to fire people isn't the way to drive proper behavior within the Service," he said, because behavior "should be driven by the core values incumbent upon Appeals officers rather than fear of the commissioner."

The IRS already has internal conduct rules for handling ex parte violations, Jones said, noting that it is unlikely that if an intentional breach occurs creating prejudice or harm to a taxpayer, the IRS won't have a process for adequately addressing the situation. Most ex parte violations are inadvertent, and there is a growing body of case law in the Tax Court concerning violations, he said. The only problem is the lack of transparency over what ex parte training is being given to IRS personnel and how discipline is handled, he said.

Ryan said that frustration in the tax bar over perceptions of ex parte communications between IRS employees and Appeals may be overstated because "it is not widely understood how infrequent these occurrences are." Violations happen from time to time, but are usually inadvertent -- such as the result of a memo accidentally getting slipped into a file -- rather than a blatant attempt to influence the outcome of a case, she said, adding, "I see the very positive effect ex parte has had on the process -- it's good for taxpayers to have the opportunity to join the discussion rather than try to inhibit all communication that can further the resolution process."

Sadler characterized the proposed ban on ex parte communications as "broad and categorical" because it prohibits any communication between Appeals officers and other IRS employees. "It would thus prohibit Appeals officers from contacting agents to discuss purely administrative matters or to obtain legal advice from counsel attorneys," he said.

The penalties in the bill make removal for misconduct the presumptive action for ex parte violations unless the commissioner personally determines that a lesser penalty is appropriate, Sadler said. Because the commissioner's responsibility in that regard cannot be delegated, "actions on ex parte violations are thus elevated all the way up to the commissioner and will necessarily require new procedures within the commissioner's office to evaluate ex parte violation issues," he said, adding, "The new penalty will likely have a very strong deterrent effect as intended."

"In my experience, ex parte violations are rare, but the bill indicates that a significant number of small business taxpayers feel that some Appeals officers are engaging in inappropriate ex parte communications that compromise their independence," Sadler said. "In light of how broadly the bill defines banned ex parte communications, the proposed penalty regime could result in overly draconian penalties for some ex parte violations."

Jones said that mediation is used infrequently by taxpayers, and he questioned whether the legislation would be effective on that front. "I've always been surprised at how few taxpayers ask for mediation, as it is another bite at the apple," he said. The proposed procedures to allow taxpayers to seek mediation at the beginning of the appeals process may lead to a lost opportunity, he said. He also wondered whether Appeals would have to represent the government in mediation when a traditional Appeals determination hasn't been made.

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But the ability of qualifying small business taxpayers under the proposed legislation to avoid paying for mediation may substantially increase interest in that process, Jones said. "Will the IRS be able to afford it, though, given its strained resources?" he asked.

Sadler said that a non-Appeals mediation option would reassure taxpayers that the decision-maker is independent and under no influence from the compliance function or other arms of the IRS. "This would be appealing to many taxpayers; however, it would come at a cost to both taxpayers and the IRS, and it would likely result in disparate and inconsistent outcomes for similarly situated taxpayers with the same issues," he said.

Regarding the bill's granting the IRS the right to carve out issues from the non-Appeals mediation option, Sadler said that authority appears to be "very broad" and could substantially limit the availability of alternative dispute resolutions.

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