The New Independent Office of Appeals Must Be Independent to Survive

By Steven Toscher, Jonathan Kalinski, and Gary Markarian*

Steven Toscher, Jonathan Kalinski, and Gary Markarian examine the new independent office of Appeals.

The Taxpayer First Act, signed into law on July 1, 2019, codified and established the "Internal Revenue Service Independent Office of Appeals." Since it was first established almost 100 years ago, Appeals was intended to be independent and for the most part it has been. So why was the legislation needed? William Shakespeare wrote, "A rose by any other name would smell as sweet." It is worth examining why there was a need for the legislation and what it may mean for the IRS Appeals of the future. We are not sure the legislation was necessary—but we are confident it will help advance the mission of an independent Appeals.

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Background

The Internal Revenue Service Office of Appeals was formed in 1927. Since its inception, Appeals' mission has been "to resolve tax controversies, without litigation, on a basis which is fair and impartial to both the Government and the taxpayer in a manner that will enhance voluntary compliance and public confidence in the integrity and efficiency of the Internal Revenue Service."[1] If these words mean what they say, why was legislation needed?

Some statutory changes to Appeals' procedures were made when Congress passed the IRS Restructuring and Reform Act of 1998 ("1998 RRA"). The 1998 RRA required the Commissioner of Internal Revenue to develop and implement a plan to reorganize the IRS.[2] It also required the Commissioner to "ensure an independent appeals function within the Internal Revenue Service, including the prohibition of *ex parte* communications between appeals officers and other Internal Revenue Service employees to the extent that such communication appears to compromise the independence of the appeals officers."[3] *Ex parte* communications

are "communications that take place between Appeals and another Service function without the participation of the taxpayer or the taxpayer's representative."[4] So even in 1998, there was a concern on the part of the Congress about the independence of Appeals.

Both the Congress' and the IRS' goal is for the Independent Office of Appeals to be truly independent. It must be independent to properly serve its vital purpose—otherwise taxpayers will just go to court.

In accordance with the 1998 RRA, the Department of the Treasury and the IRS issued guidance in Rev. Proc. 2000-43,[5] later becoming Rev. Proc. 2012-18. The Revenue Procedure explained that Appeals could continue to obtain legal advice from the Office of Chief Counsel, subject to limitations designed to ensure that the advice to Appeals is not provided by the same field attorneys who previously gave advice on the same issue to the IRS officials who made the determination Appeals is reviewing. Additionally, if Appeals requires assistance from the Office of Chief Counsel, "Counsel will assign a different attorney to provide assistance to Appeals."[6] However, the limitations provided in this Revenue Procedure did not apply to cases docketed in the U.S. Tax Court.[7] It should have.

The Taxpayer First Act

The Taxpayer First Act was signed into law on July 1, 2019, with the intention of putting the "taxpayer first." The Act established for the first time the "Internal Revenue Service Independent Office of Appeals," once a creature of IRS grace—but now a right created by the Internal Revenue Code.

The Act codified the long-standing purpose and duties of the former IRS Office of Appeals. The newly renamed "Independent Office of Appeals" is intended to "resolve Federal tax controversies without litigation on a basis which—(A) is fair and impartial to both the Government and the taxpayer; (B) promotes a consistent application and interpretation of, and voluntary compliance with, the Federal tax laws, and (C) enhances public confidence in the integrity and efficiency of the Internal Revenue Service."[8]

But what makes the new *Independent* Office of Appeals different from the old Office of Appeals? Does adding the name "independent" or making it a creature of statute change things? We think the legislation will promote a more independent appeals and it will counsel those in charge that they need to guard against procedures and processes that undermine the independence of Appeals. For example—like depriving a taxpayer of the right of an administrative appeal—which happened in the Facebook case. More on that below.

The Internal Revenue Service emphasizes that Appeals is "An Independent Organization" and that Appeals has implemented several policy and procedural changes intended to re-emphasize the importance of independence.[9] The IRS Independent Office of Appeals Policies Fact Sheet states that "Appeals employs policies and procedures that are consistent with [Appeals] mission and designed to ensure [Appeal's] independence."[10]

Compliance Involvement with Appeals

The Internal Revenue Manual provides that "Appeals has the discretion to invite Counsel and/or Compliance to the [Appeal] conference."[11] There have been reports of Appeals extending invitations in opposition to the taxpayer's or taxpayer counsel's wishes. Such participation has been worrisome to both the tax practitioner community and the National Taxpayer Advocate[12] and has undercut the appearance if not the actual independence of Appeals. The IRM needs to be revisited in light of the new legislation. Although the *ex parte* communications are prohibited, allowing Compliance personnel or Counsel to attend Appeals conferences undermines independence, changes the nature of the appeals conference and is not a good idea.

The examination functions of the IRS are charged with an important mission and they need to get it right the first time—that is the purpose of a revenue agent's report. Allowing either Counsel or someone from the examination or collection function to participate in the appeals conference is counterproductive, encourages dependency and undermines the independence of Appeals. It was a mistake to allow it and if allowed at all in the future, it must be the rare exception and subject to the highest levels of supervisory approval. We are

confident that the IRS is reviewing existing procedures as part of its implementation of the Taxpayer First Act and will strike the balance in favor of independence as mandated by the statute.

Foreign Information Reporting Penalties—A Test of Independence

One early test of the independence of the new Appeals will come from its review of foreign information reporting penalties, which are assessable prior to any appeal or judicial review, increasing the stakes for most taxpayers.

Of the many foreign penalties, let's consider the penalties for the late filing of Forms 3520/3520-A. The Form 3520 is required to be filed for certain transactions with foreign trusts and for the receipt of gifts or bequests from foreign persons. Form 3520-A is an annual filing for a foreign trust with a U.S. owner. Over the past two years, we have seen the rise of the IRS summarily assessing penalties for nearly every delinquent Form 3520/3520-A, whether filed as part of the Delinquent Filing Procedures or not. The penalties for failing to timely file these forms are draconian and anecdotal evidence suggests the IRS campus functions all too often ignore the reasonable cause statement leaving the Appeals Officer with what appears to be the first substantive review of the penalty.

In an income tax deficiency case, the taxpayer can go to Appeals pre-assessment, and if they are unsatisfied with the result, they can petition Tax Court without paying. For an assessable penalty, there is no pre-assessment or pre-payment judicial review, with the possible exception of Collection Due Process cases, which we will discuss below.

An independent Appeals would fairly administer the penalty and only sustain it where appropriate, *e.g.*, not in cases where the tax professional made a mistake, where the taxpayer is unsophisticated, where the subject is extraordinarily complex, and where there is no income tax avoidance.

The Appeals function is to do what is right and correct the excessive assessment of these penalties. We are concerned, however, that this is not the case and that Appeals is too often constrained and is limiting its review. For Appeals to be independent it must consider itself to have plenary review and not feel circumscribed in its duties. Any view that unduly limits its plenary review function not only undermines its independence, but creates unnecessary and costly litigation in the courts—eroding Appeals core function in dispute resolution.

Most taxpayers filing Form 3520/3520-A rely on their tax professionals in this highly complex area. Unlike an income tax return, few taxpayers know about or have even heard about a Form 3520/3520-A. Taxpayers voluntarily getting into compliance and filing a late information return should not be hammered with penalties. We have seen and heard from colleagues throughout the country that information returns with no income tax impact, taxpayers whose assets are in their home country, and who relied on advice of competent professionals, are being assessed penalties that are not justified by the conduct. An independent Appeals would not simply shrug and say that is the way the penalty works, but would go back to the purpose of penalties noted in the Internal Revenue Manual, which is to, "encourage voluntary compliance by supporting the standards of behavior expected by the Internal Revenue Code."[13] The system is designed for the taxpayer to report and disclose, but the current handling of these foreign penalties has disincentivized taxpayers from doing so and will ultimately undermine voluntary compliance.

The Taxpayer First Act will help bolster the historical independence of Appeal and help reverse the policies which have undermined independence.

Because the IRS can collect assessable penalties immediately, there are cases that proceed through the collection process quicker than the appeals process. In some cases the taxpayer receives a Collection Due Process notice before they are given the opportunity to go to Appeals.[14] In these cases, the underlying liability is properly at issue in the CDP. If the taxpayer does not prevail in the CDP hearing, they can then petition Tax Court and have a judge review the penalty before any payment. In many cases, however, Appeals is the only prepayment recourse for a taxpayer because of the limitations of judicial review in CDP cases where the taxpayer had the prior opportunity for an administrative appeal. This puts a heavy burden on Appeals to exercise its plenary authority. If Appeals does not exercise its independence, the only other way to insure taxpayer rights and due process would be to provide for prepayment judicial review of all assessable penalties. This would require a statutory change but would be a good idea. The authors are not aware of any policy issue

that requires that these penalties not be subject to the prepayment judicial review accorded income, estate, and gift tax deficiencies. In fact, given the penal nature of the penalties and financially crippling amount that can be assessed by the IRS, prepayment judicial review is more than appropriate.

No More Denial of the Right to Appeal

An important part of the legislation is the provision of the Act that severely limits, and for most cases precludes, the IRS from engaging in the practice of denying taxpayers the right of going to Appeals. Who would have thought that it would be Facebook that would help ensure the right of all taxpayers to have an independent appeal within the IRS.

Getting there will not only help taxpayers, it will also help Appeals and the IRS in its mission of fair enforcement and voluntary compliance.

Facebook was in a contentious audit with the IRS which is still before the Tax Court.[15] When Facebook declined to give the IRS an extension of the statute of limitations for the fifth time, the IRS issued a statutory notice of deficiency and Facebook petitioned the Tax Court. Under normal circumstances the case would be transferred to appeals for settlement consideration. The IRS refused based upon Rev. Proc. 2016-22 and its conclusion that transferring the matter to appeals was "*not in the interest of sound tax administration*."

Many of us in this business have been faced with this issue and most all tax litigants would have to just "grin and bear it" and accept the IRS unilateral deprivation of the right to go to Appeals, but the social network brought suit in federal district court to compel the IRS to provide an administrative appeal. The court held that Facebook did not have an enforceable right under the existing statute. Not surprising under the then existing law. But the end of the story is much better for all taxpayers, because under the Taxpayer First Act, it will be the very rare case—if ever—when a taxpayer can be deprived of going to IRS Appeals.

Conclusion

Both the Congress' and the IRS' goal is for the Independent Office of Appeals to be truly independent. It must be independent to properly serve its vital purpose—otherwise taxpayers will just go to court. The Taxpayer First Act will help bolster the historical independence of Appeal and help reverse the policies which have undermined independence. But we are realists and recognize it will also take thoughtful implementation and administration of the Act by the IRS to achieve these goals. Getting there will not only help taxpayers, it will also help Appeals and the IRS in its mission of fair enforcement and voluntary compliance.

ENDNOTES

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1 IRS Website *Appeals—An Independent Organization* at *www.irs.gov/appeals/appeals-an-independent-organization*.

2 IRS Restructuring and Reform Act of 1998, P.L. 105-206 (RRA 98).

3 IRS Restructuring and Reform Act of 1998, P.L. 105-206 (RRA 98) Section 1001(a)(4).

4 Rev. Proc. 2000-43, Section 3; Q-1.

5 Rev. Proc. 2000-43, 2000-2 CB 404.

6 Rev. Proc. 2000-43, Section 3; Q-11.

7 *Id.*

8 IRS Website *Appeals—An Independent Organization* at *www.irs.gov/appeals/appeals-an-independent-organization*.

9 IRS Website *Appeals—An Independent Organization* at *www.irs.gov/appeals/appeals-an-independent-organization*.

10 Fact Sheet *IRS Independent Office of Appeals Policies*.

11 I.R.M. 8.6.1.5.4, *Participation in Conferences by IRS Employees* (Oct. 1, 2016).

12 National Taxpayer Advocate 2017 Annual Report to Congress (Most Serious Problem #18: *The IRS's Decision to Expand the Participation of Counsel and Compliance Personnel in Appeals Conferences Alters the Nature of Those Conferences and Will Likely Reduce the Number of Agreed Case Resolutions*) 203-210.

13 IRM Section 20.1.1.2(1).

14 The lack of transparency concerning the review and assessment of foreign penalties is not the focus of this article. It is important to note, however, that taxpayers will typically receive a CP15 or CP215 notice informing them of the penalty assessment. These notices give the taxpayer 30 days to "appeal" (a little "a" appeal because the case is not sent to an Appeals Officer at this time) and submit a reasonable cause statement. If the IRS finds there was no reasonable cause, it will eventually issue an 854 C, which gives the taxpayer 60 days to file a capital "A" appeal. Now the case will be sent to an Appeals Officer.

15 *Facebook, Inc. & Subsidiaries v. Commissioner of Internal Revenue*, Docket No. 021959-16.