Appeals Arbitration: Not a Compelling Litigation Alternative
By Ken Jones

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In this article, Jones offers his observations about the IRS Appeals’ arbitration program, why it has not been embraced by taxpayers as a viable alternative to litigation, and why Appeals should reevaluate the role of binding arbitration.

TAX MATTERS

IRS Appeals announced its initial arbitration program in 2000, and after 14 years, there apparently have been only a few cases resolved by binding arbitration. Appeals arbitration has failed to become popular in the tax controversy marketplace, and there are some likely reasons for the program’s lack of success. I represented the taxpayer in the first case arbitrated at Appeals, and while I cannot discuss the specifics of that case, in this article I offer my observations about the arbitration program, why it has not been embraced by taxpayers as a viable alternative to litigation, and why Appeals should reevaluate the role of binding arbitration.

Background of Arbitration at the IRS

In 1998, Congress enacted several provisions that required the IRS to change its organizational structure and to improve taxpayer protections and rights. The Internal Revenue Service Restructuring and Reform Act of 1998 added section 7123(b)(2), which required that IRS Appeals establish a pilot binding arbitration program.1 The scant legislative history sheds little light on the reasons for the statutory requirement to implement a pilot arbitration program, other than the suggestion that by embracing ADR techniques, the IRS would speed up case resolution.2 At the time of enactment, Appeals already had begun testing the ADR waters and had a test mediation program in place.3

At the end of 1999, in response to the statutory mandate, the IRS announced a two-year pilot program to test a binding arbitration program for cases before Appeals in which negotiations had failed to result in settlement.4 The pilot program limited arbitration to factual disputes that could be “resolved solely upon a finding of fact, and where any interpretation of law, regulation, ruling or other legal authority is agreed to by the parties.”5 In 2002 the IRS extended the arbitration program’s test period for another year.6 Under the pilot program,

1Section 7123(b)(2) provides:
(A) The Secretary shall establish a pilot program under which a taxpayer and the Internal Revenue Service Office of Appeals may jointly request binding arbitration on any issue unresolved at the conclusion of—
(1) appeals procedures; or
(2) unsuccessful attempts to enter into a closing agreement under section 7121 or a compromise under section 7122.


5Id. The announcement excluded from arbitration issues designated for litigation, industry specialization program issues, Appeals coordinated issues, competent authority issues, issues involving the substantiation of expenses under section 162 or 274, and cases in which arbitration was deemed inappropriate under 5 U.S.C. section 572 or 5 U.S.C. section 575 (cases in which a definitive resolution is required for precedential value, the matter involves significant questions of government policy, the matter could affect persons who are not parties to the proceeding, a full public record of the proceeding is important, or the agency must maintain continuing jurisdiction over the matter in light of changing circumstances).


July 15, 2014

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the parties could jointly choose either an IRS Appeals arbitrator or a non-IRS arbitrator. The IRS announced in 2006 that the Appeals arbitration program was being made permanent. As was the case under the pilot program, the permanent procedure limited binding arbitration to factual disputes. The permanent program excludes matters already pending in court, questions designated for litigation, most collection cases, cases with specified coordinated issues, cases with whipsaw issues, cases in which the taxpayer did not negotiate in good faith, and frivolous matters.

In 2008, Appeals initiated a test of mediation and arbitration specifically for offer in compromise and trust fund recovery cases, and under some treaties, arbitration is used to resolve competent authority cases. Arbitration of factual disputes has been formally available in the Tax Court since 1990.10

**The Arbitration Process at Appeals**

Under the existing Appeals arbitration procedure, which has been in place since 2006, the taxpayer does not have a right to binding arbitration; rather, both Appeals and the taxpayer must agree to it. Arbitration is limited to factual questions. The request to arbitrate is fairly brief. The essential elements are a description of the issue and a representation that it is not excluded from arbitration under the rules. If local Appeals personnel agree to the request, it is forwarded to the IRS National Office, where Appeals officials make the final decision to accept or reject it. If the request is denied, the taxpayer may meet with local officials to discuss the denial, but there appears to be no formal right to appeal.

Within a month after an arbitration request is approved by Appeals, the parties must enter into a written agreement that describes the issues to be arbitrated, describes the answer to be obtained from the arbitrator (for example, the value is $x), describes the information the arbitrator may consider, and identifies any witnesses. Because the arbitrator’s determination is limited to factual questions, the parties jointly must provide any required legal guidance that the arbitrator may need.

The parties may agree to use either an Appeals arbitrator or a private sector arbitrator. Appeals bears all costs associated with an Appeals arbitrator, while the parties split the private arbitrator’s fee and expenses. The parties must select an administrator for the arbitration proceeding. That individual may be someone from Appeals or an administrator from a local or national dispute resolution organization. If the parties choose an Appeals arbitrator, the taxpayer must sign a statement acknowledging that the arbitrator has an inherent conflict of interest.

The arbitration agreement provides that both parties agree to be bound by the arbitrator’s decision and that the decision may not be appealed to any court. Appeals reserves the right to have the assistance of chief counsel attorneys during the arbitration process.

The arbitration session should occur within 90 days of the parties signing the agreement to arbitrate. The arbitrator will apply the Federal Rules of Evidence for the admission of testimonial and documentary evidence. Within 30 days after section 572 or 5 U.S.C. section 575, whipsaw issues, frivolous issues, and cases in which the taxpayer has not negotiated in good faith.

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274 substantiation issues and competent authority issues. It specifically excluded collection cases, issues “for which arbitration would not be consistent with sound tax administration,” frivolous issues, and cases in which the taxpayer did not act in good faith during settlement negotiations.

Also in 2002, the IRS announced a settlement initiative for some contingent liability transactions. A component of that initiative included binding arbitration limited to a determination of which of the final settlement offers submitted by the two parties best reflected the hazards of litigation. Rev. Proc. 2002-67, 2002-2 C.B. 733. The arbitration component of the novel IRS settlement initiative was a type of so-called final offer arbitration (also known as baseball arbitration) in which the arbitrator can choose only between the settlement offers of the parties.


Tax Court Rule 124. The rule was formally adopted in 1990. See Tax Court release (June 11, 1990).

Rev. Proc. 2006-44, section 4.01. See Internal Revenue Manual section 8.26.6.1 for a summary of the Appeals arbitration procedure. (The discussion herein touches only on the key elements of the arbitration procedures.)

Rev. Proc. 2006-44, section 3.01(1). As in the previous pilot program, there are some exclusions, including issues in court (for the same taxpayer), issues designated for litigation (for the taxpayer), issues pending with competent authorities, cases in which arbitration was deemed inappropriate under 5 U.S.C.
completion of the arbitration proceeding, the arbitrator must prepare a written report, and that report must be limited to findings of fact (and not include interpretation of the law). \[26\] Appeals will then prepare a closing agreement (Form 906) to document the resolution of the case. \[27\]

**Why Arbitrate Rather Than Litigate?**

Why would a taxpayer choose binding arbitration (if the IRS agreed) at the end of the Appeals process? Parties in a dispute typically choose binding arbitration because they perceive it as being better than litigation. \[28\] In the nontax world, arbitration is often agreed to by the parties at the beginning of their contractual relationship (a pre-dispute arbitration agreement), and other times it is agreed to after a dispute arises (post-dispute arbitration) — and it is usually a matter of contract. \[29\] For example, arbitration clauses are frequently included in employment contracts and consumer contracts before any dispute has arisen, and most arbitration contracts are made before the dispute arises. \[30\] (Obviously, however, a taxpayer cannot bind the IRS to arbitration by including an arbitration clause in a filed tax return.)

Several ADR scholars have characterized arbitration as a “product” that competes with litigation: Depending on the particular circumstances, the parties will determine that either arbitration or litigation is better. \[31\] If the parties choose binding arbitration at the end of an Appeals process with no settlement, logically that implies that they both have determined litigation is not the best alternative.

The parties would typically consider several factors in analyzing arbitration versus litigation, such as (1) the cost of litigation versus the cost of arbitration; (2) the additional time that litigation may require versus the potential speediness of arbitration; (3) the likelihood that arbitration may be less contentious than litigation; (4) the likelihood that the evidentiary rules will be somewhat more relaxed in arbitration; and (5) the potential publicity of the matter if it is litigated versus the privacy of arbitration. \[32\] We do not know whether and how Appeals has considered these or other factors in deciding whether to accept a taxpayer’s arbitration request.

In the arbitration case I handled several years ago, the taxpayer considered many of those factors. \[33\] First, the taxpayer’s dispute with the IRS had been ongoing for many years. Arbitration presented the opportunity to resolve the matter quicker than through litigation, which likely could have required several more years and increased dispute resolution costs. When considering arbitration, a taxpayer obviously needs to thoroughly analyze and compare the costs, burdens, and timeframes of the two processes. In my client’s case, it was determined that arbitration would be less costly and much quicker than litigation. The client had initially requested mediation, but that request was denied, and upon elevating that matter to IRS National Office officials, it was agreed that the matter could be resolved by arbitration. (More on that point below.)

Second, it was also important to my client to be able to choose a qualified, independent private sector arbitrator and not an Appeals arbitrator, who would have been perceived as not being independent. While cost and speed were important factors, it was also critical to the client that the matter be resolved by an experienced and respected arbitrator so that the decision could be viewed as equivalent to a court opinion. With the concurrence of Appeals, we chose a very experienced retired Tax Court judge to be the arbitrator.

In my case, the more relaxed environment of arbitration was definitely a plus (although the retired judge/arbitrator was somewhat taken aback that the parties had agreed to conduct the hearing in business casual attire). The taxpayer was able to present evidence to the arbitrator that might not have been allowed in court. For example, a sitting member of Congress testified about the purpose of a particular statute and its relevance to the client’s facts. It is doubtful that that testimony would have been allowed in court. \[34\] From start (the arbitration agreement) to finish (the arbitrator’s written opinion), the arbitration process took roughly nine months, with the parties submitting a stipulation of facts and pre-hearing memoranda, followed by the

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27Id. at section 8.02m.
31Drahozal and Ware, supra note 28.
33The taxpayer’s request was made under Announcement 2000-4.
34“Post-enactment legislative history (a contradiction in terms) is not a legitimate tool of statutory interpretation.” United States v. Woods, 134 S. Ct. 557, 568 (2013).
Do the Numbers Tell a Story?

When the IRS announced in 2006 that it was making Appeals arbitration a permanent program, the agency proclaimed that the program was “no longer a pilot program, but part of business as usual at the IRS.”35 But Appeals arbitration appears to have been used only a handful of times, and it clearly is not part of business as usual.

We don’t know how many times taxpayers have requested Appeals arbitration, how many times taxpayer requests have been accepted or rejected, or how many cases were resolved by the arbitration process — because Appeals does not make those statistics routinely available. But based on conversations with government officials and practitioners, and occasional comments by Appeals officials at various tax conferences, it appears that at least (and perhaps at most) two cases at Appeals were resolved through binding arbitration, and a few more cases may have been resolved during the arbitration process but before the arbitrator rendered a decision.36 Transparency about the use (and non-use) of the process could prove useful to practitioners considering arbitration, as well as to Appeals in evaluating the continued need for the program and possible ways to improve it.

One reason for the low use of arbitration could be that taxpayers and tax professionals are unaware of the program. But at the start of the Appeals settlement process, taxpayers are typically provided an ADR brochure that discusses arbitration, and IRS officials have frequently mentioned binding arbitration as an option when discussing ADR options at conferences and seminars.37 Some Appeals officers have briefed taxpayers about mediation and arbitration at the beginning of settlement discussions.

Although lack of awareness may be a factor in the low use of arbitration, IRS officials’ frequent mention of the program arguably should have triggered more than a handful of participants. It is also possible that most tax practitioners have little or no experience with arbitration and therefore simply don’t consider it. Similarly, most IRS Appeals employees have little or no arbitration experience and thus may be unlikely to consider or recommend it when settlement negotiations fail.

Another possible explanation for taxpayers not using Appeals arbitration is the prohibition on arbitrating legal questions.38 Often it may be difficult to determine whether an issue is factual, legal, or is a mixed question of fact and law. As mentioned above, my client initially requested Appeals mediation, and that request was denied, ironically, because the question was determined to be not wholly factual, and at the time, Appeals restricted mediation to factual disputes.39 The restriction on mediation of legal issues was removed in 2002, but my client’s arbitration process was already well underway.

Even after Appeals agreed to arbitration, the chief counsel’s office expressed concern whether the matter to be arbitrated was a legal issue, a factual dispute, or a mixed question of fact and law. (Be that as it may, the case was arbitrated.) As a general rule, a question of fact involves an “event or circumstance, as distinguished from its legal effect, consequence, or interpretation.”41 But defining an issue as purely factual or purely legal can be challenging, and appellate courts often disagree whether a question is one of fact or law (or mixed).

For example, if a matter to be arbitrated involves a debt versus equity question, the courts are split about whether the issue is one of fact, one of law, or one of mixed fact and law.42 Also, the courts have


37Publication 4167, Appeals Introduction to Alternative Dispute Resolution.
not adopted a uniform approach to debt-equity questions, differing on the number of factors to be analyzed. Perhaps the parties could agree on what factors the arbitrator would decide, leaving the ultimate question (debt or equity) for the Appeals officer to decide. But given that most courts agree that no one factor is controlling, it might prove difficult to instruct the arbitrator on how to apply the law to the facts.

That very few cases have been resolved at Appeals by binding arbitration does not prove most taxpayers perceive the program as having limited value; however, it strongly implies that Appeals arbitration has been unable to compete with litigation. Obviously, arbitration and litigation are different in several significant ways, but both ultimately provide the parties the same service: the final resolution of a dispute.43 Some scholars have argued that in various nontax disputes, arbitration has failed to compete with litigation because the parties often consider the courts to be well-functioning and, in effect, superior alternatives to arbitration.44 Perhaps the available forums — the Tax Court, the Court of Federal Claims, or U.S. district court, depending on the issue — all function well for purposes of resolving most tax disputes.

In most cases, if settlement cannot be achieved, the taxpayer can resolve the matter in the Tax Court. One advantage of the Tax Court is that the litigant does not have to pay the tax alleged to be owed, and there is no substantial case backlog as there may be in other courts.45 Also, taxpayers have another opportunity to choose arbitration if a case is not settled at Appeals; in the Tax Court, arbitration of factual issues is a possibility (although it appears anecdotally that arbitration has been used as infrequently in the Tax Court as Appeals arbitration has been used).46 Lastly, historically a high percentage of cases docketed in the Tax Court are settled without the need for trial. These and other factors may combine to make dispute resolution in the Tax Court a better option than Appeals arbitration.47

Time to Reevaluate

In the fall of 2012, IRS Appeals asked the Harvard Negotiation and Mediation Clinical Program to help evaluate the government’s existing ADR tools.48 The Harvard program was asked to:

- Assess [Appeals’] current ADR programs, taking into consideration the specific needs of target taxpayer segments, [Appeals’] resource constraints, time spent on case resolution, and major policies and procedures that govern the ADR program.
- Identify potential improvement opportunities based on findings from the assessment.
- Develop high-level action plan that provides a recommended implementation strategy covering sequencing and a general timeline for each recommended improvement.49

The status of the evaluation process and any recommendations made by Harvard are unknown.

We also don’t know if Appeals has reached out (or will reach out) to taxpayers and practitioners for their input on arbitration or any of the other Appeals ADR tools.50 Again, if the numbers tell us anything, Appeals may have already concluded that binding arbitration has not worked as expected.

Although the focus of this article is on Appeals arbitration, the limited use of mediation should be noted because both mediation and arbitration are

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46See American Bar Association Section of Taxation letter to the Tax Court (Mar. 7, 2011) (on commenting on arbitration in the Tax Court, the tax section stated that “the Court acknowledges that voluntary binding arbitration has been used in only a few instances over the past 20 years”). See IRM section 35.5.5.1 for a discussion of the Tax Court arbitration process. See IR-92-20 (Apple and the IRS agreed to binding arbitration in a docketed transfer pricing case).


49Id.

50Fast-track mediation, fast-track settlement, mediation, early referral, and arbitration. See IRM section 8.26 (ADR program).
tools designed to resolve disputes when the settlement discussions have stalled (arbitration is binding while mediation is not). Appeals mediation is a nonbinding process that uses a neutral party (or parties) to help the parties reach a settlement.

As is the case for arbitration, we do not have detailed historical information showing how many taxpayers have used mediation at Appeals, how many cases were resolved, etc. Anecdotally, while many more taxpayers have used Appeals mediation (compared with arbitration), the numbers appear to be relatively small, and comments by Appeals officials over the years suggest they are dissatisfied with the taxpayer participation.

It could be argued that most cases in which settlement discussions have stalled should use Appeals mediation, particularly because Appeals’ mission is to resolve cases without litigation. The request to the Harvard Negotiation and Mediation Clinical Program suggests that Appeals knows that its ADR tools — including arbitration and mediation — are not being fully used and must be improved to help Appeals achieve its mission.

54See Folan, supra note 47. The Appeals mission is “to resolve tax controversies, without litigation, on a basis which is fair and impartial to both the Government and the taxpayer and in a manner that will enhance voluntary compliance and public confidence in the integrity and efficiency of the Service.” IRM section 8.1.1.1.