NEW YORK STATE BAR ASSOCIATION TAX SECTION COMMENTS ON ANNOUNCEMENT 2000-4 PROPOSED ARBITRATION PROCEDURE FOR APPEALS[1]

These comments are submitted in response to Announcement 2000-4 setting forth notice of a Proposed Test of Arbitration Procedure for Appeals.

We strongly support the Internal Revenue Service ("IRS") proposal for a test of an arbitration procedure to resolve taxpayer disputes with the IRS. We believe that arbitration, if effectively publicized and implemented, has the promise of reducing delay and expense in resolving controversies between taxpayers and the IRS.

We have the following comments and recommendations which we believe would improve the prospects for the success of the arbitration procedure:

(1) Availability of Arbitration

(a) It is crucial to the success of the test of the arbitration procedure that the IRS ensure that taxpayers are aware of the availability of arbitration. The IRS should, for example, furnish eligible taxpayers with forms giving them information about the arbitration procedure at the time they receive a 30-day letter, and Appeals Officers should specifically apprise eligible taxpayers of the availability of arbitration and mediation.

(b) We recommend the proposed arbitration procedure be available for cases docketed in the Tax Court so long as Appeals retains settlement authority. This would enable taxpayers and the IRS to dispose of cases at an early stage of litigation and save the time and expense to the IRS and the taxpayer of a protracted litigation in the Tax Court.

(c) The arbitration procedure restricts the availability of arbitration to factual issues. Arbitration should be more inclusive of taxpayer disputes. It should not be limited to "factual issues".

Almost every tax dispute involves the application of the Internal Revenue Code, regulations, court decisions, rulings, etc. to factual situations. Unless the procedure is made more inclusive, many disputes which could have been disposed of by arbitration will be litigated in the courts.

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[1] This report was drafted by Stanley Rubenfeld. Helpful comments were received from Kathleen Comfrey, Robert Jacobs, Arnold Kapiloff, Lars Jensen, Deborah Mascucci, Mina Song and Judge B. John Williams.

(2) **Taxpayer Request to Arbitrate**

Paragraph one of the procedure states that to request arbitration a taxpayer must send a written request to the Team Chief/Appeals Officer who has responsibility for the case. The Team Chief/Appeals Officer then makes a written recommendation for action on the request. The request and recommendation is then sent to the Team Chief's/Appeals Officer's immediate supervisor for approval/disapproval. The supervisor's approval/disapproval is then reviewed by the supervisor's manager and forwarded (unclear whether with or without a recommendation) to ARDA-LC for final determination. The National Director of Appeals, Office of ADR & CS is to be consulted before making a final determination. The ARDA-LC is supposed to make a final determination within 30 calendar days of the date the Team Chief/Appeals Officer receives the taxpayer's request. Given the responsibility and workload of senior Appeals personnel, it seems very unlikely that 30 days will be sufficient time to process a taxpayer request which must be signed off on by:

a) Team Chief/Appeals Officer;

b) the immediate supervisor of the Team Chief/Appeals Officer;

c) the supervisor's manager;

d) ADR&CS; and

e) ARDA-LC.

We believe the suggested procedure for requesting arbitration has the potential for delay and will discourage taxpayers from seeking arbitration. We note that under Announcement 98-99, which sets forth the mediation procedure to request mediation, the taxpayer need only send a written request to ARDA-LC with a copy to the National Director of Appeals. We recommend a simple request procedure for arbitration similar to that used for taxpayer requests for mediation.

(3) **Scope of Arbitration**

Paragraph eight of the procedure states that the parties *may* require the arbitrator to find a specific value within a range agreed to by the parties. This does not appear to conform to the requirements of 5 U.S.C. section 575(2) of the Administrative Dispute Resolution Act of 1999 ("ADR Act"), which states that each arbitration agreement *shall* specify a maximum amount award that may be issued by the arbitrator. If the parties fail to instruct the arbitrator in the arbitration agreement as to a maximum amount award, the arbitration agreement may be defective under 5 U.S.C. section 575(2).

The procedure appears to require that if there are multiple taxpayer issues in Appeals all issues for which arbitration is not being requested will have been resolved in Appeals. It is frequently the case that there are several issues in Appeals. For example, there might be a large Section 482 and a small "reasonable compensation" dispute in Appeals. The issues are completely unrelated. Wouldn't it make sense to dispose of the larger Section 482 issue in arbitration and allow the taxpayer to litigate the smaller reasonable compensation issue? We do recognize that, as a matter of administrative convenience, the IRS may be justified in exacting a resolution of all taxpayer issues as the price for the IRS agreeing to arbitration.

(4) **Selection of Arbitrators**

(a) **IRS Conflict of Interest**

Paragraph four of the arbitration procedure states:

"An arbitrator shall have no official, financial, or personal conflict of interest with respect to the issues in controversy, unless such interest is fully disclosed in writing to the taxpayer, and the ARDA-LC and they agree the arbitrator may serve."

The procedure should not permit an Appeals Officer (or any other IRS employee) to serve as a sole arbitrator, even with the consent of the taxpayer. It is important to the success of the arbitration procedure that there be broad taxpayer and taxpayer representative confidence in the integrity, fairness and impartiality of the process. The integrity of the arbitration process and a respect for taxpayer perceptions do not permit an Appeals Officer of the IRS to act as an arbitrator in a dispute between a taxpayer and another Appeals Officer of the IRS. Unlike mediation, the arbitrator has the authority to make an award which is legally binding on the taxpayer and the IRS. An arbitrator employed by a party should not arbitrate a dispute between his or her employer and another party. The correctness of this conclusion can be more clearly seen by asking whether the IRS would perceive as fair and impartial an arbitration in which an executive of a corporate taxpayer arbitrates a dispute between the taxpayer and the IRS.

We note that Title 28 of the United States Code section 455(b) (disqualification of justice, judge or magistrate), which applies to mediators in the United States District Courts for the Eastern and Southern Districts of New York and which, according to the Federal Judicial Center in Washington, D.C., applies to mediators in most federal district courts, would prohibit a mediator from serving in most, if not all, of the circumstances that would fall under paragraph four of the procedure, even if the parties consent. This disqualification is even more compelling for an arbitrator, as compared to a mediator, because a mediator, unlike an arbitrator, cannot bind the parties.

(b) **One or Three**

Under the rules of most arbitration organizations, the parties may choose to have more than one arbitrator. In large complex cases, such as transfer pricing disputes, it may be necessary or desirable to have more than one arbitrator. In the Apple arbitration, there were three arbitrators, a retired federal judge, an economist and an industry expert. Concerns have been raised about the cost to the IRS of having a panel of three arbitrators. Since in a panel-of-three arbitration the IRS could, and likely would, insist on having one Appeals arbitrator, that arbitrator would be provided free of charge to the taxpayer. Accordingly, in a panel-of-three arbitration, there is a valid basis for having the taxpayer pay 75% of the costs of the other two non-IRS arbitrators since the taxpayer would not bear the cost of the IRS provided arbitrator.

(c) **Availability of Arbitration for Smaller Tax Adjustments**

We believe it is important to encourage the availability of arbitration for smaller tax adjustments for which there may be no taxpayer option other than total concession because of the prohibitive costs of litigation. We recommend the IRS consider establishing a simplified fast track for arbitration of small tax adjustments. To make fast track programs more attractive to taxpayers, we suggest recruiting and training a panel of *pro bono* arbitrators who would serve as arbitrators for these small tax adjustments. Such a program would have the advantage of reducing taxpayer costs of arbitration and would also increase the pool of qualified arbitrators available on a paid basis for larger, more complex claims.

(5) **Disqualification of Arbitrator**

Paragraph twelve of the arbitration procedures states:

"The arbitrator will be disqualified from representing the taxpayer in any pending or future action that involves the transactions or issues that are the particular subject matter of the arbitration. This disqualification extends to representing any other parties involved in the transactions or issues that are the particular subject matter of the arbitration."

On its face the disqualification rule, for example, would appear to preclude an arbitrator in a Section 482 controversy from representing an unrelated taxpayer in a pending or future Section 482 case. This cannot be the intent of this paragraph and it should be clarified to state that disqualification relates to representation of the taxpayer and related parties in a pending or future action that involves the transactions or issues that are the particular subject matter of the arbitration. We note that the mediation procedure has the same disqualification rule and should also be clarified.

(6) **The Hearing**

The arbitration procedure and Model Agreement to Arbitrate do not appear to address the question whether the parties have the right to cross-examine witnesses. We believe the parties should be accorded the right of cross-examination.

(7) **Refunds**

Although the procedure does not specifically refer to refunds of tax, refund claims appear to be eligible for the arbitration procedure. The procedure should inform the taxpayer that refund claims are also eligible for arbitration.

Code Section 6405, which requires submission of a report to the Joint Committee on Taxation of refunds in excess of $1,000,000, raises the question whether arbitrations which result in refunds in excess of $1,000,000 require Joint Committee approval.

(8) **Arbitrator's Report**

It is important to have a speedy conclusion to the arbitration. The Model Agreement to Arbitrate should provide that, unless the parties have otherwise agreed, the arbitrator's report must be furnished within 30 days of the closing of the hearing.

(9) **Appeals**

Paragraph fourteen of the procedure states that:

"Neither party may appeal the finding(s) of the arbitrator nor contest the findings(s) in any judicial proceeding, including but not limited to the Tax Court, United States Court of Federal Claims or a federal district or appellate court."

Although finality of the arbitrator's findings is important to the success of the process, we note that we do not believe the parties can or should waive the provisions of section 581 of the ADR Act, which gives the parties the right to judicial review of an arbitration award pursuant to the provisions of sections 9 through 13 of title 9. These are situations which involve fraud, partiality or arbitrator misconduct.

(10) Contact with Arbitrator

The arbitration procedure and paragraph 7 of the Model Agreement to Arbitrate provide that "there should be no ex parte communication between the arbitrator and the other party without the express approval of the parties."

If ARDA-LC serves as administrator for the arbitration, as it likely will do if there is a sole Appeals arbitrator, it is difficult to envision how the arbitrator and ARDA-LC can avoid ex parte communications with each other. ARDA-LC as the administrator needs to assist the arbitrator in the arbitration process but would not be permitted to have ex parte communications to do so. We believe the notion of Appeals as serving in the roles of party, arbitrator and administrator can, and likely will, create serious perceptions concerning impartiality as well as difficulties in conforming to the prohibition against ex parte communications.

(11) Assessment of the Arbitration Procedure

It is important to establish a methodology for assessment of the arbitration procedure. Computer software should be developed to track and analyze all aspects of the program. The program might be analyzed by such factors as dollar size, length of time, parties involved, arbitrator, issues, cost, outcome, etc. Also, questionnaires might be given to all participants upon conclusion of an arbitration to obtain feedback and ideas for improving the procedure.