



IRS Alternative Dispute Resolution Techniques

Issue

The IRS has developed a number of alternative dispute resolution (“ADR”) techniques. These techniques move taxpayers away from a traditional audit-appeal-litigate approach and preserve resources by working to resolve issues earlier and more quickly than traditional methods. Taxpayers applaud the IRS’s development of these initiatives. However, when implemented, the time spent or the resources used to arrive at a conclusion in an alternative approach can be as much as in a traditional approach. Ultimately, the conclusion may not be reached any earlier and the taxpayer may not believe the issue received a full and complete hearing.

Background

ADR tools are used to manage issues and eliminate controversy thereby preserving resources. Some tools address issues before the related business transactions occur and the audit begins, other tools manage issues during the course of an audit. Those designed to be used prior to an audit include:

- Advance Pricing Agreements (“APAs”) - designed to resolve disputes regarding the allocation of income and expense between related entities. A successful APA results in a binding agreement detailing an appropriate transfer pricing regime covering current, future and sometimes even prior years. The agreement may be unilateral, between the taxpayer and the IRS only, or bilateral/multilateral, among the taxpayer and several tax jurisdictions.
- Pre-Filing Agreements (“PFAs”) - used when a taxpayer and the IRS agree that a single issue can be resolved prior to filing a tax return. Controversies best resolved in a PFA are those involving factual issues under well-settled principles of law.
- Industry Issue Resolution (“IIR”) - intended to resolve frequently disputed issues that are common to a significant number of taxpayers in the same industry. The goal is to move away from auditing these issues on a case-by-case basis toward a solution that can apply to many taxpayers. The principal focus is to resolve issues arising in future years, but depending on circumstances the resolution may be applied to prior years.

Initiatives designed to be used during an IRS audit include:

- An Accelerated Issue Resolution (“AIR”) agreement - intended to apply the conclusion reached in one exam to similar issues arising in other tax periods for which returns have been filed before the date of the agreement.
- Early Referral to Appeals - through this ADR procedure certain taxpayers may request the early transfer of developed but unagreed issues to Appeals while the remaining issues continue in Examination.



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Background (cont.)

- Fast Track Settlement/Mediation - announced in Notice 2001-67, this ADR procedure establishes new opportunities for large and mid-size taxpayers, with the assistance of Appeals, to expedite case resolution at the lower levels within LMSB
- Simultaneous Appeals/Competent Authority—announced in Rev. Proc. 2002-52, this procedure encourages taxpayers to request competent authority assistance and participation of Appeals while a case is under the jurisdiction of Exam.
- Limited Issue Focused Examination (“LIFE”)—While not technically an ADR, the LIFE initiative would focus on enhanced interaction between the IRS and the taxpayer, working together on the issues most significant to the return, resulting in a more focused examination and reduced resource utilization.

Policy Considerations

The objective of these initiatives is to preserve resources by resolving differences earlier and more quickly than a traditional audit would and by giving issues a fair hearing outside of an audit atmosphere. For example:

- An APA is intended to minimize transfer pricing controversy during an examination and to eliminate the expense of defending such a challenge. However, an APA can take years to negotiate (thus no longer being an agreement in “advance”) and those negotiations sometimes seem to be driven by the field exam team. The time required to complete an APA and the fees for outside professionals during years of negotiation can rival the resource drain of defending an after-the-fact transfer pricing challenge. Moreover, the recent IRS public position is that it will not do an APA for hybrid entities (e.g., check the box). This means that taxpayers have two choices: (1) a unilateral APA that will likely produce a less favorable result to the U.S. fisc and invoke competent authority procedures when a U.S. taxpayer is audited; or (2) do nothing and still end up in competent authority with the same result as in (1).
- The PFA process requires a team of taxpayer and government representatives to assemble soon after a taxpayer’s year end in order to reach a conclusion before the taxpayer’s return is filed. In so doing, it is intended to decrease taxpayer compliance burdens and conserve the IRS’s resources. Although a conclusion can be reached within fewer calendar months, the total hours consumed can be just as high as if the issue were resolved during a traditional audit spread over a longer period when several issues are addressed simultaneously. The process change does not save resources; it merely concentrates them all on one issue for a short time period.



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Policy Considerations (cont.)

- The IIR, and AIR programs have not made a major impact upon the traditional audit process.
- While the LIFE examination process shows theoretical promise, the program is in its early stages so it would be premature to remark upon its success in meeting its objectives.

No tally has been made public showing which cases met objectives and saved resources and which did not. An analysis needs to be made creating key performance measures and monitoring their achievement. To the extent programs do not achieve outlined goals, modifications need to be considered. Modifications may be broad, such as shifting the mindset of field exam teams. They need to understand that these initiatives are not old audit techniques bearing a new name and that taxpayers have motives to participate other than believing they will get a better tax answer, such as early resolution or elimination of risk for both tax and financial statement purposes. Modifications may be narrow, such as granting team members greater flexibility to adjust the process and to make decisions at a lower level to enable them to resolve the issue within the required time frame. Every effort should be made to enable these tools to meet stated objectives of preserving government and taxpayer resources.

Recommendation

The SVTDG recommends that a task force comprised of taxpayers and LMSB members be assembled to assess the degree to which the initiatives are meeting stated objectives. The group should review achievements and benefits of these initiatives and identify areas and action plans for improvement.