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Even ADR Must Pay Its Dues: An Analysis of the Evolution of the Internal Revenue Service's ADR Programs and Where They Still Need to Grow

Stephen Folan¹

I. INTRODUCTION

It has been said that “[t]oday, there can be little doubt that ‘alternative’ dispute resolution is anything but alternative.”² Courts, agencies, and even corporations are regularly utilizing a diverse range of alternative dispute resolution procedures such as mediation, arbitration, and negotiation.³ Yet one organization where alternative dispute resolution does not seem to be fully embraced is the Internal Revenue Service (“IRS”). The IRS Appeals Office was created in 1927 to act as an independent entity for taxpayers to settle their disputes outside of the IRS—although it is still subject to the Service’s jurisdiction—and it was designed as an option where taxpayers could contest their claims in a fair and impartial forum.⁴ However, although the stated goals of the Appeals Office are to resolve tax controversies without litigation and to be fair and impartial to both parties, the IRS has had significant difficulty implementing alternative dispute resolution.⁵ In fact, one former tax court judge and mediator stated that “[p]ost-appeal mediation

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2. Nancy A. Welsh, *Integrating “Alternative” Dispute Resolution into Bankruptcy: As Simple (and Pure) as Motherhood and Apple Pie?*, 11 NEV. L.J. 397, 397 (2011).

3. *Id.*

4. Gregory P. Mathews, *Using Negotiation, Mediation, and Arbitration to Resolve IRS-Taxpayer Disputes*, 19 OHIO ST. J. ON DISP. RESOL. 709, 713 (2004).

5. Christopher Wagner et al., *How to Handle a Tax Controversy at the IRS and in Court*, ST009 ALI-ABA 89, 93 (2011).

at the IRS is broken.”⁶ Although this declaration may be extreme, it is true that, under the appeals process, both mediation and arbitration suffer mutual problems that prevent the IRS from being effectively utilizing them to resolve taxpayer disputes.⁷

Among other reasons, disputes arise when taxpayers disagree with an IRS finding, refuse to file a tax return, or fail to comply with the IRS’s request for more information.⁸ However, while the purpose of the IRS Appeals Office is to resolve and settle disputes at the earliest opportunity, the issues holding back mediation and arbitration limit them to acting as narrowly focused alternatives with few of the advantages of commercial alternative dispute resolution.⁹

The main cause for these issues is speculated to be a lack of trust between both parties, which creates no incentive for taxpayers to actually treat mediation or arbitration as viable alternatives to resolving their dispute in the first place.¹⁰ Under the present alternative dispute resolution systems, it appears difficult to actually establish that necessary trust between the IRS and taxpayers. It appears that trust cannot be established because the post-appeal process focuses on protecting the IRS rather than on creating a neutral and independent environment with incentives for both parties to resolve their disagreement.¹¹

This article analyzes the IRS’s post-appeal mediation and arbitration systems, and advocates for its adoption of contemporary commercial arbitration principles to make its program desirable for both the IRS and taxpayers. Part II will discuss the history and evolution of alternative dispute resolution in the IRS’s appeals system. Part III will look at the present state of the IRS’s dispute resolution processes. Part IV will consider the underlying problems with the available dispute resolution processes. Part V will recognize defenses in favor of the present systems. Part VI will analyze three possible reforms and will advocate their adoption by the IRS,

6. Carolyn Miller Parr, *Why Postappeal Mediation Isn’t Working and How to Fix It*, TAX.COM (Sept. 16, 2009), <http://www.tax.com/taxcom/features.nsf/Articles/11704085C68E8F78852576330002C150>. Although IRS mediators attempt to be genuinely neutral and professional, the problems with the post-appeal programs lie with the structure of the programs themselves. *Id.*

7. *See id.*

8. Mathews, *supra* note 4, at 709.

9. *Id.* at 709–10. Rather than extensively utilizing mediation and arbitration, the Appeals Office relies on negotiations with an appeals officer, which results in questionable outcomes when the taxpayer’s claim is too small to warrant an extensive defense or too large to bridge the gap between the parties’ desires. *Id.* at 710–11.

10. *See* Parr, *supra* note 6.

11. *See id.* While it is true that IRS mediators and arbitrators strive to be genuinely impartial and professional in performing their duties, the appearance of partiality still seems to prevent the establishment of trust between both sides in the appeal process. *Id.*

with the goal of making its dispute resolution processes more cost-effective and desirable for both parties. Part VII will anticipate the potential impact of these reforms on the IRS. Finally, Part VIII will restate the current IRS appeals process and advocate its reform before briefly concluding.

II. HISTORY OF THE APPEALS MEDIATION AND ARBITRATION SYSTEMS

The Appeals Office of the IRS was first established in 1927 and regards itself as one of the earliest dispute resolution organizations in the United States.¹² The Appeals Office was founded with the purpose of settling disputes with taxpayers and avoiding litigation.¹³ As a result, unlike the IRS Examination Division, which only analyzed black letter law and applied it to taxpayers, the Appeals Office was empowered with the authority to consider broader issues, such as the administrative costs and expenses of following through with litigation or continued appeals.¹⁴ Although the primary method used during the appeals process was negotiating settlements through IRS officials, if those negotiations proved unsuccessful, the taxpayer had the option to elect either mediation or arbitration.¹⁵ Mediation and arbitration were initially quite limited in scope and applicability, but both are well established parts of the IRS history of appeals.

While negotiation was traditionally the preferred method of resolving disputes at the IRS, the Appeals Office began to expand its mediation and arbitration programs following the Administrative Dispute Resolution Act (“ADRA”), which Congress passed in 1990.¹⁶ The ADRA mandated that government agencies establish and implement alternative dispute resolution methods in their administrative dispute resolution processes.¹⁷ As a result of

12. David Parsly, *The Internal Revenue Service and Alternative Dispute Resolution: Moving From Infancy to Legitimacy*, 8 CARDOZO J. CONFLICT RESOL. 677, 678 (2007).

13. *Id.* at 678–79. The Appeals Office is seen as an efficient alternative to costly litigation in the federal district courts or in the U.S. Tax Court that allows both parties to avoid litigation expenses. Amy S. Wei, *Can Mediation Be the Answer to Taxpayers’ Woes?: An Examination of the Internal Revenue Service’s Mediation Program*, 15 OHIO ST. J. ON DISP. RESOL. 549, 551 (2000).

14. Parsly, *supra* note 12, at 679.

15. *Id.* However, these programs were not significantly expanded by the Appeals Office because the negotiation process was generally regarded by the IRS as sufficient for settling taxpayer disputes. See Wei, *supra* note 13, at 551. Because of this, a taxpayer is still only able to elect alternative dispute resolution once settlement has failed under the normal negotiation procedures. *Id.* at 552.

16. Parsly, *supra* note 12, at 679.

17. Mathews, *supra* note 4, at 715.

the congressional mandate, the IRS expanded and created more formal procedures for arbitration and mediation of taxpayer disputes.¹⁸

The IRS's first step was to further integrate mediation in 1995 by making it available both during the appeals program and during litigation in tax court.¹⁹ In 2000, the IRS implemented the second step by introducing arbitration during the post-appeal process.²⁰ However, the scope of the arbitration is highly limited and is designed only to resolve factual issues relevant to the taxpayers' disputes.²¹ In addition, at any time during the appeals process or during the available alternative dispute resolution procedures, the taxpayer remains free to pursue traditional litigation instead.²²

III. OVERVIEW OF THE CURRENT APPEALS SYSTEMS

Although alternative dispute resolution programs are available both prior to and following the appeals program, it is prudent to start at the beginning because the pre-appeal programs are considerably more utilized than the post-appeal programs.²³ Generally when an audit of a taxpayer's tax return leads to a disputed amount in his taxable income, the taxpayer is issued a letter informing him that he has thirty days in which to file a request for appeals to reconsider the adjustment.²⁴ However, prior to receiving the thirty-day letter, the taxpayer may elect to engage in mediation with the IRS

18. *See id.* at 716. As part of the IRS Restructuring and Reform Act of 1998, the IRS began to implement more formalized alternative dispute resolution procedures in order to supplement the negotiations process and to improve its image and service to taxpayers. *Id.* at 715–16.

19. Parsly, *supra* note 12, at 679. The role of mediation has consistently increased since the program was instituted. *Id.* However, the program has not met significant success, most likely due to the unequal positions between the two parties under the current system. *See* Peyton H. Robinson, *Alternative Dispute Resolution Procedures with IRS Appeals*, 23 UTAH B.J. 18, 21–22 (March/April 2010).

20. Parsly, *supra* note 12, at 679–80. Although post-appeal arbitration was only introduced as a trial program, the program was modified and extended past its trial period in 2002 and is still offered to taxpayers. *Id.*

21. Robinson, *supra* note 19, at 22. This program is significantly different from commercial arbitration because it lacks many of the rules and procedures that commercial arbitration uses to enforce independence. *Id.* Furthermore, it is also distinct from international treaties between the IRS and other countries, which mandate that the arbitrator must choose between the best positions offered by both parties. *Id.* Without assurances of independence or other incentives, taxpayers have had relatively little reason to elect the program.

22. *See* Parsly, *supra* note 12, at 680.

23. *See id.* at 711.

24. *See* Robinson, *supra* note 19, at 18. If the taxpayers fail to file the request for appeals, then a second letter advises them that they have ninety days to file a petition with the tax court before collection begins. *Id.* The original letter is generally the taxpayer's only window for reconsidering the proposed adjustment prior to litigation. *Id.*

under either the Fast Track Mediation (FTM) or Fast Track Settlement (FTS) programs.²⁵

Under the FTM program, the taxpayer can choose to mediate disputed issues with the IRS by calling in an appeals officer empowered to act as a “neutral third party” to the dispute.²⁶ FTM is generally available as an optional program, that may be elected by the taxpayer, but the process may be terminated at will by either party.²⁷ One advantage of FTM is that it does not replace other dispute resolution options, and should mediation prove unsuccessful, the taxpayer may still choose to continue through the appeals process once the mediation is over and the thirty-day letter is issued.²⁸ Because the appeals officer is not empowered to consider the hazards of litigation in mediating the factual dispute, the FTM program is generally thought to be advantageous where the law is clear and only the facts are in dispute, because it allows the parties to come to a quick and expedient understanding before the issue goes on to appeals or litigation.²⁹

While the goal of the FTM program is to mediate the dispute prior to receiving a thirty-day letter, the purpose of the FTS program is to resolve and settle the case within 120 days by arriving at a mediated settlement.³⁰ One of the primary distinctions between FTM mediation and FTS mediation is that, under the FTS program, the appeals officer acting as a mediator is empowered to consider the hazards of litigation as part of his or her settlement authority.³¹ Much like under the IRS’s other mediation programs, if the FTS mediation is unsuccessful, the taxpayer does not waive any administrative rights and may continue with the normal appeals process.³² The ideal role for the FTS program is seen not as a method for the taxpayer

25. *Id.* at 18.

26. *Id.* While successful enough to warrant extension past its initial pilot period, this program is available only to the Small Businesses/Self-Employed division of the IRS. Parsly, *supra* note 12, at 695.

27. Robinson, *supra* note 19, at 18–19.

28. *Id.* at 19.

29. *See id.*

30. *Id.* at 19–20. Similar to the limitations under the FTM program, the taxpayer is generally only eligible to elect FTS before the IRS issues a thirty-day letter. *Id.* at 20.

31. Parsly, *supra* note 12, at 692. However, if the settlement is based on the hazards of litigation, an appeals closing agreement is necessary and subject to approval from management. Robinson, *supra* note 19, at 20. A further distinction is that while FTM is available to small businesses and to self-employed taxpayers, FTS is limited to large and mid-sized businesses. *See id.* at 18–20.

32. Robinson, *supra* note 19, at 20.

to avoid adjustment, but instead as an outlet for the parties to reach an agreement on how much will be paid in a quicker and more efficient manner.³³

Because not all taxpayers agree upon a settlement during the appeals process, a taxpayer still has the option to participate in post-appeal mediation or arbitration.³⁴ However, these programs are significantly less utilized and are considered more controversial because of perceived inequality between the two parties.³⁵ The IRS updated its post-appeals mediation program, which was formally established in 2002, in 2009 by issuing Revenue Procedure 2009-44, which expanded and clarified the types of cases that were applicable for post-appeals mediation.³⁶ As a general rule, post-appeal mediation is available only in situations where appeals settlement negotiations have occurred and there are still remaining issues to mediate.³⁷ Furthermore, in order to be applicable for post-appeal mediation, all other issues must already be resolved except for the issues being mediated.³⁸

The final option is post-appeal arbitration of tax disputes. This program is meant to be utilized when negotiations have dragged on unsuccessfully for a significant amount of time and the taxpayer believes that the dispute has legitimate merit.³⁹ In such a situation, post-appeal arbitration is available for the limited purpose of resolving only the factual issues relevant to the dispute.⁴⁰ The program is optional and may be elected by either the taxpayer or the Appeals Office, subject to consultation with the other party.⁴¹ Both parties must enter a written agreement to arbitrate that (1) specifies the issue that the parties agreed to have arbitrated, (2) assigns the arbitrator the task of finding facts, (3) precisely describes the answer that the parties seek, (4) describes and limits the information the arbitrator may consider, (5) contains an initial list of participants from each party, (6) provides a mutually agreed time and place of hearings, and (7) prohibits ex parte contacts between the

33. *Id.* at 20.

34. *Id.* at 21.

35. *See supra* notes 5–11 and accompanying text.

36. Rev. Proc. 2009-44, 2009-40 I.R.B. 462.

37. *See id.*

38. *See id.* The Revenue Procedure specifically excludes from eligibility issues that are designated for litigation, deemed inappropriate under statutory or administrative guidelines, and considered frivolous or otherwise inequitable. *Id.*

39. *See* Robinson, *supra* note 19, at 22.

40. *See id.* However, in some situations, post-appeal arbitration may also be available after the taxpayer engages in unsuccessful post-appeal mediation. *Id.* In order to transfer the mediation into arbitration, the relevant factual issues must be the determinative reason that the mediation failed. *Id.*

41. Rev. Proc. 2006-44, 2006-2 C.B. 800.

arbitrator and the parties.⁴² The parties must mutually agree to select an arbitrator either from the appeals office or from a local or national arbitration organization.⁴³

IV. CRITICISMS OF THE CURRENT APPEALS SYSTEMS

Critics of the IRS's alternative dispute resolution systems typically focus on the fact that the Appeals Office has been reluctant to fully embrace and implement mediation and arbitration as effective alternatives to its established negotiation procedures.⁴⁴ For example, although the use of pre-appeal mediation by the IRS and taxpayers is steadily increasing, to the point of being called an "unmitigated success," its integration into the appeals process has been narrowly limited in scope and expanded only gradually with each test program.⁴⁵ One issue with the FTM program is that the taxpayer cannot have an outside party conduct the mediation: the mediator must be an IRS employee.⁴⁶ Because of this restriction, one of the most enduring and problematic concerns with FTM is the perceived lack of impartiality.⁴⁷ Critics of the FTM program rightly suggest that the success of any mediation depends on open communication and trust between the participants.⁴⁸ Without a mediator that both parties recognize and trust to be impartial, the parties cannot be confident enough to fully disclose information and take the mediator's evaluations at face value.⁴⁹

42. *Id.* Examples of precise answers include a specific monetary value, a range of acceptable monetary values, and a clearly affirmative or negative finding by the court. *Id.*

43. *Id.* In the event an outside arbitrator is selected, the parties must share the costs. Robinson, *supra* note 19, at 22. This includes not only compensation for the arbitrator, but all expenses, related fees, and reasonable costs. Rev. Proc. 2006-44, 2006-2 C.B. 800. On the other hand, if an appeals officer is selected, the Appeals Office will pay all expenses associated with the arbitrator, effectively making it more likely to be the default position for a taxpayer. *Id.*

44. See Wei, *supra* note 13, at 551. As evidence of this, although the IRS is required under the ADRA to engage in alternative dispute resolution, in most cases it is available only after negotiations have been attempted and failed. *Id.* at 552-53.

45. *Id.* at 559-60. One member of Congress went so far as to recognize that not only should the IRS put mediation to greater use, but also that taxpayers should be encouraged to believe that it is "the right thing to do." *Id.* at 560.

46. See Mathews, *supra* note 4, at 730.

47. See *id.* at 729-31.

48. *Id.* at 717-18.

49. *Id.* at 718. Although appeals officers are specially trained and tend to behave with genuine neutrality, the fact that they are still IRS employees paid by the agency makes it difficult for taxpayers to actually believe they will be impartial mediators. See Parr, *supra* note 6.

In addition to sharing many of the same inherent issues as FTM, the IRS's current FTS procedure has a number of additional flaws that discourage taxpayers from believing that its election is to their benefit. One of the chief drawbacks is the lack of restrictions against ex parte communications between appeals officers.⁵⁰ As a result, if FTS is elected and results in a failure to settle, there are no limitations in place to prohibit subsequent appeals officers who work on the case from discussing anything that came up in the settlement discussions.⁵¹ There are no limitations stopping the taxpayer from returning to the appeals process after unsuccessful mediation. Yet because all information resulting from that mediation is available upon returning to appeals, this seems to indicate that there is very little reason under the current system for a taxpayer to elect the option in the first place.

Post-appeal mediation suffers from substantially similar problems as pre-appeal mediation, but in many cases these issues only become more pronounced after the appeals process.⁵² Because the default position of the IRS is to use its own specially trained appeals officers as mediators, it is difficult to convince taxpayers that the officer can truly be an unbiased party in the discussion.⁵³ This means that the taxpayer is unable to speak candidly with the mediator, even if the mediator is a specially trained professional who truly does attempt to act in a fair and unbiased manner.⁵⁴ Mediation is a second chance for a taxpayer to convince a neutral third party that he or she has a valid argument against the IRS, but it is difficult for any taxpayer to believe that an IRS employee will be more swayed by his or her argument than by his or her employer's argument.⁵⁵

While the mediation programs have definite room for improvement, post-appeal arbitration is in the worst position of the IRS's various dispute resolution options. Critics of the program recognize that, under the current process, there is very little incentive for taxpayers to elect post-appeal

50. See Robinson, *supra* note 19, at 20. This is explicitly stated in IRS revenue procedures, which clearly indicate a lack of restrictions upon intra-appeals communications. *Id.*

51. *See id.*

52. *See supra* notes 34–35, 46–57 and accompanying text.

53. See Parr, *supra* note 6. Even though it is possible for the taxpayer to bring in an outside mediator, he or she must bear the costs, which makes it an unprofitable and highly discouraging option for a taxpayer who is trying to save the money he denies is owed to the IRS. *Id.*

54. *See id.*

55. Mathews, *supra* note 4, at 728. Mediation also represents a chance for the taxpayer to discover holes in his argument in advance of litigation, convincing him to settle beforehand. *Id.* However, he clearly may be concerned that an IRS mediator's perspective could be biased. *See id.* at 729–30.

arbitration—and it is frequently not even attempted.⁵⁶ Similar to the mediation programs' method of selecting mediators, both IRS and non-IRS officials may be chosen as arbitrators.⁵⁷ Yet if the arbitrator is a non-IRS official, then the parties must share costs, which means that an IRS appeals officer is likely to be the arbitrator by default.⁵⁸ The problem with this is that, unlike commercial arbitration, there are no assurances of arbitrator independence.⁵⁹ In fact, the Appeals Office is even allowed to bring in other appeals officers or IRS chief counsel attorneys to participate in the arbitration, creating even more doubt for the taxpayer that the process will be independent and confidential.⁶⁰ Additionally, should the taxpayer actually attempt to elect post-appeal arbitration, the program is completely optional and must be agreed upon by both sides, so there is no guarantee that the IRS will agree to arbitrate in the first place.⁶¹ Should the IRS refuse, there is no system in place to appeal the refusal, providing even less incentive for the taxpayer to make the attempt.⁶²

V. DEFENSE OF THE CURRENT APPEALS SYSTEMS

Advocates of the present ADR programs at the Appeals Office typically emphasize the position shared by the IRS itself: that the primary focus of the Appeals Office is negotiation rather than mediation or arbitration.⁶³ As a result, its programs are designed with a purposely narrow scope and application so that they can supplement, rather than replace, the existing negotiation process.⁶⁴ Further, there are concerns that non-IRS mediators

56. See Stephen Joyce, *Officials Urge Taxpayers to Use Alternative Dispute Resolution Tools*, 105 DAILY TAX REPORT G-3 (June 1, 2007). The IRS acknowledged that although the program was instituted in 2000, only fourteen taxpayers had actually requested post-appeal arbitration as of 2007. *Id.* Furthermore, of those fourteen, only one taxpayer's case had actually been resolved as a result. *Id.*

57. See Parsly, *supra* note 12, at 711–12.

58. See *id.* at 711–12.

59. Robinson, *supra* note 19, at 22.

60. *Id.* at 22.

61. See Parsly, *supra* note 12, at 711.

62. *Id.* A taxpayer may request a conference in order to discuss the denial with the Appeals Office, but there are no regulations or standards under which the office is required to reconsider. *Id.*

63. See Mathews, *supra* note 4, at 714. This belief is partially justified by the high rate of success the IRS has with negotiations, but understates the value that mediation and arbitration offer as equally valid alternatives. See Wei, *supra* note 13, at 551–52.

64. Mathews, *supra* note 4, at 716.

would be unfamiliar with tax law and that the lack of expertise would offset the value of their mediation experience.⁶⁵

The argument in favor of the present FTM procedure emphasizes that the program is a promising development that will slowly expand as the IRS works towards improving its efficiency and fairness.⁶⁶ While recognizing that the IRS has significant room for improvement in its mediation protocol, defenders of the program see it not as a final product, but as a good foundation, noting that in 2002 the program was made a permanent and more accessible part of the appeals process.⁶⁷ The success of its limited trial programs is an encouraging sign that the IRS will further expand mediation as a viable alternative, but this can only happen once the IRS overcomes its reluctance to expand from its existing negotiations programs.⁶⁸

Furthermore, promoters of the FTS program recognize that, although it may be ineffective in assisting taxpayers to actually avoid a judgment, it is at least moderately successful as a way of coming to a quickly expedited agreement with the IRS.⁶⁹ While average audit cases take almost two years to move through the appeals process, successful FTS cases resolve in considerably less time, saving both parties time and money regardless of the amount the case settles for.⁷⁰ The FTS program routinely settles cases even faster than its stated goal of resolving cases in 120 days, indicating that the program is both quick and efficient despite its procedural shortcomings.⁷¹

The program proved sufficiently successful by the IRS's standards, such that it was expanded to small businesses and to tax exempt or governmental entities in 2008.⁷² However, while it is clear that FTS is a moderate success in spite of its procedural shortcomings, the program can become an even greater success by addressing its problems and by becoming more procedurally efficient. Therefore, it is important to do this early on, before

65. Wei, *supra* note 13, at 567. However, some state agencies have had success with outside mediators by placing strict requirements such as classroom training, a minimum number of observations or co-mediators with experienced IRS mediators, and a degree from an accredited college. *Id.* In order to even qualify for mediation of a topic outside of their expertise, more extensive training is further required. *Id.* This seems to greatly reduce the concern that only appeals officers are qualified to mediate tax issues.

66. Mathews, *supra* note 4, at 728.

67. *Id.* at 720. Specifically, eligibility requirements for access to the program were significantly reduced, with an amount in controversy requirement being completely abolished. *Id.*

68. *See id.* at 721.

69. *See* Robinson, *supra* note 19, at 20.

70. *Id.* at 21. IRS officials note that FTS cases typically resolve in an average of only seventy-nine days, compared to typical results of over 600 days for complex audit cases subjected to negotiations. *Id.*

71. *See id.* at 20.

72. *Id.* at 21.

subsequent programs pattern themselves on the same approach, so that the steps taken by the IRS to expand its mediation system are as effective as possible.

Although recognizing that the IRS's post-appeal arbitration program is flawed when compared to both negotiation and mediation, defenders of the IRS's arbitration program believe that it still offers significant advantages over litigation.⁷³ Namely, it provides an average taxpayer with a setting in which to present his case that is more relaxed, but still formal and structured.⁷⁴ The program is emphasized as a "last resort" after negotiations and mediation have failed to settle the dispute.⁷⁵ Under this interpretation, the fact that it is rarely elected may be an intentional outcome, because the goal of the Appeals Office is to resolve cases before they ever reach the point where arbitration becomes necessary.⁷⁶

VI. A CASE FOR POSSIBLE REFORMS OF THE APPEALS SYSTEMS

The first possible reform of the current Appeals Office's alternative dispute resolution process is to mandate mediation. This is one of the first places where reform of the dispute resolution procedure should begin, as mediation's benefits are such that it should be placed as early in the appeals process as possible. Mediation is recognized as particularly well-suited to tax disputes because it allows for flexible outcomes and greatly decreases transaction costs if successful; this means that even settling for an amount less than the full amount in controversy is more profitable than receiving the full amount after costly litigation.⁷⁷ In addition, it is clear that there is both political and public support for mediation as a viable method of resolving tax disputes, making it an excellent time to consider mediation as an alternative option rather than merely a secondary approach to negotiation.⁷⁸

73. Mathews, *supra* note 4, at 731–32.

74. See Parsly, *supra* note 12, at 713–14.

75. *Id.* at 714.

76. *Id.* Because post-appeal arbitration is rarely ever elected, this is taken as validating this belief in practice. *Id.* However, it is unclear whether the rare usage of the program is a result of intentional design or is an unexpected consequence of the program's lack of incentives for taxpayers to elect it in the first place. See *supra* notes 56–62 and accompanying text.

77. Leonora Meyercord, *Avoiding State Bankruptcy: Mediation as an Alternative to Resolving State Tax Disputes*, 29 REV. LITIG. 925, 931 (2010).

78. See *id.* at 934–35. The ADRA is a clear indication that the trend in Congress is to further encourage ADR procedures. See Parsly, *supra* note 12, at 679. This is reinforced by the IRS's tentative but promising attempts to expand and formalize its mediation programs. *Id.*

With more and more agencies and courts adopting mediation as a regular facet of their dispute resolution procedures, there is little reason for it to be merely a second choice at the IRS, and requiring it at the outset as a precursor to negotiations could lead to a beneficial result much earlier in the appeals process.⁷⁹ In many state courts, mediation as a form of dispute resolution is not only strongly encouraged, but is often a required pre-litigation consideration by the parties.⁸⁰ This is true even though the parties in such cases do not necessarily have to settle or accept the outcome of their mediation.⁸¹ In some approaches, initial participation in the mediation process is a condition precedent to even advancing onward to litigation at all.⁸²

Because mediation remains essentially voluntary, both the courts' interest in efficient, less expensive resolutions and the power of parties to resolve their disputes in the manner they see fit are still respected and advanced.⁸³ Putting mediation at the forefront of the appeals process and requiring the parties to at least attempt mediation benefit both the IRS and the taxpayer sooner, by giving them an option to attempt resolving their dispute before continuing on to the appeals process, rather than leaving them to go through the negotiation process first.⁸⁴

A second suggested reform of the Appeals Office's alternative dispute resolution procedures is making it more independent. Although all evidence indicates that appeals officers are professionals who strive to remain independent and impartial—despite being on the IRS payroll—the Appeals Office has been rightfully criticized for fostering at least the appearance of partiality.⁸⁵ Though not always a rational or even realistic belief, it is easy to understand why a taxpayer might believe that an IRS agent acting as a

79. Welsh, *supra* note 2, at 397.

80. Jacqueline Nolan-Haley, *Mediation Exceptionality*, 78 *FORDHAM L. REV.* 1247, 1247 (2009). *See also* 28 U.S.C. § 652(a) (2006) (requiring litigants to at least consider the use of alternative dispute resolution processes and permitting district courts to require their use in appropriate cases).

81. Nolan-Haley, *supra* note 80, at 1254. This approach has also been explicitly allowed by Congress for labor disputes, where the Railway Labor Act codified mediation as the primary method of resolving disputes and required initial attendance of both parties at mediations. Wei, *supra* note 11, at 565–66.

82. Nolan-Haley, *supra* note 80, at 1253.

83. Dr. iur. Ulrich Boettger, *Efficiency Versus Party Empowerment—Against a Good-Faith Requirement in Mandatory Mediation*, 23 *REV. LITIG.* 1, 10–11 (2004).

84. Although the IRS is experimenting with early mediation through the FTM and FTS programs, the problem is that entry into both programs remains optional and is easily terminated. *See id.* at 5–7. Rather than requiring the parties to at least consider mediation at the outset, using these programs is completely optional, which means many cases that could benefit from early mediation do not. *See* Robinson, *supra* note 19, at 19–20.

85. Parr, *supra* note 6.

mediator is inherently biased in favor of his or her employer. Yet under the present system, it is unfortunately often difficult for taxpayers to justify bringing in an independent mediator because the default position of the IRS is to use their own appeals officers.⁸⁶ In order to convince taxpayers that mediation is in their best interest, it is necessary to take steps to convince them that their mediator will act as an impartial third party rather than as an IRS agent.

For example, one solution proposed by scholars is the creation of a new unit, tentatively titled the “ADR Center,” which would be distinct from the Appeals Office with its own staff acting as mediators and arbitrators.⁸⁷ This would bring the IRS closer in line to the dispute resolution programs available under other federal agencies, which provide for outside third party mediators rather than agency employees.⁸⁸ Furthermore, this would also bring IRS dispute resolution more in line with commercial dispute resolution procedure, which emphasizes not only the reality but also the perception of impartiality as being equally necessary for dispute resolution to be effective.⁸⁹ It is vital for the IRS to take steps to both provide impartiality and to convince taxpayers that it exists—and this simply cannot be accomplished by continuing to utilize in-house employees on the payroll of only one party in the dispute.

The third reform for the Appeals Office’s alternative dispute resolution programs is updating the arbitration process to better match the standards of commercial arbitration. Although arbitration reform may be seen as less urgent than mediation reform due to its placement at the end of the appeals process—when both parties have already established their positions before trial—it is still worth developing because it is a highly preferable alternative

86. See Wei, *supra* note 13, at 567. This is particularly true of post-appeals mediation because, in order to bring in an outside mediator, the taxpayer must bear the mediator’s full fee and expenses rather than split the costs between both parties. Parr, *supra* note 6. Additionally, even if the outside mediator is brought in, he is required to co-mediate with an IRS mediator under circumstances in which each party only trusts “its” mediator to be on its side. *Id.*

87. John Klotsche, *Jousting with the Tax Man: ADR at the IRS, Part II*, TAX.COM (Sept. 14, 2009), <http://www.tax.com/taxcom/features.nsf/Articles/BF3113A27C566E3D8525762E0060948D>. The proposal recognizes that taxpayers are unlikely to see IRS appeals offices as independent third parties, despite the officers’ training as such. *Id.*

88. *Id.*

89. *Id.* However, it would be difficult for the Appeals Office to achieve genuine independence with its current staff and structure. *Id.* Thus, the concept of a separate ADR Center working together with the Appeals Office is ideal because it would provide experienced mediators who are well-versed with the tax process, but without having to put appeals employees in the middle of disputes between Appeals and the taxpayer. *Id.*

to litigation should the other processes fail.⁹⁰ Even if a majority of cases settle before that point, a well-established and efficient arbitration program may mean the difference between settling the remainder of cases that reach that point or going onward to the expense of litigation.

The Appeals Office's current arbitration procedure has little in common with modern arbitration methods either in commercial settings or even in other IRS arbitration programs. In commercial arbitration, arbitrators must be impartial and satisfy strict standards in order to ensure both sides are satisfied that the arbitrator is a neutral party.⁹¹ In fact, this strictly enforced independence is typically one of the primary motivations that compel parties in commercial settings to use arbitration in the first place: because the opposing sides are more willing to settle their dispute in arbitration because they believe the forum is a neutral setting where they each have a fair chance of obtaining what they want.⁹² In order to compel the parties to make a good faith effort to work out their dispute, commercial arbitrators commonly employ "last offer arbitration"—otherwise known as "baseball arbitration"—to lead both parties towards a mutually acceptable settlement amount.⁹³ This technique requires each party to state its best offer for the award amount. The arbitrator is empowered only to select one offer or the other.⁹⁴ As a result, it is in the best interest of both parties to determine what they honestly believe to be a reasonable offer; if one side is too extreme, then that side runs the risk of the other party's number being chosen instead.⁹⁵ Though not perfectly applicable to tax disputes, this demonstrates the flexibility that arbitration can still bring to the appeals process. It would make an excellent starting point for the IRS in considering alternative methods, which settle otherwise irreconcilable disputes before the parties run the risk of taking the last step towards even more time consuming and expensive litigation.

Another important principle of commercial arbitration that the Appeals Office should consider adopting is an emphasis on the impartiality of arbitrators. In international commercial arbitration, the procedures specifically mandate that any potential arbitrator act impartially according to a list of recognized standards and rules of practice.⁹⁶ There are no similar

90. MARGARET L. MOSES, *THE PRINCIPLES AND PRACTICE OF INTERNATIONAL COMMERCIAL ARBITRATION* 4 (2008).

91. See Klotsche, *supra* note 87.

92. See MOSES, *supra* note 90, at 3.

93. *Id.* at 15.

94. *Id.*

95. *Id.*

96. *International Dispute Resolution Procedures*, AMERICAN ARBITRATION ASSOCIATION (June 1, 2010), <http://www.adr.org/sp.asp?id=33994>.

assurances under IRS procedures that an appeals arbitrator's independence is ensured by such specific guidelines, and in the absence of any serious restrictions on the partiality of an appeals arbitrator, taxpayers seemingly are not convinced that the program is in their best interests.⁹⁷ By taking similar steps to commercial arbitration procedures, to assure taxpayers that they truly are being heard by a neutral arbitrator, the Appeals Office may be able to foster the taxpayer confidence necessary for arbitration to be a successful, viable dispute resolution alternative and encourage disputants to pursue it when appeals reach that point.

However, it is noteworthy that not only is appeals arbitration different from what is successfully practiced in commercial settings, but the system is also markedly different from the methods otherwise utilized by the IRS. This is because its arbitration is an optional choice at the end of the appeals process, rather than mandatory like in other IRS programs.⁹⁸ For example, under its international income tax treaties with other countries, mandatory arbitration is allowed for the specific purpose of supplementing the negotiation process.⁹⁹ In order to carry out mandatory arbitration, the IRS partnered with the International Center for Dispute Resolution (ICDR), a non-profit public service organization which agreed to provide administrative services.¹⁰⁰ Rather than using IRS employees as arbitrators, through their partnership agreement, the ICDR is able to independently select potential arbitrators with relevant tax and arbitration experience.¹⁰¹ The Appeals Office may well be able to benefit from a similar partnership in order to provide mandatory arbitration at the end of the appeals process, further reducing the amount of tax disputes that actually go all the way to trial.

While mediation is the first and foremost topic of reform that the Appeals Office should look at, it is clear that there are also numerous ways that its arbitration program can be refined and modernized by examining

97. See *supra* notes 59–62 and accompanying text (suggesting that without assurances of independent and impartial arbitrators that there is little incentive for taxpayers to attempt arbitration).

98. Compare I.R.S. Announcement 2011-4 I.R.B. 433 (limiting arbitration and mediation to an optional election that may be requested only after consulting with the other party and getting them to concur), with *Mandatory Tax Treaty Arbitration*, INTERNAL REVENUE SERVICE (Dec. 10, 2008), <http://www.irs.gov/Businesses/International-Businesses/Mandatory-Tax-Treaty-Arbitration> (requiring mandatory arbitration as a supplement to the standard negotiation process).

99. See *Mandatory Tax Treaty Arbitration*, *supra* note 98.

100. *Id.* Services rendered include training, selection of neutral arbitrators, case management, and institutional experience and expertise in the field. *Id.*

101. *Id.*

how successful arbitration programs are run elsewhere. By reforming the process for post-appeal arbitration to better resemble these more successful commercial and international arbitration institutions, arbitration may be converted from an inferior “last resort” to a more viable alternative or effective safety net should mediation and negotiation fail.

VII. THE POTENTIAL IMPACT OF IMPLEMENTING MEDIATION AND ARBITRATION REFORMS IN THE IRS APPEALS PROCESS

It is important to stress that this article does not propose that the IRS should elevate alternative dispute resolution procedures to a higher status than the existing negotiation process, but instead suggests that the appeals office should integrate mediation and arbitration in ways that complement the negotiations procedure. Dispute resolution processes should serve as “bookends” that potentially settle disputes either before or after they go through the negotiation process.¹⁰² The success of the existing negotiation process cannot be questioned, but the IRS can further improve the process through better use of mediation and arbitration.¹⁰³ There are several possible benefits that both the IRS and taxpayers may expect from these reforms.

The first impact from mediation and arbitration reforms—perhaps even the primary impact—would be offering a significant financial benefit to both the IRS and taxpayers. Integrating alternative dispute resolution into the appeals process would allow the IRS to manage its costs and allocate its resources more effectively, allowing the Service to not only settle more disputes without reaching litigation, but also to more efficiently prepare for the smaller number of cases which are not settled by the appeals office.¹⁰⁴ This increased flexibility would also benefit taxpayers by providing them with a faster and more reliable way to equitably settle their disputes in comparison to litigation, which is recognized as “costly, time-consuming, unpredictable, and . . . a last-resort remedial option.”¹⁰⁵ Finally, a less

102. See *supra* notes 77–79 and accompanying text (noting that mediation is particularly well-suited to settling tax disputes and should be equal in status to negotiations as a viable alternative dispute resolution option).

103. See *supra* notes 15, 63 and accompanying text (recognizing that the IRS relies on negotiations as its primary focus due to its high rate of success but arguing that arbitration and mediation are capable of equivalent levels of success).

104. See, e.g., John Klotsche, *Jousting with the Tax Man, Part 1, Section III.A.*, TAX.COM (Sept. 14, 2009), <http://www.tax.com/taxcom/features.nsf/Articles/C844618C8C5792968525762E0063E693>. Recognized benefits to the IRS include the ability to reduce the total cost and labor currently devoted to conflicts rather than to negotiation, as well as the option to craft more flexible results and terms than are possible under the current system. *Id.*

105. *Id.*

obvious benefit to the IRS is that, by improving the mediation and arbitration procedures utilized by the Appeals Office, the agency will also create a more “resolution-focused atmosphere” where the quality of each settlement reached would improve with experience.¹⁰⁶ Such an atmosphere could lead to more cases being settled through arbitration and mediation, resulting in greater financial benefit for the IRS as more cases are settled quickly for amounts that are satisfactory to both parties.¹⁰⁷

In addition, a second promising outcome of alternative dispute resolution reform is that it could significantly bolster the IRS’s public relations efforts, while improving the Appeals Office’s legitimacy in the eyes of taxpayers. The IRS has a vested interest in improving its public relations because improving the way taxpayers look at the tax system has a direct relationship in how willingly they submit both to taxation itself and to participation in dispute resolution related to taxation.¹⁰⁸ Increased willingness to engage in open dispute resolution with a neutral third party acting as the arbitrator or mediator, rather than an IRS employee whose interests are seen as closer to the Service than to the taxpayer, would greatly improve the outlook that the taxpayer takes away from the experience.¹⁰⁹ However, the potential benefits from such an improvement would extend beyond merely improving the Service’s reputation. In order to have a successful taxation system, it is vital for the IRS to have “an effective grievance handling system” for dealing with unsatisfied taxpayers when conflicts arise.¹¹⁰ Developing the idea that the IRS is open to settlement through arbitration and mediation is in the Service’s best interest: a system that taxpayers trust to ensure a fair and equitable outcome results in increased confidence that resolution will be possible outside of court.¹¹¹ The Appeals Office already enjoys a high success rate, thanks to its well-

106. Mathews, *supra* note 4, at 734–35. This atmosphere would be the result of most disputes going through the various ADR processes, creating a perception that almost all disputes could be settled without litigation. *Id.*

107. *See id.* at 735.

108. *See* Wei, *supra* note 13, at 549.

109. *See supra* notes 46–49 and accompanying text (stating that mediators in the current appeals mediation programs typically must be IRS employees, and that this system prevents the taxpayer from believing that the mediator is a truly neutral third party).

110. Wei, *supra* note 13, at 549. The IRS National Director of Appeals has gone as far as suggesting that improved alternative dispute resolution is essential to creating an effective system that handles grievances and promotes voluntary participation by taxpayers. *Id.* at 549–50.

111. Mathews, *supra* note 4, at 736.

established negotiations process,¹¹² but providing more well-rounded procedures to cater to taxpayer needs can only further improve its public image. Further bolstering the image of the Appeals Office as a legitimate outlet for dispute resolution where settlement is not only possible, but almost a certainty—even if negotiations fall through—could have the direct result of convincing more taxpayers that it is in their best interest to comply with the appeals process and to consistently avoid the expense of possible litigation.¹¹³

As a result of improving the public's perception of the Appeals Office, the third outcome is creating greater incentive for taxpayers to participate in the appeals process in the first place. One of the biggest issues that scholars recognize with the current mediation and arbitration programs is a lack of taxpayer participation.¹¹⁴ However, this reluctance is unsurprising, because under the current system there is relatively little reason for taxpayers to believe that submitting to arbitration or mediation is in their best interests.¹¹⁵ The current mediation system offered by the Appeals Office is regarded as “designed solely to protect the IRS from wily taxpayers” and does little to encourage trust on the part of the taxpayer who must submit to it.¹¹⁶ This runs contrary to one of the main advantages of both arbitration and mediation, which is the ability for the parties to settle their dispute in a neutral forum where neither side believes the other has a “home court advantage.”¹¹⁷ In fact, this promise of a neutral forum has been recognized as one of the primary reasons that commercial arbitration is so desirable: it encourages disputants to take part in a settlement process where they are confident that they will receive a fair hearing and an equitable outcome.¹¹⁸

While the accomplishments of the Appeals Office and its negotiation procedures are an impressive testament to the IRS's history of resolving disputes without litigation, the success of appeals in one approach should not prevent Appeals from exploring other avenues that may be promising as

112. See *supra* notes 9, 63 and accompanying text (suggesting that the success of the appeals office's traditional negotiations approach led to reluctance in applying arbitration and mediation programs as serious alternatives).

113. See Mathews, *supra* note 4, at 736–37. This outcome is especially probable because favorably resolved mediations have already been recognized as demonstratively improving the outlook of participants and reducing the odds of subsequent conflicts. See Klotsche, *supra* note 87. This is true for both commercial and federal entities, which extensively utilize ADR. *Id.*

114. Parsly, *supra* note 12, at 707. Taxpayers' reluctance to participate was seen as “perplexing” because, in light of the daunting number of cases pending in the appeals system each year, the actual number of cases submitted for mediation was comparatively insignificant. *Id.*

115. See *supra* notes 9–11 and accompanying text.

116. Parr, *supra* note 6.

117. MOSES, *supra* note 89, at 1.

118. *Id.* at 1–3.

equal and valid alternatives to negotiation. Reforming its arbitration and mediation programs has the potential to greatly improve the image and reputation of the IRS Appeals Office, while also securing considerable financial benefits to both the Service and to taxpayers. Based on the success of mediation and arbitration in commercial contexts, as well as the success of the Service's limited experiments with mediation, it is reasonable to believe that the two programs will flourish if given the chance. They should be vigorously pursued by the Appeals Office going forward.

VIII. CONCLUSION

Since its founding over eighty-four years ago, the IRS Appeals Office has been one of the nation's earliest dispute resolution entities, and it offers a successful alternative to costly litigation through its well-established negotiations procedures. Despite having proven that alternative dispute resolution of tax disputes can be efficient and fair to both parties, the Appeals Office has been understandably reluctant to expand its already successful program to encompass arbitration and mediation as well, out of concern that it may take away from the success they have had with negotiations. However, while the present negotiations procedure is a viable and enduring institution, there is ample incentive for the IRS to embrace both mediation and arbitration as alternatives to the traditional negotiations process.

Both the IRS and taxpayers would greatly benefit from increased availability of refined mediation and arbitration programs, which save both parties more time and money when utilized together than negotiations do alone. By taking steps to convince taxpayers that their mediators and arbitrators are independent, neutral third parties who will reliably help them reach fair outcomes, the appeals process as a whole benefits by leading to shorter appeals processes, more settlements, and reduced costs to all parties while still achieving an equitable result.