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ADMINISTRATIVE APPEAL RIGHTS: Amend Internal Revenue Code Section 7803(a) to Provide Taxpayers With a Legally Enforceable Administrative Appeal Right Within the IRS Unless Specifically Barred by Regulations

TAXPAYER RIGHTS IMPACTED¹

- *The Right to Challenge the IRS's Position and Be Heard*
- *The Right to Appeal an IRS Decision in an Independent Forum*
- *The Right to a Fair and Just Tax System*

PROBLEM

Congress has long understood the importance of an independent Appeals function within the IRS as a means of facilitating case resolutions and minimizing litigation, which is burdensome to both taxpayers and the government. Accordingly, Congress mandated the creation of the IRS Office of Appeals (Appeals) as an independent function within the IRS as part of the IRS Restructuring and Reform Act of 1998 (RRA 98).² As explained by Senator William Roth:

One of the major concerns we've listened to throughout our oversight initiative—a theme that repeated itself over and over again—was that the taxpayers who get caught in the IRS hall of mirrors have no place to turn that is truly independent and structured to represent their concerns. With this legislation, we require the agency to establish an independent Office of Appeals—one that may not be influenced by tax collection employees or auditors.³

Appeals subsequently adopted this charge as its guiding principle: “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.”⁴ Appeals, however, is unable to perform its intended role when its jurisdiction is curtailed by various means, such as precipitous issuance of statutory notices of deficiency (SNOD) or the use of the “sound tax administration” rationale as a reason for bypassing Appeals.⁵ The National Taxpayer Advocate has repeatedly warned against depriving taxpayers of their *right to appeal an IRS decision in an independent forum*, a right that was adopted by the IRS in 2014 and reaffirmed by Congress in 2015.⁶ Circumventing Appeals causes the IRS to waste resources and taxpayers to incur needless expense, delay, and uncertainty, all of which undermine sound tax administration.

1 See Taxpayer Bill of Rights (TBOR), www.TaxpayerAdvocate.irs.gov/taxpayer-rights. The rights contained in the TBOR are also codified in the Internal Revenue Code (IRC). See IRC § 7803(a)(3).

2 Pub. L. No. 105-206, § 1001(a)(4), 112 Stat. 685, 689 (1998).

3 144 CONG. REC. S7622 (July 8, 1998) (Statement of Sen. Roth).

4 Internal Revenue Manual (IRM) 8.1.1.1(1), *Accomplishing the Appeals Mission* (Oct. 1, 2016).

5 National Taxpayer Advocate Fiscal Year (FY) 2016 Objectives Report to Congress 66-69. Certain IRS officials have the power to determine “that a docketed case or issue will not be referred to Appeals.” Rev. Proc. 2016-22, § 3.03, 2016-15 I.R.B. 577, 578.

6 IRS News Release IR-2014-72 (June 10, 2014); IRC § 7803(a)(3)(E). See National Taxpayer Advocate FY 2019 Objectives Report to Congress 140-141; National Taxpayer Advocate FY 2016 Objectives Report to Congress 66-69; National Taxpayer Advocate 2015 Annual Report to Congress 376-382.

EXAMPLE

Taxpayer, a diversified business, enters into a transaction that the IRS believes to be suspiciously similar to a type of transaction it has previously identified as a tax shelter. As a result, the IRS asserts large deficiencies and penalties against Taxpayer. Thereafter, Taxpayer files a protest with Appeals, arguing that the transaction in question is fundamentally different from the tax shelter transaction with which the IRS is attempting to equate it. Further, Taxpayer contends that, in addition to being distinguishable from a tax shelter, the transaction in question has a legitimate business purpose, and should not generate either tax deficiencies or penalties.

The Office of Chief Counsel, however, unilaterally decides that Taxpayer should not have the opportunity to raise these arguments at Appeals. Instead, Counsel determines that the case should proceed directly to litigation on the basis of “sound tax administration.” As a result, Taxpayer is unable to present its arguments to an independent third party within the IRS and is prevented from seeking the administrative case resolution it believes could have been achieved. Instead, Taxpayer is forced to pursue its case in court, as a matter of public record, incurring substantial cost, delay, and ill-will for the IRS along the way.

RECOMMENDATIONS

The National Taxpayer Advocate recommends that Congress amend § 7803(a) to establish an independent Office of Appeals and grant taxpayers the right to a prompt administrative appeal within the IRS that provides an impartial review of all compliance actions and an explanation of the Appeals decision, except where the Secretary has determined, pursuant to regulations, that an appeal is not available, including on the basis of designation for litigation or adoption of a frivolous position. Where an appeal is not available, the Secretary shall furnish taxpayers with the procedures for protesting to the Commissioner the decision to bar an appeal in these circumstances.

PRESENT LAW

Since 1955, the IRS’s Statement of Procedural Rules has provided that taxpayers have the right to an administrative appeal.⁷ However, courts have held that the IRS is not bound by its own procedural rules.⁸ In addition, Rev. Proc. 87-24 clarified that certain IRS officials could “determine that a case, or an issue or issues in a case, should not be considered by Appeals.”⁹ Specifically, cases or issues can be designated for litigation if they “present recurring, significant legal issues affecting large numbers of taxpayers. When there is a critical need for enforcement activity with respect to such issues, cases are designated for litigation in the interest of sound tax administration to establish judicial precedent,

7 20 Fed. Reg. 4621, 4626 (June 30, 1955) (codified at 26 C.F.R. § 601.106(b), which provided that if the IRS “has issued a preliminary or ‘30-day letter’” and the taxpayer has filed a timely protest, “the taxpayer has the right (and will be so advised by the district director) of administrative appeal.”). The situations in which a taxpayer may request an appeal are now at 26 C.F.R. § 601.106(b)(3).

8 See *Ward v. Comm’r*, 784 F.2d 1424, 1430-31 (9th Cir. 1986); *Estate of Weiss v. Comm’r*, T.C. Memo. 2005-284. *But see*, *Richardson v. Joslin*, 501 F.3d 415, 418 (5th Cir. 2007) (“[A]n agency must abide by its own regulations.”) (citing *Accardi v. Shaughnessy*, 347 U.S. 260 (1954)); *United States v. Heffner*, 420 F.2d 809 (4th Cir. 1969) (IRS bound by instructions given to Special Agents); *Rauenhorst v. Comm’r*, 119 T.C. 157 (2002) (IRS bound by revenue rulings).

9 Rev. Proc. 87-24, 1987-1 C.B. 720, *superseded by* Rev. Proc. 2016-22, 2016-15 I.R.B. 577. The superseding Revenue Procedure clarifies and elaborates on Rev. Proc. 87-24, stating, among other things, that Division Counsel or a higher level Counsel can determine that referral to Appeals is not in the interest of sound tax administration.

conserve resources, or reduce litigation costs for the Service and taxpayers.”¹⁰ Typically, the decision of whether or not to designate a given case or issue for litigation requires consultation and approval of a range of parties.¹¹ Depending upon the procedural posture of the case or issue, these parties can include the operating division with jurisdiction, Chief Counsel, and the Chief of Appeals.¹²

Subsequently, RRA 98 granted taxpayers the statutory right to an administrative appeal in certain circumstances.¹³ In particular, these circumstances involve Collection Due Process cases and offers-in-compromise.¹⁴ Even in these instances, however, no right to appeal exists in the case of a frivolous position adopted by a taxpayer.¹⁵

In late 2015, the IRS requested public comments on procedures that would deny taxpayers the right to go to Appeals if the “referral is not in the interest of sound tax administration,” even in cases not designated for litigation.¹⁶ The American Bar Association Section of Taxation suggested that the IRS “elaborate and clarify the limited circumstances in which docketed cases will be ineligible to be returned to Appeals due to ‘sound tax administration.’”¹⁷ However, the IRS finalized these procedures as Rev. Proc. 2016-22 without addressing this comment. The IRS did not explain why it declined to elaborate on or clarify this standard, which, at least at this point, appears to be both vague and open-ended.¹⁸

At the National Taxpayer Advocate’s urging, the IRS adopted the Taxpayer Bill of Rights (TBOR) in 2014 and incorporated it into Publication 1, *Your Rights as a Taxpayer*.¹⁹ The TBOR was subsequently enacted by Congress in 2015 and was codified as IRC § 7803(a)(3), which states that the “Commissioner shall ensure that employees of the Internal Revenue Service are familiar with and act in accord with taxpayer rights as afforded by other provisions of this title, including— ... the right to appeal a decision of the Internal Revenue Service in an independent forum.”²⁰ As further elaborated

10 Chief Counsel Directives Manual (CCDM) 33.3.6.1(1), *Purpose and Effect of Designating a Case for Litigation* (Aug. 11, 2004).

11 CCDM 33.3.6.1(3), *Purpose and Effect of Designating a Case for Litigation* (Aug. 11, 2004).

12 *Id.*

13 Pub. L. No. 105-206, §§ 1001(a)(4), 3401, 112 Stat. 685, 689, 746 (1998) (establishing Appeals as an independent function within the IRS, and granting taxpayers a statutory right to a hearing before Appeals in connection with liens and levies, codified at IRC §§ 6320(b)(1) (lien), 6330(b)(1) (levy)). RRA 98 § 3462 also directed the IRS to establish procedures for administrative appeals of IRS rejections of proposed installment agreements or offers-in-compromise under IRC §§ 6159 and 7122, respectively. In addition, other provisions assume that taxpayers have access to Appeals. See, e.g., IRC §§ 6015(c)(4)(B)(ii)(I), 7430(c)(2), 6621(c)(2)(A)(i).

14 Internal Revenue Service Restructuring and Reform Act of 1998 (RRA 98), Pub. L. No. 105-206, § 3462(c), 112 Stat. 685, 766 (1998). See IRC §§ 6330, 6159(e), and (f); 7122(e).

15 IRC § 6702(b)(2)(A); IRC § 7122(g); IRM 8.22.5.5.3, *Frivolous Issues* (Nov. 8, 2013).

16 Notice 2015-72, 2015-44 I.R.B. 613.

17 Letter from American Bar Association (ABA) Section of Taxation to Comm’r, IRS, Comments on Notice 2015-72 (Nov. 16, 2015), https://www.americanbar.org/groups/taxation/policy/policy_2015.html.

18 The IRS’s request for comments may suggest the IRS was seeking to increase the deference given to the final rule. However, the revenue procedure did not purport to establish “legislative” rules. If it had, the IRS would have been required to consider comments and provide a concise statement explaining the basis and purpose for a final rule under 5 U.S.C. § 553(c). The rule could have been challenged on the basis that the IRS did not address the comment and provide a reasoned explanation and that it was arbitrary and capricious under 5 U.S.C. § 706(2)(A). See, e.g., *Altera Corp. & Subs. v. Comm’r*, 145 T.C. 91, 130 (2015) (holding that a regulation was invalid because, in promulgating the regulation, the Treasury did not “adequately respond to commentators,” citing *Motor Vehicle Mfrs. Ass’n v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29 (1983) (requiring rules to be the product of reasoned decision-making)).

19 National Taxpayer Advocate 2013 Annual Report to Congress 5-19; National Taxpayer Advocate 2007 Annual Report to Congress 478-489; IRS News Release IR-2014-72 (June 10, 2014).

20 IRC §§ 7803(a)(3), (a)(3)(E).

in IRS Publication 1, which is a statutorily mandated publication, “Taxpayers are entitled to a fair and impartial administrative appeal of most IRS decisions, including many penalties...”²¹

The U.S. District Court for the Northern District of California recently weighed in on the scope of taxpayers’ right to an administrative appeal in *Facebook, Inc. v. IRS*.²² That case arose out of a five-year audit of Facebook by the IRS, in which the IRS interviewed Facebook employees, issued more than 200 requests for documents, and asked it to agree to five extensions of the statutory period of limitations. When Facebook declined to extend the period for a sixth time, the IRS issued a SNOD. Facebook filed a petition to the Tax Court and asked the IRS to transfer the case to Appeals. The IRS refused based on its view that doing so was “not in the interest of sound tax administration.”²³ Facebook responded by filing suit in District Court and arguing, among other things, that the IRS violated its “right to appeal a decision of the Internal Revenue Service in an independent forum,” under IRC § 7803(a)(3)(E).

The U.S. District Court for the Northern District of California granted the IRS’s motion to dismiss, holding that Facebook did not have an enforceable right to take its case to Appeals. The District Court reasoned that the IRS’s Statement of Procedural Rules did not create enforceable rights and neither did IRC § 7803(a)(3)(E). By its terms, IRC § 7803(a)(3) required the Commissioner to train employees and ensure they act in accord with rights granted under “other provisions.” Moreover, the District Court stated that even if IRC § 7803(a)(3) had created enforceable rights, it was not clear that the “right to appeal in an independent forum” refers to a right to take a case to IRS Appeals, as opposed to a federal court.²⁴

REASONS FOR CHANGE

The right to appeal a decision within the IRS is an indispensable element of fair and equitable tax administration. Such is the case because an appeal represents the final administrative opportunity to resolve a case without resort to litigation. Further, the Office of Appeals is the only IRS decision-making function that attempts to act independently of other agency determinations and to provide taxpayers with an unbiased forum for negotiating case settlements.²⁵

Access to Appeals is important for a variety of reasons, including Appeals’ ability to:

- Accept affidavits and weigh oral testimony;
- Consider hazards of litigation; and
- Apply the *Cohan* rule as a means of negotiating a case resolution.²⁶

21 IRS, Pub. 1, *Your Rights as a Taxpayer* (Sept. 2017); Pub. L. No. 100-647, § 6227(a), 102 Stat. 3342, 3731 (1988).

22 *Facebook, Inc. & Subs. v. IRS*, 2018-1 U.S.T.C. (CCH) ¶50,248 (N.D. Cal. 2018). For a more in-depth discussion of the *Facebook* decision, see the applicable analysis presented in the Significant Cases Summary, *infra*.

23 Rev. Proc. 2016-22, 2016-15 I.R.B. 577.

24 *But see* IRS, Pub. 1, *Your Rights as a Taxpayer* (Sept. 2017). “Taxpayers are entitled to a fair and impartial administrative appeal of most IRS decisions, including many penalties...” This language, which was the subject of in-depth discussion between the National Taxpayer Advocate and the IRS when Pub. 1 was revised to incorporate the TBOR, explicitly contemplates that the appeal right in question is intended to exist within the IRS, not just in the judicial realm. By law, Publication 1 is required to be sent to taxpayers at various stages of an ongoing dispute.

25 TAS also acts independently, but in keeping with its origins as an ombuds function, TAS does not make substantive case decisions.

26 The *Cohan* rule was developed under federal case law as a means of allowing the fact finder to estimate deductible expenses where the fact of those expenses, although not their amount, can be substantiated. See *Cohan v. Comm’r*, 39 F.2d 540 (2d Cir. 1930).

Currently, however, the IRS has the unilateral ability to deny this forum to any taxpayer on an *ad hoc* basis. Because taxpayers lack a legally enforceable right to an appeal, they are powerless to prevent the IRS from bypassing Appeals if it wishes to punish uncooperative behavior or to avoid settlement negotiations involving a particular taxpayer or issue. This unchecked and unreviewable power raises the specter of unfair and inequitable treatment of individual taxpayers or broader taxpayer groups.

In some very limited circumstances, curtailing taxpayer access to Appeals may indeed prove warranted. However, these situations should not be left to the IRS to determine on an *ad hoc* basis. Rather, they should be clearly laid out by statute so as to protect both taxpayers and the IRS.²⁷

Indeed, the IRS already has the ability to bypass Appeals in a number of situations, including when a taxpayer adopts a frivolous position or when the filing of a Collection Due Process hearing request reflects a desire to delay or impede the administration of the federal tax laws.²⁸ Likewise, Chief Counsel, subject to appropriate consultations and approvals, can designate broad categories of issues or cases for litigation. Accordingly, another such mechanism that is less well-defined and more open to individual discretion is not only unnecessary, but heightens risk of government overreach and jeopardizes taxpayer rights.

EXPLANATION OF RECOMMENDATIONS

The National Taxpayer Advocate recommends that Congress amend section 7803(a) to establish an independent Office of Appeals and grant taxpayers the right to a prompt administrative appeal within the IRS that provides an impartial review of all compliance actions and an explanation of the Appeals decision, except where the Secretary has determined, pursuant to regulations, that an appeal is not available, including on the basis of designation for litigation or adoption of a frivolous position. Where an appeal is not available, the Secretary shall furnish taxpayers with the procedures for protesting to the Commissioner the decision to bar an appeal in these circumstances.

This legislation would establish the presumption that taxpayers have the right to an appeal, subject only to narrowly defined and clearly articulated regulatory exceptions. Only where these exceptions exist would the IRS have the right to deny an appeal. However, the basis for such a denial must be explained to taxpayers and they would have the right to challenge this determination.

By adopting these recommendations, Congress would protect the viability of the Appeals process within the IRS. At long last, taxpayers would have a legally enforceable right to an administrative appeal, which is their last, and often best, opportunity to resolve a case within the IRS. By permitting this right to be circumscribed only when the Secretary has specified by regulations that an appeal is unavailable, Congress would ensure that any such limitations would be imposed solely when warranted and applied fairly across the overall taxpayer population.

²⁷ For example, a reasonable case can be made in support of a statutory provision barring appeals of positions determined to be frivolous within the meaning of IRC § 6702(c). Section 11101(a) of the Taxpayer First Act, H.R. 5444, (115th Cong.) (2018) proposes a similar but less sweeping recommendation than the one put forward by the National Taxpayer Advocate. That proposed legislation would amend IRC § 7803 to provide a more generalized right of administrative appeal that could be curtailed only with appropriate notice and explanation from the IRS Commissioner. Among other things, it also would specify that the rights created by the legislation did not extend to appeals of frivolous positions.

²⁸ IRM 8.11.8.2(1), *IRC 6702 – Frivolous Tax Submissions* (Oct. 28, 2013); IRM 8.22.5.5.3, *Frivolous Issues* (Nov. 8, 2013).