

Fast Track Settlement—On the Fast Track, but to Where? A Practical Guide to the Program

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The authors' first-hand experience with FTS demonstrates the usefulness of the program, particularly for a taxpayer facing an enormous potential penalty. It also discloses several flaws in the structure and operation of the program, especially in an era when there is a heavy emphasis on compliance at the Service's Examination level. The extent to which these problems may be timely resolved is an unknown.

Although the Service's Fast Track Settlement (FTS) program was adopted permanently in a Revenue Procedure issued more than two years ago, some practitioners are still not aware that FTS may be available to resolve taxpayer disputes with the IRS.

The importance of FTS, which is not widely used, is that it does not deny taxpayers any applicable Appeals rights—the case remains at the Examination level until final resolution under FTS or failure to reach a final resolution under that process and issuance of final adjustments. Therefore, even if a practitioner uses FTS and is unsuccessful in resolving the dispute, the practitioner can still request a hearing before Appeals or a conference with an IRS district manager. Cases within FTS are expected to be resolved within 120 days, with most settlements occurring between 70-120 days. Because of the expedited nature of FTS, if the process is successful taxpayers will save time, money, and likely stress.

ORIGINS OF THE PROGRAM

The Fast Track Dispute Resolution Pilot Program was created by Notice 2001-67, 2001-2 CB 544. It was originally designed to run for one year, but was eventually extended to run for 17 months. In IR-2003-44, 4/4/03, the Service stated its intentions to make the pilot program permanent.

The pilot program was a joint effort between the Large and Mid-Size Business Division (LMSB) and Appeals. It permitted Appeals to help resolve outstanding issues while cases remained within the jurisdiction of LMSB. The stated purpose of the program was to "expedite case resolution at the lowest level within the LMSB jurisdiction" and to determine whether the program "reduces cost and time" to the parties. The program was to accomplish these objectives by creating an opportunity for corporate taxpayers to obtain a meeting with Appeals through FTS, which was in addition to the regular appeals process. Thus, taxpayers with greater than \$10 million in assets, at

least one open year under examination, and one disputed item were able to benefit from the involvement of Appeals.¹

The Notice authorized two options through the pilot program, Fast Track Mediation (FTM) and FTS.² The greatest distinction between the two is that in FTS, the Appeals officer helps the Service and taxpayer to evaluate the hazards of litigation. Consequently, the Appeals officer can use settlement authority to help resolve the dispute. By providing the neutral Appeals officer with settlement authority, the goal is that the two sides eventually will work out their differences and arrive at a settlement. In contrast, under FTM there is no analysis of the hazards of litigation and the Appeals officer plays the role of mediator to help resolve factual differences.

Expansion of FTS

Even though in IR-2003-44 the Service stated its intentions to make the pilot program permanent and in Rev. Proc. 2003-40, 2003-1 CB 1044, the IRS detailed the requirements for admission into FTS, the Treasury reviewed the entire program in 2004. The audit of the program was undertaken to determine whether the program was being run properly, should be modified, or even terminated. The audit report stated that the purpose of the pilot program was to determine whether it was possible for the Appeals Division and LMSB to actually resolve the disputed tax issues with corporate taxpayers.³

The audit tracked the pilot program from November 2002 through June 2003 and showed that 142 taxpayers were admitted into the 17-month pilot program and approximately \$6.7 billion in disputed tax items were resolved within the 120-day period. Since the audit did not track how much time and money the process saved taxpayers or the Service, those figures were not available. Nevertheless, since it took an average of 6.6 years for LMSB as of fiscal year 2002 to resolve cases that went all the way up to Appeals, the savings to taxpayers in professional fees alone could be significant.

OPERATION OF THE FTS PROGRAM

The first step for a taxpayer is getting admitted to the FTS program. Once admitted, several steps should be taken to improve the taxpayer's chances of a favorable settlement.

Admission Process

Generally, any case within the LMSB Compliance jurisdiction is available for FTS. One important change wrought by Rev. Proc. 2003-40, which formally established FTS, is that participation is not limited to taxpayers within the LMSB jurisdiction. In certain situations, IRS operating divisions besides LMSB may participate. For example, if the Small Business/Self Employed (SBSE) manager agrees, then cases from SBSE Examination may be accepted into FTS.

While taxpayers can initiate participation in FTS by submitting an application, the IRS division manager also can initiate the process by inviting the taxpayer to participate. Similarly, either party can terminate the process once it has begun.

An application for entry into FTS must be submitted after issuance of the Form 5701 (the proposed adjustments) and before the first notice of deficiency has been issued. The application will not be accepted if the Fast Track program managers (Appeals and LMSB or SBSE Fast Track program managers) believe that the issues have not been sufficiently developed to permit a resolution to be reached during FTS.

Typically, applications for FTS will not be accepted for any case:

- (1) That has been designated for litigation.
- (2) That is under consideration for designation for litigation.
- (3) For which competent authority assistance has been requested.
- (4) For which resolution might result in inconsistent treatment to a taxpayer not a party to FTS.

Once an application has been denied entry into FTS, the decision is final and not subject to Appeals or judicial review.

Anyone considering FTS should carefully review Rev. Proc. 2003-40 for a detailed discussion on its applicability and availability. Although FTS has existed in some form since 2001, confusion remains within the Service as to what exactly is required. For example, we encountered an SBSE agent who incorrectly believed that the Fast Track program managers were unable to accept an application for entry into FTS without first issuing a judicial 30-day letter and without first assessing any assessable penalties (those not subject to the deficiency process). That is not so.

In order to reserve all Appeals rights, the FTS application should be submitted at least a year before the statute of limitations expires for the tax year in question. The one-year time period is not a requirement but rather a safe harbor since FTS is designed to be completed within 120 days and Appeals does not have to accept a case if there is less than 180 days before the statute will expire.⁴ When there is less than 180 days, the Appeals team manager will decide whether to accept the case into Appeals.⁵ Practitioners should feel comfortable initiating contact with the Fast Track program managers well in advance of the one-year safe harbor to determine whether (1) the managers believe that the case is proper for FTS and (2) the managers will provide guidance for resolution.

Steps to Take After Admission

What happens once the taxpayer's case is accepted into the FTS program?

Acceptance. Appeals will send the IRS division and the taxpayer notice as to whether the dispute has been accepted into FTS. If the case is accepted, Appeals will then send an

"introductory letter" outlining the process. Appeals will instruct the parties to keep an open mind and "be committed to give the process a chance." In order for FTS to be a success, this instruction should be enforced by the Commissioner. A structure should be in place so that Appeals can report on those who fail to adhere to the process.

Attached to the introductory letter is a sample Fast Track Session Report, which is used to "identify the issues and obtain agreement from all parties as to the number of issues, description of issues, amounts in dispute, and to develop a plan of action to be followed."

Taxpayer submission. We advised Appeals that we intended to submit a written response to the Form 5701 proposed adjustments prior to the FTS conference. We believed it was important for Appeals to have a clear understanding of the issues and for us to position the taxpayer in the best light. Part of this effort consisted of acknowledging those facts that were adverse to the taxpayer and summarizing the Service's (disjointed) case analysis. Our written submission resembled an appellate brief with numerous flowcharts and copies of each and every document referenced. We believe a similar submission by all taxpayers admitted to FTS is advisable to narrow the issues and focus the analysis.

Chronological history. In the days leading up to the FTS conference, Appeals will send the parties a "chronological history" of the transaction, to be used as a guide during the conference. Each party has an opportunity to request revisions to the document. This shortly thereafter is followed by "agenda questions," which challenges the positions taken by each party, and then by the actual agenda.

The importance of the agenda questions is that it foreshadows Appeals' position on certain issues, and gives each party a chance to either bolster an argument or make the decision to concede the point.

THE AUTHORS' EXPERIENCE

There are less than 150 individual taxpayer cases in FTS. One was our case, which involved (1) income tax, (2) gift tax, and (3) penalties for failure to file Forms 3520 and 3520-A as required by Section 6048.

Form 3520 is used to report contributions to and distributions from a foreign trust. Form 3520-A is an annual document used to report grantor trust status. While additional penalties related to income and gift tax also were at stake, the penalties imposed under Section 6677 for failure to file Forms 3520 and 3520-A were of greatest significance because of the absence of deficiency procedures and the size of the actual penalties. For example, the Code imposes penalties of \$10,000 for every 30 days that either form is not filed. To the extent that we were unable to resolve the penalty issue during FTS, the taxpayer would be assessed in excess of \$3.5 million.

The FTS conference was scheduled for two days. While we were instructed to expect a rather lengthy Day 1, Appeals was confident that we could complete the settlement in one day. Consistent therewith, the agenda Appeals prepared had the process finishing on the first day.

After clearing security at the IRS (do not carry a cell phone with picture capability or any type of weapon), we encountered a large rectangular table setup as we entered the conference room. The Service was represented by (1) Counsel, who assisted and advised Examination, (2) the Income Tax Examination agent, (3) a technical advisor on international matters, and (4) a group manager, who acted as IRS decision-maker for income and gift taxes. The group manager sat at the head of the table; all the rest of the IRS representatives sat on the same side of the table. No one from the Estate and Gift Tax division was physically present, as that group manager had ceded his decision-making authority to the group manager from Income Tax. Nonetheless, the Estate and Gift Tax attorney's presence was definitely felt (more on this later).

As is required by the FTS process, the taxpayer was present throughout the settlement discussions. This requirement adds an interesting dynamic as it provides an opportunity for taxpayers to see exactly what we, as practitioners, encounter when dealing with the Service. Additionally, it can lead to open hostility between the client and Service since the client is free to engage the Service. Our taxpayer was represented by his CPA and counsel, who sat opposite the Service. The taxpayer's lead counsel sat at the head of the table adjacent to the group manager and served as the taxpayer's decision-maker. Appeals was represented by both a senior Fast Track Appeals officer and an Appeals specialist in gift taxes with expertise in international taxes. They sat at the other end of the table opposite the two decision-makers.

Each party present received a copy of the Fast Track Session Report, which was prepared by Appeals, summarizing the issues at stake. After a brief introduction by Appeals, we made an opening statement on behalf of taxpayer. While the statement outlined our positions, we concluded with the declaration that we felt it was important to reach a global settlement that both parties could accept, rather than to argue issue by issue. We already had conceded several arguments prior to the actual settlement, one of which was that the foreign trust was a grantor trust. Unfortunately, the IRS did not come to the FTS conference prepared to offer any concessions.

Appeals acknowledged that the taxpayer was motivated and committed to the process. This was in contrast to the Service. In spite of being openly challenged by Appeals with regard to certain issues in the agenda questions, the IRS continued with the same line of reasoning even though certain arguments were seemingly inexplicable and lacked legal support.

It does not appear as though all levels of Service personnel understand the spirit and intent of FTS, which is to settle disputes. This is despite the instruction provided by Appeals in the FTS acceptance letter that the parties are to keep an open mind. In the current environment, the Service appears to be emboldened to attack taxpayers, perhaps believing fraud is behind every transaction. IRS proceeds, even in FTS, with an enforcement-heavy mindset, as National Taxpayer Advocate Nina Olson has recognized.⁶ Acting consistent therewith, the Service insisted on a somewhat unusual argument that foreign grantor trust status under Section 679 is proof that an irrevocable trust is really a revocable trust. This argument eventually morphed into an argument that because the irrevocable foreign trust was deemed a revocable trust, the eventual domestication of the foreign trust was in substance a taxable gift from the grantor to the domestic trust. Both arguments added the requirement to file Forms 3520 and 3520-A.

The actual domestication of the foreign trust involved a direct transfer from the foreign trust to the domestic trust. The transfer was undertaken to ensure full compliance and that there would be no adverse penalties because of accumulations in a foreign trust. In spite of the (albeit limited) body of law in support of our position that domestication is not a taxable event and the fact that we reported the existence of the foreign trust through the Offshore Voluntary Compliance Initiative (OVCI),⁷ the IRS would not budge on the issue. It insisted that the domestication was a taxable gift for which it denied taxpayer's ability to split the gift with his spouse. There was no legal support that domesticating a foreign trust results in a taxable event, or justification for denying split-gift treatment.

Until the Service begins to understand and embrace the theory of resolution encompassed by FTS, problems likely will continue. It has been reported that the Taxpayer Advocate told Congress that the Service's primary objective should be in strengthening voluntary compliance. She noted that the Service's current approach under Commissioner Mark Everson, which emphasizes enforcement, conflicts with the agency's mission under the Internal Revenue Service Restructuring and Reform Act of 1998.⁸

Resolution of the Authors' Case

While the process worked and we reached a settlement, it is important to understand that, unless the taxpayer is prepared to make major concessions, settlement can prove to be elusive. The taxpayer essentially entered FTS with a gun to his head. Failure to settle the issues would have resulted in an immediate assessment in excess of \$3.5 million. Appeals recognized the punitive situation the taxpayer would face if he failed to settle.

In the end, the settlement involved (1) some penalty concessions (the numbers are large because of the confiscatory nature of the penalties), (2) major gift tax deficiencies because IRS refused to negotiate, and (3) income tax refunds only because of the conversion of ordinary income items to capital gain. The capital gain issue generated additional arguments, albeit inexplicable. While these arguments were summarily dismissed by Appeals, they led to additional stress for the client and needless debate.

Despite delays in the Examination process, there is only limited relief available as to interest on income taxes under Section 6404(g), and FTS is not able to offer relief.

Settlement was by no means an easy process. At the end of Day 1 (we began at 8:00 a.m. and concluded at 8:00 p.m. with a one hour break for lunch), after making little to no progress during discussions with the Service, taxpayer initiated settlement by making an offer. The IRS accepted the offer in part and rejected it in part. It was agreed that we would adjourn for the evening so that taxpayer's CPA could compute the total tax and penalties that would be due under the counteroffer.

Day 2 began with the IRS refusing to accept our acceptance of its counteroffer. This process continued several more times throughout the day with the Service continuing to back away from settlement until the Fast Track Session Report Final Settlement Agreement was executed by the decision-makers and Appeals at close to 7:00 p.m. Several days after FTS concluded and the

Final Settlement Agreement was signed, Examination continued to argue that the settlement was not binding for all tax years subject to FTS and included in the Final Settlement Agreement, as continuing issues, perhaps because they were "out years" not included in the Closing Agreement (Form 866) as they were not yet under examination.

But for the unfortunate circumstance the taxpayer faced if he failed to settle, Appeals itself would have terminated the FTS process because of the seeming inability to reach a final consensus. Arguably the group manager failed to control his agents, but we would be more inclined to suggest that the need to work with other Service personnel on an ongoing basis led to a perception that a forced settlement would affect the future work environment. While Appeals has settlement authority, in theory it cannot force Examination to accept settlement. Nevertheless, Appeals could have forced the issue (the initial counteroffer that taxpayer accepted) to a territory manager because of Examination's refusal to join in the taxpayer's acceptance of the settlement. The process provides Appeals with settlement authority to "avoid situations in which the team is refusing to agree for reasons not based on sound legal principles,"² exactly the situation in which we found ourselves.

There is an inherent failure in providing Appeals with settlement authority but not having the territory manager either (1) attend the FTS conference or (2) be immediately available to address cases sent by Appeals so that the parties do not leave the FTS conference without a resolution. In the event the territory manager also refuses to accept the settlement, there is always the possibility that the parties may arrive at a different agreement. Not having the territory manager available, however, makes this impossible.

Another option is that Appeals can sign the Final Settlement Agreement along with the taxpayer. The validity or practical effectiveness of the agreement as an authoritative document when it is not signed by the group manager, particularly if it involves continuing issues, is questionable at best.

Appeals advised us that in FTS it prefers to have the territory manager, who was unavailable during our FTS conference, serve as the decision-maker. The belief is that the participation of someone higher on the hierarchy ladder and thus further from the actual Examination team will remove any emotional or personality issues from the decision-making process. Additionally, the territory manager is more concerned with resolving and disposing of cases rather than seeking maximum revenue.

Since the territory manager was unable to attend, we had the group manager serving as decision-maker. The group manager chose not to take an active part in the FTS conference. All arguments were led by Counsel and when Appeals tried to urge Counsel against pursuing certain arguments, the group manager's silence effectively may have been perceived by Counsel as supporting the continuation of such arguments. When members of the Examination team disagreed with the terms of settlement, the group manager seemed unwilling to proceed with the agreement. Although the Estate and Gift Tax group manager had ceded decision-making authority to the Income Tax group manager, it was an authority that the latter did not appear to be comfortable exercising. In fairness to the Income Tax group manager, Appeals advised us after the FTS

conference that it is extremely rare to have one IRS division cede decision-making authority to another division.

Appeals as a Neutral Party

Appeals was aggressive in insisting that IRS be flexible, and to the extent appropriate, clearly sided with the taxpayer on disputed facts and concessions. Nonetheless, Appeals was only prepared to "override" the IRS decision-maker by submitting its views to the territory manager. As noted above, in theory the territory manager may have agreed to the settlement, but the delay would have eliminated any opportunity for taxpayer to leave the FTS conference with an agreed settlement. The process took two very long days, and we settled late in Day 2 after 25 hours. We could have held firm, but our facts were not the best and the assessment of penalties prior to a formal administrative appeal, which remains available if Fast Track fails, made that impractical.

From our perspective, the process worked because Appeals made it work. Nevertheless, we recognize that many others believe that Appeals lacks independence, which calls into question the validity of the FTS and FTM process. For example, some commentators observed that taxpayers "have expressed concern that Appeals' independence is jeopardized." ¹⁰ Other commentators have recently written that there are concerns about Appeals' perceived or actual independence in administrative dispute resolution transactions. ¹¹

At no point leading up to the FTS conference or through the final settlement did we have any reason to question Appeals' independence. We also challenge the propriety of eliminating the prohibition on *ex parte* communications between Appeals and other IRS employees under section 1001(a)(4) of the Internal Revenue Service Restructuring and Reform Act of 1998. It is our belief that without the ability of Appeals to communicate with Service employees, settlement in our case would have been virtually impossible or the FTS process would have lasted much longer than two days. The issues involved in our particular case were so intricate that it would have been difficult for Appeals to understand and in turn assess the hazards of litigation in any meaningful way without preparing in advance.

LESSONS LEARNED

The moral of this story is as follows:

- (1) Supplement the FTS application with a position paper outlining taxpayer's arguments. If necessary, include a table of contents, index and exhibits.
- (2) Be prepared to concede issues at the outset to narrow the disputed items.
- (3) Be prepared to make a settlement offer at the conclusion of debate (or posturing, as the case may be).
- (4) To the extent possible, write down any settlement offer you make and encourage any counteroffers to be written as well.
- (5) Expect an enormous penalty to be assessed if the failure involves Forms 3520 and 3520-A. If you are at all in doubt about such filings, file them on a timely protective basis. This may well be the most important conclusion.

(6) IRS feels emboldened by the Commissioner when it comes to compliance. It is much less flexible and much more inclined to find fault—ergo, penalties.

(7) Make full disclosure of facts at every opportunity. We tried to take advantage of OVCI and that was clearly helpful, but expect IRS to argue that any disclosures were (a) not made in good faith, (b) were too late, (c) were inadequate, and (d) IRS could have secured the facts absent the disclosures.

(8) Be well aware of Circular 230. IRS is encouraged to report practitioner noncompliance at every stage, including the advocacy process. Protect yourself with written statements and clear understandings with IRS. ¹²

(9) Until the Examination process improves and the playing field is more level, expect sometimes nonsensical arguments by persons who should be better educated and trained, but seem to be otherwise.

(10) Keep in mind that often the issues which are at stake are continuing issues. Thus, the debate also involves the creation of a closing agreement. The Service is unable to agree to any issues affecting an open tax year. Therefore practitioners should carefully think about how to include future intentions to report an issue on a return consistent with the resolution of the issues at stake, and document those intentions to the extent possible.

(11) Be certain to know the bottom line. Do not leave the FTS conference without having a specific final tax liability written in the closing agreement. Consider a final closing agreement on Form 866 rather than a specific matters closing agreement on Form 906. ¹³

CONCLUSION

Taxpayers or practitioners who would like to submit a case to the FTS program, or who have questions about the program and its suitability for the taxpayer's case, should consult section 9 of Revenue Procedure 2003-40 for a list of contacts.

Practice Notes

The FTS program has advantages for taxpayers but is not without hazards. Practitioners should prepare for the conference as thoroughly as possible, keeping in mind the consequences for the taxpayer if settlement is not reached. A comprehensive position paper may be helpful. Any offers and counteroffers should be in writing, and compliance with the requirements of Circular 230 is essential.

¹ See Dougherty and Fielman, "Large and Mid-Size Business Division Fast Track Dispute Resolution Pilot Program," 54 The Tax Executive No.1 (January-February 2002), pages 41-43.

² For purposes of this article, we will not discuss FTM other than to distinguish it from FTS. For mediation generally, see Rock, "A First-Hand Look at Mediation With the Service: How to Make the Most of It," 93 JTAX 69 (August 2000).

³ See Treasury Inspector General for Tax Administration, "Final Audit Report—the Fast Track Dispute Resolution Pilot Program Was A Success, but Some Challenges Remain" (July 2004), Reference Number 2004-30-119.

⁴ IRM 8.2.1.3.1.

⁵ *Id.*

⁶ Kenney, "Focus on Voluntary Compliance, Not Enforcement, Olson Says," 2005 TNT 131-2.

⁷ For another aspect of OVCI, see generally Ostrander, "The Offshore Credit Card and Financial Arrangement Probe: Fraught With Danger for Taxpayers," 99 JTAX 113 (August 2003).

⁸ See note 6, *supra*.

⁹ Pearlman, "IRS Fast Track Mediation and Settlement," 73 CPA Journal No. 6 (June 2003), pages 68-69.

¹⁰ See Dougherty and Fielman, "IRS Appeals—Maintaining Independence, Balancing Enforcement, and Improving Currency," 56 The Tax Executive No. 6 (November-December 2004), pages 484-485.

¹¹ Canciello and Carney, "Tax Shelters and Appeals Independence," 7 J. Tax Prac. & Proc. No. 3 (June-July 2005), page 25.

¹² For more on these requirements, see Lipton, Walton, and Dixon, "The World Changes: Broad Sweep of New Tax Shelter Rules in AJCA and Circular 230 Affect Everyone," 102 JTAX 134 (March 2005).

¹³ Form 866 will provide absolute finality, but is not structured to allow for the disposition of continuing issues. To that end, this will need to be addressed in the FTS Final Settlement Agreement.

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