Perspective

The Case for Mediation of Tax Controversies

By Maxine Aaronson

The use of mediation to resolve controversies is becoming more frequent in all areas. Car wrecks, eminent domain suits, will contests, contract disputes, multi-party toxic tort litigation, and neighborhood squabbles are much more likely to be referred to a mediator today than they were 10 years ago. Mediation is also becoming more common in tax controversies although it has yet to reach its full potential.

While not a panacea for ridding the world of conflict and strife, mediation is an effective and efficient dispute resolution technique with broad application. It has been adopted by federal courts at all levels, with many U.S. district courts incorporating mediation and other alternative dispute resolution (ADR) techniques into the local Civil Justice Delay and Expense Reduction plans mandated under the Civil Justice Reform Act of 1990, 28 U.S.C. §471 *et seq.*[1]

The bankruptcy courts are likewise encouraging the use of mediation. A study of mediation in bankruptcy in the San Diego area a decade ago reported positive reactions from practitioners and their clients,[2] and the number of such courts with formal policies promoting mediation continues to grow. Following rules adopted by the local bankruptcy court in 1997, the Pittsburgh Penguins recently completed a reorganization after mediation involving all major creditors of the bankrupt hockey team.[3] The Court of Federal Claims has adopted procedures to encourage parties to use alternative dispute resolution, including mediation, in that court. Its Amended General Order No. 13 expresses the court's philosophy in favor of ADR, including mediation: "Courts are institutions of last resort and while preserving that 'last resort' as a sacred trust, they should insure their use only when other methods of dispute resolution have failed."

The United States Tax Court has no formal procedures for court referral to mediation, but its Rule 124 clearly contemplates the use of mediation and anecdotal reports indicate a trend among practitioners to refer cases to the mediation process. "The Tax Court recognizes mediation, but it is the exception, not the rule, unlike many of the federal district courts," says Donald Lan, a tax litigator at the Dallas law firm of Kroney Mincey Inc. He considers mediation in his Tax Court cases "depending on the kind of issue involved in the case and how fully the record was developed at the audit and appeals stages. In the right case, such as valuation, reasonable compensation, or other highly factual cases, mediation can be useful."

Federal appellate courts also refer cases to mediation after trial,[4] as do some state court systems. One of the most interesting approaches is that taken by the Utah Supreme Court, which refers appellate cases to mandatory mediation through a random selection process.[5]

ADR in Federal Agencies. In adopting the Administrative Dispute Resolution Act of 1996, 5 U.S.C. 571 *et seq.*, Congress instructed federal agencies to incorporate alternative dispute resolution, including mediation, at the administrative level. The Internal Revenue Service, through its Office of Appeals, has been utilizing alternative dispute resolution techniques for decades. A request for an Appeals conference is essentially a request for a settlement conference with a Service employee outside the group that did the examination. As most tax professionals are aware from their own personal experience, the settlement percentages at Appeals indicate that this program has been highly successful in achieving resolution of controversies.

The IRS has announced that it too, is interested in actively promoting the use of mediation in both docketed and non-docketed cases. By specifically endorsing the use of mediation in controversies still at the investigational level, the Service placed itself in the forefront of those governmental agencies that have embraced alternative dispute resolution techniques. The IRS an-

[1] An exhaustive study of the effect of mediation programs in six federal judicial districts in five states (California, New York, Oklahoma, Pennsylvania, and Texas) can be found in J. Kakalik, *et al*, An Evaluation of Mediation and Early Neutral Evaluation Under the Civil Justice Reform Act (The Institute for Civil Justice 1996). The Federal Judicial Center collects data about ADR in all of the federal courts; its reports can be accessed at www.fjc.gov by clicking on "Publications."

[2] See, S. Hartwell & G. Bermant, *Alternative Dispute Resolution In a Bankruptcy Court* (Federal Judicial Center 1988).

[3] See *Bankruptcy Mediation Hits Pennsylvania by Storm: Alternative to litigation saves the day in Penguins hockey reorganization*, Pa. L. Weekly (Sept. 20, 1999).

Maxine Aaronson practices law in Dallas and Houston, Texas. She is board certified in tax law by the Texas Board of Legal Specialization and is an experienced mediator, having completed formal negotiation and mediation training from Harvard Law School and the Attorney Mediators Institute.

[4] Two recent articles in the American Bar Association's quarterly on ADR discuss the growing use of post trial mediation. See S. Kinnard, *Mediating the Decided Case*, Dispute Resolution, Vol. 5, Number 4 at 16 (Summer 1999), and R. Niemic, *On Appeal, id.* at 13.

[5] See "Appellate Mediation Program at the Utah Court of Appeals," www.courtlink.utcourts.gov/mediation.

nounced that it would promote the active use of mediation, along with other alternative dispute resolution techniques at both the exam and appeals levels, first for the large corporate taxpayers involved in the Coordinated Examination Program (CEP)[6] and later for cases with $1 million or more in controversy.[7] More importantly, the Service has authorized the use of outside (non-IRS personnel) mediators at these levels.

The IRS Restructuring and Reform Act of 1998 codified and expanded these mediation procedures in Internal Revenue Code Section 7123. Although the Service has yet to issue formal guidance in this area, cases with amounts in controversy below $1 million are also eligible for referral to mediation. For issues below $1 million, Appeals is accepting requests for mediation on an *ad hoc* basis.[8]

What Is Mediation? Mediation is a facilitated negotiation in which the parties are not forced to make offers and the mediator makes no decisions, except to decide when to call it quits. It is sometimes called "nonbinding mediation" to distinguish it from binding arbitration, a form of private adjudication in which the parties agree to be bound by the arbitrator's decision.

A mediator is a specially trained, neutral third party whose job it is to assist all the parties in the negotiation. While most good mediators are also extraordinary negotiators, it is important to remember that the mediator's job is to remain neutral and to not take sides. A mediator's job is not to negotiate the case for either side, but to help both negotiate the case themselves. Anything told to a mediator during the process of mediation is, and should be, confidential.

Even the most effective mediators recognize that not all cases settle in mediation and therefore a primary concern is to do no harm to the case—thereby leaving the parties in the same positions that they were prior to the mediation if the case does not settle.

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Mediated settlement agreements, once reached, are enforceable as contracts between the parties. Good mediators help the parties to commit agreements in writing before leaving the mediation session, so that later problems do not occur

Despite the increasingly frequent use of mediation in the last few years, the general public (and many professionals) still often confuses it with arbitration. Mediation is much like bringing the proverbial horse to water—the mediator has no power to make anyone actually take a drink.[9] "While the mediator does not have settlement authority, the parties to the mediation do" says Thomas Carter Louthan, director of alternative dispute resolution and customer service at the IRS' Office of Appeals, "and if the parties reach agreement they can resolve the dispute with finality. Mediation is particularly useful for issues that are highly factual, such as valuation, reasonable compensation, or transfer pricing issues. Mediation facilitates communication and also enhances our services to taxpayers."

Why should tax practitioners consider mediation? Quite simply, mediation works. It is successful in settling cases. The overwhelming majority of cases that employ mediation settle the day of the mediation, or within a few days thereafter. The overall general settlement percentage in mediation has been estimated to be in excess of 80 percent.[10] Interestingly, it does not seem to matter whether the cases go voluntarily to mediation or are sent to mediation by court order.[11] In Texas, a state which has substantial experience with court-ordered mediation, attorneys and judges alike report no substantial difference in the settlement rates between voluntary and court-ordered mediation. "I'm a big fan of mediation," says James Klancnik, a Dallas pension lawyer who successfully settled an ERISA case after being ordered to mediation by a federal judge. In fact, because of the push toward mediation of nearly all types of civil cases in that state, many Texas lawyers have come to treat mediation as simply another step in the process, just as they treat discovery and pretrial conferences.

In jurisdictions where courts order parties to mediation (sometimes referred to as "court-annexed mediation"), all that a party and his attorneys are required to do is attend, be reasonably polite, and stay as long as the mediator believes progress can be made. Even parties who initially opposed mediation may eventually start to exchange information, then exchange offers, and ultimately settle as a result of the mediation.

The Ongoing Relationship with the IRS. Mediation of tax cases has some interesting twists, in comparison with the average tort or contract claim mediation. In nontax disputes, the parties may never have to deal with each other again, but taxpayers must deal with the Service on an ongoing basis. This makes tax cases especially conducive to settlement through the mediation process. "Since the prime success in mediation is said to be in the areas where the parties have to live together in a continuous relationship, tax is in principle, the best example of this – after all the taxpayer and the revenue [service] have to live together for a lifetime," says Justice Graham Hill of the Federal Court of Australia, a tax law expert who received mediation training in the United States and is a strong advocate for mediation in his nation's court system.

Mediation almost always improves the relationship between the parties. Through the mediation process,

[6] Announcement 95-86, 1995-44 I.R.B 27 and Announcement 97-1, 1997-2 I.R.B. 62.

[7] Announcement 98-99, 1998-46 I.R.B. 34.

[8] See 1 *IRS Practice Adviser Report* 279, 9/11/98

[9] For a discussion of this issue with court-ordered mediation, see *Participation Standards in Mandatory Mediation Statutes: "You Can Lead a Horse to Water. . . "*, 11 Ohio St. J. on Disp. Resolution 189 (1996).

[10] "Why Mediation Works" by Michael J. Roberts, available from The Mediation Information and Resource Center Web site at www.mediate.com/articles/roberts. The IRS test program, while small in numbers, seems to indicate that mediated tax cases settle at about the same rate as other mediated cases. Current statistics indicate that nine of 12 mediations have been completed with settlements, a 75 percent success rate. The IRS reported having 13 cases in mediation in October 1999.

[11] See the Ohio State Journal of Dispute Resolution, Vol. 14, Number 3, symposium on the structure of court connected mediation programs.

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emotional issues are addressed and misconceptions corrected. Once the emotional baggage is gone, the parties can deal with each other to address the disputed issues. While trust between the parties is not required for settlement, it always helps. Each small area of agreement leads to increased confidence in the process. Agreement breeds further agreement.

Mediation is an efficient use of resources. While proper preparation is essential for a successful mediation, the preparation for a mediation is not as extensive as preparing the case for trial. In particular, a case can go to mediation when most, but not all, of the discovery is done. However, it is essential for counsel to know his own case, and his opponent's, extremely well. If the case does not settle in mediation, the case file is already organized for trial.

Mediation also works well in cases where the parties and their advisers are extremely successful negotiators. For these parties, formal scheduled mediation provides an opportunity to set aside other distractions and focus for a period of time on the question of settlement. For that one day, consideration of settlement is the most important thing that you are doing. There is no competition for your time or for your opponent's time. Mediation also collapses the time frame for the exchange of offers and counteroffers. It is not unusual for five or six sets of offers to be made in the course of a full-day mediation. If handled by mail, phone, and fax, the exchange of so many offers and counteroffers could stretch over several weeks or months. Mediation can conserve precious resources by simply saving time.

Mediation is also an excellent way to maneuver around personality conflicts. Although it is not often a problem among tax professionals, personality clashes occasionally occur, even among reasonable people. Mediation provides a neutral third party through whom the principals can communicate.

Keeping Communications Open. Even if a case is not completely settled, the process of mediation can simplify the case, or be the catalyst for settling the case later. This is because the mere process of mediation frequently opens avenues of communication between the parties, and provides the initial framework for subsequent productive discussions.

Reports of settlement weeks or even months after a seemingly unsuccessful mediation session are not unusual. Many effective mediators will continue to work with the parties over the telephone or occasionally by convening a second formal mediation session. Sometimes the parties simply need more time to assimilate a creative or unexpected settlement proposal. Other times, the mediation has been scheduled prematurely—either because a crucial ruling is pending (motions *in limine* or summary judgment motions, for example) or because discovery is not yet complete. Many times the issue is simply emotional readiness—are the parties really ready to give up the idea of waging war and get down to the business of focusing on the aftermath? As any tax practitioner is aware, many clients relish the idea of doing battle with the IRS, at least until they receive the bill for professional services.

The Difference with Tax Cases. There are differences between mediation in tax cases and mediation in other cases. Most non tax cases arise out of one transaction or occurrence. The issues in those cases are interrelated and interdependent. It is difficult, but not impossible, to settle only a portion of the intertwined issues in the case. One of the hallmarks of a typical commercial or personal injury case is that the litigated claims are all part of the same transaction or occurrence. By contrast, federal tax cases rarely involve all the same transaction or occurrence—in fact, most of the issues in a tax case have nothing to do with one another. The only common factor for these issues is that they are all reportable on the same year's tax return.

In a sense, a tax case is really a collection of smaller disputes, rather than a cohesive whole. This provides both complexity and a greater opportunity for creative settlement. In any negotiation, the various components are valued differently by each party.[12] A skillful negotiator learns to quickly recognize the issues that are important to the other side but that are less important to him. Likewise, many negotiators begin their negotiation strategy by obtaining the things that are most important to them but not at all important to the other side. Additionally, in tax cases, because of the unrelated nature of the various issues in a case, partial settlements can be achieved at mediation, greatly simplifying the case at

[12] For an excellent discussion of how to discover and exploit these complementary differences, see D. Lax and J. Sebenius, *The Manager as Negotiator* (Free Press 1986) at 88-106.

Persistence Pays Off

I recently mediated an extremely difficult case between two very tenacious corporate presidents with strong personalities. Each president had a hands-on approach to resolution of business disputes at his company. After a full day mediation session in which little progress was made, I continued to work with the parties and their attorneys and encouraged the free exchange of information for several months.

While some mediators would have declared impasse at the end of the full day mediation session, others believe that we have a continuing obligation to try to advance settlement right up to the date of trial. I did this simply by keeping in touch with both parties and their counsel and asking about their case. As mediator, I was able to convey information from one party to the other without the emotionally laden phrases typically used by litigants. Over a period of time, I was able to alter the tenor of the dialogue to that of a business discussion.

A few weeks before trial, a round of offers was made, the first in a month. Neither was accepted, but the very next day, one president called the other (without their lawyers on the line but with their attorneys' full knowledge and cooperation) and two telephone calls later these gentlemen had settled the entire case. It is my belief that the mediation *process* is what eventually unclogged the lines of communication in this business relationship.

—Maxine Aaronson

been successfully mediated using this approach to the question of settlement authority. In each instance, the elected body approved the recommended settlement at its next regular meeting. Similar issues might arise in mediating a dispute that needed to be ultimately approved by the appointed board of a state unemployment fund, for example.

Assessing Hazards of Litigation. When the dispute is one of policy interpretation, such as those the IRS designates national coordinated issues, the government's interest (which it does not readily admit) is in trying only the one case with the "perfect facts"—the one case out of the hundreds pending on the same issue nationwide with the best chance of success. From a tax practitioner's point of view, the best strategy is two pronged: first, to convince the IRS that this case does not have those "perfect facts" and second, to resolve it before the perfect fact case is decided.

Mediation can help in both those respects. A good mediator focuses the attention of the litigants away from the strengths of their case, and toward the risk of an unfavorable result. Though confidence in one's own case is important in negotiation (and impresses the client), it also works to blind both practitioner and client to the realities of litigation. It is good to remember that one of the fundamental truths of going to the courthouse is that for every successful litigant, there is a corresponding party who has failed. The mediator's challenge is to force the parties to face the uncertainty inherent in every case. "The most obvious feature of mediation is that both sides get a benefit. The IRS gets the benefit of a neutral party with real commercial experience and the taxpayer's representative gets a neutral view of the cold realities and uncertainty of litigation," said Marvin J. Garbis, judge of the U.S. District Court for the District of Maryland, who litigated many tax cases before his appointment to the bench.

Harvard Law School professor Roger Fisher describes the problem of objectivity as one of partisan perception.[14] He likes to quote an old Russian saying that everyone looks at the world from the bell tower of his own village. In essence, Fisher posits that the way we perceive new information is influenced by what we already believe. When we receive information that does not fit into our existing belief system, we tend to discount it and to disbelieve it. Further, as time goes on, we tend to selectively remember only those facts which bolster our prior conclusions, and confirm our prior views.

This process is rarely conscious, and its greatest danger to litigators is that it creates a false aura of invincibility. The partisan perception feels good (who does not like to find "evidence" that tends to show that he is right?) even as imperceptible self-bias seduces us into poor decision making about our case. Mediation helps readjust the parties' perception of their case back to a more realistic and objective view. It permits assumptions to be tested and trial balloons flown.

Although a mediator is impartial and should not judge the issues in the case, a good one can frequently nudge the parties back toward reality. Questions involving ambiguous facts, litigation expense, the time and trouble of additional discovery, and evidentiary burden of proof problems will focus the parties on the true risks of litigation and remind them of what has be conveniently "forgotten" because it does not fit neatly into the party's prior assumptions. A mediator without a thorough grounding in the substantive issues is at a real disadvantage here. "We try to choose a mediator who has a good background in tax law for our mediations," said Louise Hytken, section chief of the Southwestern Civil Trial Section of the Justice Department's Tax Division. "It improves the chances of a successful mediation."

Cultural Expectations. Successful mediators are also firmly steeped in the cultural expectations of both parties. The outlook of the average taxpayer varies substantially from the outlook of the average district counsel attorney. A good mediator appreciates them both, understanding the bureaucratic subtleties on both sides.

There are sometimes surprisingly different philosophies among different divisions of the same agency. For example, a capable tax lawyer, experienced in audit representation but not very familiar with the IRS' Employee Plans Division, would be very concerned upon hearing the dreaded words "plan disqualification," especially if the plan really had violated the relevant provisions and disqualification would cause an immediate $200,000 tax hit. But one who understands the unspoken subtext— that the government's interest in encouraging employers to adopt and maintain retirement plans exceeds its interest in generating revenue—would probably be able to end the audit with a plan correction and a manageable fine. Transfer pricing issues, valuation issues, employee benefits, accumulated earnings, reasonable compensation, summons enforcement, and oil and gas issues are just some examples of kinds of cases that will benefit from a mediator who has a experience in tax law.

Mediation is an incredibly flexible tool, vastly underused in the tax practice. It frequently leads to an increase in client satisfaction about the settlement itself over and above that which would be experienced with traditional negotiation. Such settlement agreements are more likely to endure. Although the mediation of tax controversies presents some special issues, if the mediator is carefully selected, the potential for mediation is tremendous. It is a tool every practitioner should know how to use.

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method involved considerable delay in payment of claims and in resolution of disputes. The new statute authorizes settlements of claims less than $250,000 out of previously appropriated funds without the need for additional legislative action.

[14] R. Fisher, E. Kopelman and A. Schneider, *Beyond Machiavelli: Tools for Coping with Conflict* (Harvard University Press 1994) at 19-41.