

IRS Memo Sheds Light on Process for Designating Cases for Litigation

The IRS recently published a [memorandum](#) that provides guidance on the process of designating certain cases or issues for litigation (the “*IRS Memo*”).¹ When a case or issue is designated for litigation, a taxpayer’s ability to try to resolve that issue through the IRS Independent Office of Appeals (“*Appeals*”) is foreclosed. While IRS guidance on the process of designating cases or issues for litigation existed previously, the IRS Memo provides more transparency on certain details of the process, and clarifies the procedure if a taxpayer wishes to challenge a designation for litigation.

Purpose of Designating a Case for Litigation

The IRS generally encourages settlement and the use of Appeals to resolve tax disputes. Among other rights, the Taxpayer Bill of Rights specifically lists “The Right to Appeal an IRS Decision in an Independent Forum,” stating “taxpayers are entitled to a fair and impartial administrative appeal of most IRS decisions, including many penalties.” Section 8.1.1.1(1) of the Internal Revenue Manual (“*IRM*”) expands upon the mission of Appeals: the independent forum is meant “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.” For both the Government and the taxpayer, the Appeals process will generally be less time-consuming and expensive than litigating the issue.

In certain cases, however, the IRS believes that the use of the Appeals process may be inappropriate. Concerning the purpose of designating a case for litigation, section 33.3.6.1(1) of the IRM states “certain cases 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, conserve resources or reduce litigation costs for the Service and taxpayers.” Tax shelters, or issues that are industry-wide, are listed as examples of instances where the designation for litigation may be applied.

The IRS Memo provides additional detail on the type of cases that should be designated for litigation, and mentions such a designation may be appropriate to “resolve issues with respect to which published guidance has not resulted in compliance or where there is a wide divergence between IRS and taxpayer viewpoints on the law.” (at 2).

Finally the IRS Memo acknowledges that a designation for litigation is only warranted “infrequently, subject to careful consideration at all levels of the process” (at 1) and “in the limited circumstances where sound tax administration is best served by establishing a legal precedent on the issue and not merely to prevent Appeals’ review.” (at 2).

¹ Memorandum for Commissioner, Large Business and International Division, Commissioner, Small Business/Self-Employed Division, Commissioner, Tax Exempt and Government Entities Division, and Chief counsel from Sunita Lough, Deputy Commissioner for Services and Enforcement regarding Interim Guidance on Designation of Cases for Litigation (Aug. 24, 2020).

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Process of Designating a Case for Litigation

The IRS Memo summarizes the internal procedures that must be undertaken for a nondocketed case to receive a designation for litigation. While the IRS Memo sets forth the requirements in more detail, at a high level the IRS must follow these processes—that provide taxpayers with opportunities to respond—before a case may be designated for litigation:

- Examination personnel must prepare a written memorandum setting forth the facts of the case and factors justifying a designation for litigation.
- The Exam Director and Division Counsel, in consultation with the Associate Chief Counsel, will review the written memo and consider the merits of designating the case for litigation.
- If the Exam Director and Division Counsel conclude a designation for litigation is appropriate, they will prepare a “Designation Recommendation Memorandum” (“**DRM**”). This DRM will explain the rationale for the recommendation of designation. The matter is then referred to the Business Operating Division Deputy Commissioner (“**Deputy Commissioner**”).
- After the DRM is completed, the Exam Director must provide written notice to the taxpayer regarding the proposed designation. This notice must explain the rationale for the recommendation, and that the matter has been referred to the Deputy Commissioner. This notice also gives the taxpayer 60 days to respond to the designation for litigation or request a meeting with the Deputy Commissioner and the Division Counsel.
- The Deputy Commissioner and the Division Counsel will review any materials provided by the taxpayer over the 60-day period. If they still determine designation for litigation is appropriate they will forward the DRM to the Chief Counsel and Associate Chief Counsel with jurisdiction.
- The taxpayer must be notified within five days after the DRM is sent to the Chief Counsel. Again, the taxpayer is given 30 days to respond in writing or request a meeting with the Chief Counsel. The Associate Chief Counsel will consider any additional materials and provide the Chief Counsel with written comments on the DRM within 30 days. The Chief Counsel will then approve or deny the designation for litigation.
- The taxpayer must be notified within five days of the Chief Counsel’s decision. At that point, the taxpayer may request referral to Appeals. The taxpayer may also wait to receive the statutory notice of deficiency (“**SNOD**”) before requesting referral to Appeals.

Process After a Case Is Designated for Litigation

In 2019, the Taxpayer First Act (“**TFA**”) imposed new requirements on denial of taxpayers’ request for referral to Appeals. These requirements are now codified in section 7803(e)(5) of the Internal Revenue Code (“**IRC**”). Section 7803(e)(5) provides that if a taxpayer is in receipt of SNOD and requests referral to Appeals and is denied, the IRS shall provide the taxpayer a written notice that “provides a detailed description of the facts involved, the basis for the decision to deny the request, and a detailed explanation of how the basis of such decision applies.” Section 7803(e)(5)(C) also provides that if taxpayers are denied in such a request, there must be “procedures for protesting to the Commissioner of Internal Revenue.” The IRS Memo provides interim guidance on those procedures.

The IRS Memo provides the following procedures in cases where taxpayers wish to contest a designation for litigation:

- When a taxpayer receives a SNOD or the notification of the Chief Counsel’s decision to designate the case for litigation, the taxpayer may still request referral to Appeals. This request is reviewed by the appropriate Business Operating Division Commissioner, who must approve or deny the request in writing within 30 days.
- If the Business Operating Division Commissioner denies the request, they must provide the taxpayer a detailed written description explaining the rationale behind the denial, as required by section 7803(e)(5)(A)(i).
- The taxpayer then has 30 days to protest the decision with the Deputy Commissioner for Services and Enforcement, who has 30 days to issue a written decision sustaining or reversing the denial of the taxpayer’s protest.

Effect of Designation for Litigation and Other Key Takeaways

If a case is designated for litigation, “the designated issue in a case will not be resolved without a full concession by the taxpayer.” IRM 33.3.6.1(2). As the detailed process above indicates, however, a designation for litigation is not lightly invoked and involves significant high-level approvals. This point is emphasized in the IRS Memo, which states the procedures established further “congressional intent by ensuring that designation of cases for litigation will remain infrequent and subject to the highest level of oversight within the IRS and the Office of Chief Counsel” (at 4).

While a designation for litigation is rather severe, a couple key points should be noted.

First, a designation for litigation applies to discrete issues. The IRS Memo indicates that the taxpayer and the IRS may proceed to Appeals and settle other issues that are not designated for litigation.

Second, and perhaps even more significantly, the fact that the IRS designates a case for litigation does not require the IRS to designate all similar cases for litigation as well. The IRS Memo provides that a designation for litigation will not “preclude Appeals from considering and settling the same issue in other cases within its jurisdiction. (at 3). While perhaps understandable from an administrative perspective (as designating all similar cases for litigation would likely be unduly burdensome), this essentially is a tacit admission that similarly situated taxpayers will not necessarily be treated equally.