

Chapter 13. Researching a Tax Question and Appeals Procedures

Very few sections of the Internal Revenue Code (Code) were written specifically for timber activities. The purpose of this publication is to answer common timber tax questions asked by nonindustrial private forest landowners. You may, however, have questions not adequately covered in this handbook or IRS publications. This chapter introduces the basic steps involved in researching tax questions. Taxpayers with difficult tax questions typically seek the assistance of legal counsel, CPA's, enrolled agents, or other qualified tax professionals. Even if you are not comfortable researching tax questions yourself, knowledge of the process will enable you to help your advisor.

The process starts by answering several basic questions. You must determine which section(s) of the Internal Revenue Code (Code) (statutory law) apply and how these sections are interpreted by the IRS (in regulations and revenue rulings) and by the courts (as case law). The final step is to determine how this total body of law and interpretations applies to the facts in your particular situation. Obviously you must provide these facts.

STATUTORY LAW

The forms the foundation of Federal income tax law. The Internal Revenue Code (Code) is promulgated by legislation passed by the U.S. Congress. The U.S. Constitution requires all revenue bills to be initiated in the House of Representatives. When a revenue bill is introduced by a member of the House, the bill is referred to the House Committee on Ways and Means. If the committee recommends further action on the bill, public hearings are held. The Senate also considers the bill. The Senate Finance Committee may hold hearings. If the House and Senate pass different versions of the bill, the differences are reconciled in the Joint Conference Committee, which also may hold hearings. When the bill completes the legislative process and is signed by the President, it becomes part of the Code of 1986, as amended.

The records of hearings and committee reports involving the legislation provide information on what the legislators hoped to accomplish by enacting the law. This "legislative intent" is

important in interpreting the law when there is doubt about specific language included in the law or how it is implemented by the IRS.

If you are unfamiliar with tax law it may be difficult to determine which sections of the Internal Revenue Code (Code) apply to a particular tax question. Most topics are indexed in tax publications according to tax issues and use tax terms. Direct access to appropriate Internal Revenue Code (Code) sections is possible by using the comprehensive index included at the Timber Tax Internet site at <http://www.fnr.purdue.edu/ttax>. Cross-references between commonly used terms and technical terms are included. The applicable Internal Revenue Code (Code) sections are listed under the major headings. The commercial tax services listed on page 108 also include comprehensive indexes that can be used to determine the appropriate Internal Revenue Code (Code) section.

ADMINISTRATIVE LAW

The Commissioner of Internal Revenue is charged with implementation of the Code. The first step is to write and issue Treasury Regulations interpreting the Internal Revenue Code (Code) and specifying how it is to be implemented. These regulations have the force and effect of law. However, the courts may nullify regulations that are not consistent with the Internal Revenue Code (Code) or with the intent of Congress. After drafting, internal study, and review, regulations are issued as proposed regulations and/or as temporary regulations. Temporary regulations have the force of law and must be followed. Proposed regulations do not have the force of law. Proposed regulations become final only after the public has had the opportunity to comment on them and these comments are evaluated by the IRS. The temporary regulations are superseded when final regulations are issued.

New regulations and amendments to existing regulations are issued as Treasury Decisions published in the *Federal Register* and the *Internal Revenue Bulletin*. It would be impossible to write regulations covering all possible circumstances. Thus, other types of rulings and forms of

communication are issued by the IRS as the need arises. All of these are published in the Internal Revenue Bulletin.

Revenue Rulings

Revenue rulings (Rev. Rul.) are official interpretations by the IRS of the Internal Revenue Code (Code), related statutes, tax treaties, and regulations. They are published for the information and guidance of taxpayers, IRS personnel, and others. Generally, a revenue ruling sets forth the tax consequences of the specific transaction described in it. They represent the official policy of the IRS and are binding on the IRS until revoked, amended, or otherwise changed. They carry less authority than regulations, and courts need not follow them if they are found to conflict with the intent of the regulations or Internal Revenue Code (Code).

Revenue Procedures

Revenue procedures (Rev. Proc.) are issued to explain administrative practices and procedures within the IRS. They relate to statutes, tax treaties, and regulations. Revenue procedures may set forth a procedure that affects the rights and duties of taxpayers or other members of the public and should be a matter of public knowledge. In general, a revenue procedure tells the taxpayer how to do something—for example, make an election relating to tax consequences.

Chief Counsel's Memoranda

These are issued by the Office of Chief Counsel of the IRS. This category includes technical memoranda, general counsel's memoranda, and actions on decisions. General Counsel Memoranda (GCM's) are internal working documents of the IRS reflecting the opinion of its attorneys on a specific issue. GCM's reflect the logic behind the official position taken by the IRS in an administrative pronouncement such as a revenue ruling.

News Releases, Notices, and Announcements

Matters of immediate and general concern to taxpayers may be addressed in news releases that are provided to the media. Notices and announcements are published in the Internal Revenue Bulletin and may be released first as news

releases. Notices and announcements may be issued to inform taxpayers of recent changes in the law, the IRS intention to study a particular area of the tax law, or to clarify the tax consequences of a particular type of transaction.

Private Letter Rulings

A private letter ruling (LTR) is a written statement by the National Office of the IRS that is issued in response to a taxpayer's request. It interprets and applies the tax laws to the taxpayer's specific set of facts. In effect, the taxpayer asks the IRS what the tax consequences will be if he or she takes a proposed action. Although letter rulings are made available to the public, you should not rely on a ruling issued to another taxpayer. Instructions for requesting a ruling appear in a revenue procedure that is updated annually. Under current law, payment of a user fee is required for requests.

Technical Advice Memoranda

A technical advice memorandum (TAM) consists of advice or guidance furnished by the National Office of the IRS upon request of an IRS district office or appeals office. It responds to a technical or procedural question on a specific set of facts arising out of an examination and involves the interpretation and proper application of tax law, tax treaties, regulations, revenue rulings, or other precedents published by the National Office. Although these memoranda are made available to the public, you should not rely on a technical advice memorandum issued with respect to another taxpayer. The taxpayer may request that a district or appeals office refer an issue to the National Office for technical advice. Instructions on requesting technical advice are published in a revenue procedure that is updated annually.

CASE LAW

If a question is clearly covered by the Internal Revenue Code (Code), you must follow the Internal Revenue Code (Code) or seek legislative remedy—that is, have the Internal Revenue Code (Code) changed. If your circumstances are covered by the regulations or revenue rulings, then you must follow them or expect that the IRS will challenge any contrary position taken. If you disagree with the position taken by the IRS in proposing adjustments to your tax, then you may

appeal through the administrative appeals process and may have to defend your position in court. Sometimes your circumstances may not be specifically covered by the Internal Revenue Code (Code), regulations, rulings, court decisions, and so forth. In that case, you and your advisors must interpret the law yourselves, consistent with what you believe to be congressional intent, and seek justification for your interpretation in the general body of tax literature.

Case law consists of the findings of the various Federal courts on tax questions that have been brought to trial. The significance of the findings of a court on an income tax matter varies greatly, depending on the particular court involved and the response of the IRS to the findings of the court.

The types of courts are reviewed first, then the possible responses of the IRS to court rulings. Finally, guidelines are provided on how to interpret court decisions.

Federal Court System

If you and the IRS still disagree after your appeals conference within the IRS, you may take your case to either the U.S. Tax Court, the U.S. District Court for the district in which your tax home is located, or the U.S. Court of Federal Claims if you meet certain jurisdictional requirements discussed below. These courts are independent judicial bodies and have no connection with the IRS.

If you elect to bypass the IRS appeals system, you may take your case to any of the above-mentioned courts. However, a case petitioned to the U.S. Tax Court normally will be considered for settlement by an appeals office in the IRS region before the Tax Court hears the case. Where the taxpayer elects to bypass the IRS appeals system, the Tax Court may impose a penalty of up to \$5,000 if it appears to the Tax Court that the taxpayer unreasonably failed to pursue available administrative remedies. Generally, findings of these courts may be appealed to a higher court. The appeals process is discussed under “Audits and Appeals,” page 102. The following Federal courts hear tax cases.

Tax Court. The Tax Court was created by Congress specifically to hear Federal tax cases. The court is an independent court with its principal address in Washington, DC, but it hears cases throughout the

Nation in designated Federal courtrooms. The Tax Court has jurisdiction of a case only if the IRS issues a statutory notice of deficiency. You have 90 days (150 days if mailed to you outside the United States) from the date the notice is mailed to file a petition with the Tax Court. Generally, the Tax Court hears cases only if the tax has not been assessed and paid; however, you may pay the tax after the notice of deficiency has been issued and still petition the Tax Court for review. If your case involves a dispute of not more than \$10,000 for any one tax year or period, the Tax Court provides a simple alternative for resolving disputes. At your request, and with the approval of the Tax Court, your case may be handled under “the small tax case procedures” whereby you can present your own case to the Tax Court for a binding decision. If your case is handled under this procedure, the decision of the Tax Court is final and cannot be appealed. You can get more information regarding the small tax case procedures and other Tax Court matters from the U.S. Tax Court, 400 Second Street, NW, Washington, DC, 20217.

District Courts and Claims Court. Generally, district courts and the U.S. Court of Federal Claims hear tax cases only after you have paid the tax and have filed a claim for a credit or refund with the IRS. You may file a claim for a credit or refund if, after you pay your tax, you believe the tax is incorrect. If your claim is rejected by the IRS, you will receive a notice of disallowance of the claim unless you signed a Form 2297, “Waiver of Statutory Notification of Claim Disallowance.” If the IRS has not acted on your claim within 6 months from the date you filed it, you may then file suit for refund. You must file a suit for a credit or refund no later than 2 years after the IRS disallows your claim or a Form 2297 is filed.

You may file your suit for credit or refund in your U.S. District Court or in the U.S. Court of Federal Claims. However, the Court of Federal Claims does not have jurisdiction if your claim is for credit or refund of a penalty that relates to promoting an abusive tax shelter or to aiding and abetting the understatement of tax liability on someone else’s return.

Circuit Courts of Appeals. The findings of either the Tax Court or Federal District Courts can be appealed by either the taxpayer or the Government to the appropriate regional U.S. Court of Appeals.

The United States is divided into nine multi-State regions with one U.S. Court of Appeals for each region. Appeals from the Court of Federal Claims are heard by the Court of Appeals for the Federal Circuit in Washington, DC.

U.S. Supreme Court. The findings of U.S. Courts of Appeals and the Court of Appeals for the Federal Circuit may be reviewed by the U.S. Supreme Court. The taxpayer or the Government may file a petition for a “writ of certiorari” (request to be heard) with the Court. If the Justices agree to hear the case, a writ of certiorari will be granted. Otherwise, certiorari will be denied and the findings of the appeals court are binding on the parties. As a practical matter, the Supreme Court hears very few tax cases. Appeals court decisions are usually the final word in a tax matter.

Interpreting Case Law

Findings of the U.S. Supreme Court become law and must be followed by the IRS. This is not the case with decisions of lower courts that find against the Government or the Commissioner of Internal Revenue. In such cases, if the court finds for the taxpayer in whole or in part, the findings are controlling—assuming no appeal is made—only upon that particular taxpayer for the years involved. In some cases, the IRS will not comment at all. The IRS may, however, concur with certain findings by formally issuing an announcement of “acquiescence” (Act. or A.). This means that the IRS will apply the findings of the court, with regard to the specific points of law involved, to other taxpayers as well. The IRS also may announce its “nonacquiescence” (Nonacq. or NA.), which means that it will not follow the findings of the court and any taxpayer relying on the case as precedent likely will be challenged by the IRS.

In the process of interpreting and applying the Internal Revenue Code (Code) to particular factual circumstances, the courts create nuances in the law. Because the Federal courts follow the common law system, relying on precedents instead of on a strict case-by-case reading of the statutes, court decisions can be cited to support a position. Precedents must be used appropriately, however. First, the precedent cited should be “on point,” that is, it should deal with the same point of law as is involved in the present case. Second, the precedent should be

applicable to the jurisdiction in which the case would be tried. Other cases from the same Federal district or region carry the most weight. Decisions from other districts or regions may be cited, but need not be followed unless the case has been upheld by the U.S. Court of Appeals for the taxpayer’s jurisdiction. U.S. Supreme Court decisions are precedent in any jurisdiction. Decisions by the U.S. Court of Appeals for the Federal Circuit are precedent in the Court of Federal Claims.

Interpretation of the weight a case carries can be made by studying the entry for the case in a findings list or citator. A findings list shows the history of a case and where it has been published. A findings list for timber-related cases is available on the Timber Tax Website. The trial (initial) case is given first followed by any appellate cases. The appellate case entries show their effect on the trial case. The appeals court can affirm (Aff’d, Aff’g), amplify, or reverse (Rev’d, Rev’g) the trial court. A citator also gives the history of a case, but in addition it cites the other cases in which the case was cited as precedent.

AUDITS AND APPEALS

Special audit programs have been developed to monitor abusive tax shelters. Timber-related activities generally are not considered as abusive tax shelters. Although auditors are provided with special industry guidelines concerning what to look for in auditing returns that report timber transactions, your likelihood of being audited is not known to be increased because of your timber activities. You should, however, always conduct your affairs and keep records under the assumption that you will be audited.

How Returns Are Selected for Examination

Your return may be examined to verify the correctness of income, deductions, exemptions, and credits. Most returns are selected and given a score by a computer program called Discriminant Function System (DIF). The scores assigned by DIF relate to the probability that an entry is erroneous. Based upon these scores, IRS personnel screen and select returns for examination. Periodically, returns are also selected under the Taxpayer Compliance Measurement Program (TCMP). This is a random selection system used to evaluate overall

compliance and provide the statistical base used to score returns under the DIF program. Returns may also be selected as part of a “compliance initiative” aimed at a specific market segment (occupation, industry, geographic area, or economic activity) where an area of noncompliance has been identified. The report of an initiative involving timber is available at the Timber Tax Website. The IRS also does a computer match of information documents, such as Forms 1099 and W-2, which can uncover discrepancies and result in an examination.

The Examination Process

If your return is selected for examination, you will be notified in writing. The notification will inform you of the method of examination and the records you will need to make available to the examiner to clarify or support entries on your return. The examination may be conducted by correspondence, or it may take place in your home or place of business, an Internal Revenue Service office, or the office of your attorney or accountant. Although the place and method of examination are determined by the IRS, if the place is not convenient for you the examiner will try to work out something more suitable.

Whatever method of examination is used, you may act on your own behalf or you may have someone represent you or accompany you. If you filed a joint return, either you or your spouse, or both, may meet with the examiner. An attorney, a certified public accountant, a person enrolled to practice before the IRS, or the person who prepared the return and signed it as the preparer may represent or accompany you. You must furnish your representative with written authorization. IRS Form 2848, “Power of Attorney and Declaration of Representative,” or any other properly written authorization may be used for this purpose.

Generally, your tax return is examined in the IRS district where you live. However, at your request, the examination may be moved to another district for a reasonable cause.

If You Agree. If you agree with the findings of the examination, you will be asked to sign an agreement form. If you owe additional tax, you may pay it when you sign the agreement. If you

pay when you sign the agreement, interest is charged on the additional tax from the due date of the return examined to the date you pay.

If you do not pay the additional tax when you sign the agreement, you will receive a bill for it. The bill will include interest on the additional tax from the due date of the return examined to the billing date. If the tax is not paid within 10 days after the billing date, interest starts accruing again. If the examination results in a refund, you will receive interest at the applicable rate on the refund.

If You Do Not Agree. If you do not agree with the changes proposed by the examiner, the examiner will explain your appeal rights. This includes your right to request an immediate meeting with the examiner’s supervisor to explain your position. If agreement is not reached at this meeting, or if the examination takes place outside of an IRS office, the IRS will send you the following:

1. A letter notifying you of your right to appeal the proposed adjustment within 30 days.
2. A copy of the examination report explaining the proposed adjustments.
3. An agreement or waiver form.
4. A copy of IRS Publication 5, Appeal Rights and Preparation of Protests for Unagreed Cases.

If after receiving the examination report you decide to agree with the findings, you sign the form and return it to the examiner. You may pay any additional amount and the applicable interest you owe without waiting for a bill.

If after receiving the examination report you decide not to agree with the examiner’s findings, the IRS urges you to appeal your case within the IRS before you go to court. Most differences can be settled with an appeals office in the region without the need to go to court.

How to Stop Interest from Accruing. You can stop the further accrual of interest on any amount the IRS claims you owe or you believe they will claim you owe by remitting the appropriate amount to the IRS. Your remittance may be made either as a deposit in the nature of a cash bond

(deposit) or as a payment of tax. If you also want to stop the accrual of compound interest, you should remit any interest due. Deposits differ from payments in that you can request the return of a deposit at any time without filing a claim for a refund. However, deposits will not be returned if the IRS has determined that returning it will jeopardize collection of a possible deficiency or that it should be applied against another tax liability. Also, deposits do not earn interest.

If at the end of the examination you agree with the findings of the examiner, your deposit will be applied against the amount you owe. A notice of deficiency will not be mailed to you and you will not have the right to take your case to the Tax Court.

Appeals Within the IRS

There is a single level of appeal within the IRS. Your appeal from the findings of the examiner is to an appeals office in the region. This office is independent of the District Director. Appeals conferences are conducted as informally as possible. If you want an appeals conference, address your request to your District Director according to the instructions in the letter you will receive. If agreement is not reached at your appeals conference, you may, at any stage of the procedure, take your case to court.

Along with your request for a conference, you may need to file a written protest or brief statement of disputed issues with your District Director. Such filings are unnecessary if the proposed increase or decrease in tax, including penalties, or claimed refund due to a field examination is not more than \$2,500 for any of the tax periods involved, or your examination was conducted by correspondence or in an IRS office by a tax auditor. If the proposed increase or decrease in tax or claimed refund is more than \$2,500 but not more than \$10,000, an appeals office conference will be granted if a brief written statement on the disputed issues is provided. You should list in the statement the unagreed adjustment(s) and the reason you disagree with each. A written protest of disputed issues is required to obtain an appeals office conference if the proposed increase or decrease in tax, or claimed refund, is more than \$10,000. In addition, a written protest is required to obtain

appeals consideration in all partnership and S corporation cases, as well as in two others. See IRS Publication 556, *Examination of Returns, Appeal Rights, and Claims for Refund*, for more information on appeal rights, including guidance on preparing a written protest.

Appeals to the Courts

If you and the IRS still disagree after your conference, or if you bypassed the appeals process within the IRS, you may take your case to the U.S. Tax Court, the U.S. Court of Federal Claims, or your U.S. District Court as explained earlier. Even if you elect to bypass the IRS appeals system, a case petitioned to the U.S. Tax Court normally will be considered for settlement by an appeals office before the Tax Court hears the case. If you are a prevailing party in a civil court case against the IRS, you may be entitled to recover reasonable litigation costs, if: (1) you exhausted all administrative remedies within the IRS, (2) your net worth is below a certain limit, and (3) you do not unreasonably delay the proceeding.

For information about procedures for filing suit in the courts, contact the Clerk of the Tax Court, the Clerk of your District Court, or the Clerk of the Court of Federal Claims. Addresses of the courts are given in IRS Publication 556.

Claims for Refund

Once you have paid your tax, you have the right to file a claim for a credit or refund if you believe the tax was calculated incorrectly and is too much. If you filed Form 1040, 1040 A, or 1040 EZ, you may claim a credit or refund by filing Form 1040 X, "Amended U.S. Individual Income Tax Return." Mail it to the IRS Center where you filed your original return. A separate form must be filed for each tax year or period involved. Include an explanation of each item of income, deduction, or credit on which you are basing your claim.

A claim for a credit or refund must be filed within 3 years from the date the original return was filed (including extensions) or within 2 years from the date the tax was paid, whichever is later. Original returns filed before the due date are considered to have been filed on the due date.

ADDITIONAL INFORMATION

For additional information, consult IRS Publication 5, *Appeal Rights and Preparation of Protests for Unagreed Cases*, and IRS Publication 556, *Examination of Returns, Appeal Rights, and Claims for Refund*.

INTEGRATED EXAMPLE OF TAX RESEARCH

As an example of tax research procedures, assume you execute an oral agreement to sell timber “on the shares” to a logger. The logger agrees to cut your timber, sell the logs produced to a sawmill, and give you 40 percent of the amount received from the sawmill for the logs. You are not certain how to report the payments you receive from the logger on your tax return—that is, whether as a capital gain or ordinary income—and how to recover your basis in the timber cut.

From reading this publication, you are aware that capital gain treatment depends on how you dispose of timber and your primary purpose for holding it. If you “dispose” of timber on the stump and the timber is a capital asset in your hands, the proceeds are reported as a long-term capital gain if you held the timber for more than 1 year. If you held the timber primarily for sale to customers in the ordinary course of a trade or business, your disposal must meet the requirements of Section 631 (b) to qualify for capital gain treatment. If you sell products from your timber cut by you or by others providing a logging service for you, you do not qualify for capital gain treatment on the proceeds from the sale of the logs, but may elect to treat the cutting of the timber as a sale under the provisions of Section 631 (a) of the Code.

Because you have conducted many timber sales from your land in the 20 years you have owned it, receive a substantial portion of your total income from these timber sales, and in general conduct your timber-related activities in a manner consistent with being in the business of selling timber, you conclude that your timber is held primarily for sale.

The next question is whether you have disposed of timber on the stump, or whether the logger is

providing a logging service under the oral contract and is selling the logs produced on your account. Since nothing in the Code or regulations specifically deals with oral timber agreements, you must research case law for guidance. In the index of one of the tax services, under “disposal with a retained economic interest,” you find several cases. The first one listed is *Ah Pah Redwood Co. versus Commissioner*, 26 T.C. 1197 (1956) (reversed in part and remanded), 251 F. 2d 163 (9th Cir. 1957), 18 T.C.M. 202 (1959), which happens to involve an oral agreement. By reading this case, you find that the court concluded that the oral contract in question was valid under the laws of the State in which it was executed because real property to be severed upon sale was not subject to the contract law generally applicable to a sale of real estate (the Statute of Frauds did not apply). Since the same law applies in your State, you conclude that your oral agreement with the logger is an enforceable contract. But in reading *Ah Pah Redwood Co.*, you note that the court ruled that the taxpayer could get capital gain treatment under a disposal with an economic interest retained only if the taxpayer was not holding the timber primarily for sale. This court’s ruling conflicts with the discussion in this publication, which says that disposals qualifying under Section 631 (b) receive capital gain treatment regardless of the purpose for which the timber was held. Upon further investigation, the index in the tax service refers you to Revenue Ruling 57-90 (1957-1 C.B. 199), in which the IRS notes that the finding of the court in *Ah Pah Redwood Co.* will not be followed by the IRS to the extent that it is inconsistent with the IRS position that Section 631 (b) will be applied to a disposal of timber with an economic interest retained regardless of the taxpayer’s business or the purpose for which the timber is held.

In analyzing whether you have disposed of your timber with an economic interest retained, you conclude that you in fact did dispose of the standing timber to the logger. Under the oral agreement, the logger was obligated to cut the timber, the logger could sell the logs to any mill he chose, you could not dispose of the same timber to anyone else, and you had no control over the logger’s activities other than to ensure that his activities did not cause serious soil erosion or damage field crops.

You also conclude that you retained an economic interest in the timber disposed of because you would be paid only for the timber actually cut and sold. The logger did not agree to pay you any fixed amount.

Therefore, you conclude that under the terms of the shares agreement in question, payments you received from the logger during the tax year qualify for long-term capital gain treatment under Section 631(b) of the Code, and that your allowable basis in the timber disposed of can be recovered as discussed on page 53.