
Chapter 13. Researching a Tax Question and Appeals Procedures

Very few sections of the Internal Revenue Code (IRC) were written specifically for timber activities. The purpose of this guide is to answer common timber tax questions asked by family forest landowners. You may, however, have questions not adequately covered here, in Internal Revenue Service (IRS) publications, or on the *National Timber Tax Web site* (<http://www.timbertax.org/>). This chapter introduces the basic steps involved in researching tax questions. Taxpayers with difficult tax questions typically seek the assistance of legal counsel, tax accountants, 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 better work with your advisor.

The process starts by answering several basic questions. You must determine which section(s) of the IRC (statutory law) apply and how these sections are interpreted by the IRS (in regulations and revenue rulings) and by the courts (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 foundation of Federal income tax law is the Internal Revenue Code (IRC), 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 (House). 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 also may hold hearings. If the House and Senate pass different versions of the bill, the differences are reconciled by 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 IRC of 1986, as amended.

The official records of hearings and committee reports involving the legislation provide information on what the legislators intended to accomplish by enacting the law. This “legislative intent” is important in interpreting the law when doubt arises about specific language included in it or how it is to be implemented by the IRS.

If you are unfamiliar with tax law it may be difficult to determine which sections of the IRC 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 IRC sections is possible by using the comprehensive index included at the *National Timber Tax Web site*, <http://www.timbertax.org/research/irc/>. Cross-references between commonly used terms and technical terms are included. The applicable IRC sections are listed under the major headings. The commercial tax services listed in chapter 14 also include comprehensive indexes that can be used to determine the appropriate IRC sections.

Administrative Law

The Commissioner of Internal Revenue is charged with implementation of the IRC. The first step is to write and issue Treasury Regulations interpreting the IRC and specifying how it is to be implemented. These regulations have the force and effect of law. The courts, however, may nullify regulations that are not consistent with the IRC or the intent of Congress. After drafting, internal study, and review, regulations are issued as proposed regulations 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 an 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 (IRB), available on the IRS Web site at <http://www.irs.gov/irb/>. It would be impossible to write regulations covering all possible factual circumstances. Thus, other types of rulings and forms of communication are issued by the IRS as the need arises, and also are published in the IRB.

Revenue Rulings

Revenue rulings (Rev. Rul.) are official IRS interpretations of the IRC, related statutes, tax treaties, and regulations. They are published for the information and guidance of taxpayers, IRS personnel, and others. In general, revenue rulings set forth the tax consequences of the specific transactions described in them.

They represent the official policy of the IRS and are binding on the agency until revoked, amended, or otherwise changed. Revenue rulings carry less authority than do regulations, and courts need not follow them if they are found to conflict with the intent of the regulations or the IRC.

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, which should be a matter of public knowledge. In general, a revenue procedure tells taxpayers how to do something—for example, how to make an election relating to tax consequences.

General Counsel Memoranda

General Counsel Memoranda (GCMs) are issued by the Office of Chief Counsel of the IRS. They include technical memoranda and actions on decisions. A GCM is an internal working document of the IRS reflecting the opinion of IRS attorneys on a specific issue. The Office of Chief Counsel only makes selected GCMs available to the public, because of the nature of their subject matter. A GCM provides insight into the logic behind the official position taken by the IRS in an administrative pronouncement such as a revenue ruling, but cannot be used or cited as precedent.

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 IRB and may be released first as news releases; they are issued to inform taxpayers of recent changes in the law, the IRS's 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. An LTR interprets and applies the tax laws to the taxpayer's specific factual circumstances. 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, they are not binding precedent and you

cannot rely on a ruling issued to another taxpayer. Instructions for requesting a ruling appear in a Rev. Proc. that is updated annually. Payment of a user fee is required for requests. The IRS also limits the issues upon which it will provide rulings for specific taxpayers.

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 of a tax return and involves the interpretation and proper application of tax law, tax treaties, regulations, revenue rulings, or other precedents published by the National Office. A taxpayer also may request that a district or appeals office refer an audit issue to the National Office. Although technical advice memoranda are made available to the public, you should not rely on a TAM issued with respect to another taxpayer. Instructions on requesting a TAM are published in a Rev. Proc. that is updated annually.

Case Law

If a question is clearly covered by the IRC, you must follow the IRC or seek legislative remedy—that is, have the IRC changed. If your circumstances are covered by the regulations or revenue rulings, 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 ultimately may have to defend your position in court. Sometimes your circumstances may not be specifically covered by the IRC, regulations, revenue rulings, court decisions, or other authority. 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, followed by 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 later in this section. These courts are independent judicial bodies and have no connection with the IRS. The Federal court system is explained at <http://www.uscourts.gov/FederalCourts/UnderstandingtheFederalCourts/FederalCourtsInAmericanGovernment.aspx>.

If you elect to bypass the IRS appeals system, you may take your case to any of the courts mentioned in the previous paragraph. A case petitioned to the U.S. Tax Court, however, will normally be considered for settlement by an appeals office in the applicable 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 Court that the taxpayer unreasonably failed to pursue available administrative remedies. In general, findings of the Tax Court may be appealed to a higher court. The appeals process is discussed under “Audits and Appeals,” later in this chapter. The following Federal courts hear tax cases.

U.S. Tax Court. The U.S. Tax Court (Tax Court) was created by Congress specifically to hear Federal tax cases. The court is independent 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. Procedures for taking a case to the Court are at http://www.ustaxcourt.gov/taxpayer_info_intro.htm. You have 90 days from the date the deficiency notice is mailed (150 days if mailed to you outside the United States) to file a petition with the Tax Court. In general, 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 is issued and still petition the Tax Court for review.

If your case involves a dispute of not more than \$50,000 for any single 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.

U.S. District Courts and U.S. Court of Federal Claims. In general, U.S. District Courts (District Courts) and the U.S. Court of Federal Claims (Federal Claims Court) hear tax cases only after you have paid the tax deemed due by the IRS and have filed a claim for a credit or refund. 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 an IRS 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 an IRS Form 2297 is filed.

You may file your suit for credit or refund in your District Court or in the Federal Claims Court. The Federal Claims Court does not have jurisdiction, however, 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.

U.S. Circuit Courts of Appeals. The findings of either the Tax Court or District Courts can be appealed by either the taxpayer or the Government to the appropriate regional U.S. Circuit Court of Appeals (Court of Appeals). The United States is divided into nine multi-State regions with one Court of Appeals for each region. Appeals from the Federal Claims Court 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 (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 Supreme Court become law and must be followed by the IRS and taxpayers. 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* (Acq. 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. 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 is likely to be challenged by the IRS.

In the process of interpreting and applying the IRC 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 is upheld by the Court of Appeals for the taxpayer's jurisdiction. Supreme Court decisions are precedent in any jurisdiction. Decisions by the Court of Appeals for the Federal Circuit are precedent in the Federal Claims Court.

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 the decision is published. A findings list for timber-related cases is available on the *National Timber Tax Web site* (<http://www.timbertax.org/research/caselaw/>). The trial (initial) decision is given first, followed by any appellate decisions. 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

The IRS has developed special audit programs to monitor abusive tax shelters. Timber-related activities generally are not considered 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 also may 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 IRS also does a computer match of information documents, such as IRS 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 IRS 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, 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.

In general, your tax return is examined in the IRS district where you live. At your request, however, the examination may be moved to another district for 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. These include 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; and
4. A copy of IRS Publication 5, *Your Appeal Rights and How To Prepare a Protest If You Don't Agree*.

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 that you believe it will claim you owe, by remitting the appropriate amount. 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. A deposit differs from a payment in that you can request the return of a deposit at any time without filing a claim for a refund. A deposit will not be returned, however, 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

Within the IRS, there is a single level of appeal. 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.

Together 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 resulting from 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 adjustment(s) to which you disagree and the reason you disagree with each. A written protest of disputed issues is required to obtain an appeals office conference when 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 Subchapter 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 Tax Court, the Federal Claims Court, or your District Court as explained previously. Even if you elect to bypass the IRS appeals system, a case petitioned to the 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 less than 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 Federal Claims Court. Addresses of the courts are given in IRS Publication 556.

Claims for Refund

After 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 IRS Form 1040, 1040-A, or 1040-EZ, you may claim a credit or refund by filing IRS 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 Publications 5, *Your Appeal Rights and How To Prepare a Protest If You Don't Agree* and 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 guide, 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 IRC 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 IRC section 631(a).

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. Because nothing in the IRC 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). Because 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 IRC 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 Rev. Rul. 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 a 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 IRC section 631(b), and that your allowable basis in the timber disposed of can be recovered as discussed in chapter 5.

