

IRS notice response tips everyone should know

These 13 tips can help practitioners and taxpayers respond effectively to notices from the IRS.

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Everyone must pay federal income taxes. Yet exactly how much taxpayers owe, and on exactly how much, is famously complex. All tax returns must be signed under penalties of perjury. That means taxpayers have to do their best to report everything fully and honestly. But, as practitioners know, there are many gray areas.

For example, exactly when is an item included in income? What types of proceeds qualify for long-term capital gain rather than ordinary income rates? What losses are full write-offs, and which ones are limited to offsetting gains? What assets can be written off all at once, and what must be capitalized and written off ratably over a number of years?

These and many other questions come up at tax return time. Taxpayers must have some answers to be able to file, even if they are leaving many of the details to tax return preparers. But once a taxpayer signs his or her name and files, what about the IRS notices that come? How should taxpayers react, and in what order?

Taxpayers can contest many IRS tax bills, although there are times when it is wiser not to. When taxpayers disagree with the IRS, procedure is important. Pay attention to the order in which notices arrive and the specific ways in which taxpayers can respond.

Here are basic guidelines your clients need to know about IRS notices and the best responses to them:

Most audits are via correspondence: Many taxpayers are surprised to discover that most audits do not involve sitting across the desk from an IRS agent. Let's say a taxpayer files his or her tax return and later receives a notice from the IRS saying it has information that the taxpayer received \$6,000 that was not reported on the return. That discrepancy might be because of a mislaid Form 1099 or one that failed to show up in the mail, or because the IRS has some other bit of information that does not match the return.

Usually the notice will ask the taxpayer to sign the form and mail it back if he or she agrees. Or it might ask for an explanation of why the information is incorrect. Taxpayers can contest these notices—but must do so promptly.

Don't fight every tax bill: A taxpayer who knows the IRS is correct should not contest a tax bill. Likewise, if the IRS is seeking a small amount of tax, taxpayers may be better off not fighting, even if they are right. Just consider whether it is worth it if the amount is small. Of course, what is a small tax bill can mean different things to different people.

Sometimes, disputing something small can end up triggering other issues that might have best been left alone. So consider that too. But in most cases, taxpayers who get a bill for additional taxes should preserve their rights. Timelines and procedures are critical.

Watch out for proposed deficiencies: The notice described above is not a Notice of Proposed Deficiency but a taxpayer should still answer it. An Examination Report may follow the first notice if the taxpayer fails to respond. Most tax lawyers and practitioners call the Examination Report and the accompanying letter a 30-day letter because it says the taxpayer has 30 days to respond in an administrative "protest." A protest is just a letter.

Make sure to prepare a timely protest: If a taxpayer receives an IRS Examination Report, make sure to prepare a protest and sign and mail it before the deadline. Keep a copy and proof of mailing, preferably a certified mail receipt to verify mailing and IRS receipt. Taxpayers should explain themselves thoroughly, and attach documents where they will be helpful.

The protest should analyze the facts and the law and put the taxpayer's best foot forward. The IRS may review the protest and agree. Even if it doesn't, how the protest is framed can help later. If the protest is timely, the IRS normally responds that it is transferring your case to the IRS Office of Appeals.

The IRS Office of Appeals is nationwide: The IRS Office of Appeals is a separate part of the IRS. Its mission is to resolve cases in which the auditor has recommended additional taxes, and the taxpayer disagrees. The Appeals officer assigned to the case works for the IRS and, in that sense, can never be truly unbiased.

Even so, the IRS Appeals function is separate, and officers try to be impartial and fair to both parties. This process of working out compromises works surprisingly well. A tax lawyer may be best qualified for some cases, but a CPA can also represent a taxpayer. Alternatively, taxpayers can handle their cases themselves.

While it is less expensive for a taxpayer to handle the case themselves, it is also generally less effective. The vast majority of tax cases are resolved at Appeals. Usually, taxpayers are assigned to the Appeals office closest to them, but offices are located throughout the United States. Sometimes, taxpayers are assigned to an Appeals office in some far corner of the country.

The assignment of locations is generally based on the workload of the offices and Appeals officers. It can also be based on particular tax issues that some offices are handling. If the location assigned doesn't facilitate a face-to-face meeting and the taxpayer wants one, he or she may ask for the case to be moved to the IRS Appeals office nearest the taxpayer, his or her tax lawyer or tax preparer, and the taxpayer's books and records, etc. The IRS is not required to grant those requests, but it usually does. Most IRS Appeals officers are happy to get a case they are assigned off their desk and assigned to someone else!

Beware a Notice of Deficiency: If a taxpayer fails to protest, or resolve the case at IRS Appeals, the IRS will send an IRS Notice of Deficiency via certified mail, which is the required delivery method. A Notice of Deficiency is often called a 90-day letter by tax practitioners, because taxpayers have 90 days to respond.

There used to be many misunderstandings about exactly when that 90 days ran out. So today, the IRS is required to prominently display on page one of the Notice of Deficiency the actual deadline for a response. Don't write the IRS to protest a Notice of Deficiency. In fact, only one response to a Notice of Deficiency is permitted: filing a petition in the U.S. Tax Court clerk's office in Washington.

Although it is best to hire a tax lawyer, some taxpayers handle their Tax Court case on their own, pro se. There are special simplified procedures available to taxpayers who represent themselves in cases where less than \$50,000 in tax is in dispute. Whether a taxpayer handles the case himself or herself or hires a tax lawyer, the U.S. Tax Court cannot hear the case if the taxpayer misses the 90-day deadline for filing a petition.

Tax Court judges travel around the country: The Tax Court building and clerks are all in Washington. However, the 19 Tax Court judges travel to federal courthouses all around the country to conduct trials. Taxpayers can pick the city where they want their cases to be heard when they file their Tax Court petition.

Tax Court procedures and rules of evidence are streamlined, with no jury and with relaxed rules of evidence. Taxpayers can call witnesses, and many cases are presented based on a "stipulated record," in which the taxpayer and the government agree on certain facts.

Cases can go back to IRS Appeals: Remember, the only way to respond to a Notice of Deficiency is to file a timely petition in U.S. Tax Court. Fortunately, though, that does not mean the case will necessarily be decided in court. An IRS lawyer will file an answer to the taxpayer's petition. As with most other answers in litigation, the IRS will generally deny whatever the taxpayer's petition says.

At this point, the taxpayer can ask the IRS lawyer to transfer the case to IRS Appeals. Often, a Notice of Deficiency is issued before a case has ever gone to IRS Appeals and in that sense, it can seem as if the IRS is trying to cut off a taxpayer's right to an appeal. Actually, though, it is usually because of workload, or because the IRS is worried that the statute of limitation on the tax year in question is about to run.

The IRS often issues a Notice of Deficiency to make sure taxpayers can't later claim that the IRS cannot make an assessment because the statute of limitation to assess taxes has expired. When this happens, the IRS lawyer will almost always be happy to transfer the case to (or back to) IRS Appeals. This also ties into extensions of the IRS statute of limitation.

IRS often asks taxpayers to extend the statute: Often, the IRS tells taxpayers it is auditing them, but it needs more time to conduct the audit. Giving the IRS more time for an audit? It may sound counterintuitive, if not downright crazy to give the IRS more time, but it is not, as we will see.

A taxpayer's first reaction may be to relish the thought of telling the IRS absolutely not! Even a routine tax audit can be expensive and nerve-wracking. The IRS normally has three years to audit, measured from the return due date or filing date, whichever is later. But the three years is doubled in a number of cases. For example, the IRS gets six years if a taxpayer omitted 25% or more of income reported on the return.

Even worse, the IRS has no time limit if a taxpayer never files a return, or skips certain key forms (for example, if the taxpayer has an offshore company but fails to file IRS Form 5471, Information Return of U.S. Persons With Respect to Certain Foreign Corporations). Assume that if the IRS is asking for an extension of the statute, the IRS is already monitoring that person closely. For the most part, people usually do voluntarily give the IRS more time to audit.

Why would anyone do that? It works like this. The IRS contacts a taxpayer (usually about two and a half years after the return was filed), asking the taxpayer to extend the statute of limitation. Most tax advisers usually tell taxpayers to agree because saying no or ignoring the request will often lead the IRS to assess extra taxes, usually based on an incomplete and quite unfavorable picture.

Taxpayers might think that they could fail to say yes or no and that the IRS might forget about them, but this is something the IRS is very careful about. The IRS rarely misses issuing a Notice of Deficiency, and taxpayers usually will be worse off (often much worse off) than if they agreed to the extension. There are exceptions to this rule, but relatively few. In addition, sometimes taxpayers can agree to the extension but limit the extra time, or even the tax issues at stake. Get a professional to help weigh the facts.

Taxpayers can sometimes get extensions too: Everyone knows there are automatic six-month extensions to filing taxes. April 15 can become Oct. 15, although any taxes due must be paid by April 15. But what about extensions when the IRS demands a response to a notice or letter within 30 days?

For many notices, the IRS will grant an extension of time to respond. In some cases, though, it cannot extend the deadline. For example, when taxpayers receive a Notice of Deficiency (90-day letter), they must file in Tax Court within 90 days, and this date cannot be extended because it is statutory. However, rules for most other notices are less strict. Taxpayers who ask the IRS for extensions should confirm the IRS's response in writing, and keep a copy. In fact, taxpayers should confirm everything they do with the IRS in writing.

Some IRS actions can be undone: It is always best to respond to IRS notices within their stated time frames. Still, it is sometimes possible to undo IRS action after the fact. For example, even after the IRS places a lien on property or levies on a bank account, this can be reversed. However, it is usually harder and more expensive to undo something the IRS has already done, and it usually requires professional help.

Pay up, then sue: If the taxpayer did not respond to a Notice of Deficiency within 90 days, and there is an assessment, all is not lost. The taxpayer will not be able to go to Tax Court, but he or she can contest the taxes in federal district court or in the U.S. Court of Federal Claims. Usually, taxpayers must pay the taxes first and file a claim for refund. If the refund request is not granted, then the taxpayer can sue for a refund.

The primary advantage of proceeding in Tax Court is that taxpayers need not pay the tax first. In contrast, most taxpayer suits in federal district court or claims court are after the tax has been paid. Sometimes, though, taxpayers can cleverly shoehorn themselves into a forum even though it might seem that they don't satisfy the rules for it.

Take the case of *Colosimo*, 630 F.3d 749 (8th Cir. 2011). There, the IRS pursued the company and its owners for payroll taxes. The owners sued in federal district court for a ruling they were not "responsible persons" required to pay the payroll taxes. But, before they sued, the owners paid only a fraction of the taxes the IRS was seeking. This was a clever use of the notion that sometimes you can pay only a portion of the tax due, and let the lawsuit resolve both pieces of the asserted tax: the part you paid, and the part you didn't.

Be careful. Remember, there are many different types of IRS tax notices. We have covered a few types of IRS notices here, including a Notice of Deficiency. However, there are many other types of important notices, including liens, levies, and summonses. Forms of response vary, and procedure is important. It's best to get some professional help. In general, don't ignore anything from the IRS!

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