

Layman's Guide to Handling an IRS Tax Dispute

by Robert W. Wood



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In this article, Wood outlines how taxpayers should handle communications from the IRS and the options they have to dispute assessments.

This discussion is not intended as legal advice.

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Everyone knows that taxes are complex, yet tax returns must be signed under penalties of perjury. That doesn't mean you have to be 100 percent right all the time, but you are required to declare that you have examined your return, and that it is true, correct, and complete to the best of your knowledge. And sometimes you may be required to seek out professional advice. For example, it wouldn't be enough to say that you honestly but incorrectly believed that the tax code allowed you to write off all the educational expenses for your children in high school, college, and beyond.

But the gray areas of the tax law are legion, and taxpayers often feel caught between a rock and a hard place. When is something income, even though you physically don't have it? What types of proceeds qualify for long-term capital gain rates? What losses are limited to offsetting gains? What assets can be written off all at once, and

what must be capitalized and written off over many years?

The rules are so confusing that sometimes taxpayers need professional help just to determine whether they need professional help. Then, too, three well-meaning tax professionals might give three different answers. The recordkeeping and substantiation requirements are another deep source of anxiety. And, of course, audits.

Most taxpayers fear an audit. Some are in such dread of a letter from the IRS that they find they cannot open it. Of course, that tends to make tax problems snowball. Once you sign your name and file your return, what about the IRS notices that come later, with or without a full-blown audit? How should you react, and in what order?

You can contest many IRS tax bills, although there are times not to. But when you disagree with the IRS, both timing and procedure matter. It is important to pay attention to the order in which notices arrive and to the specific ways in which you can respond. Most audits do not involve sitting across the desk from an IRS agent.

Let's say you file your tax return and later receive a notice from the IRS saying it has information that you received \$6,000, which you failed to report. This might be because you mislaid a Form 1099, or that one failed to show up in the mail, or the IRS has some other bit of information that does not match your return. Usually, that type of IRS notice will ask you to sign the form and mail it back if you agree with what it says.

Alternatively, the notice will ask for an explanation of why the IRS's information is incorrect. You can contest the notice if you do so promptly. Of course, if the IRS is correct, you should agree. Likewise, if the IRS is seeking a small amount of tax, you may be better off not fighting it, even if you are right.

Consider whether it is worth fighting if the dollar amounts at issue are small. Of course, what

constitutes a small tax bill can mean different things to different people. But it is worth noting that sometimes, disputing something small can end up triggering other issues that might have been better left alone. So consider that you may be poking a bear if you push back on a tax bill, which may give rise to something worse.

But in most cases, if you get a bill for additional taxes, you'll want to preserve your rights. It is worth repeating that when it comes to the IRS, both timeline and procedure are critical.

Asking the IRS for Extensions

Everyone knows there are automatic six-month extensions for filing your taxes. April 15 can become October 15, although you must still *pay* any taxes due 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 taxpayers an extension of time in which to respond. In some cases, though, it can't. For example, when you receive a notice of deficiency (90-day letter), as discussed below, you must file in the Tax Court within 90 days, and this date cannot be extended. Most other notices are less strict. If you do ask the IRS for an extension, confirm it in writing and keep a copy. In fact, confirm everything you 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 an IRS action after the fact. For example, even after the IRS places a tax lien on property or levies on a bank account, these actions can sometimes be reversed. However, undoing something is usually harder and more expensive, and it usually requires professional help.

Protesting Proposed Deficiencies

Even if a notice does not say it is a notice of proposed deficiency, you should answer it. An examination report may follow the first notice if you fail to respond. Most tax lawyers call an examination report and accompanying letter a "30-day letter." It will say you have 30 days to respond with a so-called administrative protest. A

protest is a formal letter saying that you think the IRS is wrong and explaining why.

If you receive an IRS examination report, make sure you prepare a protest and sign and mail it before the deadline. Keep a copy. Keep proof of mailing, too, preferably certified mail to provide verification of mailing and of IRS receipt. Explain yourself thoroughly and attach documents when they will be helpful.

Your protest should analyze the facts and the law, and you should try to put your best foot forward. The IRS may review your protest and agree with you. Even if it doesn't, how you frame your protest can help later. If you have protested in a timely way, you will normally receive a response that the IRS is transferring your case to its Appeals division.

Going to IRS Appeals Division

The IRS Office of Appeals is separate and independent from the agency's examination and collection functions, and its mission is to resolve cases. By definition, these are cases in which an auditor has recommended additional taxes, and the taxpayer disagrees. An Appeals officer will be assigned to your case. That person works for the IRS and, in that sense, can never be truly unbiased.

Even so, Appeals is separate, and its officers try to be impartial and (when they can) split the baby. This process of working out compromises works surprisingly well. A tax lawyer may be best qualified to handle your case, but an accountant can too. You can represent yourself, and while it is less expensive to do so, it is also generally less effective.

The vast majority of tax cases are resolved at Appeals. Usually, you'll be assigned to the Appeals office closest to you. But there are offices throughout the United States, and sometimes you are assigned to an Appeals office in some far corner of the country. This is generally based on the workload of the offices and the Appeals officers. It can also be based on particular tax issues that some offices are handling.

Many meetings with IRS Appeals are handled remotely. However, if the location you're assigned doesn't facilitate a face-to-face meeting and you want one, you can ask for the case to be moved to the IRS Appeals office nearest you, your tax

lawyer, your books and records, and so on. While the IRS is not required to grant those requests, it often does. Many Appeals officers are happy to get an assigned case off their desk and assigned to someone else.

Beware Notices of Deficiency

If you fail to file a timely protest or don't resolve your case at Appeals, you'll next receive an IRS notice of deficiency. An IRS notice of deficiency always comes via certified mail. It can't come any other way. A notice of deficiency is often called a "90-day letter" by tax practitioners because you'll have 90 days to respond.

There have been many flubs and misunderstandings over exactly when the 90 days runs out. So today, the IRS is required to prominently display on page 1 of the notice of deficiency the actual deadline for your response. But even with that clear warning, many taxpayers have gotten into trouble and have failed to preserve their legal rights — for example, by writing to the IRS to protest a notice of deficiency.

Only one response to a notice of deficiency is permitted: filing a Tax Court petition in the Tax Court clerk's office in Washington. Although it is best to hire a tax lawyer, some taxpayers handle their Tax Court cases on their own, pro se. There are special simplified procedures available to taxpayers who represent themselves in cases in which less than \$50,000 in tax is in dispute. Whether you are handling the case yourself or you hire a tax lawyer, the Tax Court cannot hear your case if you miss the 90-day deadline.

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. You can pick the city in which you want your case to be heard when you file your Tax Court petition.

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

Going Back to IRS Appeals

Remember, the only way you can respond to a notice of deficiency is to file a timely petition with

the Tax Court. Fortunately, though, that doesn't mean your case will necessarily be decided in court. An IRS lawyer will file an answer to your Tax Court petition. As with most other answers in litigation, the IRS will generally deny whatever your petition says.

But then you can ask the IRS lawyer to transfer your case to IRS Appeals. Often, a notice of deficiency is issued before a case has ever gone to Appeals. In that sense, it can seem as if the IRS is trying to cut off your right to an appeal. Actually, though, it is often because of workload, or because the IRS is worried that the statute of limitations on the tax year in question is about to run out.

The IRS may issue a notice of deficiency to make sure you can't later say it is too late to assess taxes. When this happens, the IRS lawyer who files an answer to your Tax Court petition will usually be happy to transfer your case to IRS Appeals if you did not already go through the appeals process. This also ties into extensions of the IRS's statute of limitations.

IRS Requests to Extend the Statute

If the IRS is auditing you, it may tell you that it needs more time. Why would you agree to give the IRS more time to audit you? It may sound counterintuitive, if not downright crazy, to give the IRS more time, but it is not, as we will see. If the IRS asks you for an extension because it needs more time to audit you, your first reaction may be to relish the thought of responding, "Absolutely not!"

Even a routine tax audit can be expensive and nerve-racking. 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 several cases. For example, the IRS gets six years if you omitted 25 percent or more of your income.

Even worse, the IRS has no time limit if you never file a return or if you skip certain key forms (for example, if you have an offshore company but fail to file IRS Form 5471, "Information Return of U.S. Persons With Respect to Certain Foreign Corporations"). You must assume that if the IRS is asking you to extend the statute of limitations, it is already monitoring you closely. And 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 you (perhaps about two and a half years after you file), asking you to extend the statute. Most tax advisers say you should usually agree. If you say no or ignore the request, the IRS will assess extra taxes, usually based on an incomplete and quite unfavorable picture.

You might think that you could fail to say yes or no and the IRS might forget about you. But this is something the IRS is careful about. The IRS rarely misses issuing a notice of deficiency, and you usually will be worse off (often *much* worse off) than if you agreed to the extension. There are exceptions to this rule — but relatively few. And sometimes you can agree to the extension but limit the extra time you give, or even the tax issues at stake. Get a professional to help you weigh your facts.

Suing for a Refund

If you do not respond to a notice of deficiency within 90 days, and you have an assessment, all is not lost. You will not be able to go to the Tax Court, but you can contest the taxes in federal district court or the U.S. Court of Federal Claims. You must usually pay the taxes first and then file a claim for refund. If the refund request is not granted, then you can sue for a refund.

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

Take the case of *Colosimo*.¹ There, the IRS pursued the company and its owners for payroll taxes. The owners sued in district court for a ruling that they were not “responsible persons” required to pay the payroll taxes. But 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 your suit will resolve both pieces of the asserted tax: the part you paid and the part you didn't.

¹*Colosimo v. United States*, 630 F.3d 749 (8th Cir. 2011).

Conclusion

There are many different types of tax notices, even if you are only talking about the IRS. We have covered a few types here, including a notice of deficiency. However, there are many other types of important notices, including liens, levies, and summonses. The forms of response vary, and procedure is important. You're best advised to get some professional help. Most importantly, don't ignore anything you get from the IRS! ■