



Defending a Federal (IRS) Income Tax or Excise Tax Audit or a State Sales and Use Tax Audit

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Upcoming GKG Law Webinars

May 07, 2013 at 1:00PM EDT: *Aircraft Financing - Current Issues and Hot Topics/Unique Issues In Aircraft Purchase & Sale Transactions Involving Importation Into the U.S.*; Presented by Keith Swirsky and Michael Amalfitano, Managing Director, Executive Head, Banc of America Leasing, Global Corporate Aircraft Finance

June 11, 2013 at 1:00PM EDT: Federal Income Tax Treatment of Personal Use of Aircraft – Update on Final Regulations; Presented by Troy Rolf



Defending a Federal (IRS) Income Tax or Excise Tax Audit



Overview

Topics we will cover in this webinar include:

- How to respond when the IRS initiates an income tax or excise tax audit
- Procedural and substantive aspects of the audit process
- Possible outcomes – “no change” letter or proposed income or excise tax liability



Overview

- Settling the case and/or filing a Protest Letter with IRS Appellate Division
- Alternatives to filing a Protest
- Current “hot” issues in IRS income tax and excise tax audits



Audit Triggers

- Not always clear what triggers an audit
- Increased audits of “flow through” entities (S Corporations/LLC partnerships) and high net worth individuals
- Large losses reported on Form 1040 (e.g., bonus depreciation)
- Large travel & entertainment deductions
- IRS deemed “non-compliant industries”



New IRS Procedural Mandates

- Reduce time period for completion of the audit (has not really happened)
- More comprehensive initial IRS information document request (IDR)
- Detailed questionnaire required for taxpayer and any corporate entity



Life Cycle of IRS Tax Audit

- IRS examination akin to a “chess” game
 - Need to thoroughly understand substantive and procedural rights
 - Need to appropriately respond to IRS requests
- Procedural aspects
 - Which IRS Office issued the letter?
 - What tax years/tax returns are involved?
 - How detailed is the initial IRS information document request (IDR)?
 - Why are you being audited (referral, special IRS project or audit lottery – any criminal overtones) ?



Life Cycle of IRS Tax Audit

- ➔ Proposed date and location of audit
- ➔ Who should represent the taxpayer?
 - When should legal counsel get involved?
- ➔ Has the IRS “tipped its hand” regarding the issues it will focus on?
- ➔ Conduct of due diligence efforts on IRS Agent
- ➔ Overall scope of examination
- ➔ Determining at the outset whether there are any “looming” issues that may be discovered



Life Cycle of IRS Tax Audit

- ➔ Does the audit involve strictly income or excise tax issues or could both tax types be involved?
 - Does the revenue officer/agent focus on income tax or excise tax?
- ➔ Document retrieval
 - Original records/flight logs vs. information that is recreated
 - Ensuring accuracy of information
- ➔ Limiting scope of audit
 - Presentation of material in a manner that will not encourage revenue agent/officer to expand scope of audit



Life Cycle of IRS Tax Audit

→ “Hot” audit issues

- Hobby loss rules
- Passive vs. active characterization of loss
- Deduction limitations for personal entertainment use of aircraft
- Imposition of air transportation excise (“ticket”) tax on aircraft management fees and cost reimbursements



IRS Revenue Agent Report

- Typically have 30 days to review/respond before final assessment (“30 day letter”)
- Any proposal of penalties (e.g, 20% accuracy)?
- Number of issues involved
- Determine your willingness to settle case at examination level versus challenging it on appeal



Appellate Case

- Pros and cons of Appellate Division
- Interest (and/or) penalties continue to accrue if no prepayment made
- Analysis of “hazards” of litigation
- Ability to trade issues (is this all or nothing or is compromise a possibility)
- Complexity of issues – Appellate Division may have higher level of expertise



Appellate Case

- Is case one of first impression/do you want to be the “test” case?
- Is taxpayer willing to extend statute of limitations (Form 872 (income tax)/Form 872-B (excise tax)) for open tax years
- Timing of appellate case and choice of appellate case jurisdiction



Appellate Division

→ Settlement opportunities

- Carryback and/or amended tax returns and impact on prospective reporting position

→ Dealing with the liability

- Payment plan (avoiding IRS enforcement action)



Alternatives To Appellate Division

- Should the case be litigated? Is a courtroom a better forum for the issues involved?
- Analyze cost of litigation and choice of forum
 - If income tax related can continue in prepayment by filing complaint with United States Tax Court or, alternatively, can pay tax and claim refund (Federal District Court or Court of Federal Claims)
 - If excise tax – must pay assessed tax and proceed in Federal District Court or Court of Federal Claims



State Sales and Use Tax Audits

- Sales taxes are collected in 45 states and, additionally, in thousands of local jurisdictions
- Some states have no income tax and are therefore more likely to aggressively enforce imposition of sales and use taxes
- Aircraft are “big ticket” items with large sales and use tax exposure
- States are facing unprecedented budget shortfalls and need to locate additional revenues – aircraft are easy targets with potentially large tax liability



State Sales and Use Tax Audits

- Sales tax audit process is similar in many ways to IRS audit process but is generally less formal
- A sales tax audit typically starts with an inquiry letter
 - Letter may be automatically generated following receipt of notice of registration of aircraft in state
 - May result from information reported to state revenue agency by airport/FBO/management company



State Sales and Use Tax Audits

- Taxpayer must reply to letter in writing with specific information, including supporting documentation, regarding any exemption from sales or use tax that is claimed; otherwise sales tax will likely be assessed
- Nature of inquiry and required response varies from state to state



State Sales and Use Tax Audits

- Documents typically requested include
- Copies of filed sales and use tax returns and proof of payment of sales or use tax
 - Copies of Aircraft Purchase Agreement/Bill of Sale/Invoice
 - Copies of Issued Resale Certificate(s)/Exemption Certificates and proof that such certificates were remitted/filed as needed
 - Copies of aircraft leases/invoices for rent/proof of rent payment



State Sales and Use Tax Audits

- Common issues that arise in sales and use tax audits
 - Nexus – whether or not aircraft has sufficient connection with state in question to give rise to sales or use tax liability
 - Validity of claimed exemptions
 - Application of sales and use tax is formalistic
 - Need to prove application of exemption based on clear and convincing documentary evidence
 - Commercial aircraft exemption – usually strictly construed against taxpayer if any ambiguity



State Sales and Use Tax Audits

→ Common issues (continued)

- Sale for Resale (Leasing) Structures
 - Signed leases and Resale Certificates executed/issued as of closing date
 - Clear transfer of aircraft possession to lessee(s) as documented in flight logs
 - Registration as sales tax vendor with state prior to closing date
 - Sufficiency of rent amount and proof that rent payments were actually and timely made (not just book entries)



State Sales and Use Tax Audits

- Results of audit will be reported in writing
- Must carefully follow procedure for appeal/redetermination paying special attention to all deadlines, which vary from state to state
- Appeals process in most states is extremely backlogged and can take months or years to resolve – be prepared for a lengthy process
- Consider settlement options based on assessed liability, penalties and interest and cost of appeal



State Sales and Use Tax Audits

- Appellate conferences/hearings are generally informal and may be conducted in person or by telephone
- Appeals officer may request documentation such as copies of filed Federal income tax returns and taxpayer financial statements
- Appeals officer may be more willing to accept alternative theories of liability to reduce overall tax amount and reduce or eliminate penalties



State Sales and Use Tax Audits

- Depending on the specific state and the amount of the assessed sales or use tax liability, it may be prudent to consider other alternatives
 - If a state revenue authority is known to be particularly taxpayer unfriendly or biased against aircraft owners, it may be advisable to consider paying tax and filing suit for refund in courts



State Sales and Use Tax Audits

- Many states have enacted voluntary disclosure programs that allow taxpayers to voluntarily report unpaid sales or use tax and avoid payment of penalties as long as taxpayer is not under audit or criminal investigation at the time of disclosure.



Closing Remarks

Q & A





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