



***Defending an IRS Income Tax
or Excise Tax Audit or a
State Sales and Use Tax Audit***

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Defending Tax Audits

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This presentation is being provided for general information and should not be construed as legal advice or legal opinion on any specific facts or circumstances. You are urged to consult your attorney or other advisor concerning your specific situation and for any specific legal or financial questions you may have.

Defending Tax Audits

Overview

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

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Audit Triggers

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

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Recent 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

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Form 4564 (Rev. September 2006)	Department of the Treasury — Internal Revenue Service Information Document Request	Request Number 1
To: (Name of Taxpayer and Company Division or Branch)		Subject
		SAN Number _____ Submitted To: _____
		Date of Previous Requests _____
Please return Part 2 with listed documents to requester identified below		
Description of documents requested		
<p>1. Did the company provide air transportation to or for employees other than regularly scheduled commercial carriers during calendar year 2012 or 2011?</p> <p>2. If the company provided employees air transportation utilizing "Business Aircraft", then please:</p> <p>a. Describe the circumstances and employees involved. For example, was the aircraft chartered, leased, or owned by the company or a related entity. If the aircraft was chartered or leased, please provide a copy of the contract/agreement.</p> <p>b. Provide a listing of each flight on Business Aircraft showing the:</p> <ul style="list-style-type: none"> i. Flight date ii. Origin of flight iii. Destination of flight iv. Mileage of each flight leg v. Number of seats available on aircraft vi. Name of each passenger, and vii. Whether the passenger was traveling for company business, personal, or personal entertainment purposes. <p>c. If the passenger was traveling for company business purposes, also provide:</p> <ul style="list-style-type: none"> i. Business relationship of each passenger to taxpayer, and ii. Business purpose for each passenger's trip. 		
Information Due By	At Next Appointment <input type="checkbox"/>	Mail In <input type="checkbox"/>
From:	Name and Title of Requester	Employee ID number
		Date (mm/dd/yyyy)
	Office Location	Telephone Number
Catalog Number 23146K	1	Form 4564 (Rev. 9-2006)

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Form 4564 <small>(Rev. September 2008)</small>	Department of the Treasury — Internal Revenue Service Information Document Request	Request Number 1
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d. If the passenger was traveling for personal purposes, provide:

- i. Whether the passenger was a "specified individual", guest or relative of a "specified individual" under IRC 274(c)(2)(B);
- ii. Whether the passenger was a "control employee", guest or relative of a "control employee" as defined in 1.61-21(g)(8)
- iii. What amount, if any, the employee (officer, shareholder, partner) reimbursed in expenses or paid the taxpayer for the personal flight.

3. Please provide all computations made under IRC 274(e), Notice 2005-45 or proposed regulations related to the amount deductible under IRC 274(c)(2) or (9) for personal entertainment flight's aircraft expenses incurred for "specified individuals." Please make sure the information provided reflects the:

- a. Type of Aircraft expense (fuel, interest, depreciation, flight crews, etc.) considered in the IRC 274(e) calculation, and
- b. Flight by Flight computations.

4. Please provide detailed "Fair Market Value" or "Standard Industry Fare Level (SIFL)" computations where the taxpayer has calculated taxable compensation of wages for Personal Use of Business Aircraft for employees or independent contractors. Additionally, provide the related Form W-2 or Form 1099 along with a computation showing how much of the compensation on the Form is related to personal use of aircraft.

5. Copy of each aircraft purchase contract and invoice.

6. Copy of each aircraft's tax depreciation schedule from date first placed in service through 2012. Be sure this information includes any depreciation disallowed as a result of application of IRC 274(c)(2) or (9) limitations.

7. Each aircraft registration number, manufacturer's serial number, type and model of aircraft, and number of passenger seats on the aircraft.

Information Due By	At Next Appointment <input type="checkbox"/>	Mail in <input type="checkbox"/>
From:	Name and Title of Requester	Employee ID number
	Office Location	Date (mm/dd/yyyy)
		Telephone Number

Catalog Number 23149K 2 Form 4564 (Rev. 9-2008)

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Life Cycle of IRS Tax Audit

- ▶ Proposed date and location of audit; initial meeting with IRS
- ▶ Who should represent the taxpayer?
- ▶ When should legal counsel get involved?
- ▶ Anticipating tax issues - has the IRS “tipped its hand” regarding the issues on which it will focus?
- ▶ Determining overall scope of examination
- ▶ Determining at the outset whether there are any “looming” issues that may be discovered

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Life Cycle of IRS Tax Audit (cont'd)

- ▶ Does the IRS agent focus on income tax, excise tax or both?
- ▶ Document retrieval – pre-summons letter; summons
- ▶ Original contemporaneous records/flight logs vs. information that is created after the event(s) occur
- ▶ Ensuring accuracy of information
- ▶ Limiting scope of responses – IDRs to be narrowly tailored per IRS policy; asserting applicable privileges (attorney-client; work product)
- ▶ Directly responding to IDR questions, without providing extraneous or unnecessary information

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“Hot” Audit Issues

- ▶ MACRS (including Bonus) vs. ADS depreciation
- ▶ Passive vs. active characterization of loss
- ▶ Deduction limitations for personal entertainment use of aircraft
- ▶ Hobby loss disallowance

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IRS Revenue Agent Report

- ▶ IDR Agreement of Facts – Best not to respond and to state facts in Protest of 30 day letter.
- ▶ IRS Form 5701 – Notice of Proposed Adjustment (NOPA)
- ▶ Determine your ability/willingness to settle case at examination level versus challenging it on appeal
- ▶ Respond to NOPA if any items clearly erroneous; Otherwise, acknowledge receipt and wait for 30 day letter
- ▶ Any proposal of penalties (e.g., 20% accuracy)?

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Internal Revenue Service	Department of the Treasury
.....	Taxpayer Identification Number:
Date:	Form:
	Tax Period(s) Entered and Delinquency Amount(s):
	Person to Contact:
	Contact Telephone Number:
	Employee Identification Number:
	Last Date to Respond to this Letter:

Dear _____

We have enclosed an examination report showing proposed changes to your tax for the period(s) shown above. Please read the report, and tell us whether you agree or disagree with the changes by the date shown above.

If you agree with the proposed changes...

1. Sign and date the enclosed agreement form.
2. Return the signed agreement form to us.
3. Enclose payment for tax, interest and any penalties due. Make your check or money order payable to the **United States Treasury**. You can call the person identified above to determine the total amount due as of the date you intend to make payment.
4. After we receive your signed agreement form, we will close your case.

If you pay the full amount due now, you will limit the amount of interest and penalties charged to your account. If you agree with our findings, but can only pay part of the bill, please call the person identified above to discuss different payment options. We may ask you to complete a collection information statement to determine your payment options, such as paying in installments. You can also write to us or visit your nearest IRS office to explain your circumstances. If you don't enclose payment for the additional tax, interest, and any penalties, we will bill you for the unpaid amounts.

If you don't agree with the proposed changes...

1. You may request a meeting or telephone conference with the supervisor of the person identified in the heading of this letter. If you still don't agree after the meeting or telephone conference, you can:

Letter 850-E(DO) (8-2005)
Catalog Number 39911C

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2. Request a conference with our Appeals Office. If the total proposed change to your tax is:

- \$25,000 or less for *each* referenced tax period, send us a letter requesting consideration by Appeals. Indicate the issues you don't agree with and the reasons why you don't agree. If you don't want to write a separate letter, you can complete the Statement of Disputed Issues at the end of this letter and return it to us.
- More than \$25,000 for *any* referenced tax period; you must submit a formal protest.

If you request a conference with our Appeals Office, an Appeals Officer will call you (if necessary) for an appointment to take a fresh look at your case. The Appeals Office is an independent office and most disputes considered by the Appeals Office are resolved informally and promptly. By requesting a conference with our Appeals Office you may resolve the matter sooner and/or prevent interest and any penalties from increasing on your account.

The requirements for filing a formal protest are explained in the enclosed Publication 3498, *The Examination Process*. Publication 3498 also includes information on your *Rights as a Taxpayer* and the *IRS Collection Process*.

You must mail your signed agreement form, completed Statement of Disputed Issues, or a formal protest to us by the response date shown in the heading of this letter. If you decide to request a conference with the examiner's supervisor, your request should also be made by the response date indicated.

MAIL RESPONSES TO: **Internal Revenue Service**

If we don't hear from you by the response date shown in the heading of this letter, we will have to process your case on the basis of the adjustments shown in the enclosed statement.

If you have any questions, please contact the person whose name and telephone number are shown above.

Thank you for your cooperation.

Sincerely yours,

Enclosures:
Copy of this letter
Examination Report
Form 13683
Publication 3498
Envelope

Letter 950-E(DO) (6-2005)
Catalog Number 39911C

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Appellate Division

- ▶ Pros and cons of Appellate Division
- ▶ Interest (and/or) penalties continue to accrue if no prepayment made
- ▶ 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; not always the case, e.g. excise tax

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Appellate Division (cont'd)

- ▶ Is taxpayer willing to extend statute of limitations (Form 872 (income tax)/Form 872-B (excise)) for open tax years
- ▶ Best to request and participate in face to face meeting with appeals officer
- ▶ Usually best to utilize administrative appeal opportunity unless IRS will clearly not settle issues at any level (clear IRS position in direct opposition to taxpayer)
- ▶ Must cover all facts in audit or Protest; Not normally allowed to raise new facts after Protest filed without giving IRS opportunity to respond

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Appellate Division (cont'd)

- ▶ Settlement opportunities
 - Amended tax returns and impact on prospective reporting position
 - Appeals has authority to settle based on “hazards of litigation”
- ▶ Ability to glean further information regarding IRS position during appeal
- ▶ IRS usually uses Form 870-AD and avoids use of Form 906
- ▶ Dealing with the liability
 - Payment plan (avoiding IRS enforcement action)

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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 without prepayment of tax by filing complaint with United States Tax Court or Court of Federal Claims
 - If excise tax – must pay assessed tax and proceed in Federal District Court or Court of Federal Claims

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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 that generate potentially large tax liabilities

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State Sales and Use Tax Audits (cont'd)

- ▶ 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 state's receipt of notice of FAA registration of aircraft using an address in that state
 - May result from information reported to state revenue agency by airport/FBO/management company

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State Sales and Use Tax Audits (cont'd)

- ▶ 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

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State Sales and Use Tax Audits (cont'd)

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

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State Sales and Use Tax Audits (cont'd)

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 there is any ambiguity regarding the application of this exemption

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State Sales and Use Tax Audits (cont'd)

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)
- Clear lease structure, particularly with charter leases

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State Sales and Use Tax Audits (cont'd)

- ▶ 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 many months or even years to resolve – be prepared for a lengthy process
- ▶ Consider settlement options based on assessed liability, penalties and interest, and cost of appeal

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State Sales and Use Tax Audits (cont'd)

- ▶ 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's financial statements
- ▶ Appeals officer may be more willing to accept alternative theories of liability to reduce overall tax amount and reduce or eliminate penalties

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State Sales and Use Tax Audits (cont'd)

- ▶ 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

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State Sales and Use Tax Audits (cont'd)

- ▶ 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

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Closing Remarks Q & A



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