

## **BUYER BEWARE**

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Professional Pilot. This article is still valid under current tax law.**

Although the purpose of the IRS Restructuring and Reform Act of 1998 was to make the Internal Revenue Service a more user-friendly organization for taxpayers, some of the new provisions of the Internal Revenue Code could backfire on aircraft manufacturers, their corporate tax department, sales staff and, ultimately, the aircraft buyer.

Two of those new provisions are: Confidentiality Privileges Relating to Taxpayer Communications, known as attorney-client privilege, section 7525, and Burden of Proof, section 7491.

### **ATTORNEY-CLIENT PRIVILEGE**

Senate Finance Committee Report No. 105-174 states, "... a right to privileged communications between a taxpayer and his or her advisor should be available in noncriminal proceedings before the IRS and in noncriminal proceedings in Federal courts with respect to such matters where the IRS is a party, so long as the advisor is authorized to practice before the IRS. A right to privileged communications in such situations should not depend upon whether the advisor is also licensed to practice law."

As of July 22, 1998 the privilege of confidentiality of taxpayer communications is extended to tax advice rendered to current or even potential clients by any federally authorized practitioner, as long as subject matter of the advice is covered by any provision of the Internal Revenue Code. Federally authorized practitioners include practicing attorneys, certified public accountants, enrolled agents, or enrolled actuaries.

The American Bar Association has suggested that the confidentiality privilege extended to nonattorneys would include "any tax aspect of any matter, even if the tax component of the matter is very slight in relation to the overall content of the matter."

## **RISK OF PRIVILEGE WAIVER**

Conference Committee Report (H.R. Conf. Rep. No. 105-599) states, “The privilege created by this provision may be waived in the same manner as the attorney-client privilege. For example, if a taxpayer or federally authorized tax practitioner discloses to a third party the substance of a communication protected by the privilege, the privilege for that communication and any related communications is considered to be waived to the same extent and in the same manner as the privilege would be waived if the disclosure related to an attorney-client communication.”

In order to avoid an inadvertent privilege waiver, tax practitioners need to initiate procedures that will protect privileged tax communications. For the aircraft industry, the greatest risk of an inadvertent privilege waiver could come from discussions between customers and employees of aircraft manufacturers or brokers.

If the American Bar Association is correct in its analysis of the scope of communications covered by privilege, then the entire substance of the privileged communications relative to the aircraft purchase could be waived, even if the tax component of the purchase negotiations with the manufacturer’s representative was very slight. Taxpayer communications between the current or a potential tax advisor and the buyer are covered by new Internal Revenue Code Section 7525.

## **PRECAUTIONARY MEASURES**

Sellers of new or used aircraft, aircraft buyers, flight department managers and anyone else involved in sales and purchase of aircraft or accessories need to take precautions to make sure that the privilege is not inadvertently waived by discussions concerning tax issues.

Aircraft manufacturers or brokers may want to consider adopting policies or resolutions prohibiting the rendering of tax advice or anything that could be “construed” as tax advice by their employees. Many manufacturers require annual attendance at meetings or discussions concerning the prohibition of acts which could have the appearance of committing any crime covered by the Sherman-Clayton Antitrust Acts, such as price fixing, etc. The employees are then required to sign an attendance form which validates their attendance.

Perhaps the same precautions should be taken relative to customer tax issues. Aircraft manufacturers could protect themselves by informing potential customers of their policy prohibiting the discussion of tax issues, no matter how slight, by any company employee.

## **BURDEN OF PROOF**

Until July 22, 1998 the taxpayers had the burden of proof in all but a few carved out exceptions for noncriminal tax controversies with the IRS. The new law provides that for noncriminal controversies the burden of proof may be shifted to the IRS for individuals and small businesses. In order to shift the burden of proof to the IRS, taxpayers must have:

1. complied with all substantiation requirements; (provide canceled checks, receipts, other documentation, etc.)
2. maintained all records and have cooperated with reasonable requests for witnesses, information, documents, meetings and interviews; and
3. corporations, trusts and partnerships cannot have a net worth that exceeds \$7,000,000.

It should be noted that the IRS has started developing audit workpaper techniques to document and track the cooperation of taxpayers.

In addition to the above requirements, the taxpayers are required to exhaust every administrative remedy, e.g., conferences with the examining agent's supervisor, appeals conference, etc. It is anticipated that IRS agents will become more intrusive during the examination and appeals process because the IRS will be trying to satisfy its potential burden of proof.

## **INTERACTION OF NEW PROVISIONS**

Even under prior law, the IRS engaged in pre-trial discovery to gather facts and information to build its case. Under the new law, the IRS District Counsel will certainly use even more intrusive discovery procedures. During my research for this article, I have learned that the IRS Chief Counsel is already developing substantial and rigorous interrogatories to be used for intensive fact finding purposes. Third party summonses and subpoenas will be issued with increased frequency.

In an aviation audit, third parties (such as aircraft salesmen and others) may be called to provide information as to the circumstances surrounding the purchase of an aircraft. During the interrogation, interview or deposition, information could be obtained from the salesman to help the IRS meet its burden of proof against the customer. If the IRS is able to learn that the customer and the salesman or other factory employee engaged in discussions concerning tax issues, no matter how slight, then the IRS would also be in a position to assert that privilege communications regarding the aircraft acquisition had been waived. If this were to happen, then customers may be forced to endure three

different trials, i.e., one trial to see if the burden of proof will shift to the IRS, another trial to see if privileged communications have been waived and, finally, the U.S. Tax Court trial to see if the customer could still retain the benefit of the aircraft tax deductions.

A careless salesman and/or his associates could end up being the best set of witnesses against the customer the IRS could ever want. This is why there should be no discussions relative to aircraft tax issues between a salesman and a customer.

Even under the old law, aircraft salesmen and others could have been, and still can be, ensnared by the aiding or abetting and preparer penalty sections of the Internal Revenue Code, even though the salesman did not actually prepare the customer's tax return. Now with the new law, the results of careless communications can be much worse.

## **SUMMARY**

There are many provisions of the IRS Restructuring and Reform Act of 1998 that will benefit taxpayers. However, some of the new promulgations could have serious ramifications for our industry.

Aircraft manufacturers and brokers will need to develop policies and procedures to ensure that tax issues, no matter how slight, are not discussed between their employees and current or potential customers.

Customers will need to strengthen their substantiation and documentation procedures so that they will be in a better position to transfer the burden of proof to the IRS for audits initiated after July 22, 1998.