Office of Chief Counsel
Internal Revenue Service

memorandum

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SMurray

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to: ASSOCIATE AREA COUNSEL (LARGE & MID-SIZE BUSINESS)
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subject: **Restrictions on Examinations and Inspections of Books of Account for Air Transportation Excise Taxes**

This Chief Counsel Advice responds to your request dated January 14, 2003. In accordance with I.R.C. 6110(k)(3), Chief Counsel Advice may not be used or cited as precedent.

ISSUES

1. Is the Service's issuance of a Letter 898, *Statement of Proposed Adjustments*, to a taxpayer, concerning the taxpayer's liability for excise tax on the purchase of air transportation or air transportation mileage awards from an air carrier, an examination?

2. Is a subsequent Letter 898 issued to the taxpayer, concerning the taxpayer's excise tax liability for the same taxable period for purchases of air transportation or mileage awards from a different carrier, an unnecessary examination for purposes of I.R.C. §7605(b)?

3. Is a subsequent Letter 898 as described in Issue 2 a reopening of a closed case subject to the policy and procedures on reopenings in Policy Statement P-4-3 (IRM 1.2.1.4.1) and Rev. Proc. 94-68?

4. Is an inspection by the Service of the taxpayer's books of account, to determine liability for taxable air transportation purchases, a prohibited repeat inspection under

I.R.C. § 7605(b), when the Service previously inspected the books of account for purchases from a different carrier?

CONCLUSIONS

1. The Service's issuance of a Letter 898, *Statement of Proposed Adjustments*, to a taxpayer for excise tax liability, based on information from the air carrier that sold the taxable transportation to the taxpayer, is not an examination.

2. A subsequent Letter 898 for the same taxable period issued to the taxpayer, based on information from a different air carrier on the purchase of taxable transportation by the taxpayer, is not an unnecessary examination for purposes of I.R.C. § 7605(b).

3. A subsequent Letter 898 is not a reopening of a closed case subject to the reopening policy and procedures of Policy Statement P-4-3 and Rev. Proc. 94-68.

4. When the Service has inspected the taxpayer's books of account to determine liability for excise tax on purchases of taxable transportation from an air carrier, later inspection of the books of account, to determine liability for purchases made from a different carrier, is not prohibited by section 7605(b) if the taxpayer requests the inspection or the inspection is necessary.

FACTS

In the hypothetical scenario you have laid out, a corporation purchased in one quarter taxable air transportation mileage awards from four commercial air carriers. The carriers filed Forms 720, *Quarterly Federal Excise Tax Returns*, with the Service, reporting the sales of the mileage awards to the corporation. In your scenario, the Service determined separately and sequentially, by carrier, the excise tax consequences for the corporation (the taxpayer) on the mileage award purchases. Thus, the Service issued a Letter 898 to the taxpayer for the purchases of mileage awards base on the return filed by the first carrier.

In the hypothetical, the taxpayer agreed to the adjustment, and assessment was made. After which, the Service issued another Letter 898 to the taxpayer based on information from the air carrier (received after the first Letter 898), advising the taxpayer that it was liable for excise tax on the purchase of mileage awards from the second carrier. The taxpayer requested a meeting with the Service and produced at the meeting its books of account for inspection; a reduced liability was agreed to. Then the Service issued its third letter 898 to the taxpayer upon information from the third carrier; the taxpayer requested its books be inspected again, and the Service found no liability on the taxpayer's part. Lastly, the Service issued a fourth letter upon information from the fourth carrier, and the taxpayer has apparently responded that the proposed adjustment

is an unnecessary examination violative of I.R.C. § 7605(b) and preemptively advised it will not make its books of account available again and cannot be made to do so.

LAW AND ANALYSIS

Taxable transportation

Taxable transportation is, in general, air transportation of persons or property within the United States. I.R.C. §§ 4262, 4272. An excise tax is imposed on the amount paid for taxable transportation, currently 7.5 percent for the transportation of persons and 6.25 percent for the transportation of property. I.R.C. §§ 4261, 4271.

An amount paid to an air carrier for the right to provide mileage awards is taxed as taxable transportation. I.R.C. § 4261(e)(3). The tax is paid by the purchaser, I.R.C. §§ 4261(d), 4271(b), and the air carrier receiving payment collects the tax, I.R.C. § 4291. Carriers report the tax collected on the Form 720. Additionally, if the purchaser of taxable transportation refuses to pay the tax to the air carrier, or it is impossible for the air carrier to collect the tax, the air carrier must report the purchaser's name and address, the taxable transportation rendered, the amount paid, and the date of payment to the Service. Treas. Reg. § 49.4291-1.

Unnecessary examinations

The Service is prohibited from conducting "unnecessary examination[s] or investigations" pursuant to I.R.C. § 7605(b). In applying section 7605(b) in any particular case, a threshold question is whether the action at issue is an examination or investigation. In the factual scenario presented here, the question is whether the Service's issuance of a Form 898 to the taxpayer, proposing an adjustment to liability for unpaid excise tax on purchases of taxable air transportation, is an examination. Although neither the Code nor the regulations define an examination, in our opinion, issuing a Form 898 in the circumstances described is not an examination because the Service is not making inquiries of the taxpayer or asking the taxpayer to explain or document return items or transactions; rather, the proposed adjustment is based on a return or notice filed by a third party, the air carrier.[1] This conclusion is consistent with Rev. Proc. 94-68, paragraph 4.02(5) of which, for instance, provides, "The adjustment of an unallowable item, or an adjustment resulting from other types of service center correction programs, is not considered to be an examination," and paragraph 4.02(10) provides, "An adjustment to a taxpayer's income tax return arising from a discrepancy disclosed during [Tax Exempt and Government Entities] compliance activities . . . does

[1] As you put it, "based on information from [the air carrier] and its Form 720." Conversely, to the extent a proposed adjustment is based instead on an inspection of the taxpayer's books and records, we conclude it would be an examination.

not constitute an examination . . . if the adjustment is not made in conjunction with an examination of the taxpayer's income tax return." Because the issuance of a Form 898 in these circumstances is not an examination, it cannot be an "unnecessary examination" for purposes of section 7605(b), even where a series of Forms 898—four in your hypothetical—are issued to a taxpayer for the same taxable period.

Even assuming arguendo that issuance of a Form 898 is an examination, doing so, including issuing the second, third, and fourth forms, is nevertheless not unnecessary. As you point out, where a taxpayer purchases taxable transportation from multiple carriers, each responsible for filing its own excise tax return and section 4291 notice, the Service may learn of the taxpayer's non-payment of excise taxes piecemeal and at different times, sometimes years apart. Therefore, it will often be necessary to issue multiple Forms 898.

Reopenings

Apart from the restrictions on examinations in I.R.C. § 7605(b), the Service has established a policy on the reopening of cases closed after examination, including adopting certain approval requirements. Specifically,

Because we conclude that issuing Forms 898 to a taxpayer under the facts you have presented is not an examination, Policy Statement P-4-3 and Rev. Proc. 94-68, both of which pertain only to a "case closed after examination," do not apply here. Even if we were to conclude that issuing Form 898 under these facts is an examination, the reopening criteria would seem to be satisfied, in particular the third criterion, which permits reopening where "other circumstances exist which indicate failure to reopen would be a serious administrative omission." As mentioned, purchases of taxable air transportation on which the taxpayer-purchaser is liable for any unpaid excise tax are disclosed at different times. If the Service closed a case following an adjustment to the taxpayer's liability resulting from what the Service learned from one carrier, not to issue a subsequent Form 898 proposing another adjustment to excise tax liability upon learning of purchases from another carrier we think would be "a serious administrative omission" justifying reopening.[2]

Inspections of a taxpayer's books of account

Under I.R.C. § 7605(b), the Service may make only one inspection of a taxpayer's books of account fro each taxable year unless the taxpayer requests otherwise or the Service, after determining it needs another inspection, notifies the taxpayer in writing that an additional inspection is necessary. Policy Statement P-4-3, Rev. Proc. 94-68,

[2] A reopening would, of course, still require approval.

and Delegation Order 57 (IRM 1.2.2.30) list the officials with authority to sign the notice to the taxpayer.

In your example, although the Service thrice inspected the taxpayer's books of account for the same taxable quarter, the taxpayer asked in connection with the second and third Letters 898 that the Service inspect the taxpayer's books of account, bringing the second and third inspections squarely within the statute's exception to its general prohibition ("unless the taxpayer requests otherwise"). With regard to the fourth Letter 898, the taxpayer has not asked for another inspection and has declared that such an inspection violates section 7605(b). The question, then, is whether the Service may inspect again, if it wants to, the books of account without the taxpayer's consent. To do so, the inspection must fall within the second exception in section 7605(b), i.e., it must be necessary, and if it is necessary, written notice of that fact must be sent to the taxpayer. Necessity will depend on the nature of the particular case, but we can readily envision a situation where the first inspection was based on information from one carrier, and for the Service to later determine the taxpayer's liability or potential liability arising from information from another carrier, the Service needs to again inspect the taxpayer's books of account.

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Please call (202) 622-3630 if you have any further questions.