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Exports to Mexico – Proof of Export, Proof of Product & the Joint and Several Liability of Terminal Operators

As exports of fuel from the U.S. to Mexico continue to grow, the IRS audits of this activity are also beginning to ramp up. Historical precedent in audits of this type of business tells us that there are two main areas where taxpayers can run into problems: (1) proof of export; and (2) proving the product is, or is not, a taxable fuel (gasoline, diesel or jet fuel). There is also a third area of concern for terminal operators and that is the joint and several liability for excise taxes that can come into play if the terminal operator is audited and the position holders in the terminal are found to have not paid taxes (this arises most often if the position holder has gone out of business by the time of the audit).

One case that addresses all of these issues is *In Re: RTW Properties, L.P.* (119 AFTR 2d. 2017-1441 (2016)). This case arose from an IRS audit of RTW Properties LP, the owner/operator of a storage facility in Brownsville, TX, RTW Terminal. The facility stored fuel products for several taxpayers. Despite meeting the statutory definition of a terminal, RTW Properties, LP, did not hold a 637 registration. Consequently, the terminal was not an approved terminal and not considered to be within the bulk terminal transfer system. According to the IRS audit report, RTW Terminal leased storage tanks to third parties who stored lubricating base oils, solvents, wax and taxable fuels, including diesel and kerosene. The fuels arrived at the facility via barge or vessel and were discharged from the facility via truck.

The IRS audit report stated that the diesel and kerosene was renamed upon removal from the facility, and further stated that renaming a product does not change the characteristics identified and known to both the facility operator and the position holders when the product was independently inspected upon arrival at the facility. The IRS relied on API gravity to determine the product was a taxable fuel saying that it is standard industry practice to use API gravity as a means of identification. As the facility was not a registered terminal, and none of the position holders were 637 "S" registrants, the IRS sought to impose federal excise tax on "inbound and outbound shipments of taxable fuel," and said that as the terminal operator had knowledge as to the nature of the product, the IRS determined that the failure to report and pay taxes was not due to reasonable cause but rather willful neglect. Having made the determination that the fuel was taxable, the burden shifts to the taxpayer to refute the IRS determination.

When auditing one of the position holders in RTW Terminal, McAllen Trading Ltd., the taxpayer claimed that fuel was exempt from tax when removed from the terminal because it was exported to Mexico either via vessel, truck or rail. With respect to all methods of transport, the IRS took the position that as the description of the product was not a taxable fuel, the taxpayer did not substantiate that a taxable fuel was exported to Mexico. This position is curious because the IRS relied on the product description and not the product characteristics as in the RTW Terminal audit.

When it came to the court case, *In Re: RTW Properties, L.P,* the Court agreed with the IRS audit in that matter when it came to determining whether or not a product is a taxable fuel based on its characteristics. On the export question, the IRS argued that the taxpayer had not provided sufficient evidence that product

removed from the facility was exported to Mexico; the Court agreed with this analysis and said that insufficient evidence to substantiate export had been provided. The Court did not get to the question of who the proper claimant would be with respect an export. In the audit of McAllen Trading Ltd., one of RTW Terminals' customers, the IRS stated that the taxpayer's customers who were the ultimate purchasers of the fuel would be the proper claimant.

The three core issues for analysis from these cases are: (1) proof of export; (2) proof of product; and (3) joint and several liability of terminal operators.

Proof of Export

Both the IRS and the Courts have taken the position that exempting taxable fuel from federal excise tax on the basis of export, requires clear proof that the fuel was actually exported. An intent to export, the proximity of a storage facility to the U.S.-Mexico border nor delivery of fuel into foreign-owned trucks are deemed sufficient by the courts to prove that fuel was exported. Rather, there must be clear evidence that the fuel has entered into the stream of export from the United States and been imported into Mexico. The best example of evidence that merchandise has entered the stream of export is a copy of the export documents filed with the U.S. government as well as a copy of import documents (pedimento) completed by Mexican customs authorities (evidencing the import into Mexico). Anything else – bill of lading, documents showing delivery into a Mexican truck – show an intent to export but do not prove that export actually occurred; indeed the Courts have pointed out that fuel can be, and is, diverted from its originally intended destination. Taxpayers claiming a refund without clear proof of export may be denied the refund, and taxpayers audited who claim the export exemption may find themselves subject to assessment if there is insufficient evidence to substantiate the export actually occurred.

Proof of Product

Rather than remit tax and seek a refund upon proof of export, taxpayers may seek to show that the fuel product being exported is exempt from federal excise tax because it is not a taxable fuel. When claiming that a fuel product is exempt from federal excise tax, it is important that the product specifications support that. All products that come into a storage facility are subject to inspection and both the terminal operator and the position holder receive copies of the inspection reports. It is these inspection reports that the IRS will use upon audit to determine whether a product claimed to be exempt from tax actually is. A product that meets the specifications for diesel (defined in 26 C.F.R. § 48-4081.1 as "any liquid that, without further processing or blending, is suitable for use as a fuel in a diesel-powered highway vehicle or diesel-powered train." Gasoline, kerosene, excluded liquid and No. 5 and No. 6 Fuel Oils are not included in the definition of diesel) is and will be taxed as diesel, no matter what it is called on the transaction paperwork. Moreover, when the terminal operator and the position holder have knowledge of the product specifications from the inspection reports, there is no reasonable basis position for a penalty waiver upon tax assessment.

Joint and Several Liability of Terminal Operator

Under the applicable Treasury regulations, a terminal operator (whether or not registered with the IRS) is jointly and severally liable for taxes owed on product stored in his terminal. The terminal operator need not have an ownership stake in the product in order to be held liable. As a result, if the IRS conducts an audit of a facility where fuel is stored, any taxes that may be determined to owed may be assessed on the terminal operator. This is most common when the position holder has gone out of business. In *In Re: RTW Properties, L.P* the IRS sought to hold RTW Terminal for tax due on the taxable fuel stored in is terminal. To avoid a tax assessment it is important for terminal operators to ensure that they correctly report the receipts and disbursements into the facility (when registered) and keep proper records concerning the nature of the products. Terminal operators also need to know their customers and take steps to ensure that all documents between the terminal operator and the customer are consistent.

What can be taken from the IRS position on substantiating both exports and product type is that the IRS will often pick the argument that works best for an assessment. Taxpayers want to have as much evidence as possible to substantiate an export and want to ensure that the taxability of a product is determined by its characteristics rather than merely its name.

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