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Managing New IRS Global High-Wealth Audits

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A summer webinar hosted by New York University featured comments by Doug O'Donnell, the commissioner for the Internal Revenue Service Large Business and International, or LB&I, Division regarding the division's global high-wealth audit program. He announced that LB&I agents would start opening several hundred audits of high-net-worth individuals in mid-July.

While some high-wealth taxpayers will have already received audit notices from the IRS, likely the majority have yet to be notified. The first wave of these coordinated enterprise audits deluged taxpayers over 10 years ago, and were highly scrutinizing and searching audits.[1] This new wave will be at least as scrutinizing as the first.

The IRS has consistently believed that expenditure of resources in this area will reap significant collection benefits. It understands that very wealthy taxpayers can use their assets to take advantage of offshore vehicles and alternative investments, including cryptocurrency, and further believes some such taxpayers are doing so to avoid paying their full tax liability.

Over the past 10 years the IRS has gathered data from its original audit program and decided to devote additional resources to make its global high-wealth audit efforts more efficient.[2]

As with the inaugural audit initiative in 2009, these new audits will look at the whole network of persons and entities affiliated with the wealthy individual taxpayer — the whole enterprise — such as S corporations and closely held C corporations, to name some structures utilized by wealthy individuals. In our experience, the IRS scrutinized all of these and more. For example, it issued several information requests regarding a benefit plan sponsored by a related entity.

The audits will also scrutinize foreign asset holdings and foreign structures, as the IRS considers these areas ripe for noncompliance. Multi-tier foreign structures will attract even more attention for this reason, even though such complexity may be needed to achieve the taxpayer's overall nontax financial objectives.

The IRS will request and a taxpayer should be ready to supply documentation establishing the nontax purpose of these structures. Transactions between related domestic persons will also be scrutinized on several levels, including, for example, consideration of indicia of constructive dividends, or perhaps to question debt arrangements.

In addition to these areas, for this new audit effort the IRS will enhance their scrutiny of private foundation transactions. To this end, the IRS has invested in significant training of LB&I agents in the complex regulatory area of private foundations.

Tamera Ripperda, who formerly led the global high-wealth audit unit, is now commissioner of the Tax Exempt and Government Entities Division. Her division supported the private foundation audit training for 400 LB&I agents.

During the same NYU webinar, Ripperda said that her division has identified over 1,000 private foundations connected to wealthy individual networks that are potentially up for audit.

The IRS will likely focus primarily on whether private foundations have engaged in prohibited self-dealing with disqualified persons — i.e., foundation insiders, such as substantial donors, foundation managers, and their family members and businesses.

Self-dealing transactions can include transactions between a foundation and a business controlled by a foundation insider, loans to insiders, the use of foundation assets for the benefit of insiders' family members, or investments in businesses or partnerships owned or managed by insiders. The audits likely will also assess the reasonableness of trustee or director compensation and misuse of expense accounts.

Grantmaking that benefits insiders, such as foundation grants used to fulfill personal pledges, will likely be targeted, as well as grants to entities other than public charities. Alternative investments also will be subject to close scrutiny.

In addition to private foundation relationships, the new audit effort will focus on issues arising out of the Tax Cuts and Job Act.[3] LB&I recently identified this area as a general campaign audit issue, and we anticipate that issues relating to the Section 199A qualified business income deduction, the application of the global intangible low-taxed income tax and limits on business interest deduction, to name a few, could be considered in these new audits.

Being on the receiving end of an appointment letter from LB&I requires preparation for a thorough examination process that may include third-party contacts by the IRS, administrative summonses and interviews.

Keep in mind that preceding selection the IRS analyzed the risk profile of a return, and determined that the materiality and complexity presented by the return warranted the allocation of significant resources.

The IRS will have also already obtained information available in the public domain about the taxpayer and related entities. Indeed, the first request for information — what is called an information document request — could ask very specific questions about the taxpayer's entities and investments and, frankly, could be overwhelming in scope.

Wealthy individuals targeted by this audit program should review the status of tax filings, both individual and for related entities, and the record-keeping for prior years' filings. It is important to get an

understanding of the possible scope of the audit by pulling together the returns for all related filers. The review should include one to two years prior to the audit year(s) under examination. It should begin a process of self-examination in order to identify potential key areas upon which the IRS may focus.

Taxpayers should evaluate the possible assertion of privilege under Section 7525 of the Internal Revenue Code,[4] attorney-client privilege or work product in response to IRS audit inquiries. Taxpayers should also consider honing the legal analysis supporting their return positions in preparation for a possible review with IRS appeals, and consider the long-term consequences of the audit in case one or more audit issues must be litigated.

If the taxpayers primary tax advisers are also the return preparers, special consideration should be given to the possible limits of the application of the tax adviser privilege under Section 7525. If outside counsel is retained, then consideration should be given whether to have the taxpayer's counsel retain the tax accountant under a Kovel arrangement in order to preserve privilege claims that may insulate communications among the taxpayer's team from disclosure.

The audit itself will be led by a trained LB&I auditor supported by specialists in financial products, international transactions, pass-through entities, and other areas as identified by the lead auditor after preaudit analysis of the return.

During the audit, it is important that the taxpayer be cooperative and responsive to reasonable requests for information. This will establish a good working relationship with the agents.

In our experience, responsiveness in providing information improved our ability to speak with the agents in a fair and open manner, and increased their willingness to communicate their views on potential issues and areas of less concern, so that the audit could be more focused and streamlined.

Given that the burden to support tax positions is typically on the taxpayer, and that the agents will be on the lookout for potential tax abuse, the need to be responsive and open cannot be overemphasized. However, it is not improper to question a request that seems disproportionately burdensome, treads into areas of privileged or protected information, or is unclear. It is always appropriate to assert good faith claims of privilege and work product.

A typical field audit should last no more than two years. However, a particularly complex return that implicates other tax filing entities could stretch out that two-year period for at least another six months.

For lengthy audits, individual taxpayers should be aware that, with some exceptions, interest on any underpayments ultimately assessed must be suspended under Section 6404(g) of the Code if the IRS fails to provide timely notice to the taxpayer, specifically stating the taxpayer's liability and the basis for the liability[5] To be timely, the notice must be provided before the close of the 36-month period beginning on the later of the date on which the return is filed or the due date of the return without regard to extensions.

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[1] See "Global High Wealth Industry Audits Underway – Observations from the Foxhole," https://media2.mofo.com/documents/100726fedtax.pdf.

[2] In May, the Treasury inspector general delivered a report critical of the IRS titled "High-Income Nonfilers Owing Billions of Dollars Are Not Being Worked by the Internal Revenue Service." Though the IRS had already started retooling its global high-wealth audit program at this point, the expectation of the report's publication may have spurred the IRS to quicker action.

[3] Tax Cuts and Job Act, 115 P.L. 97.

[4] IRC Section 7525.

[5] IRC Section 6404(g).