IRS Sharpens Approach to Audits of High Net Worth Individuals: What it Means and How to be Prepared

White Paper

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In an attempt to close an estimated $345 billion[1] "tax gap" between what it collects and what is owed, the IRS is pursuing a wide range of initiatives aimed at taxpayer noncompliance. Among these is the recent creation of a new enforcement unit, the Global High Wealth Industry Group. As described in prepared remarks by IRS Commissioner Douglas Shulman in December 2009,[2] this new unit will centralize and focus IRS compliance expertise involving high net worth individuals and their related entities. Shulman noted that many high net worth individuals make use of sophisticated financial, business, and investment arrangements with complicated legal structures and tax consequences such as actual or beneficial ownership in trusts, private foundations, privately-held companies, partnerships and other flow-through entities either alone or with other family members or business associates.

In defining high net worth individuals, at least initially the threshold is anticipated to be those with "tens of millions of dollars of assets or income," according to the IRS. Among the first steps will be a small number of examinations of these individuals using a new integrated or enterprise approach. This new approach will look at the entire web of business entities controlled by the individual under examination. It is anticipated that the scope of the examination will not be limited to income taxes but may address estate and gift tax filings as well. Based on these initial enterprise examinations, the IRS will then define the scope of future work.

IRS Exam Types

There are three types of IRS examinations:[3]

- Correspondence audit -- IRS requests additional information or proposes an additional tax payment be mailed to them. According to IRS statistics, approximately 77% of all IRS audits are relatively simple correspondence audits;
- Office audit -- face-to-face examination conducted at an IRS office whereby the taxpayer is asked to bring certain information for review and verification by a tax compliance officer; and
- Field audit -- face-to face examination of the taxpayer's books and records generally conducted at the taxpayer's premises or their representative's office. Field audits are the most comprehensive audit requiring extensive documentation, and are generally conducted by a more experienced, technically proficient IRS agent.

IRS Examination Triggers

What are the chances of being audited? Roughly 1% of all individual income tax returns are audited each year. However examination coverage increases for higher earners. In 2009, the IRS audited approximately 6.5% of the returns filed by taxpayers with $1 million or more in income.

IRS Results: Total Individual Return Coverage Rates*	Fiscal Year 2006	Fiscal Year 2007	Fiscal Year 2008	Fiscal Year 2009
Field/Office	302,785	311,339	310,429	326,249
Correspondence	981,165	1,073,224	1,081,152	1,099,639
Total Examinations	1,283,950	1,384,563	1,391,581	1,425,888
Returns Filed in Prior Calendar Year	132,275,830	134,542,879	137,849,635	138,949,670
Coverage	0.97%	1.03%	1.01%	1.03%

Figure 1: *Internal Revenue Service, Fiscal Year 2009 Enforcement Results*

IRS Results: Individual Return Coverage Rates – Income $1 Million and Higher*	Fiscal Year 2006	Fiscal Year 2007	Fiscal Year 2008	Fiscal Year 2009
Field/Office	9,459	12,259	12,233	15,730
Correspondence	4,728	10,941	9,641	12,619
Total Examinations	14,187	23,200	21,874	28,349
Returns Filed in Prior Calendar Year	270,161	339,138	392,776	441,715
Coverage	5.25%	6.84%	5.57%	6.42%

Figure 2: *Internal Revenue Service, Fiscal Year 2009 Enforcement Results*

Income level is only one IRS examination selection factor. There are several other ways that the IRS goes about determining which taxpayers it selects for examination. The primary way is through the assignment of a so-called "DIF" score to each return filed. DIF, or the Discriminate Function system, uses a mathematical formula to weigh various characteristics of tax returns in order to determine which ones are most likely to have a difference between taxes owed and reported. The higher the DIF score, the more likely that the return will be subject to IRS review. Some of the items that a DIF may flag include:

- Large amounts of income not subject to withholding;
- More deductions than seem reasonable for a taxpayer's income level;
- Claims for an unusual amount of dependency deductions in relation to withholding and other items;
- Discrepancies, such as an address change combined with deductions claimed for owning a residence when a taxpayer has not reported a sale of an old residence;
- Items that may trigger alternative minimum tax, such as significant miscellaneous itemized deductions and state, local, and property taxes; and
- Complex investment or business transactions without clear explanations[4].

Although the DIF system is the primary IRS audit selection mechanism, there are other ways to identify an individual's return for examination. Returns can also come under scrutiny through an audit of a corporation that reports the individual as a corporate officer, or through the audit of a flow-through entity such as an S corporation or partnership that issues the individual a Schedule K-1.

IRS Examination Tips

While one of the components of the overall IRS strategy is to "enhance taxpayer services," you should prepare your documentation now to ensure you are properly prepared in the event of an IRS audit. Here are some IRS examination readiness suggestions:

Keep accurate records. "Audit" is defined as the systematic examination of records and documents and the securing of other evidence by confirmation. According to Matt Sica, head of the Family Office Group for Rothstein Kass & Co.'s Beverly Hills office, "the likelihood of surviving an audit and receiving a coveted "no change" notice is directly tied to the amount and accuracy of documentation". With respect to records, a taxpayer should at a minimum:

- Keep copies of all W-2s, 1099s and K-1s and review them to verify their accuracy.
- Maintain accurate banking records and be prepared to explain and reconcile deposits and cash inflows against taxable income reported on the return.
- Keep receipts to support all charitable donations. Under IRS rules a donor must have a bank record or written communication from a charity for any monetary contribution before the donor can claim a charitable contribution on his or her federal income tax return.[5] In addition, a donor is responsible for obtaining a written acknowledgment from a charity for any single contribution of $250 or more.[6]
- Keep a diary of gambling losses. If you do hit it big at the casino, your winnings will be reported to the IRS. Your gambling losses can offset those winnings.[7]
- Track your tax basis in investments. For investments in stocks and other securities, records supporting the tax basis should be kept for as long as you hold the assets. In most instances, maintaining the documentation from the acquisition should be sufficient. However, assets acquired through inheritance or as a gift may be subject to a separate set of tax basis rules that require additional recordkeeping.
- Track your cost of improvements to real estate, both personal and rental. There is no statute of limitation on substantiating basis. Improvements to your home can reduce future gain recognition. Improvements to your rental property can provide current and future deductions.
- Consider obtaining an independent valuation to support the fair market value of family businesses, real estate, art, or antiquities when reporting the tax consequences of a purchase, sale, donation, or gift.
- If you are engaged in a less-than-full time venture, to avoid the passive activity loss rules, you will need to substantiate that you "materially participated" in that activity. The most reliable substantiation consists of contemporaneously kept appointment books, calendars, daily time reports, logs, or similar documents.
- If you split your time between multiple states, maintain documentation or other evidence to support your conclusion as to which state you consider to be your state of primary residence.

Watch the mail. If you get a letter from the IRS open it, read it and deal with it immediately. IRS correspondence routinely provides a limited time frame, such as 30 days, with which to respond. Not responding to a correspondence audit notification or a Proposed Individual Tax Assessment letter can then lead to a Notice of Deficiency assessing penalties and interest on top of the tax assessed.[8]

Keep business and personal activities separate. Many tax disputes arise from improperly mixing business and personal expenses, especially as it relates to the use of company cars, meals, entertainment, and travel expenses. Another pitfall lies in attaching domestic workers to a business in order to meet payroll tax requirements. However, compensation, related taxes and payroll expenses for domestic workers are generally not deductible for federal and state income tax purposes. Properly segregating and filing required payroll tax returns for domestic workers is the recommended course of action. For more information, refer to our white paper "The Domestic Staffing Cycle: From Hire to Fire" available from HUB International.

Stay onside of the "hobby loss rules." If you are engaged in an activity consistently generating business losses on Schedule C of your tax return, the IRS may step in and say it is a hobby and reclassify the expenses as miscellaneous itemized deductions subject to limitation. To avoid the hobby loss rules either show a profit in at least three out of five consecutive years or offer proof that you have run the venture with the intent to turn a profit.[9] Examples of activities routinely classified as hobbies include horse racing, horse breeding, farming, auto racing, and yacht and airplane chartering.

Be sure to disclose all holdings in offshore bank accounts. Any United States citizen who has a financial interest in or signature authority over any bank account over $10,000 in a foreign country is required to separately file a Foreign Bank and Financial Account disclosure form ("FBAR") with the U.S. Treasury Department by June 30 each year. The price of noncompliance is steep. Generally, the civil penalty for willfully failing to file an FBAR can be as high as the greater of $100,000 or 50% of the total balance of the foreign account. Nonwillful violations are subject to a civil penalty of not more than $10,000. The failure to file an FBAR and the filing of a false FBAR are violations that also can be subject to criminal penalties.[10]

Comply with any "nanny tax" obligations. Withholding and payment of FICA taxes are required if you pay a household employee cash wages over an annual threshold as determined by the IRS. For 2010 the FICA withholding wage threshold is $1,700.[11]

Adequately disclose all reportable transactions. This covers a broad range of activity including transactions offered under either condition of confidentiality or with the right to a refund if the transaction's intended tax consequences do not occur as well as "listed transactions" identified as abusive by the IRS. There are stiff penalties for failure to comply with these rules. Individuals who fail to adequately disclose a reportable transaction are subject to a $10,000 penalty. The penalty is increased to $100,000 for failure to disclose a listed transaction. If the reportable transaction results in an understatement of tax, you may have to pay a penalty equal to 20% of the amount of that understatement. The penalty is 30% rather than 20% for the part of any reportable transaction understatement if the transaction was not properly disclosed.[12]

Utilize and communicate regularly with qualified tax advisors. Work with an honest tax preparer and provide him or her with all the relevant facts and records in a timely manner. Be sure to hire someone with the appropriate level of technical competency and available resources to meet your requirements. Complex investments and transactions require a more sophisticated level of service provider especially when the scope of services needed extends beyond income taxes to include areas such as estate, gift, and trust tax filings. Nationwide tax franchise organizations offer reasonably priced tax preparation services for individuals who file relatively straightforward returns. However, to handle tax planning and more complex tax situations you should seek out the advice of a licensed tax professional, such as a Certified Public Account ("CPA") , Enrolled Agent ("EA"), or tax attorney. Most licensed tax advisors specialize and so it is advisable to get referrals from others that you know and trust in the same or similar tax situation as your own. Hiring a CPA, EA, or tax attorney who has the appropriate experience, knowledge, and skills can serve not only your current tax compliance and planning needs but can also establish the building blocks for a long-term relationship to meet future tax challenges.

Finally, don't forget the states. If you do end up with an adjustment as the result of an IRS audit, depending upon your state tax filing obligations, there may be a corresponding requirement to amend one or several state tax returns to reflect the IRS change.

As a higher-income taxpayer, your odds of being audited are increased under the IRS' new mission to close the tax gap. Taking a few preventive steps now to put your tax house in order can make a big difference later if you do have to navigate an IRS examination.

Sources

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About the Author

James Vogdes. James Vogdes is the Tax Director at HUB International Limited. He previously spent nine years in public accounting, seven of those at KPMG LLP in Chicago. He holds an M.B.A. concentrated in Finance, a C.P.A. license in New Jersey, and is a member of the Illinois Bar Association. He received his B.S. in Accountancy at Miami University. He received his M.B.A. and J.D. from DePaul University.

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