



FEATURE: ESTATE PLANNING & TAXATION

By **Domingo P. Such, III**, **Richard E. Peterson** & **Christopher Sigmund**

IRS Enforcement Aimed at High-Net-Worth Taxpayers

Is the Wealth Squad coming for your clients?

As high-net-worth (HNW) taxpayers learn of recent Internal Revenue Service pronouncements, they're rightfully asking their trusted advisors, "Could the IRS Wealth Squad be coming for me?"

Clients face IRS scrutiny that's two-pronged. In June 2020, top IRS officials announced a renewed examination focus on the business, charitable and personal enterprises of HNW taxpayers. These complex and onerous audits are often conducted by the IRS Global High Wealth Industry Group of the IRS Large Business and International Division, known colloquially as the "Wealth Squad."¹ In addition, in September 2020, the distinct IRS Small Business/Self-Employed Division similarly announced a focus on high income individuals that overlaps with the Wealth Squad "but it is a separate work stream that [the IRS is] spending a significant amount of time on this year, and we will next year as well."²

Given that there's a target on the backs of HNW taxpayers, tax advisors should be working closely with their HNW clients to prepare a full legal workup. The complex and broad scope of these potential IRS examinations by two IRS divisions, and the overwhelming information gathering that such audits may require, is the forewarning to be forearmed. Indeed, soon after the IRS first created the Wealth Squad in Fall 2009,

the now current IRS Commissioner Charles P. Rettig (and then private practice attorney) gave sage advice that still applies today:

Practitioners must respect the nature of these [Wealth Squad] examinations and exercise discretion and their best judgment in responding to each request for information. The IRS has determined that high-wealth taxpayers represent a compliance challenge worthy of devoting substantial enforcement resources to the creation, funding, and operation of the wealth squad. Taxpayers and their representatives must be prepared to respond in kind. We are not in Kansas anymore. . . .³

Let's review what to typically expect in these audits and discuss ideas for how to advise clients in preparation for a Wealth Squad examination (or frankly, any examination) that involves the complex financial lives of sophisticated modern taxpayers.

We'll also outline best practices that may provide benefits regardless of whether an audit is initiated, such as helping your clients get their houses in order before potential changes in law and increased IRS enforcement in coming years.

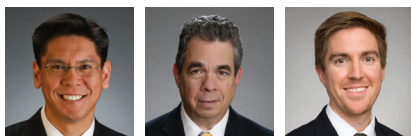
Wealth Squad History

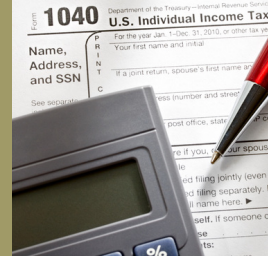
The Wealth Squad is part of the IRS division that oversees large domestic enterprises and foreign businesses with a U.S. tax reporting presence. These enterprises are generally controlled by individuals with assets or earnings in the tens of millions of dollars.

The Wealth Squad isn't new. It was established under the Obama administration in Fall 2009, with the IRS acknowledging that "high wealth individuals are not your typical Form 1040 filers with a W-2 Their tax

(From left to right) **Domingo P. Such, III** and **Richard E. Peterson** are partners at Perkins Coie in Chicago, and **Christopher Sigmund** is counsel based at Perkins

Coie's Dallas office





picture is much more complicated than this.”⁴ The IRS commissioner at the time acknowledged that:

... many high wealth individuals make use of sophisticated financial, business, and investment arrangements with complicated legal structures and tax consequences. Many of these arrangements are entirely above board. Others mask aggressive tax strategies.⁵

Public announcements about renewed efforts of the Wealth Squad also aren’t new. Around 2013, such announcements followed criticism about the agency’s lack of enforcement efforts regarding HNW individuals. In fact, the recent 2020 announcements followed a U.S. Department of the Treasury inspector general’s report recommending that the IRS increase its focus on certain high income taxpayers.⁶

But, what makes 2020 potentially different are the rapid advances in technology and big data over the past decade, which are enabling the IRS to refine and improve its screening and enforcement efforts. In July 2020, for example, the IRS announced further digitalization efforts, both taxpayer-facing and with respect to internal record keeping, across the vast network of IRS systems, co-led by a former Wealth Squad deputy.⁷ So, while it may feel for some practitioners like Groundhog Day, this round of increased enforcement announcements shouldn’t be ignored.

What to Expect

Based on experience with prior Wealth Squad audits, we expect the IRS to take a holistic approach—using both information provided by the taxpayer and information gathered independently by the IRS—to build a financial picture of HNW individuals and their related entities that’s as complete as possible. Beyond our practical experience with such audits, the IRS also updated its internal audit manuals as recently as December 2019,⁸ which confirms that the IRS “look[s] at the complete financial picture of high wealth individuals and the enterprises they control.”

At a high level, a Wealth Squad audit unpacks complexity by taking a coordinated approach often reserved for large corporate audits. This means that numerous types of returns may be implicated, including individual, partnership and corporate tax returns

as well as trust, private foundation (PF) and estate/gift tax returns.⁹ While most audits start with individual income tax returns, those entities (including PFs) over which the taxpayer has a controlling interest will likely be implicated. The IRS has stated that a “[c]ontrolling interest can include significant ownership of or significant influence over an entity or multiple entities within the enterprise.”¹⁰

How to Proactively Prepare

Individual taxpayers and their accountants may be overwhelmed at the start of an audit unless they’ve done at least some proactive preparation. While the preparation for each audit will be unique, there are numerous critical actions that taxpayers and their advisors can take to proactively prepare.

Taxpayers and certain of their staff may benefit from revisiting the history of why certain business structures were implemented.

Develop a thoughtful taxpayer narrative. A taxpayer and the taxpayer’s representatives can positively impact an audit by ensuring that the IRS understands foundational elements of the taxpayer’s business, personal and charitable activity. Ensuring that clients have a clear, comprehensive and updated organizational chart prior to an audit can help your clients identify areas in which they may need to obtain more information.

Taxpayers can also document the overall history of major recent activities and the non-tax business reasons for such activities (as well as provide support for those reasons). Consideration of privacy and privilege will be important with this review. Additionally, taxpayers and certain of their staff may benefit from revisiting the history of why certain business structures were implemented and the extent to which formalities were properly followed.

Compile a complete understanding of the key assets. We expect that the IRS will target assets



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commonly implicated in complex audits. These include, among other things:

- Foreign assets (for example, bank accounts, trusts, business interests, overseas inheritance and reporting compliance);
- Associated entities (for example, trusts, partnerships, S corporations and C corporations);
- Gifting practices;
- PFs; and
- Virtual currency transactions.

Taxpayers can benefit from proactively compiling a careful record of any transactions that, absent such records and clear explanation, the IRS could challenge as self-dealing.

Obtaining records for foreign assets may require significant lead time. And, for taxpayers involved with virtual currency-related or cryptocurrency-related personal or business ventures, the IRS has continued to increase its focus on these transactions. The IRS has sent thousands of inquiry letters to taxpayers regarding virtual currency transactions¹¹ and has added a question about virtual currency on the first page of the Form 1040 individual tax return.

In short, no issues are off-limits. Limited published guidance provided by IRS attorneys to Wealth Squad auditors, for example, shows a diverse range of issues that have arisen, including the proper tax treatment of Cyprus-based holding companies,¹² aggregation of offline third-party computer software programs¹³ and a professional sports team's gross receipts from broadcasting contracts.

Understand PFs and charitable endeavors. Notably, for many HNW taxpayers, the IRS announced that it had identified over 1,000 PFs that are linked to

or interwoven into global high wealth enterprises and invested in significant training on PF issues.¹⁴ There are indications that in prior years, the IRS was less focused on the interplay of tax-exempt entities and examinations of HNW individuals.¹⁵

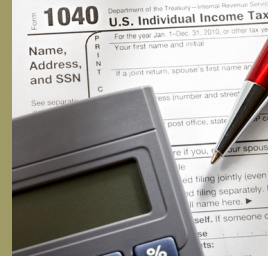
PF issues commonly include potential self-dealing transactions that can touch both fiduciaries and donors. A PF's lending relationships and interactions with private businesses, especially businesses controlled by PF insiders, may also be scrutinized. Were certain issues at a PF to become public—for example, in litigation against the IRS—state attorneys general may also take notice and open independent investigations of the PF.

Thus, taxpayers benefit from proactively compiling a careful record of any transactions that, absent such records and clear explanation, the IRS could challenge as self-dealing or otherwise subject to onerous examination.

Proactively consider privilege issues. Given the number of advisors and staff that many HNW taxpayers and their enterprises implicate, it's important to understand what information may be protected by attorney-client privilege, attorney work product or other potential privilege such as for federally authorized tax practitioners under Internal Revenue Code Section 7525. Often, issues of privilege aren't straightforward, and communications that clients may believe are protected by privilege won't hold up to scrutiny in litigation. Building the relevant context and circumstances to manage communications could prove vital to preventing an examination from taking an unnecessary detour based on the well-intentioned statements of clients or others.

Identify business partners and family members who may be involved for coordinated preparation. The IRS has the power to summon third parties for information, including demands for business records and testimony. Because the IRS has wide latitude regarding the issuance of a summons, taxpayers shouldn't assume that they can control this process during the audit. Additionally, the receipt of an IRS summons may cause some to act unexpectedly. While skilled counsel can try to work with the IRS to narrow third-party requests, it's valuable for taxpayers to understand which of their business partners, or family members, may receive requests for information from the IRS.

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Confidentiality provisions in business agreements may limit disclosure of certain information unless compelled by the government, and taxpayers should be ready to work with the relevant parties to make more limited disclosures in lieu of official IRS summonses.

In the event a taxpayer or a third party doesn't comply with an IRS summons, enforcement typically begins in U.S. district court, litigated by the U.S. Department of Justice on behalf of the IRS. In addition to causing expense and stress, federal litigation may introduce certain privacy and other high stakes considerations.

Conduct a detailed or high level pre-audit. Many taxpayers may benefit from a pre-audit exercise by existing advisors already familiar with their situation and/or new advisors with fresh eyes for a peer review. Depending on the client's situation, the scope of such work can be customized. Conducting a detailed review of tax returns to get ahead of any potential questions from the IRS about the face of the

returns is generally prudent.

Collection and analysis of financial statements and other books and records also may alert taxpayers about whether a more detailed forensic accounting is necessary prior to being examined by the IRS. Often, these exercises can help identify when additional records will be critical to substantiate the return positions and when third-party contact from the IRS may be most likely.

Certain issues can also benefit from detailed legal analyses to bolster previously taken return positions or supplement past analyses with beneficial guidance or case law since the returns were filed. There also may be areas of corporate law, state-specific law or business valuation in which additional, proactive expertise could provide significant value in developing cogent explanations for a future tax auditor (who may make incorrect assumptions in those areas because of a lack of familiarity).



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Finally, experienced practitioners can conduct interviews or informal discussions with stakeholders, staff and relatives to better understand their thinking, memory and ability to clearly communicate information to the government.

Think preliminarily about a potential audit plan. In past Wealth Squad audits, as well as typical large corporate audits, the first step is defining the scope of the audit with the IRS through an audit plan that addresses initial expectations and timing.


It's critical not to overpromise to the IRS as part of this process. It's often better to identify records that may take extra time to compile or obtain as early as possible in the audit process (and ideally, as this article suggests above, before any audit is commenced).

Advisors and HNW clients should expect increased and intrusive IRS scrutiny and should prepare in advance of an audit to gain peace of mind and avoid unwanted surprises.

Considerations such as extensions to the statute of limitations and appropriate deadlines for responses from taxpayers can have a direct impact on the scope and tenor of the audit, and at the time of this writing, with remote working being the norm, careful attention to the negotiated responses is paramount. Preparing clients for these decisions can be useful. Additionally, clients should be prepared to address expansions of the scope of the audit.

Advance Preparation is Crucial
IRS audits of HNW individuals are often complex and require a sophisticated understanding of various interrelated areas of tax law. While the IRS has made announcements in the past about an increased focus on high income and high wealth taxpayers, 2020 brings increased data analytics, improved cooperation

among IRS divisions and greater publicity about tax enforcement of such taxpayers.

As a result, advisors and HNW clients should expect increased and intrusive IRS scrutiny and should prepare in advance of an audit to gain peace of mind and avoid unwanted surprises. 

Endnotes

1. Large Business and International Division Commissioner Douglas O'Donnell made the announcement at New York University's annual Tax Controversy Forum in June 2020.
2. See "IRS Increases Scrutiny of Wealthy Taxpayers," 168 *Tax Notes Federal* 2507 (Sept. 28, 2020) (quoting Internal Revenue Service Large Business and International Division Deputy Commissioner Nikole Flax).
3. Charles P. Rettig, "IRS High-Wealth Industry Group: Evaluation of Wealth Squad IDR," 2010 *TNT* 213-7 (Nov. 1, 2010).
4. Prepared Remarks of Douglas H. Shulman, commissioner of Internal Revenue, Before the AICPA National Conference on Federal Taxation, 2009 WL 3455952, at *4.
5. *Ibid.*
6. See "U.S. Treasury Inspector General for Tax Administration (TIGTA) Report," www.treasury.gov/tigta/auditreports/2020reports/202030015fr.pdf. TIGTA also engaged in an ongoing effort to evaluate the IRS' efforts to ensure tax compliance with respect to high income individuals under its 2020 Annual Audit Plan, www.treasury.gov/tigta/auditplans/auditplans_fy2020.pdf, but aimed particularly at those who don't file taxes at all or don't file taxes on foreign income, those who don't pay U.S. taxes and those who report no tax liability.
7. *IRS Creates New Enterprise Digitalization and Case Management Office*, IRS Press Release, 2020 WL 4192572 (July 21, 2020).
8. See *Internal Revenue Manual* Section 4.52.1, Global High Wealth Program, Global High Wealth Program Processes and Procedures (updated Dec. 26, 2019) (IRM GHW).
9. IRM GHW Section 4.52.1.3(3).
10. IRM GHW Section 4.52.1.1.1(1).
11. IR-2019-132 (July 26, 2019).
12. See Chief Counsel Advice 201343019.
13. See CCA 201226025.
14. Tamera Ripperda, commissioner of the Tax Exempt and Government Entities Division, made this announcement at New York University's annual Tax Controversy Forum in June 2020.
15. See *Judicial Watch, Inc. v. IRS*, No. CV 13-1759, 2015 WL 4072431, at *4 (D.D.C. July 3, 2015) ("In the Global High Wealth Industry Group, all audit referrals are recorded in a database. . . . A search of that database revealed that only one referral for audit had come in from the Tax Exempt and Government Entities Division during the relevant time period [January 2010 to May 2013].")