Effectively Managing IRS Audits of High-Net-Worth Taxpayers

By Fran Obeid

On June 27, 2024, at the 16th Annual NYU Tax Controversy Forum, I was joined by attorneys Emily Hughes, Niles Elber, and Starling Johnson to discuss the Internal Revenue Service's (IRS') initiative on examinations of high-net-worth individuals and how to effectively manage those audits. From 2011 to 2020, the number of IRS audits of taxpayers with incomes ranging from $200,000 to $5,000,000 plummeted.[1] In 2023, Commissioner Werfel explained that, "[t]he years of underfunding that predated the Inflation Reduction Act led to the lowest audit rate of wealthy filers in our history. I am committed to reversing this trend, making sure that new funding will mean more effective compliance efforts on the wealthy … to ensure that the IRS holds our wealthiest filers accountable to pay the full amount of what they owe."[2]

Enforcement Mechanisms by the IRS

The mechanisms that the IRS is using to increase enforcement of wealthy taxpayers are: (i) increased use of soft notices and non-audit contacts; (ii) enhanced coordination with treaty partners and international organizations; (iii) international tax training of Large Business & International (LB & I) counsel; (iv) enhanced case selection procedures to better identify high-risk transactions; and (v) focus on corporations, high-income individuals, and complex flow-through entities, by partnering employees of LB & I and Small Business/Self-Employed (SB/SE) to increase coverage.

Additionally, the IRS is focusing its collection efforts on taxpayers with incomes of $1,000,000 or more who owe tax debt of $250,000 or more and are leveraging artificial intelligence (AI) to expand partnership compliance to include private equity and hedge funds, publicly traded partnerships, and large law firms. Specifically, AI is being leveraged to identify and send compliance letters to partnerships with discrepancies between balance sheets and partnership returns.

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The IRS' Non-Filer Initiative

In February 2024, Commissioner Werfel announced the IRS' non-filer initiative, focusing on taxpayers whose income is at least $400,000 and who had not filed tax returns since 2017.[3] The IRS initially sends those taxpayers a CP59 notice, informing them that their return has not been received and should be filed immediately, or instructing them to complete and return Form 15103 to explain why they do not need to file. At that time, 125,000 CP59 notices went out, with an additional 20,000–40,000 notices going out each week.

The panel advised practitioners to bring non-filer clients into compliance and file the last six years of tax returns to avoid criminal liability. The attorney should (i) enter into a *Kovel* arrangement with an accountant to protect the preparation of the tax returns; and (ii) find out why the client has not filed, as it could be a basis for penalty abatement. First-time abatement should be explored for the earliest year of non-filing.

The client may, however, come to the attorney after ignoring the CP59 notice, prompting a summons to issue for documents concerning income so that the IRS may "use the information to prepare a federal income tax return." The attorney should contact the summons' issuing officer and offer to provide prepared tax returns for the years at issue, which will likely be agreed. The attorney should file the returns once they are prepared by an accountant and provide the issuing officer with copies in order to have a proper record as to when the Service Center received the original tax returns. Clients should be informed that manually filed tax returns may take up to a year or more for the IRS to process.

The attorney should also request that the issuing officer assist with (i) setting up an installment agreement; and penalty abatement. If the officer resists, the attorney should speak with a supervisor so as not to delay these matters. The client is likely to have delinquent state tax returns as well, and in bringing the client into compliance, state voluntary disclosure programs should be explored.

Recent Campaigns

The panel discussed two recent campaigns announced by the IRS earlier in the year: corporate jet deductions and sports industry losses. Regarding corporate jet deductions, the IRS' campaign launched audits focusing on whether large corporations, partnerships, and wealthy aircraft owners have properly reported their business and personal aircraft usage to ensure that owners are only taking deductions to which they are entitled. Given the value of an aircraft, the amount of a deduction on a taxpayer's return can be in the tens of millions of dollars.

The panel advised that allocating expenses between personal and business use is crucial and can involve intense documentation requirements, which must be meticulously kept. The attorney will have to marshal the evidence should the client be audited and decide how to best approach the audit given the documentation or lack thereof.

Another recently announced campaign concerns sports industry losses, which is "designed to identify partnerships within the sports industry that report significant tax losses and determine if the income and deductions driving the losses are reported in compliance with the applicable sections of the Internal Revenue Code." In other words, are the losses taken legitimate? Potential losses that may be examined during an audit are depreciation deductions relating to the stadium and other fixed assets, as well as amortization deductions for media rights and player contracts.

The Code contains limitations on the utilization of losses in a particular year, including basis limitations, at-risk rules, excess business losses, and passive activity losses. The partnership losses flow through to the individual partners—here typically owners of sports teams. It is important for an attorney to work with a good *Kovel* accountant who can review the returns and understand where positions were taken that the IRS might question so a defense may be prepared. If the partnership is audited, it is likely to be subject to the Bipartisan Budget Act (BBA) audit regime and it is the partnership representative who has the authority to represent the partnership. The individual partners do not have a statutory right to receive notice or participate in the partnership proceeding under the BBA audit regime.

The Dirty Dozen List

The panel also discussed a few targets on the IRS' Dirty Dozen List.[4] One such target is art donations where taxpayers are taking inflated valuations.[5] Additionally, some art dealers sell unwary taxpayers discounted art, encourage them to hold it for a period of time, and then donate the art at an "appreciated" value.

The panel advised that the amount of the deduction depends on how tax-exempt organizations will use the art. If the art furthers the organization's tax-exempt purpose, taxpayers can generally deduct the fair market value of the art. However, if the charity does not use art in furtherance of its purpose, the taxpayer may only deduct the *lesser* of the fair market value or cost basis. If the charity sells the artwork within three years, special recapture rules apply. The panel advised that taxpayers should hire qualified appraisers, keep detailed records, and carefully consider how the tax-exempt organization will use the artwork.

Malta Pension Plans

Malta pension plans are another target on the IRS' Dirty Dozen List and have been for years. This target involves taxpayers who, often working with advisers, transferred assets with built-in gains into Malta pension plans, where the assets appreciate and upon distribution are tax free, per the advisers' interpretation of the U.S.–Malta treaty.

On December 21, 2021, the IRS announced that the competent authorities of the United States and Malta signed a competent authority arrangement "confirming their understanding of the meaning of pension fund for purposes of the United States-Malta income tax treaty," which does not include arrangements that allow participants to (i) contribute property other than cash or (ii) do not limit contributions to income earned from employment activities.[6]

While some professionals are defending the Malta pension plans as proper under the treaty, the IRS issued proposed regulations in June 2023 to make these plans a listed transaction.[7] At about the same time, CI agents showed up at the doors of taxpayers and their accountants, issuing summonses, which were later withdrawn in most cases. More recently, the IRS has begun taking steps criminally and civilly against taxpayers who are engaged in these types of arrangements.

Digital Assets

Digital assets also made the Dirty Dozen List as there are promoters who are recommending these assets to taxpayers and claiming them to be untraceable by the IRS, which is not the case.[8] The following question is now on Form 1040 of the personal income tax return to assist with the enforcement of digital assets: "Did you (a) receive (as a reward or payment for property or services) or (b) sell, exchange, or otherwise dispose of a digital asset (or a financial interest in a digital asset)?"

The Dirty Dozen notice reminds taxpayers that if they held a digital asset as a capital asset and sold, exchanged, or transferred it, this activity must be reported on Form 8949, which concerns the Sales and Dispositions of Capital Assets to determine the gain or loss to report on Schedule D. If taxpayers gifted digital assets, a gift tax return may be required. Employees who are paid with digital assets must report the payment on their return as wage income, and contractors must report payment for services with digital assets on Schedule C, along with anyone who sold, exchanged, or transferred digital assets in connection with a trade or business.

Strategic Considerations

The panel advised that in representing taxpayers, it is best to "audit proof" your client by explaining the rules of such targeted transactions and the proper documentation needed to be prepared in the event of an audit, so it may be prepared contemporaneously.

Should the client come to you after issuance of an audit notice, issues to consider include whether the accountant or attorney should be on the front lines of the audit representing the taxpayer (noting that with the attorney on the front lines the reasonable reliance defense on the accountant may be argued more successfully); conceding certain issues; limiting the scope of issues and time frame along with statute of limitations considerations.

Change in Method of Accounting (CAM) adjustments are creeping into audits of high-net-worth individuals as such an adjustment under Code Sec. 481 allows for a three-year allocation adjustment—even if some years are closed by the statute of limitations to "prevent amounts from being duplicated or omitted." A proper CAM, however, only concerns the timing of a material item and does not change the overall lifetime income of the taxpayer.[9]

With the Inflation Reduction Act, tax professionals and their clients will be facing new enforcement actions from the IRS, which is receiving a long overdue infusion of funding. The IRS has made clear that its focus will be on high-net-worth individuals and complex passthrough entities so taxpayers and professionals best be prepared.

ENDNOTES

1 IRS Data Book, Table 17, Examination Coverage. *www.irs.gov/statistics/soi-tax-stats-examination-coverage-and-recommended-additional-tax-after-examination-by-type-and-size-of-return-irs-data-book-table-17*.

2 Commissioner Danny Werfel, Sep. 8, 2023.

3 IR-2024-56, Feb. 29, 2024.

4 IR-105, Apr. 11, 2024.

5 IR-2024-104, Apr. 10, 2024.

6 IR-2021-253, Dec. 21, 2021.

7 REG-106228-22 (Jun. 7, 2023).

8 IR-2024-105, Apr. 11, 2024.

9 Reg. §1.446-1(e)(2)(ii)(a).