Tax controversies and the family office
An ounce of prevention is worth a pound of cure

Julia Cloud
Partner
Tax-Private Company Services
Deloitte

In 2009, the Internal Revenue Service (IRS) announced the formation of a Global High Wealth Industry (GHWI) group to increase the focus on certain matters related to high-income taxpayers, as well as to strengthen the rigor of its audit processes in this taxpayer segment. The IRS has stated that this focus on high income taxpayers will continue.

There is no formula that can reliably predict whether your family office will be subject to some type of examination or what may happen if you are. Each situation is unique and the resources available vary. What is consistent from situation to situation, however, is the advantage you can gain from being prepared.

How likely is an examination?

Available data indicates that as Adjusted Gross Income (AGI) rises, so does the likelihood of examination. Individuals with income of US$1 million or more are much more likely than those at lower income levels to be subject to an exam. According to the 2011 Data Book, during fiscal year 2011, IRS examination coverage for individual taxpayers with US$100,000 to under US$200,000 in AGI was just 1%. For individual taxpayers with US$1 million to under US$5 million in AGI, that percentage jumped to 11.8%. For taxpayers with US$10 million or more of AGI, examination coverage was nearly a third of all returns filed, at 29.93%.

What is the IRS's Global High Wealth Industry Group?

In late 2009, the IRS announced the creation of the GHWI group to provide closer scrutiny of high-wealth individuals and their related entities, which often involve an international component with interests in foreign assets. This IRS industry group is charged with strengthening the examination process for high-income individuals, or those that the IRS states have tens of millions of dollars in assets or income.

To fulfil this purpose, the GHWI group has adopted an 'enterprise examination' audit approach that involves the consideration of the entire group of entities controlled by a high-wealth individual instead of the former approach of analysing each return as a separate exam with little impact on related parties. This enterprise examination approach may involve a larger team of revenue agents, including specialists in targeted technical disciplines as well as IRS attorneys assigned to advise the revenue agents. More significantly, it poses the potential for an audit in one area to open doors to the examination of other related entities and/or individuals.

Notably, this group resides in the division responsible for examinations of large businesses and international taxpayers, meaning that the agents are more experienced in examining large enterprises, have more sophisticated training, and are familiar with more complex issues such as valuations and wealth planning.

How has the level of audit activity changed since the GHWI group's inception?

Statistics acquired by the Transactional Records Access Clearinghouse (TRAC) at Syracuse University under a court order indicate that in the first 29 months since the programme's inception (October 2009 to February 2012), the GHWI group completed 36 total audits of individual taxpayers with US$1 million or more of income.[1]

The GHWI group now has eight teams and a total of approximately 100 agents assigned to focus on this area. Although the completed examination numbers are still relatively low with regard to number of cases closed, there is significant activity in progress and evidence that the examination teams are becoming more focused and organised in their approach.

There is no formula that can reliably predict whether your family office will be subject to some type of examination or what may happen if you are. Each situation is unique and the resources available vary

What results has the programme produced?

According to the data received by TRAC, in the 36 GHWI examinations of individual tax returns completed as of February 2012, agents concluded that an additional US$47 million in taxes were owed. Notably, a third of all completed GHWI examinations over this period produced no change in taxes owed. This rate is significantly higher than the no change rate for field exams shown in the 2011 Data Book and may indicate difficulty on the part of the IRS to select returns that have the most potential for adjustment.

1 *'Few Millionaires Audited by IRS Global High Wealth Group,' TRAC IRS, April 10, 2012*

What have we observed about the group's approach through activity to date?

We are now seeing some shifts in process as well as in focus. Agents regularly ask for organisational charts and examinations are expanding to related individuals and entities at a quicker pace. It is now common for a related individual or trust to receive an exam notice within weeks of the original examination. The most recent statistics indicate that the GHWI has 500 returns under examination, suggesting that for each return started, it is extending the examination to four to five related entities. The IRS has indicated that more emphasis will be placed on partnerships and Form 1120-S returns related to high-wealth individuals in the future.

In addition, the group is involving IRS specialists more often, enabling examination teams to identify issues more quickly. Depending on the return(s) involved, teams may include financial products specialists; estate, gift, and trust attorneys in cases involving significant wealth transfer; or engineers and appraisers for matters involving valuation issues. Valuation issues, in particular, require careful preparation to facilitate ready access to all the necessary supporting information.

Finally, agents appear to be doing a better job of preparing information requests, which were initially broad in nature but now are often focused on more specific issues. The Large Business & International Division (LB&I) has been making efforts to confirm that document requests are more focused in case a summons for information may be needed in the future.

What are the common tax issues arising in the GHWI's enterprise reviews?

Enterprise examinations, in general, should involve the most significant taxpayers within the structure of related parties. Some examinations start with individual income tax returns (Form 1040s), although some begin with flow-through entities, including partnership (Form 1065) and subchapter S corporation (Form 1120-S) returns. Data obtained by TRAC, however, indicates that, while the GHWI group targeted increased numbers of partnership and S corporation returns (75 in FY2011 and 96 in FY2012), it completed relatively few examinations: a total of 18 partnership examinations and six large S corporation examinations until February 2012. Additionally, while the IRS historically has not devoted a lot of attention to examining trusts, we are starting to see more GHWI exams pick up on trust issues or examine trusts as related entities.

Areas likely to get particular scrutiny include valuation issues (such as those related to wealth transfer or charitable contributions), management fees paid by related entities, private foundations, and off-shore holdings, especially those involving financial instruments. Passive foreign investment companies are also attracting more attention in examinations.

One of the common areas of focus for the IRS is to examine compliance with reporting requirements for foreign accounts, including those related to the Report of Foreign Bank and Financial Accounts (FBAR), new foreign asset reporting under the Hiring Incentives to Restore Employment (HIRE) Act, and other foreign information returns related to investments in foreign entities.

Note that there are treaties and tax information agreements in place between the United States and other countries and that the IRS can and does automatically exchange information with other countries. This access to information has been evident in some of the questions posed during examinations, even before implementation of the new Foreign Accounts Tax Compliance Act (FATCA) rules. This access to information suggests the need to be particularly diligent in this area.

What can be expected with a GHWI examination?

Most examinations begin with a letter or call to schedule an initial appointment. Often, examiners do not provide much notice and they likely will want to meet at a site relevant to the entity involved to interview the individual(s) most closely associated with the issue at hand and to tour business facilities.

Available data indicates that as Adjusted Gross Income (AGI) rises, so does the likelihood of examination

Following initial interview(s), the agents will re-scope the examination to define the material issues, and then you can expect to see a number of information requests. Under the GHWI group's audit approach, it would not be unusual to receive document requests from more than one agent. Revenue agents are under pressure to complete an examination as quickly as possible and, accordingly, expect quick turnaround on their requests.

GHWI examinations have IRS attorneys as well as agents assigned to them. Having counsel involved can elevate the level of the examination, which is another reason for implementing a proper level of care in preparation and conduct of the examination. That said, with just 100 agents, the GHWI group does not always have teams or individuals available in proximity to the individuals or entities being audited. Accordingly, some GHWI exams take place primarily by correspondence. This can create issues, particularly when the examination requires an exchange of large numbers of documents.

What are some keys to managing an examination effectively?

Managing a tax controversy situation is as much an art as it is a science. It can involve much more than just responding to information requests and following up to determine the status of the examination. A family office will need to make some critical decisions that may have a bearing on the outcome, most of which are matters that the family office executives and staff do not manage on a recurring basis.

How will you obtain the necessary information and how quickly? Which documents must be provided to the examiner to respond to the agent's request, but what are the implications for other parties? Who is best suited to present your arguments on technical issues when the law is not agreed upon? When is it beneficial to consider an alternative resolution approach? How will you communicate with others; within the family office, with advisors, and with related individuals and entities? Open communication is particularly important under the enterprise audit concept, where related parties are increasingly becoming part of the examination.

How do GHWI information and document requests typically work?

Initially, your family office may receive an inquiry with the letter confirming the initial conference to request documents to verify items on a tax return. In some cases, the preliminary information requests may be broad. In others, where the IRS has defined the particular issues involved, requests may be relatively specific; for example, substantiating a large charitable contribution on a tax return or partnership income that does not match with the Schedule K-1 provided. It is not unusual for the IRS to ask for information it already has – such as tax returns for a prior or subsequent tax year – during an examination.

These requests usually require a response within a short period of time, often within 14 to 21 days. Based on the response, the IRS should make its determination on the issue or may follow up for additional information.

Responding to an information request can be demanding on a family office and may interfere with their ability to perform regular responsibilities. Regardless, it is important to respond within the timeframe requested. If the agent does not get the information from your office, he or she may turn to other sources for information or issue summonses. In these situations, you may lose control over the information the examiners ultimately acquire and consider, as well as your opportunity to manage the information flow.

Finally, while it is important to be responsive to requests, you should be diligent in understanding what information you are required to provide in response to the specific questions posed and the preferred way to communicate with the agent. Carefully review the information you are providing and be aware of potential exposure to others of providing certain information.

Enterprise examinations, in general, should involve the most significant taxpayers within the structure of related parties

How long do GHWI examinations typically take to resolve?

Historically, the average time to complete a traditional individual examination has been 12 to 18 months, although the timeframe depends on the complexity of the issues involved. Under the GHWI group's enterprise examination approach, examinations appear to be taking, on average, 18 to 24 months to close depending on the issues and number of entities involved.

What can you do to improve your preparedness for an examination?

It is helpful to perform a periodic risk assessment of the returns your family office oversees before the IRS initiates an examination, or to conduct an audit readiness assessment. From these assessments, you should be able to identify material issues that could be a focus during an examination and whether you have a system in place for handling any information requests you will receive. For example, selling a business should be your cue to gather relevant information and make sure it is easily accessible.

How should you prioritise your preparation efforts?

While the GHWI group has not publicised its selection model and the extent to which it selects returns based on AGI or other factors, its stated focus is on the 'most significant' taxpayers. The IRS approach is to consider 'expanded income'. Under this approach, the IRS would focus resources and effort on returns that have the greatest level of total income, including tax-exempt income, rather than simply those with the highest AGI. There is not an answer for this, but within your office you may be able to prioritise any examination readiness assessments that need to be completed while keeping this in mind.

Of course, careful record keeping is important. Tax laws include minimum periods during which a filing may be subject to an exam. At the very least, your family office should take care to retain tax documents and records for the minimum statutory period, but there may be some you should retain longer; for example, income tax returns should be retained for at least three years, but if there are foreign tax credits involved, a different 10-year statute may apply and require access to prior year returns.

As any entity should, your family office should also establish specific procedures and formats for retaining tax-related documents, as well as intervals for document destruction. There will be some documents that require retention of physical copies, but electronic storage does reduce physical space requirements and enables access from multiple locations. The IRS increasingly asks for electronic books and records in conjunction with information requests, but to date it has not mandated electronic record keeping.

What is the outlook for GHWI programme?

Announcement of the GHWI programme promised a 'game-changing strategy', but it is not clear whether the programme is producing the level of change intended. In its Audit Plan for FY2012, the Treasury Inspector General for Tax Administration said that it will review the programme to review IRS progress in this group.

What else should family offices be aware of in 2013 and beyond?

Your family office should be aware of and plan for two new taxes targeting earned and investment income of high-income individuals as of 1 January 2013.

First, beginning in 2013, an additional 0.9% Medicare Hospital Insurance tax (HI) tax applies to wages of an employee or earnings of self-employed individuals that exceed specified thresholds. Also beginning in 2013, unearned income received by wealthier individuals – such as interest, dividends, capital gains, annuities, royalties, and rents, other than such income that is derived in the ordinary course of a trade or business and not treated as a passive activity – will be subject to a 3.8% 'net investment income tax.' Notably, the investment income tax and the 0.9% additional HI tax on earned income apply independently.

Consult the *2013 Essential Tax and Wealth Planning Guide* for more detail and planning tips.

Historically, the average time to complete a traditional individual examination has been 12 to 18 months, although the timeframe depends on the complexity of the issues involved

To the **point**:

- For fiscal year 2011, IRS examination coverage taxpayers with $10 million or more of AGI, examination coverage was nearly a third of all returns filed, at 29.93%
- Statistics indicate that the IRS is extending examinations to four to five related entities and the IRS has indicated that more emphasis will be placed on partnerships and Form 1120-S returns
- Areas likely to get scrutiny include valuation issues, management fees paid by related entities, private foundations, off-shore holdings, and passive foreign investment companies
- The IRS is commonly examining compliance with reporting requirements for foreign accounts, including those related to FBAR and new foreign asset reporting under the HIRE Act
- Family Offices must be carefully review the information they providing and must be aware of potential exposure to others of providing certain information
- Family Offices can prepare by doing periodic risk assessments or by conducting an audit readiness assessment
- Family Offices should establish specific procedures and formats for retaining tax-related documents, as well as intervals for document destruction