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

In 2009, the Internal Revenue Service 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. Shortly after, we published an article, Tax Controversies and the Family Office: Prepare for a Changing Examination Environment, to provide some information about this new group and its goals and, more importantly, offer some suggestions for steps to take given the increased focus in this area.

In the ensuing two-plus years, how has that group's presence altered the examination landscape for the high-income taxpayer? The IRS doesn't publish detailed information about the activities of its GHWI group; however, available information combined with our own observations and experiences suggests that, while the group started somewhat slowly and hasn't closed a significant number of cases to date, it has opened many more and continues to work in support of its mission. We have detailed some of our observations in this article.

The IRS has stated that the focus on high income taxpayers will continue. Statistics from the Internal Revenue Service Data Book, 2011 ("2011 Data Book") indicate that taxpayers with higher adjusted gross income amounts were more likely to be examined as compared to taxpayers with lower adjusted gross income, even if not by the GHWI group. If you are not ready for an IRS exam, now is the time to get ready, for example by making sure that you can readily access the information you need to substantiate large transactions or large charitable contributions.

Despite recent tax increases, there is much that is uncertain about the tax environment affecting family offices and wealthy individuals in 2013 and beyond — whether the tax burden for these individuals will increase more, the future of certain wealth planning opportunities, and the future growth of the GHWI group and the examination environment.

This article provides an overview of some important considerations in light of the current environment and addresses some common questions. How has the level of audit activity changed since the GHWI group's inception? What are some common tax issues arising in the GHWI's enterprise exams? What are some leading practices in managing an examination effectively? And what else should a family office be aware of?

The fact is, in this environment, there is no formula that can help you predict whether you will be subject to some type of examination or what may happen if you are. Each situation will look different, the issues will be different, and the resources at the table will be different. What is consistent from situation to situation, though, is the advantage you can gain from being prepared. We hope this article provides some food for thought as you work with your advisors to assess and manage tax risks.

Generally speaking, what are the chances of an examination?

Available data indicates that as adjusted gross income (AGI) rises, so does the likelihood of examination. Individuals with income of $1 million or more are much more likely than those at lower income levels to be subject to an exam. This will not change.

According to the 2011 Data Book during fiscal year 2011, IRS examination coverage for individual taxpayers with $100,000 to under $200,000 in adjusted gross income (AGI) was just 1%. For individual taxpayers with $1 million to under $5 million in AGI, that percentage jumped to 11.8%. For taxpayers with $10 million or more of AGI, examination coverage was nearly a third of all returns filed, at 29.93%.

Recent IRS initiatives, such as the formation of the GHWI group and increased focus on foreign income and information reporting, suggest that family offices should be prepared for the possibility of an examination.

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

In late 2009, the IRS announced establishment 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 IRS states have tens of millions of dollars of assets or income.

To fulfill this purpose, the GHWI group has adopted an "enterprise examination" audit approach that involves a look at the entire group of entities controlled by a high-wealth individual instead of the former approach of analyzing 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 the 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?

The IRS doesn't provide data on the total number of taxpayers examined by the GHWI group. Statistics acquired by the Transactional Records Access Clearinghouse (TRAC) at Syracuse University under a court order, however, indicated that in the first 29 months of the program's inception (October 2009 to February 2012), the GHWI group completed 36 total audits of individual taxpayers with $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 as to number of cases closed, there is significant activity in progress and evidence that the examination teams are becoming more focused and organized in their approach.

What results has the program produced?

According to the data received by TRAC, the 36 GHWI examinations of individual tax returns completed as of February 2012, resulted in an additional $47 million in taxes that agents said 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?

After a slow start, we are now seeing some shifts in process as well as in focus.

For one thing, agents regularly ask for organization charts, and examinations are expanding to related individuals and entities at a quicker pace. Now, it is not uncommon 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 quicker. 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, though, 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 through February 2012. And while the IRS historically hasn't devoted a lot of attention to examining trusts, we are starting to see more GHWI exams pick up on trust issues or to 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.

What is important to note here is 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.

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.

Of note, GHWI examinations have IRS attorneys as well as agents assigned to them. Individual exams traditionally haven't involved IRS attorneys, at least initially. Having counsel involved can elevate the level of the examination — another reason for implementing a proper level of care in preparation and conduct of the examination.

That said, with just 100 agents in the GHWI group the group doesn't always have teams or individuals available in proximity to the individuals or entities being audited. The face-to-face approach that is typical for large corporation examinations may not always be possible in the individual examinations. 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. In fact, it can involve much more than just responding to information requests and following up to determine the status of the examination. Your 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 increasingly are becoming part of the examination.

Please refer to Tax Controversies and the Family Office: Prepare for a Changing Examination Landscape for more discussion about this area.

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.

Regardless of whether the scope of examination involves a broad or narrow focus, information requests can involve a substantial number of documents. Depending on your family office operations, responding to the request may be demanding on your team and 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 — and 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, given the greater likelihood that an examination today may extend to related parties. This will aid in your expectation and preparation for subsequent information requests.

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.

If a revenue agent finds technical issues requiring referral to an international specialist or an appraiser, you can expect to be dealing with the IRS for a longer period of time.

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

It is helpful to do 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 on 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 prioritize your preparation efforts? While the GHWI group hasn't publicized 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 prioritize any examination readiness assessments that need to be completed keeping this in mind.

Of course, careful recordkeeping 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 statute 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. Increasingly, the IRS asks for electronic books and records in conjunction with information requests, but to date it has not mandated electronic recordkeeping. Commercially available technology solutions can be valuable in environments that face multiple audits.

What is the outlook for GHWI program?

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

The GHWI program was a focus for the IRS Commissioner Douglas Shulman. Although his term was up in November 2012, it is not likely that a new commissioner will be named for some time. It is likely, then, that the program will remain in force, but the emphasis and priorities — as well as the investment supporting it — could change in the future. The GHWI program will need additional budget to continue with its current hiring plans. At the same time, the IRS is preparing to administer provisions of the Healthcare Act and FATCA, and this could detract from continuing to build the GHWI program.

Nevertheless, we can expect certain priority areas, such as off-shore income and information reporting, to receive at least as much focus as they do now — if not more so. And, given the smaller population of individuals with income over $1 million, focus on this area won't go away entirely in the IRS examination plans.

Finally, while it is important to be aware of trends, it is prudent not to count too much on past activity as an indicator of future direction. The IRS is continually looking for ways to improve selection of returns for examination. It conducts research every few years and its approach can, and does, shift—therefore changing the audit risk for a taxpayer.

The tax landscape for high-income individuals continues to evolve. 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 January 1, 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.

What remains up in the air?

In short, a lot.

While the recent American Taxpayer Relief Act of 2012 (the Act) provides greater certainty about the individual and estate tax landscape for the foreseeable future, there nevertheless may be more changes coming down the pike that increase the tax burden of wealthy individuals.

The Act, which Congress passed to help avert the so-called "fiscal cliff," partly achieves President Obama's stated goals of making the tax code more progressive and increasing the tax burden on high-income individuals. It sets the top tax rate on ordinary income at 39.6%, increases the top rate for investment income to 20%, and scales back the benefit provided by deductions and personal exemptions, all beginning in 2013. It also raises the top tax rate for large estates to 40%. (For additional information on changes made by the Act, please see Swerving from the cliff – Tax provisions in the American Tax Relief Act of 2012.) With these changes, a high-income taxpayer could expect an effective tax rate on long-term capital gains of 23.8% and an effective tax rate for dividends of 43.4%. Reinstating the three-percent itemized deduction limitation and the phase-out of personal exemptions would further boost the effective tax rate on long-term capital gains and dividends to 25.8% and 45.4%, respectively.

But the Act is likely to set the stage for a larger debate on deficit reduction and fundamental tax reform that will continue to play out in 2013 and beyond. As part of that process, there may be additional tax increases on wealthy individuals, including the possibility of reducing the tax benefits provided by deductions and exclusions.

Taxpayers and estate planners alike should remain vigilant as the possibility of tax reform efforts resume. The possibility exists that Congress could adopt additional changes in the transfer tax area, including perceived estate and gift tax "loophole closers" previously proposed by the administration. These include a 10-year minimum term for grantor retained annuity trusts (GRATs), restrictions limiting the use of discounts for transferred property, consistency in tax basis determinations for estate taxed assets for income tax purposes, extending the disregard of transactions with grantor trusts to gifts and estates, and requiring the GST-exempt status of any trust to expire at the end of 90 years. Keeping abreast of tax legislative developments will give taxpayers and estate planners the opportunity to plan ahead and react quickly as more changes transpire.

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