

Beware High Income Audits by the Internal Revenue Service

By Robert W. Wood

No one likes a tax audit except the auditor. Although the Internal Revenue Service is fairly closed-mouth about its audit statistics and criteria, it should come as no surprise that higher incomes and more complex tax returns are fertile sources of audit for the agency. After all, the job of the IRS is to collect revenue.

One new program that is generating fear as well as controversy is the IRS' latest foray into auditing the wealthy. The unit tasked with this job is called the IRS' Global High Wealth Industry Group. (See "Audits From Hell Target Rich," by Arden Dale, Nov. 13, 2010, <http://online.wsj.com/article/SB10001424052748704865704575610641497495762.html>). Some now call this "The Wealth Squad," but I prefer "The Rich Squad."



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Although the IRS' Rich Squad is just getting started, it makes sense to start going through your records and getting organized if you might be targeted. Keeping good documents and records is important, for they will help in any audit. But these Rich Squad audits are particularly document intensive, even for a tax audit. If you ever have to go down this road, much of the audit process will be providing copies of just about everything.

Based on IRS statistics, someone with income of \$388,000 or so a year is in the top 1 percent of taxpayers in the nation. Based on this benchmark, you might think the Rich Squad would target anyone at or above that income level. Interestingly, though, no one seems to be saying precisely how rich one must be to get targeted.

Still, there are some figures available, which suggest that this is not about income levels. The Rich Squad is part of the IRS' Large Business and International Division. Being associated with that division generally means that the target of the audit would have more than \$10 million in assets. Assets and income are not the same, of course. A business might have \$10 million or more in assets, but only a tiny fraction of that in annual income. That applies to individuals too.

Conversely, even if you have a large annual income, if you don't have \$10 million or more in assets, you don't seem to fit the profile the IRS seeks for the Rich Squad. Indeed, judging from the other business units the IRS' Large Business and International Division monitors, most advisers believe the Rich Squad will not deal primarily with people who simply have a large amount of income on their Form 1040. That is not its focus.

In fact, there's a reason the Rich Squad sprang from the IRS' Large Business and International Division. That unit of the IRS is adept at dealing with complex business and investment entity structures wealthy people (and big companies) often employ. For reasons of tax law, liability protection, hedging investment risk, anonymity, and succession planning, most wealthy people (and most big companies) do not put all their eggs in one basket. The

Rich Squad audit would take into account the range of assets and entities across a family group.

Most observers and practitioners suggest that this program is still in its startup phase. Yet, of the details that have emerged so far, some are very clear. The written questions and paperwork required in such an audit are extraordinary. The IRS commonly issues information document requests, usually abbreviated to "IDRs" by tax professionals. If you receive such a request, you are not required by law to respond. However, you should respond or you will usually end up with a subpoena. Responding to subpoenas is mandatory, and you will likely need a tax professional's help. If the case involves significant liabilities or issues, and certainly if it is brought by the Rich Squad, you should probably seek assistance from tax attorneys rather than accountants. Attorneys have the added benefit of attorney-client privilege.

Wherever you fit on the wealth scale, you should be aware that the IRS is doing more to troll for compliance glitches with wealthy taxpayers.

This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.

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