

# Evaluating the IRS Wealth Squad

*By Charles P. Rettig*

Charles Rettig examines LB&I's IRS Global High Wealth Industry segment. He also shares practice insights into this unique examination area and concludes as with any examination engagement, preparation and more preparation are the keys to success.



**T**he Treasury Inspector General for Tax Administration (TIGTA) recently audited the ongoing compliance efforts of the IRS Global High Wealth Industry (commonly referred to as the “Wealth Squad”).<sup>1</sup> In 2009, the IRS Large Business and International Division (LB&I) adopted a High-Income and High-Wealth strategy focused on auditing more tax returns related to high-income individuals. In January 2010, High-Income and High-Wealth Strategy Council (hereafter referred to as the “Strategy Council”) was established to oversee the implementation of the High-Income and High-Wealth strategy.

The Strategy Council's mission has been to design, develop and implement a Service-wide approach to maximize high-income taxpayer audit coverage; select the best possible workload to ensure coverage and collectability while also considering taxpayer burden issues; and oversee the high-income audit workload selection and delivery among the business operating divisions and determining which is best suited to address a high-income taxpayer's unique characteristics. Strategy Council members include executives from all IRS business operating divisions.

LB&I generally serves corporations, S corporations, partnerships and other passthrough entities having more than \$10 million in assets. These entities typically have large numbers of employees, deal with complicated issues involving tax law and accounting principles and conduct their operations in an expanding global environment. LB&I operates within various Industry Groups that include Communications, Technology, and Media; Financial Services; Heavy Manufacturing and Pharmaceutical; Natural Resources and Construction; Retailers, Food, Transportation, and Healthcare; and the Global High Wealth Industry.

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TABLE 1

GHW Industry Business Results for Fiscal Years 2010 Through 2014					
Fiscal Year	Enterprise Cases Risk Assessed	Enterprise Cases Outsourced	Enterprise Cases Sent to GHW Industry Examination	Number of Returns Closed <sup>1</sup>	Dollars Recommended for Returns Closed (in Millions)
2010	56	0	50	12	None
2011	147	0	129	29	\$21.1
2012	184	0	157	171	\$98.2
2013	197	18	154	310	\$154.0
2014	214	12	154	359	\$234.9

<sup>1</sup> Each enterprise case involves multiple returns. These are return examinations closed during the fiscal year but may not correspond to a particular enterprise case examination started in the same year.

In announcing the creation of the Wealth Squad in 2010 to address tax compliance issues of high-income taxpayers, then IRS Commissioner Douglas Shulman stated, “For a variety of reasons—including valid business reasons—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.”<sup>2</sup>

The Wealth Squad pursues a comprehensive approach to auditing high-income taxpayers by expanding the examinations beyond the individual income tax return to include examinations of related and controlled entities. A typical Wealth Squad examination consists of a key case, generally the taxpayer’s Form 1040, and related income tax returns for which the taxpayer has a controlling interest in the entity and for which a significant compliance risk may exist. These entities may include partnerships, trusts, S corporations, C corporations, private foundations, *etc.* The examination often includes other individual income tax returns affected by flow-through adjustments made on the tax returns for partnerships and S corporations controlled by the key taxpayer.

Due to the complexity of most high-income taxpayers’ returns, it generally takes more time than a traditional audit to build and assess the risk in each case. A typical IRS audit of an individual taxpayer is focused solely on his or her Form 1040 and other supporting forms and schedules. If warranted, the examiner may add the taxpayer’s prior and/or subsequent year’s tax returns if the same questionable issue was reported on those returns. Throughout, focus of the examination generally remains on the individual taxpayer. In contrast, under the more comprehensive Wealth Squad audit approach, the examination scope of a high-income taxpayer includes the tax returns of that taxpayer, the business entities he or

she is involved in and often other taxpayers (investors and partners) who are involved with the same business enterprises. As a result, the complex nature of a Wealth Squad examination typically requires significantly more IRS compliance resources.

Initially, it was envisioned that the Wealth Squad would grow to 242 examiners (*e.g.*, revenue agents) and 58 management/support staff by the end of FY 2011 (September 30). However, due to budget and related compliance resource limitations, by the end of FY 2014, the Wealth Squad had only 96 examiners and 24 management/support staff—about 40 percent of what LB&I initially believed would be effective. In order to compensate for a lack of resources, LB&I outsourced Wealth Squad examinations to other LB&I Industry Groups—Financial Services, Natural Resources and Construction and, beginning in FY 2015, to the Communications Technology and Media Industry.<sup>3</sup> The TIGTA report set forth a belief that LB&I is currently at a crossroads concerning the Wealth Squad and how it might fit within the overall compliance strategy of LB&I.<sup>4</sup> See Table 1.

Interestingly, the TIGTA Report compared Wealth Squad examination results with those of outsourced examinations and determined the “Examination Productivity Yield: Dollars per Hour” as shown in Table 2.

TABLE 2

Examination Productivity Yield: Dollars per Hour				
Fiscal Year	GHW Industry	Outsourced LB&I Division Industries		
		Financial Services	Natural Resources and Construction	Communications Technology and Media
2012	\$1,787	\$4,153	\$4,014	\$3,189
2013	\$1,543	\$2,868	\$6,022	\$2,860
2014	\$1,897	\$9,843	\$1,454	\$1,751

In addition to the productivity comparisons, TIGTA determined that Wealth Squad examiners have higher rates of tax return examinations closed with no adjustments (a “no-change”) than all of the other LB&I industries from FY 2010 through FY 2014. Since its inception through FY 2014, the Wealth Squad has closed 881 examinations with approximately 41 percent of them being closed as a no-change. Certainly, there is an inherent, undeterminable value to increased voluntary compliance of high-income taxpayers attributable to more Wealth Squad examinations. However, it is interesting that the Wealth Squad’s no-change rates generally exceeded those of the other LB&I Division’s industries. *See* Table 3.

Overall, high-income taxpayers are generally audited at a higher rate than taxpayers at lower income levels. As a result of the Wealth Squad and outsourcing of examinations to other LB&I industry groups, audit coverage of high-income taxpayers improved from FY 2010 to FY 2013, but slipped a bit in FY 2014. *See* Table 4.

## General IRS Information Gathering

The IRS has the general authority to gather evidence and request information during the course of an examination.<sup>5</sup> IRS requests are initially in the form of an Information Document Request—Form 4564 (IDR)—which must be reasonably designed to obtain information and documents

relevant to a legitimate examination purpose. IDRs are to be specific, clear and concise.<sup>6</sup> If the taxpayer fails to appropriately respond to an IDR, the IRS may issue a Summons. The IRS has broad authority to summons books and records, the taxpayer or any person having custody of records in order to ascertain the correctness of the taxpayer’s return, to make a return or to determine the liability of a taxpayer.<sup>7</sup>

The Summons will set forth the date, time and place where the summoned party is to appear, although at least 10 days’ prior notice of appearance is required.<sup>8</sup> Compliance with the Summons may take the form of a formal question-and-answer session under oath, an informal interview or the submission of (or providing access to) the records being summoned. The witness summoned is entitled to decline to produce documents or to answer particular questions if a good-faith basis exists for an objection to compliance.

Neither an IDR nor a Summons is self-enforcing. If a taxpayer fails to reasonably comply with a Summons, the IRS may proceed with Summons enforcement. Jurisdiction to enforce a Summons is in the U.S. District Court for the district in which the summoned person resides.<sup>9</sup> In such event, the IRS must demonstrate that (1) the investigation is being conducted pursuant to a legitimate purpose; (2) the inquiry is relevant to that purpose; (3) the information sought is not within the possession of

TABLE 3

Comparison of LB&I Division Industries’ No-Change Rates						
Industry Name	Fiscal Year					Fiscal Years 2010–2014 Overall
	2010	2011	2012	2013	2014	
Global High Wealth	17%	28%	47%	43%	37%	41%
Communications, Technology and Media	28%	16%	28%	14%	20%	20%
Financial Services	31%	31%	33%	38%	38%	33%
Heavy Manufacturing and Pharmaceutical	26%	26%	22%	24%	28%	25%
Natural Resources and Construction	27%	16%	28%	14%	21%	20%
Retailers, Food, Transportation and Healthcare	29%	27%	27%	14%	20%	22%

TABLE 4

Adjusted Gross Income per Individual Income Tax Return Audit Coverage Percentage by Fiscal Year				
Adjusted Gross Income per Individual Income Tax Return	Audit Coverage Percentage by Fiscal Year			Increase/Decrease in the Audit Coverage Percentage Between Fiscal Years 2010 and 2014
	2010	2013	2014	
\$200,000 to \$499,999	1.92%	2.06%	1.75%	-0.17%
\$500,000 to \$999,999	3.37%	3.79%	3.62%	0.25%
\$1,000,000 to \$4,999,999	6.67%	9.02%	6.21%	-0.46%

the IRS; and (4) the IRS has followed the administrative steps required by the Internal Revenue Code.<sup>10</sup> A District Court Judge has the power to imprison anyone required to respond to a Summons. Typically, if the IRS proceeds to issue a Summons, it intends to enforce compliance with the Summons through a District Court proceeding, if necessary.

## Wealth Squad IDRs

The initial IDRs issued in connection with the commencement of a Wealth Squad examination will seem overwhelming to even the most seasoned tax practitioners. The IRS has somewhat standardized their information requests in these matters by seeking everything imaginable with respect to the taxpayer under examination and all related entities. For the year under examination, the Wealth Squad IDRs typically request that the taxpayer do the following:

1. Provide copies of all original and amended returns for the year under examination, the prior year and the current year if filed or when filed
2. Reconcile all adjustments to all original and amended returns and explain each adjustment
3. Identify all sources of your income, including who paid it and how it was paid
4. Identify all of your assets, tangible or intangible, owned directly or indirectly, inside and outside the United States
5. Identify all liabilities owed, directly or indirectly, by you or any entity you controlled, inside and outside the United States
6. Indicate any properties that you directly or indirectly leased or rented
7. Provide the full name, taxpayer identification number (TIN), classification for U.S. tax purposes (*e.g.*, C corporation, S corporation, disregarded entity or trust), your position title and describe your responsibilities for or relationship with a U.S. or foreign entity of which you:
  - a. owned at least a 20 percent, direct or indirect, capital interest, including hybrid instruments convertible to 20 percent or more capital ownership;
  - b. had a 20 percent or more interest in profits/losses;
  - c. were a trustee or acted in a fiduciary capacity;
  - d. were a grantor or beneficiary;
  - e. had a nominee acting in your capacity or on your behalf;
  - f. were on the Board of Directors;
  - g. were an Officer or had signatory authority over funds and accounts controlled by the entity;
  - h. were a surety for guaranteed debt or other liabilities.
8. For any entity referenced above, from the inception of the entity to the present, provide:
  - a. identification of each and every current and former officer, trustee and manager;
  - b. minutes, resolutions and records regarding the appointment, resignation or termination of all officers, trustees and managers;
  - c. records regarding all assets transferred into or from the entity;
  - d. records regarding the ownership of all certificates of beneficial interest;
  - e. a statement explaining the purpose for operating the business activity inside this type of entity together with the reason this entity was created, tax benefits explained to you regarding the operation of the business activity within this type of entity, who assisted you in forming the entity, fees charged with respect to the formation of the entity;
  - f. bank statements, deposit slips, debit/credit memos and cancelled checks for all financial accounts, U.S. and foreign;
  - g. records to establish the basis of all assets held by the entity including invoices, purchase agreements and the names and addresses of persons who transferred property to the entity;
  - h. records for sales or other transfers from the entity;
  - i. copies of any contracts for business services to be rendered by the entity.
9. Provide complete copies of all financial statements and method of accounting used to compile them, net worth computations or other financial data probative of your assets, liabilities, net worth, income and losses, and cash flows from all sources, within and without the United States, including all underlying documents and any exhibits associated therewith, and if not apparent, please identify the preparer of such documents
10. Identify all assets transferred and/or sold to your children or other relatives
11. Identify all assets transferred or sold to a charitable organization or foundation and provide TIN and legal name of entity and describe your role or position with such entity
12. Provide complete copies of the tax preparation workpapers, including adjusting trial balances, tax mappings and closing adjustments used to prepare your return
13. Identify any asset transferred and/or sold utilizing estate planning to reduce potential estate tax

- obligations, including Family Limited Partnerships (FLPs), Living Trust Agreements, Grantor Retained Annuity Trusts (GRATs), Private Foundations (PFs), Community Foundations (CFs), Donor Advised Funds (DAFs), Qualified Personal Residence Trusts (QPRTs), Charitable Remainder Trusts (CRATs) and/or Intentionally Defective Grantor Trusts (IDGTs)
14. Provide complete copies of any audited financial statements, including applicable exhibits and/or footnotes, for any entity referenced above
  15. Provide copies of all organizational charts (including all tax organizational charts) of any related entity or for any entity referenced above
  16. For any partnership referenced above:
    - a. provide copies of all organizational documents, including but not limited to, the partnership agreements, and all amendments, modifications, supplemental agreements, operating agreements, by-laws, side letters and side pocket agreements;
    - b. describe all of your reasons and/or objectives for entering into the partnership;
    - c. describe the business/investment model for the partnership's activities;
    - d. describe the background pertaining to the formation of the partnership.
  17. Provide copies of all tax opinions received impacting any return under examination
  18. Detail any fees you paid with regard to tax or estate planning including the amount paid, provider who received the fee, description of the planning that was done for the fee, whether a confidentiality agreement was signed and copies of any marketing materials received with regard to the planning
  19. Indicate whether you had an interest or signatory authority over a foreign financial account with assets in excess of \$10,000 and provide copies of FBARs
  20. Provide a copy of the annual brokerage account statement for each brokerage account you held
  21. Describe any securities lending agreements you entered, exited or were engaged in and provide a copy
  22. Provide copies of all information filed for any disclosures to the IRS regarding any offshore or cross-border transactions and/or accounts. If no disclosures were required, provide an affirmative statement to that effect and the reason that no disclosure was required
  23. Describe any offshore or cross-border financial transaction you treated differently for tax purposes in the United States than you treated in a foreign taxing jurisdiction
  24. For any assets (tangible or intangible) you sold or transferred from the United States to any foreign person or entity or *vice versa*, indicate each asset sold or transferred, indicate the value at the time of sale or transfer and describe how the value was determined. Provide copies of any appraisal or reports received that indicate how the value was determined
  25. For each of the following investments held directly or indirectly, describe the investment, provide the name of the financial institution and account where the investment was held and provide copies of all documents received regarding the investment:
    - a. Financial derivatives
    - b. Notional principal contracts, swaps, swaptions
    - c. Prepaid forward contracts, hedge funds
    - d. Private equity funds
    - e. Foreign partnerships, foreign limited liability companies, foreign corporations or other foreign entities
    - f. Real Estate Investment Trusts (REITs)
    - g. Real Estate Mortgage Investment Conduits (REMICs)
    - h. Financial Asset Securitization Trusts (FASITs)
    - i. Other collateralized debt obligations (CDOs, including any pay-through bonds)
    - j. U.S. or foreign distressed assets or nonperforming loans
    - k. Securities reported as worthless
    - l. Debt reported as a loss on your return
    - m. Gains or losses from foreign currency
    - n. Code Sec. 1256 contracts
    - o. Debt instruments with OID
  26. For each hedge fund or private equity fund investment identified above:
    - a. provide Schedules K-1 received from each investment;
    - b. provide the name and TIN for each entity in which you were a general partner, managing partner or Tax Matters Partner;
    - c. if a party to a deferred compensation arrangement with such an entity, provide a copy of the deferred compensation agreement;
    - d. provide the name and TIN for each foreign hedge fund in which you owned an interest directly, indirectly or through a nominee.
- Detailed responses to detailed requests for information often generate additional detailed requests for information. As such, Wealth Squad IDRs typically conclude with the admonition that additional information or records may be requested in order to complete the examination. Further, taxpayers are cautioned to retain all potentially

relevant and previously requested records or documents until the examination is concluded.

Practitioners specializing in transactional and wealth transfer (estate, gift and charitable planning, *etc.*) matters should carefully review the foregoing list of information requested in a Wealth Squad examination. There is no better time to prepare for a later examination than when the documents are being drafted and executed. Files for relevant documents and schedules should be coordinated with a view toward accelerating any later examination. If the transaction has any unique concerns, those issues should be well documented. It is sometimes difficult to later recall why documents were drafted in a certain manner or with unique provisions.

## Resolution of Wealth Squad Examinations

Near the commencement of the Wealth Squad examination, the taxpayer will be requested to sign an audit plan that will set forth audit mutual audit expectations, timeframes, responsiveness, *etc.* The IRS may require responses within a relatively short timeframe. If the practitioner believes they may be unable to satisfy the projected time schedule for responses, that fact should be raised before execution of the audit plan. Do not sign on for something that may later turn against you in the examination process. If documents are not readily available, make that fact known in advance.

They are likely to also receive the standardized IDR that may cause practitioners to wonder about their ability to effectively respond as well as their ethical responsibilities. Upon request by the IRS, practitioners must promptly submit nonprivileged records and information to the IRS, notify the IRS of the location of requested records and information in possession of others, and make reasonable inquiries of the taxpayer regarding the location of requested records and information in possession of others.<sup>11</sup> Further, a practitioner may not unreasonably delay the prompt disposition of any matter before the IRS.<sup>12</sup>

How can any practitioner promptly and effectively respond to a plethora of requests for everything imaginable with respect to the investment and business activities of a typical high-wealth taxpayer having numerous domestic and foreign related entities? The initial thought of most practitioners is that such requests are overbroad and essentially penalize the taxpayer for being wealthy through the required expenditure of significant of accounting and legal fees in order to respond appropriately. Coordinate a meeting with the Wealth Squad examination team to

determine whether it might be possible to streamline the examination process. Provide an overview of the taxpayer's business operations, internal controls and review procedures, *etc.* Neither the taxpayer nor the IRS has any desire to unnecessarily prolong the audit process. However, the IRS often has little, if any, information initially available to help it determine whether the returns, as filed, were substantially accurate. That is the purpose of the examination—auditor's audit.

The practitioner's duty of representation to the client must be balanced with the effort to reasonably cooperate with the examination process. The practitioner should attempt to reasonably limit the scope of the inquiry and limit the information provided so as to avoid the waiver of any potential privileges. If matters are privileged, the correspondence and relevant files should be appropriately labeled. Be aware of any potential privileges that may apply and make sure not to inadvertently waive any privilege. Separate files should be maintained for relevant documents that might be requested by the IRS as well as documents that contain potentially confidential, privileged information. It is important to know exactly which documents are deemed important to the IRS. Copies of documents provided during the course of the examination should be made in duplicate—one copy for the IRS and an extra copy to be maintained in a separate audit file specifically identifying documents provided during the course of the audit.

The purpose of the Wealth Squad is to bring together a team of IRS specialists to coordinate the compliance review and, if necessary, detailed examination of complex returns of high-wealth individuals and their related entities. Although it is generally advisable to attempt to resolve any examination at the earliest opportunity, the complexity inherent within most Wealth Squad examinations often precludes any realistic ability to achieve a prompt resolution. Practitioners must respect the detailed nature of these examinations. When facing a Wealth Squad examination notice, prepare, prepare, prepare . . . and then prepare some more.

## ENDNOTES

<sup>1</sup> TIGTA Report, *Improvements Are Needed in Resource Allocation and Management Controls for Audits of High-Income Taxpayers*, (Sept. 18, 2015; Reference Number: 2015-30-078), available online at [www.treasury.gov/tigta/auditreports/2015reports/201530078fr.html](http://www.treasury.gov/tigta/auditreports/2015reports/201530078fr.html); The IRS identifies high-income taxpayers as those who reported total positive income (TPI) of at least \$200,000 on Form 1040, *U.S. Individual Income Tax Return*. To ensure a comprehensive coverage of the high-income taxpayer population, the Strategy Council stratified the population into six tiers (based generally on the individual's TPI) and assigned primary responsibility for each tier to a business operating division. The Large Business and International (LB&I) Division assumed responsibility for two tiers, covering high-income taxpayers with TPIs of at least \$5 million, while the Small Business/Self-Employed (SB/SE) Division took on the remaining four tiers, covering all high-income taxpayers with

TPIs greater than \$199,999 but less than \$5 million. In addition, the SB/SE Division is responsible for addressing the compliance of high-income individual nonfilers and partnership investors falling under the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA).

<sup>2</sup> See [www.treasury.gov/tigta/auditreports/2015reports/201530078fr.html](http://www.treasury.gov/tigta/auditreports/2015reports/201530078fr.html).

<sup>3</sup> LB&I outsourced 18 Wealth Squads in FY 2013; 12 in FY 2014; and 50 in FY 2015. See [www.treasury.gov/tigta/auditreports/2015reports/201530078fr.html](http://www.treasury.gov/tigta/auditreports/2015reports/201530078fr.html).

<sup>4</sup> *Id.*

<sup>5</sup> Code Sec. 7602, *et seq.*

<sup>6</sup> IRM 4.46.4.4.1 (Mar. 1, 2006).

<sup>7</sup> Code Sec. 7602, *et seq.*; see also *M. Powell*, S Ct, 64-2 ustr ¶19858, 379 US 48, 57-58, 85 S Ct 248 .

<sup>8</sup> Code Sec. 7605.

<sup>9</sup> Code Sec. 7604.

<sup>10</sup> *Powell*, S Ct, 64-2 ustr ¶19858, 379 US 48, 57-58, 85 S Ct 248.

<sup>11</sup> Treasury Department Circular No. 230, Regulations Governing the Practice of Attorneys, Certified Public Accountants, Enrolled Agents, Enrolled Actuaries, Enrolled Retirement Plan Agents and Appraisers before the IRS, §10.20.

<sup>12</sup> Circular 230 §10.23.

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