Practice

By Kathryn Keneally and Charles P. Rettig

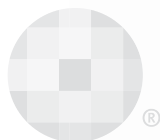
Holistic Audits: The Price of Being Rich

The IRS has begun a new initiative focused on high-wealth individuals. Dubbed the "holistic audit" approach, this initiative is a commitment to focus on tax compliance by individuals at the highest income levels, as well as those with very substantial net worth. It also represents a new approach to determining the tax compliance by those individuals—an approach that may well come to permeate the IRS's approach to examinations generally.

The IRS's New Holistic Philosophy

The IRS's plan to conduct holistic audits was first announced in a speech given by the Commissioner in October of last year. In the Commissioner's words, the goal of holistic audits will be "to better understand the entire economic picture of the enterprise controlled by the wealthy individual and to assess the tax compliance of that overall enterprise."[1] As an underlying principle, the IRS has concluded that, to understand the tax compliance of a high-wealth individual, it is necessary to understand all of the sophisticated financial, business and investment arrangements of that individual.

In a holistic audit, the IRS will no longer conduct a separate audit of each entity on a stand-alone basis. Rather, the examination team will look to all of the entities in which the high-wealth individual under examination has some interest or involvement, in an effort to gain a complete picture of that taxpayer's sources of income. The IRS will also look to what it is calling "nodes" of activity in which there may be significant opportunity for significant numbers of taxpayers to underreport or fail to report their tax liabilities.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Targeted Taxpayers and Their Activities

The definition of "rich" is elusive.[2] For purposes of holistic audits, the IRS's initial focus will apparently be on those individuals with $10 million or more in income or assets. It is also apparent, however, that the standard for inclusion in this audit process will not be based solely on stated income. Indeed, one purpose of the holistic audit approach is to ferret out those high-wealth individuals who use complicated structures to avoid their tax liabilities. Thus, the IRS will also target individuals whose financial arrangements render their income picture opaque.

In his speech announcing the holistic audit approach, the Commissioner identified a number of financial arrangements that the IRS may regard as indicative of high wealth at a level to attract its attention. These financial arrangements, as noted by the Commissioner, include real estate investments, royalty and licensing arrangements, privately held businesses, significant investment assets, trusts, private foundations, partnership and other flow-through entities, and revenue-based or equity-sharing arrangements.[3] Tax returns that include multiple K-1s or other indicia of these types of financial arrangements are more likely to result in an examination that takes a holistic audit approach.

It is very clear that offshore transactions will be one of the key "nodes" of activity that will be the focus of the IRS's holistic audit approach. Offshore and international activity has been the focus of repeated tax initiatives in recent times and are an obvious focal point for holistic audits. Moreover, the United States is not the first nation to conclude that high-wealth individuals should be the focus of tax-enforcement efforts, or that the global financial arrangements of such individuals should be examined in their totality. Other countries, including the United Kingdom, Canada, Japan, Germany and Australia, have also embarked on these efforts.

The IRS's Enhanced Resources

As a clear indication of the intent to focus on international as well as domestic transactions, the new unit formed to conduct holistic audits has been named the Global High Wealth Industry Group. Although this group will focus on tax compliance by individual taxpayers, it will be housed in the Large and Mid-Sized Business (LMSB) Division, in recognition of LMSB's experience in dealing with complex relationships among numerous tax entities. Each holistic audit will be handled by a large team with multiple areas of expertise, which have already been labeled as the "Wealth Squads" by some practitioners.[4]

The IRS has hired new agents, including specialists in flow-through entities and international transactions, and is including economists, appraisers and other experts on the examination teams. When appropriate, the examination team will also coordinate with and draw upon IRS resources within its Tax Exempt and Government Entities (TE/GE) and Small Business/Self-Employed (SB/SE) Divisions. It is also very significant to note that the IRS will likely make international cooperation and exchange of information a routine matter in its high-wealth examinations.

The Central Legal Tenet: The Economic Substance Doctrine

At the core, holistic audits will frequently center on the economic substance of the taxpayer's financial arrangements. The goal of the holistic audit approach is to understand the often complex financial structures that high-wealth individuals utilize. When these structures are shown to have a business purpose and an economic impact, the tax results that are consistent with proper treatment under the Code should be respected. When such financial structures, upon examination, arguably fail to meet the IRS's understanding of the economic substance doctrine, the IRS may look to recharacterize the tax results.

The economic substance doctrine is a judicially-created standard, superimposed on the Code by various courts over a number of years. Most recently, it was codified as Code Sec. 7701(o), in legislation that altered some of the terms that many had thought defined the doctrine.

Most briefly stated, the courts developed the economic substance doctrine to deny federal income tax benefits to a transaction that does not result in a meaningful change to a taxpayer's economic position other than a purported reduction in U.S. federal income tax, even though the transaction may literally comply with the applicable provisions of the Code.[5] The leading economic substance doctrine cases have not consistently applied the same standards. Some courts have applied a conjunctive, two-prong test, while other courts have applied a disjunctive, two-prong test, and still other courts have taken a more

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practical look at the economic consequences of the transaction at issue.

Courts that have applied the two-prong approach have considered, as the subjective component, the taxpayer's intent, or business purpose, in entering into the transaction. As the objective component, the courts have looked to whether the transaction results in a meaningful change to the taxpayer's economic position when considered without regard to the tax consequences. While some courts have made a determination that the economic substance doctrine is satisfied if either the subjective or the objective component is present—*i.e.*, if either the taxpayer entered into the transaction with the intention to achieve an economic result or if the transaction in fact yielded a meaningful economic result net of its tax treatment—other courts have required both components to be present for the tax results to be sustained. Still, other courts have moved from any rigid analysis to a more pragmatic "I know it when I see it" standard, in which the courts have regarded business purpose and economic substance as factors to be considered in determining whether the transaction had any practical economic effect apart from the tax results.

The codification of the economic substance doctrine was proposed and debated over a number of years, and a version of the doctrine was finally enacted into law as part of the Health Care and Education Reconciliation Act of 2010. Now contained in Code Sec. 7701(o), the statutory economic substance doctrine differs in significant ways from various judicial definitions that preceded it.

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As a starting point, Code Sec. 7701(o)(1) includes a two-prong, conjunctive standard, requiring that economic substance be established by a showing that (i) a transaction changes the taxpayer's economic position in a "meaningful way" apart from the tax consequences, and (ii) the taxpayer has a "substantial purpose" apart from tax effects for entering into such transaction. Notably, Code Sec. 7701(o)(5)(E) defines the term "transaction" for the newly codified economic substance doctrine as including a series of transactions, which in turn has been defined by regulation as "all of the factual elements relevant to the expected tax treatment of any investment, entity, plan, or arrangement, and includes any series of steps carried out as part of a plan."[6]

Code Sec. 7701(o) clarified or altered some other considerations that had been the focus of various court decisions. Thus under Code Sec. 7701(o)(2), if the taxpayer relies on profit potential to demonstrate the transaction has economic substance, the pre-tax profit potential must be shown to be substantial in relation to the present value of the expected net tax benefits, and fees and other transaction expenses are also to be taken into account.[7] The statute also clarified that achieving a financial accounting benefit is a valid "substantial purpose" for entering into a transaction if the origin of the financial accounting benefit is not the reduction of U.S. federal income tax.

In the legislative history, the Joint Committee on Taxation (JCT) explained that the codification of the economic substance doctrine is not intended to alter the tax treatment of certain basic business transactions that have long been respected in judicial and administrative practice, even though they are largely tax motivated.[8] The JCT explanation further provides that if the realization of tax benefits of a transaction is consistent with the Congressional purpose, it is not intended that such tax benefits be subject to penalties under Code Sec. 7701(o).[9] There is an obvious need for rulings and regulations to clarify these and other aspects of this legislation.[10]

Code Sec. 7701(o) will apply to all transactions that begin after March 30, 2010. While it remains to be seen how it will influence the evolution of the judicial definition for transactions that predate the legislation, it should be noted that the statute is entitled "Clarification of economic substance doctrine." The IRS may thus attempt to argue that these definitions should prevail in all cases.

Conversely, Code Sec. 7701(o)(5)(D) of the new legislation states that the "determination of whether the economic substance doctrine is relevant to a transaction shall be made in the same manner as if" the codification of the doctrine had not occurred. Moreover, while the IRS may now look to the economic substance doctrine to evaluate the financial arrangements of high-wealth individuals, Code Sec. 7701(o)(5)(B) makes clear that, as to taxpayers who are individuals, the economic substance doctrine will apply only to transactions in connection with a trade or business or an activity engaged in for the production of income. The most recent statements by the IRS regarding the application of the economic substance doctrine came several years ago in a speech given by the then-IRS Chief Counsel, who stated that the economic substance doctrine is not intended to be a general anti-abuse rule used by the IRS each time it confronts a transaction it does not like or a tax shelter.[11]

The New Holistic World

Although the codification of the economic substance doctrine is depicted as a "clarification," it may well seem to the IRS that it has a new, or at least newly refined, toy to pay with. With the formation of the Global High Wealth Industry Group, there is a new team on the block to make use of this toy. It remains to be seen how the new, holistic audit approach, targeted for the moment at high-wealth individuals, will work its way through the approach taken by the IRS generally.

ENDNOTES

1 Remarks of Douglas H. Shulman, Commissioner, Internal Revenue Service, at the AICPA National Conference on Federal Taxation, October 26, 2009 ("October 2009 Remarks of Commissioner").

2 The Talmud teaches "Who is rich? He who is content with his lot."

3 October 2009 Remarks of Commissioner.

4 The authors of this column credit Josh O. Ungerman of Meadows, Collier, Reed, Cousins, Crouch & Ungerman, as the first person that they heard use the "Wealth Squad" moniker.

5 *See, e.g., Frank Lyon Co.*, SCt, 78-1 USTC ¶9370, 435 US 561; *K.F. Knetsch*, SCt, 60-2 USTC ¶9785, 364 US 361; *Gregory v. Helvering*, SCt, 35-1 USTC ¶9043, 293 US 465 (1935); *K. Goldstein*, CA-2, 66-2 USTC ¶9561, 364 F2d 734.

6 Reg. §1.6011-4(b)(1).

7 The statute appears to suggest that it is at the taxpayer's option to rely on profit potential as a ground to demonstrate economic substance. It should be noted that other sections of the Code require a showing of profit potential for the tax consequences of certain transactions to be allowed.

8 JCX-18-10, at 152 (Mar. 21, 2010). Specific examples provided include the choice between capitalizing a business enterprise with debt or equity; a U.S. person's choice between utilizing a foreign corporation or a domestic corporation to make a foreign investment; and the choice to enter a transaction or series of transactions that constitute a tax-free corporate reorganization.

9 JCX-18-10, p. 156 (Mar. 21, 2010). The only examples provided in the JCT explanation as intended not to be subject to Code Sec. 7701(o) are where a tax credit—such as the Code Sec. 42 low-income housing credit, the Code Sec. 45 production tax credit, the Code Sec. 45D new markets tax credit, the Code Sec. 47 rehabilitation tax credit, the Code Sec. 48 energy tax credit—are used in a transaction pursuant to which, in form and substance, a taxpayer makes the type of investment or undertakes the type of activity that the credit was intended to encourage. JCX-18-10, at 156, fn. 344 (Mar. 21, 2010).

10 Code Sec. 7701(o)(2)(B) expressly calls for regulations in connection with the treatment of foreign taxes as expenses in determining pre-tax profit.

11 Donald L. Korb, Remarks at the 2005 University of Southern California Tax Institute, January 25, 2005 (*www.irs.gov/pub/irs-utl/economic_substance_(1_25_05).pdf*).

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Recent Developments and Decisions Under Circular 230

By Laura L. Gavioli

Laura L. Gavioli examines recent developments and decisions under Circular 230.

Recent Developments at OPR

OPR's New Approach

In an effort to conserve resources while encouraging practitioner compliance, the IRS's Office of Professional Responsibility (OPR) has developed new practices for dealing with certain types of disciplinary cases. In 2009, OPR had a significant backlog of cases, and many cases were more than a year old. OPR has come up with several new programs for dealing with less serious infractions.

In less serious cases, OPR has instituted a program of sending "soft conduct" letters to practitioners. These letters inform the practitioner that the IRS is aware of the incident but will take no further action so long as the conduct is not repeated. The "soft conduct" letter has been used in compliance cases in which a practitioner corrects his or her error by filing past-due returns. The letter informs the practitioner that the IRS is aware of the wrongdoing and the correction.

OPR has also been issuing "soft 60" letters to practitioners who are not currently in compliance but who are making efforts to get back in compliance. The letter notifies the practitioner that he or she has 60 days to correct Circular 230 violations (usually failures to file his or her own return or pay taxes). Depending on the case, good-faith efforts to enter into installment agreements or offers-in-compromise may satisfy the 60-day deadline.

OPR has also instituted a "deferred discipline" program whereby practitioners who have been found to have violated Circular 230 avoid receiving a referral to their state bar or state CPA society if they remain in compliance for five years.

In more serious cases, OPR has begun sending "pre-allegation" letters, which inform practitioners that OPR is beginning an investigation against them. If OPR decides to proceed with a case, OPR offers the practitioner a conference opportunity to discuss a possible settlement or to present evidence that would clear up the referral. If no settlement is reached, OPR will begin the normal disciplinary process.

Implementation of New Tax Preparer Standards

On January 4, the IRS announced a comprehensive new plan to regulate unenrolled tax preparers. There are currently four major facets to the new plan—(1) registration of all paid tax preparers, (2) competency testing, (3) continuing education requirements, and (4) tougher enforcement.[1]

Everyone who files a federal tax return as a paid preparer will be required to register and obtain a PTIN (preparer tax identification number). While in the past, the PTIN was optional, it will now be mandatory. PTIN users also will be required to pay a user fee. Preparers will have to renew their registration every three years, and this registration renewal will involve a compliance check. The IRS released its proposed rules regarding PTINs on March 26.[2]

Preparers who are not attorneys, CPAs or enrolled agents will have to pass a competency test and will have to complete continuing education requirements.

In addition, the IRS plans to extend the coverage of Circular 230 to all signing and nonsigning preparers. The IRS does not view this as a significant change, since the rules already require the person most responsible for preparing a return to sign the return.

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