

## IRS High-Wealth Industry Group: Evaluation of Wealth Squad IDR

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In this column, the author discusses the recently created IRS High-Wealth Industry Group and analyzes their standardized Information Document Request. The IRS is attempting to coordinate examiners and related specialists in an effort to unwind the complex legal structures behind sophisticated domestic and foreign business and investment arrangements of high-wealth individuals.

Since there is no better time to prepare for a later examination than when the documents are being drafted and executed, practitioners specializing in transactional and wealth transfer matters should carefully review the following analysis of a Wealth Squad IDR.

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The IRS Large Business and International Division, formerly the Large and Midsize Business Division, recently formed a new industry group known as the global high-wealth industry group, commonly referred to as the "Wealth Squad." The purpose of the Wealth Squad is to bring together an IRS team of specialists to coordinate the compliance review and, if necessary, a detailed examination of complex returns of high-wealth individuals and their related entities.

The stovepipe fashion of historical IRS examinations, by design, missed various compliance issues lurking within layers upon layers of related limited liability companies, partnerships, trusts, private foundations, and other entities. Based on their professional experience and training, examiners review sufficient documents and information to determine the accuracy of the taxpayer's return. The amount of documents and information to be reviewed and the depth of the examination have been matters of professional judgment based on the information developed — or not — during the examination. The Wealth Squad is now coordinating examiners with related specialists in an effort to unwind the complex legal structures behind sophisticated domestic and foreign business and investment arrangements. Similar examination groups are used by tax authorities in Australia, Canada, Germany, Japan, the United Kingdom, and elsewhere.

### LB&I Industry Groups

LB&I 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, including communications, technology, and media; financial services; heavy manufacturing and transportation; natural resources and construction; retailers, food, pharmaceuticals, and healthcare; and the global high-wealth industry. Also, LB&I maintains a field specialist examination support function that includes computer audit specialists, employment tax specialists, economists, engineers, and financial products and transactions specialists.

**Communications, technology, and media.** Headquartered in Oakland, Calif., this group serves taxpayers involved in computer production, media (including communication and software), sports franchises, and recreation firms covering approximately 15,300 taxpayers (1,100 large businesses and 14,200 midsize businesses).

**Financial services.** Headquartered in New York, this group serves more than 43,000 taxpayers involved in commercial and foreign banking, securities, insurance companies, investment bankers, mutual funds, law and accounting firms, and other financial intermediaries. It is also responsible for the U.S. withholding agent and qualified intermediary programs, and it has leadership and oversight for the technical tax shelter promoter program.

**Heavy manufacturing and transportation.** Headquartered in Iselin, N.J., this group serves approximately 58,750 taxpayers (200 large businesses and 58,550 midsize businesses) involved in air transportation, railroads, aerospace, motor vehicles, trucking, shipping, and real estate.

**Natural resources and construction.** Headquartered in Houston, this group provides end-to-end tax administration services to more than 17,000 large and midsize businesses nationwide that are engaged in the oil and gas, mining, utilities, forestry, chemical, waste management, and construction industries.

**Retailers, food, pharmaceuticals, and healthcare.** Headquartered in Downers Grove, Ill., this group serves about 18,300 taxpayers (approximately 300 large businesses and 18,000 midsize businesses) related to food and beverage, retailing, pharmaceuticals, agricultural commodities, farms, and healthcare.

**Global high wealth.** Headquartered with LB&I in Washington, this group conducts tax compliance reviews of high-wealth individuals and the networks of enterprises and entities they control.

## The Wealth Squad

In announcing the creation of the global high-wealth industry group, IRS Commissioner Douglas Shulman said, "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>1</sup> As recently stated by the Eleventh Circuit, "It is no surprise that a knowledgeable tax attorney would use numerous legal entities to accomplish different objectives. This does not make them illegitimate. Unfortunately such 'maneuvering' is apparently encouraged by our present tax laws and codes."<sup>2</sup> Tax planning is anything but sinister; it is why sophisticated, well-intentioned practitioners spend countless hours of their personal time educating and reeducating themselves on the ever-changing interpretations of the code found within the minds of members of Congress and the judiciary.

Wealthy taxpayers often engage teams of sophisticated tax, business, and estate planning lawyers, accountants, and other professional advisers to legitimately minimize their potential tax liabilities. A well-designed business and estate plan may include some or all of various domestic and foreign business entities such as LLCs, S corporations, revocable and irrevocable trusts, real estate investments, and private foundations. The plan may also include revenue-based or equity sharing arrangements together with royalty and licensing agreements and retirement plans. In this world of specialization, few private practitioners have the expertise to be specialists on developing a comprehensive plan encompassing every potential tax, business, estate, and gift-related issue.

Although there are many sophisticated IRS representatives, few could realistically expect to unravel the intricacies of a well-designed business and estate plan using multiple domestic and foreign entities and investment arrangements. The Wealth Squad is designed to allow the IRS to better understand the sophisticated financial, business, and investment arrangements of the taxpayer by engaging a team of specialists to take a unified, holistic look at the entire web of interrelated entities controlled by a high-wealth individual to discover the entire economic picture of the enterprise and to assess the tax compliance of that overall enterprise.

The initial examination focus has been on individuals with tens of millions of dollars in assets or income. Following a review of the initial examinations, the selection criteria will likely evolve to take into account information obtained in the examinations and use the expertise of the expanding group of Wealth Squad specialists. They will include flow-through specialists, international examiners, economists to identify economic

trends, appraisal experts to advise on valuation issues, and technical advisers to provide industry or specialized tax expertise. The Wealth Squad will draw on resources throughout the IRS, including the Tax-Exempt and Government Entities Division, the Small Business/Self-Employed Division, and many international information exchange agreements. In egregious cases, it will likely be referring taxpayers or their advisers to the Criminal Investigation division.

## Information Gathering

The IRS has the general authority to gather evidence and request information during the course of an examination.<sup>3</sup> IRS requests are initially in the form of an information document request (IDR) — Form 4564 — which must reasonably be designed to obtain information and documents relevant to a legitimate examination purpose. IDRs are to be specific, clear, and concise.<sup>4</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>5</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>6</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 of access to) the records being summoned. The summoned witness is entitled to decline to produce documents or to answer particular questions if there is a good-faith basis for objecting 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>7</sup> In that event the IRS must demonstrate that (1) the investigation is being conducted for a legitimate purpose; (2) the inquiry is relevant to that purpose; (3) the information sought is not within the possession of the IRS; and (4) the IRS has followed the administrative steps required by the code.<sup>8</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.

In addition to the issuance of an IDR (or summons), other audit techniques used to gather information during a typical examination include:

<sup>3</sup>Section 7602, et. seq.

<sup>4</sup>Internal Revenue Manual section 4.46.4.4.1.

<sup>5</sup>Section 7602, et. seq.; see also *United States v. Powell*, 379 U.S. 48, 57-58 (1964).

<sup>6</sup>Section 7605.

<sup>7</sup>Section 7604.

<sup>8</sup>*Powell*, 379 U.S. at 57-58.

<sup>1</sup>Remarks of IRS Commissioner Douglas Shulman before the AICPA National Conference on Federal Taxation, Oct. 26, 2009, Doc 2009-23542, 2009 TNT 205-22.

<sup>2</sup>*Ballard v. Commissioner*, 522 F.3d 1229 (11th Cir. 2008), Doc 2008-7664, 2008 TNT 68-16.

- interviews — interviews of the taxpayer and its advisers are designed to obtain leads, develop information, and establish evidence about the taxpayer's financial history, business operations, and books and records;<sup>9</sup>
- tour of the business operations — tours are designed to acquire an overview of the business operations, establish that the books and records accurately reflect actual business operations, observe and test internal controls, and identify potential audit issues;<sup>10</sup>
- internal controls — an evaluation of the taxpayer's internal controls is performed to determine the reliability of the books and records, determine the appropriate audit techniques to be used during the examination, provide an opportunity to identify high-risk accounts and eliminate verification of accounts that have little or no tax consequence, determine the scope and depth of the examination and the extent of audit procedures to be used, and assess the level of control risk;<sup>11</sup>
- examination of the books and records — a review of the books and records is performed to determine the flow of transactions, method of accounting, and so on;<sup>12</sup>
- analysis of schedules M-1, M-2, and M-3 — a review of Schedule M-1 or M-3 is important to identify potential tax issues resulting from both temporary and permanent differences between financial and tax accounting;<sup>13</sup>
- balance sheet analyses — the balance sheets and financial statements often reveal significant differences between tax years, timing differences between tax and book accounting, and a reconciliation with any Schedule M-1 or M-3 adjustments;<sup>14</sup>
- testing of gross receipts or sales — a review of gross receipts or sales is performed to determine taxable income that may not readily appear as income on the taxpayer's books because of differing accounting methods, timing of recognition, deferred income, constructive receipts, foreign-source income, and related foreign transactions, etc.;<sup>15</sup>
- testing expenses: cost of goods sold — expense testing often entails a review of the beginning and ending inventories, compliance with the absorption rules in the regulations for sections 263A and 471, and variance accounts when standard costing is used;<sup>16</sup> and
- testing expenses: operational expenses — operational expenses are reviewed to identify significant,

unusual, or questionable expenses, which will help in understanding the taxpayer's accounting methods and their application to timing and economic performance, expense versus capitalization, tax shelter write-offs, contingent liability accruals, material write-offs for tax and not for books, net operating loss carryforwards and carrybacks, etc.<sup>17</sup>

### Wealth Squad IDRs

The initial IDR 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 its IDR in these matters by requesting everything imaginable regarding the taxpayer under examination and all related entities. For the year under examination, the Wealth Squad IDR requests the following from the taxpayer:

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, classification for U.S. tax purposes (for example, C corporation, S corporation, disregarded entity, or trust), your position title and describe your responsibilities for or relationship with and 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 or guaranteed debt or other liabilities.

<sup>9</sup>IRM sections 4.10.3.2 and 4.46.4.2.1.

<sup>10</sup>IRM sections 4.10.3.3 and 4.46.4.2.2.

<sup>11</sup>Control risk is defined as the risk that a material misstatement could occur and that it will not be prevented or detected on a timely basis by the business's internal control structure, policies, or procedures. IRM sections 4.10.3.4 and 4.46.4.2.3.

<sup>12</sup>IRM sections 4.10.3.5 and 4.46.4.2.3.

<sup>13</sup>IRM sections 4.10.3.6 and 4.46.2.5.

<sup>14</sup>IRM sections 4.10.3.8 and 4.46.4.2.6.

<sup>15</sup>IRM sections 4.10.3.9 and 4.46.4.2.7.

<sup>16</sup>IRM sections 4.10.3.10 and 4.46.4.2.8.

<sup>17</sup>IRM sections 4.10.3.11 and 4.46.4.2.9.

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, private foundations (PFs), community foundations (CFs), donor advised funds (DAFs), qualified personal residence trusts

(QPRTs), charitable remainder annuity 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 foreign bank account reports.

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 U.S. to any foreign person or entity or vice versa, indicate each asset sold or transferred, 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, 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, swap options;
- c. prepaid forward contracts;
- d. hedge funds;
- e. private equity funds;
- f. foreign partnerships, foreign limited liability companies, foreign corporations or other foreign entities;
- g. real estate investment trusts;
- h. real estate mortgage investment conduits;
- i. financial asset securitization trusts (FASITs);
- j. other collateralized debt obligations (CDOs, including any pay-through bonds);
- k. U.S. or foreign distressed assets or nonperforming loans;
- l. securities reported as worthless;
- m. debt reported as a loss on your return;
- n. gains or losses from foreign currency;
- o. section 1256 contracts;
- p. debt instruments with original issue discount.

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 warning that additional information or records may be requested 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 matters (estate, gift, and charitable planning, etc.) 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 particular 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 mutual audit expectations, time frames, responsiveness, and so on. The IRS may require responses within a relatively short time frame. If the practitioner believes he 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.

Taxpayers are also likely to receive the standardized IDR, which may cause the practitioner to wonder about her ability to effectively respond, as well as her ethical responsibilities. On 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 others' possession, and make reasonable inquiries of the taxpayer regarding the location of requested records and information in others' possession.<sup>18</sup> Further, a practitioner may not unreasonably delay the prompt disposition of any matter before the IRS.<sup>19</sup>

How can any practitioner promptly and effectively respond to an IDR that requests everything imaginable regarding 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 those IDRs are overbroad and essentially penalize the taxpayer for being wealthy by requiring the expenditure of significant accounting and legal fees in order to respond appropriately. Initially, the practitioner should coordinate a meeting with the Wealth Squad examination team to determine if the examination process can be streamlined and 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 were substantially accurate as filed. That is the purpose of the examination.

The practitioner's duty of representation to the client must be balanced with the effort to reasonably cooperate with the examination process. They should attempt to reasonably limit the scope of the inquiry and limit the information provided so as to avoid the waiver of any

<sup>18</sup>Treasury Department Circular 230, "Regulations Governing the Practice of Attorneys, Certified Public Accountants, Enrolled Agents, Enrolled Actuaries, Enrolled Retirement Plan Agents, and Appraisers Before the Internal Revenue Service," section 10.20.

<sup>19</sup>Circular 230, section 10.23.

## COMMENTARY / TAX CONTROVERSY

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.

It is generally advisable to attempt to resolve any examination at the earliest opportunity. However, the design of Wealth Squad examinations mostly precludes any ability for a prompt resolution. Practitioners must respect the nature of these examinations and exercise discretion and their best judgment in responding to each request for information. The IRS has determined that high-wealth taxpayers represent a compliance challenge worthy of devoting substantial enforcement resources to the creation, funding, and operation of the wealth squad. Taxpayers and their representatives must be prepared to respond in kind. We are not in Kansas anymore. . . .