

Client Alert.

July 26, 2010

Global High Wealth Industry Audits Underway— Observations from the Foxhole

By Edward L. Froelich and James E. Merritt

It's a sure sign of a tough audit when the Commissioner of Internal Revenue sets a tough tone for his agents: "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 above board. Others mask aggressive tax strategies." Commissioner Shulman, Prepared Remarks before the 22nd Annual George Washington University International Tax Conference, December 10, 2009. And, of course, why would something need to be "masked" if it wasn't suspect? The Commissioner has also described these arrangements as a "complex web of business entities." Commissioner Shulman, Prepared Remarks to the New York State Bar Association Taxation Section Annual Meeting in New York City, January 26, 2010. This is not exactly neutral terminology; recall Sir Walter Scott's famous line "oh what a tangled web we weave," you know the rest. The Commissioner has essentially declared audit war on what are likely to be in many instances legitimate tax savings structures.

The perception that complex arrangements could be illegitimate tax avoidance schemes is the core motivation in the creation of a new audit unit within the Large and Mid-Sized Business Division ("LMSB") called the Global High Wealth Industry ("GHWI") team:

We want to better understand the entire complex economic picture of the enterprise controlled by the wealthy individual and to assess the tax compliance of that overall enterprise. We cannot do this by continuing to approach each tax return in the enterprise as a single and separate entity. We must understand and analyze the entire picture.

Id. Thus is born what the IRS has described as a "holistic" or "enterprise" audit approach of the new GHWI team.

The first order of business for the GHWI lead auditor will be to determine all of the investment, ownership and debt relationships surrounding the individual. The second will be to decide whether to open parallel audits or essentially audit these entities via the individual audit. Of course, should the audit team decide that adjustments are likely for the related entities, it will open formal audits of those entities. In one of our recent representations, the audit started with one of the entities and then branched out to the individual owner and related entities.

Clearly the revelations of the past two years about wealthy U.S. taxpayers concealing income through cooperative foreign banks were a clarion call to the IRS. The IRS does not like to find out that taxpayers have been dodging taxes in substantial amounts as then it appears that it is not doing its job; that's extremely bad for tax administration in a self-reporting system. And even though taxpayers who act concertedly and purposefully to hide income are very difficult to detect, the IRS cannot afford to have anything but a very strong response. So the IRS's answer is multi-pronged: prosecute certain taxpayers, follow up on the treasure trove of information received by these taxpayers as well as the information received from more than 15,000 taxpayers who have come forward about their foreign accounts through the

Client Alert.

voluntary disclosure process, seek assisting legislation such as was successfully done with FATCA, and set up a coordinated field unit to conduct audits of high wealth individuals. The idea of the GHWI team was apparently well-received within the IRS as a number of more seasoned agents volunteered to be on the GHWI team and were enthusiastic about the initiative.

WHO IS BEING TARGETED?

Not surprisingly, the IRS has been vague about its selection process, but there has been some useful information:

So what's our game plan here? At least initially, we will be looking at individuals with tens of millions of dollars of assets or income. Going forward, we will take a unified look at the entire web of business entities controlled by a high wealth individual, which will enable us to better assess the risk such arrangements pose to tax compliance and the integrity of our tax system.

Commissioner Shulman, Remarks at the National Press Club, April 5, 2010. Other remarks by the Commissioner indicate that the IRS has started with a small group of taxpayers and will broaden the audit pool after completing the initial audits. "What we learn from these initial enterprise examinations will help us define the scope of our future work and build compliance tools going forward." Remarks before the AICPA National Conference on Federal Taxation, October 26, 2009.

Have your advisors established foreign investment structures on your behalf? Do any of your foreign investment vehicles utilize multi-tier structures? Is your return supplemented with various schedules and attachments regarding foreign trust transfers or CFCs or PFICs? Do you have assets or income in the tens of millions of dollars or more? If you answered yes to all these, think about getting prepared for a GHWI team audit experience.

Wealthy taxpayers have investments in private equity and hedge funds, and hold other assets through complex and grantor trusts, partnerships and other flow-throughs and occasionally foreign entities. These may seem like a "mask" to a biased revenue collector's eye but may be complex for the reason that they need to be to accomplish their legitimate objectives. If the IRS gets a notion that a taxpayer is employing foreign structures to some end not clear on the face of the return, it is like taking a ticket to wait in line for your brand new GHWI audit team experience.

We know. We recently had such an audit before the IRS decided to coordinate its GHWI team in LMSB, but the audit was the same—intense and repeated questioning about complex structures and requests for documentation regarding certain domestic and foreign entities going back many years. With significant effort, we were able to provide sufficient documentation and an explanation and finally satisfied the agent that there was nothing but legitimate structuring. We could almost sense the disappointment in the agent as he realized that all his time and effort did not reveal some "masked web" of international tax deceit. However, the field agent was tenacious and enlisted the help of IRS counsel to review the analysis of the (purely domestic) adjustments he ultimately did propose.

WHAT TO DO IF YOU ARE THE LUCKY RECIPIENT OF A GHWI AUDIT LETTER?

You may first be asking, how will I know that I am the subject of a GHWI team audit? If you receive a call to schedule a preliminary audit meeting, the agent will likely give you some identifying and general information about the audit. If you receive a letter, it will be clear from the operating division that is designated on your appointment letter informs you that you have been selected for audit. If the letter is from the LMSB, a GHWI team will be auditing you. LMSB's normal audit subjects are corporations and partnerships with assets of more than \$10 million. The GHWI team has been placed within

Client Alert.

LMSB in order to draw upon existing expertise within that division, such as in pass-through, financial products and international areas, to collaborate with the front-line field agent.

Assuming you are the subject of such an audit, the first thing you should do is prepare yourself mentally for a thorough examination process which will include multiple document requests, requests for tax analysis on key issues, possible third party contacts and summons, and maybe a request for an interview by the agent. The audit will not necessarily be any longer than other LMSB audits given that the IRS places a high priority on keeping audits current, which generally means that your auditor will endeavor to reach either agreed adjustments or completion of the Revenue Agent's Report showing disagreed adjustments within 18 months of the first meeting.

Second, schedule a meeting with your primary tax advisors to discuss the status of your tax filings individually and for your related entities and the record keeping for prior years' filings. It is important to get an understanding of the possible scope of the audit by pulling together the returns for all of the filing entities, including yourself. Generally the IRS will ask for returns prior to the year under audit so those should be included in your review as well. This meeting should begin the process of self-examination in order to identify potential key areas upon which the agent may focus. At the meeting you should consider whether to retain experienced tax controversy counsel who would be able to assist you in responding to information requests, asserting privilege or work product, shaping the legal analysis in preparation for a possible review with IRS Appeals and considering the long-term consequences of the audit in case one or more audit issues must be litigated.¹ You should also consider whether such an internal meeting itself can be protected by privilege (either attorney-client or the special tax advisor privilege under section 7525 of the Internal Revenue Code) or the work product doctrine. If your primary tax advisors are also your return preparers, special consideration should be given to the possible limits of the application of the tax advisor privilege under section 7525.

Regarding the audit itself and meetings with the examining agent it is important to be cooperative and responsive to reasonable requests for information. This will establish a good working relationship with the agent. In our case, our responsiveness in providing a great deal of information helped our ability to speak with the agent in a fair and open manner and increased his willingness to tell us what he thought were issues and what were not. Given that the agent will be on the look-out for tax shelters, the need to be responsive and open cannot be overemphasized. This will neutralize the possible bias that the GHWI team may have acquired from the nature of its origin as shown by the Commissioner's remarks noted above. However, it is not improper to question the agent if a request seems disproportionately burdensome, treads into areas of protected information or is unclear. It is always appropriate to assert good faith claims of privilege and work product and no amount of pressure from the agent or his manager should convince you to waive such protections, unless there is a good reason to do so.

The auditor will have already done some research about you and your entities and prepared a preliminary risk analysis before sitting down with you for the first meeting. According to the IRS's recently released "Reference Guide, Quality

¹You and your primary tax advisors may not have enough of a sense about what the agent will target at this point, but it is generally prudent to get counsel involved early on in an audit with a potential for significant adjustments.

Client Alert.

Examination Process” (which is a shortened version of the audit process described in Internal Revenue Manual (“IRM”) Part 4, Chapter 46):

The exam team gathers publicly available information . . . and data internal to the IRS (e.g., current transcripts, data on related entities, etc.), then conducts a preliminary risk analysis to determine if an examination is warranted.

Page 2 of the Reference Guide. Such preliminary risk analysis must have concluded that there was some opportunity for tax adjustments, otherwise you would not be under audit. Your tax advisors should read the Reference Guide, which is only 8 pages, to get a good sense of how the IRS will conduct these audits.²

Finally, be prepared for the agent to assert some adjustments. It is unlikely that a GHWI agent will not find some return position to disagree with in the context of complex individual and entity returns. In our audit, while the agent discovered no lurking international tax shelter, he did focus on more pedestrian domestic items such as section 162 expenses and debt-equity issues which ultimately gave rise to proposed adjustments to both the individual and related entities. The agent may also assert accuracy-related penalties or a possible failure to file penalties depending upon the circumstances of your filing positions. With regard to penalties, it is important to consider providing the agent with any supporting tax analysis you may have received from your advisors in order to support a waiver of penalties. Of course, disclosing such analysis would raise the issue of privilege waiver and should be considered carefully.

WHAT ISSUES COULD BE RAISED?

From our experience and given the strong mandate for the GHWI team to ferret out abusive arrangements, there are any number of issues that could be raised from both a domestic and international standpoint. Here are some that may arise:

- Sham and economic substance
- Step-transaction
- Constructive dividends
- Section 482
- Debt-equity
- Subpart F income
- Withholding on U.S.-source income
- Passive-activity loss limitations
- Trade or business status and deductibility of expenses
- Foreign financial account disclosure
- Penalties

² In fact, the entire Chapter 46 of Part 4 of the IRM deserves a good review. It sets out in detail the structure of the audit, the audit team, what is expected of the auditors and the taxpayers, protocol for gathering information, standards for asserting penalties, and much more helpful information.

Client Alert.

Clearly there could be many more return items that might pique the interest of the GHWI team but a thorough internal review of the return positions should identify most of those items while the audit is still in its beginning stages.

About Morrison & Foerster:

We are Morrison & Foerster—a global firm of exceptional credentials in many areas. Our clients include some of the largest financial institutions, investment banks, Fortune 100, technology and life science companies. We've been included on *The American Lawyer's* A-List for seven straight years, and *Fortune* named us one of the "100 Best Companies to Work For." Our lawyers are committed to achieving innovative and business-minded results for our clients, while preserving the differences that make us stronger. This is MoFo. Visit us at www.mofo.com.

Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.