03 Tax controversy

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TAX CONTROVERSY

Navigating a heightened enforcement era

In today's complex and ever-evolving tax landscape, many high-net-worth individuals and their enterprises face increasing challenges that require careful navigation. With an increasing budget, the Internal Revenue Service (IRS) has significantly expanded its hiring and enforcement efforts.

The IRS's evolving audit approach involves larger teams of revenue agents and specialists, more expansive document requests, and analysis from artificial intelligence, machine learning and data analytics. The stakes can be high for those unprepared to meet intensified scrutiny from both the IRS and state tax authorities.

Historically, some taxpayers may have approached controversy with a reactive mindset, addressing issues only as they arose during an audit. Today, proactive planning from the onset is not just advisable but essential. Proactive planning can place taxpayers in a stronger position should an examination occur, mitigating risks and potentially avoiding disputes altogether.

By adopting a strategic approach to tax controversy, taxpayers can effectively manage their obligations and protect their interests. In this chapter, we will delve into the shifting dynamics of IRS examinations, explore the increased complexities introduced by recent legislative changes, and discuss leading practices that can help navigate these challenges.

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The IRS's focus on high-net-worth individuals and their related enterprises

The IRS has had a long-standing focus on high-net-worth individuals and their related enterprises, going back at least to the creation of the Global High Wealth (GHW) Audit Program in 2009. Tax gap studies (the estimated difference between taxes paid and taxes owed) show that high-net-worth individuals are the largest contributors to the tax gap.

Several additional factors have contributed to a heightened focus, including the increased budget from the Inflation Reduction Act, which enabled the IRS to hire and allocate more resources to this effort. Notably, the IRS has announced a plan to increase the size of the GHW program.

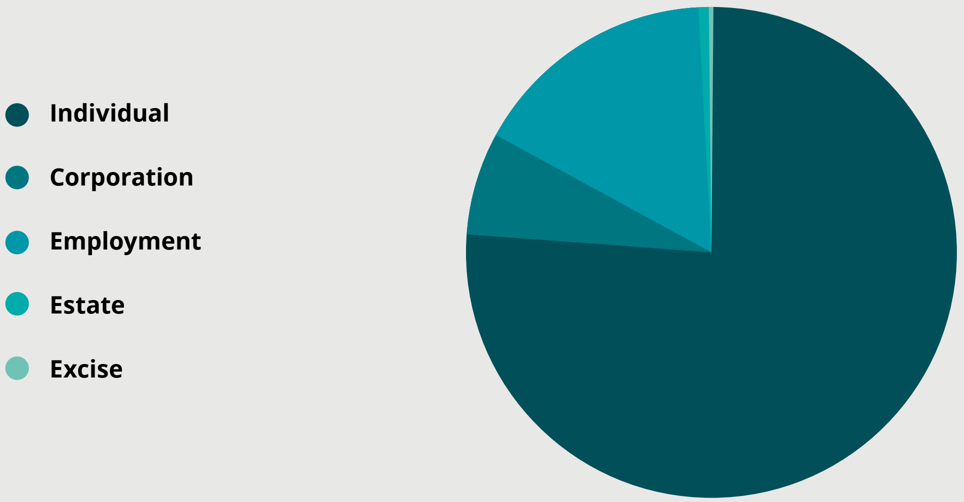
Public awareness of tax equity issues has also grown, and the Bipartisan Budget Act of 2015 (BBA) audit regime has impacted the examination process for related enterprises, making it easier for the IRS to conduct audits of an individual's broader enterprise. These elements collectively underscore the IRS's strategic emphasis on ensuring high-net-worth individuals meet their tax obligations.

These strategic priorities are supported by significant funding increases, as detailed in the following section.

"The IRS will increase audit rates by more than 50% on wealthy individual taxpayers with total positive income over $10 million."

IR-2024-130, May 2, 2024

Share of gross tax gap (2021)



Source: Publication 5869 (10-2023) (irs.gov)

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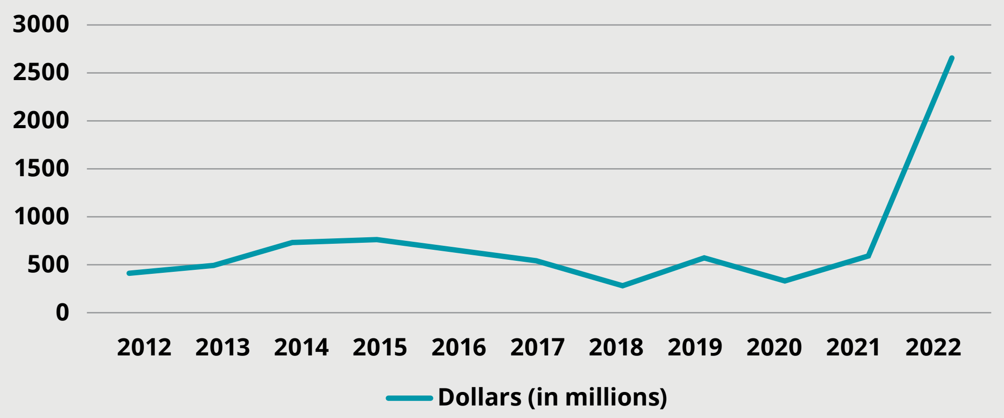
IRS total assessed additional tax (in millions) for audits of taxpayers w/ $10 million+ of total positive income (as of June 2023)



[GAO-24-106112, TAX COMPLIANCE: Opportunities Exist to Improve IRS High-Income/High-Wealth Audits]

IRS enforcement funding: Boosted by the Inflation Reduction Act and poised to surge

The Inflation Reduction Act (IRA) allocated nearly $80 billion in supplemental funding to the IRS, with $45.6 billion earmarked for enforcement activities aimed at curbing tax evasion among high-net-worth individuals and their enterprises.[4]

As of the IRS's 2023 fiscal year-end, the IRS spent $299 million of this enforcement allocation (less than 1% of the total earmark).[5] However, there was approximately a six-fold increase (from $619 million to $2.6706 billion) to total collections for the highest-income taxpayers (see chart).

The Fiscal Responsibility Act of 2023 reduced the amounts earmarked for enforcement, but despite this, the IRS projects that increased enforcement funding could boost revenue significantly over the next decade.[6]

"[A] sweeping, historic effort to restore fairness in tax compliance by shifting more attention onto high-income earners, partnerships, large corporations..."

IR-2023-186, Sept. 8, 2023

4. Brendan McDermott. "IRS-Related Funding in the Inflation Reduction Act," Congressional Research Service, October 20, 2022.
5. "Quarterly Snapshot: The IRS's Inflation Reduction Act Spending Through September 30, 2023," Treasury Inspector General for Tax Administration, January 29, 2024.
6. Department of the Treasury. "Return on Investment: Re-Examining Revenue Estimates for IRS Funding," International Revenue Service, February 2024.

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To date, the IRS has primarily used Inflation Reduction Act (IRA) funds to enhance taxpayer services (e.g., call centers, tax return processing). However, according to the strategic operating plan, a significant shift towards increased enforcement activity is planned.[7] This shift will see a substantial acceleration in the increasing of resources allocated to hiring enforcement personnel in the coming years; see the chart for planned full-time equivalents in enforcement.

Average recommended tax per audit hour, fiscal year 2022, for taxpayers with total positive income of $10 million or more:

$13,011

Table 12 - GAO-24-106112, TAX COMPLIANCE: Opportunities Exist to Improve IRS High-Income/High-Wealth Audits

Table 4: Estimated FTE funded with IRA through FY 2031

Appropriation	FY22 Actual	FY23 Actual	FY24	FY25	FY26	FY27	FY28	FY29	FY30	FY31
Taxpayer Services		10,518	7,279	12,562						
Enforcement		495	4,088	7,239	17,300	24,100	31,900	33,000		
Operations Support		2,317	2,944	3,808	5,000	4,900	5,300	5,500	3,600	
BSM		327	193	300						
Energy Security			1,810	1,810	1,400					
Direct File Study		4								
IRA Funded FTE	**0**	**13,661**	**16,314**	**25,719**	**23,700**	**29,000**	**37,200**	**38,500**	**3,600**	
Discretionary/Other FTE	**79,070**	**69,329**	**72,097**	**64,008**	**64,000**	**64,000**	**64,000**	**64,000**	**64,000**	**64,000**
Total FTE	**79,070**	**82,990**	**88,411**	**89,727**	**87,700**	**93,000**	**101,200**	**102,500**	**67,600**	**64,000**

Publication 3744-A (Rev.4-2024) (irs.gov)

7. "Quarterly Snapshot: The IRS's Inflation Reduction Act Spending Through September 30, 2023," Treasury Inspector General for Tax Administration, January 29, 2024.

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IRS service center operations

The IRS's service centers continue to play a crucial role in its operations. In recent years, their operations have seen both significant improvements and ongoing challenges. The Government Accountability Office (GAO) reported that the backlog of unprocessed correspondence, including amended returns, reached high levels by the end of the 2023 filing season.[8]

However, the IRS has made strides in reducing call wait times, achieving an average of three minutes for the 2024 filing season.[9] The agency also reported an 88 percent level of phone service, a substantial improvement from previous years.[9] The IRS has also hired 5,000 additional employees to enhance customer service,[10] though this rapid hiring has coincided with an increase in return processing errors.[11] The identity theft resolution service remains backlogged, with an average resolution time of 19 months and approximately 484,000 cases awaiting processing by the end of fiscal 2023.[12]

Leading practices:

- Retain proof of mailing for extensions, payments, returns
- E-file & electronically pay where possible
- Monitor tax accounts with transcripts
- Consider responding to notices with a written & phone response
- Review interest computations
- Understand electronic signature rules

8. Jessica Lucas-Judy. "IRS Improved Customer Service, but Could Further Improve Processing and Evaluate Expedited Hiring," United States Government Accountability Office, January 2024.
9. "IRS delivers strong 2024 tax filing season; expands services for millions of people on phones, in-person and online with expanded funding," IRS, April 15, 2024.
10. "IRS sets January 23 as official start to 2023 tax filing season; more help available for taxpayers this year," IRS, January 12, 2023.
11. "National Taxpayer Advocate issues mid-year report to Congress; highlights filing season challenges and focuses on strategic priorities," Taxpayer Advocate Service, June 26, 2024.
12. Department of the Treasury. "IRA Strategic Operating Plan: Annual Update Supplement," IRS, 2024.

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Despite these challenges, the IRS has reduced the average processing time for Form 1040 paper returns from 51 days in 2022 to just eight days in 2023.[13] Initiatives like the Paperless Processing Initiative and updates to the "Where's My Refund?" tool have further improved taxpayer services. Digital services have also expanded, allowing more types of notices to be responded to online, streamlining processes and reducing administrative burdens.[14]

In addition to these operational improvements, the IRS is leveraging advanced technologies like artificial intelligence to enhance its enforcement capabilities.

Enforcement of related passthrough entities

The IRS has significantly increased its focus on the enforcement of passthrough entities, particularly through the Bipartisan Budget Act of 2015 (BBA) audit regime. This regime streamlines the audit process for partnerships and other passthrough entities. The IRS is intensifying its focus on passthrough entities through new initiatives, campaigns, and increased hiring. For example, the IRS introduced a large partnership compliance program and stood up a special work unit to focus on large or complex pass-through entities. The IRS has ongoing campaigns including SECA taxes for LPs, sales of partnership interests, and non-filing partnerships.

Areas of focus

- sales of partnership interest,
- syndicated conservation easements,
- noncash charitable contribution arrangements,
- negative tax basis capital account reporting issues,
- disguised sales,
- SECA taxes for LPs,
- special allocations (e.g., stuffing allocations) and targeted allocations, and
- related party basis shifting transactions.

Global high-wealth audits start with an individual taxpayer and can expand out to any connected tax return, even if the taxpayer doesn't have a direct ownership interest.

13. Jessica Lucas-Judy. "IRS Improved Customer Service, but Could Further Improve Processing and Evaluate Expedited Hiring," United States Government Accountability Office, January 2024.
14. Department of the Treasury. "IRA Strategic Operating Plan: Annual Update Supplement," IRS, 2024.

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Furthermore, partnership audits may intersect with gift and estate issues in areas such as:

- gifting being taxable to an extent when partnerships have liabilities,
- section 2036, and
- partnership asset basis adjustments upon death.

Other considerations of the BBA audit regime?

Bipartisan Budget Act of 2015 (BBA) partnerships are now required to address adjustments at the partnership level unless they choose to push these adjustments out to their partners. This change means that partnerships can no longer amend prior year tax returns but must file adjustments within a specified timeframe. These adjustments, once pushed out, affect partners' tax liabilities and attributes, requiring recalculations for reviewed and intervening years.

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Form 8978 serves as a crucial tool in this process, functioning like a pro forma amended return included within the partner's income tax return. It requires detailed recalculations and adjustments, with potential penalties and interest implications for partners. Similarly, Form 8986 must be meticulously managed, with strict deadlines and potential penalties for non-compliance.

Strategic planning and coordination is important to mitigate risks such as stranded overpayments and imputed underpayments. By adopting leading practices, partnerships and their partners can effectively navigate the complexities introduced by the BBA, enabling partnerships and their partners to be well-prepared to meet intensified scrutiny from the IRS and state tax authorities.

Upon receipt of Form 8986

- **Is the Form 8986 completed correctly?**
- **Has partner already accounted for adjustment?**
- **Calendar when need to push out**
- **Evaluate the ultimate taxpaying partner**

TAX CONTROVERSY

Audit readiness

As we've discussed, taxpayers are facing heightened scrutiny from revenue authorities around the world. Authorities seek greater transparency and what they believe to be their jurisdiction's fair share of the tax pie, and they are using increasingly sophisticated technology and techniques to enforce tax laws and regulations.

In such an environment, a prudent step for taxpayers is to identify and prepare for potential examination risks, understand changing examination procedures and navigate dispute resolution alternatives available to them, if needed. Taxpayers should proactively incorporate such practices into their tax planning and compliance processes. For example, many financial decisions, transactions and events can trigger revenue authority scrutiny. Proactive planning is important both to document the related tax positions and a strategy for defending them.

By conducting a periodic risk assessment, taxpayers can be effectively prepared for a tax examination if one takes place. Such risk assessments can range from a simple discussion with internal advisors to a detailed examination readiness assessment that includes document analysis, interviews, and other data gathering.

The assessment can help taxpayers identify and quantify potential issues that may be a focus of an examination. In addition, it can help taxpayers develop and maintain a system for handling information requests that may be received from revenue authorities.

In this section, we will identify issues which may become a focus on examination, discuss what risk assessments could look like and recommend how taxpayers can prepare for examination of these issues.

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Audit readiness

Important considerations

Recognizing and identifying issues that can become the focus of examinations is critical, as is preparing for examination of these issues. Accordingly, there are specific areas of interest that revenue authorities tend to target more commonly. Some topics of interest include:

IRC § 183 hobby

The IRS frequently investigates hobby potential for Schedule C businesses (sole proprietorships) that generate consistent losses. Examinations related to hobby loss focus on the setup of the entity in question. Taxpayers should operate the business with the intention to make a profit. Evidence of that may include having a business plan in place, consulting experts, separate books and records for the activity, and a business bank account to name a few. It's important that the taxpayer treats the activity like a business in all facets, with a clear intent to make a profit.

Sports teams

Sports teams are often examined by revenue authorities, with a particular emphasis on basis. The IRS has a campaign specifically to identity partnerships within the sports industry that report large losses. The purpose of the campaign is to ensure that the income and deductions creating the losses are properly reported per the Internal Revenue Code. Additional topics that are commonly examined are deferred compensation and fringe benefits, amortization of player contracts, depreciation, broadcasting rights and revenue, as well as multistate tax issues.

Audit readiness

Artwork

In anticipation of an examination which focuses on art valuation, it is prudent to have a system in place to manage artwork inventory, specifically if the art is part of an estate plan or if it is to be gifted. Important documentation to retain includes appraisals, condition reports, provenance, insurance policies and high-definition photographs. This documentation may be requested by the IRS's Art Appraisal Services and the Art Advisory Panel.

Charitable contributions

Taxpayers should retain contemporaneous written acknowledgement letters for all charitable contributions made, including the "no goods or services" language if applicable. Also important is maintaining qualified appraisals and working with an appraiser who is knowledgeable of the rules. If a taxpayer has charitable contribution carryovers, the IRS may ask for support of contributions made in prior years. Another leading practice is to be mindful of charitable contributions made prior to realization events, which could be viewed by revenue authorities as subject to claw back under the assignment of income doctrine.

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Audit readiness

Basis

Basis is a key issue for many of the IRS's campaigns, like sales of partnership interests, losses in excess of basis, and distributions in excess of basis. However, basis can be difficult to substantiate when the relevant interest was acquired years or even decades in the past. A leading practice is to maintain an updated basis schedule as well as to retain underlying support for the schedule, such as Schedules K-1 from partnership interests as well as wire transfers, cancelled checks, or bank confirmations for any capital contributions. If the entity has document retention policies in place, basis records often necessitate a separate retention policy, until a number of years after the interest is disposed of.

Aircraft

The IRS introduced a Business Aircraft Campaign in February 2024, but aircraft has been a significant focus for an extended period. A leading practice is to keep detailed flight logs of all business flights, including classification of the passengers on board, the purpose of each person's travel, the location(s) of travel, and what events took place at each destination, along with support.

Real estate professional

Taxpayers should be aware that claiming status as a real estate professional on a tax return may be reviewed by the IRS. A leading practice is to keep detailed records of hours spent as a real estate professional, including a calendar of all related work, a mileage log, and travel records if applicable. If the taxpayer has any professional licenses in the field or attends any professional conferences related to their work as a real estate professional, those items should be documented as well.

Audit readiness

Investment interest expense

It is essential to establish systems that trace loan proceeds directly to individual investments. Given the fungibility of cash, tracing funds from a loan into a central bank account and subsequently to specific investments can be challenging.

Passive/non-passive determinations

If an individual is considered non-passive under one of the hours-based tests of IRC 469, then a leading practice is to proactively keep a calendar or other log of working hours should an examination arise. Other tracking methods may be instituted, such as keeping track of badge swipe data or other location data. Reconstructing these records during an examination can be exceedingly time-consuming and challenging.

Residency

In recent years, as high-net-worth individuals have relocated more frequently, state tax authorities have intensified their enforcement of residency examinations, which can be fact-intensive and intrusive. A leading practice for those who are considering a move is to keep robust records of their change of residency. This can include keeping a detailed calendar of their whereabouts during the year of re-location. This is particularly important if the individual split time between two states throughout the year.

Audit readiness

Family office

A taxing authority's examination and challenge of a high-net-worth individual's or entity's tax position could affect a family office in several ways. The family office, itself, could come under exam, or an individual or entity whose affairs the family office manages could be subject to such a review. As previously discussed, IRS examinations have the potential to initiate audits in one area, which may subsequently lead to the examination of other related entities and/or individuals.

As a result, family offices not only may face a higher probability of involvement in a tax controversy, they may encounter a lengthier and more complex examination process, as well. Regardless of whether the involvement pertains to a simple inquiry or an extended examination, responses must be timely and executed with meticulous care.

While virtually any issue could prompt a tax controversy, the IRS does enhance its focus on certain issues from time to time. Recent areas of focus that may impact the operations of a family office include foreign tax credits, reasonable compensation, transfer pricing issues, research credits, and information reporting, particularly concerning foreign accounts and interests.

Some important considerations to contemplate in preparing for the possibility of an examination are:

- if the family office receives management fees, how are the fees determined and are they supported by legal contracts,
- understanding recent case law and analyzing the potential impact for your family office structure, and
- if the family office provides centralized employees for a number of legal entities, are there contracts between the entities setting forth the reimbursement computation and are invoices being issued.

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Audit readiness

Final thoughts

High-net-worth individuals and their related enterprises face increasing challenges in today's tax landscape. The IRS has expanded its capabilities, using advanced technologies for more rigorous examinations, making proactive planning essential.

The heightened enforcement era underscores the importance of adopting leading practices in tax planning and compliance. Implementing robust internal controls, meticulous document retention, and periodic risk assessments are crucial for mitigating risks. Staying informed about IRS examination dynamics and recent legislative changes is vital.

A strategic approach to tax controversy is necessary. By equipping themselves with the right knowledge and strategies, high-net-worth individuals and their related enterprises can effectively manage tax obligations and safeguard their financial interests.

For more information on Deloitte's tax controversy services, visit [Tax Controversy Services | Deloitte US]