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IRS Auditors Turn Up Heat On Wealthy Taxpayers

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Federal audit rates for the wealthy dropped over most of the past decade, but that is now changing as the IRS, buttressed by a Biden administration that has made tax enforcement a priority, has pledged to increase scrutiny of high-net-worth taxpayers.

For all individual taxpayers, the average audit rate fell from 0.9% in 2010 to 0.25% in 2019, or by 72%, the Government Accountability Office said in a recent report. Taxpayers with incomes of $5 million or more were the most likely to be audited throughout the decade, though they still saw their audit rates drop 86%.

But in a recent report, the IRS said audit rates for incomes between $100,000 and $500,000 have risen to 0.6% this year, doubling from 2019. The agency said audits for taxpayers making more than $10 million annually quadrupled to 8%. And audit rates for the $1 million to $5 million category more than doubled to 1.3%.

That may only be the start. The Inflation Reduction Act of 2022, which was passed by majority Democrats in the Congress in mid-August, includes $45.6 billion for enhanced IRS enforcement (part of an $80 billion increase for the agency overall) and a billionaire's minimum income tax that would require taxpayers worth more than $100 million to pay a minimum of 20% on their capital gains annually.

The legislation would also do away with pass-through tax deductions that have shielded investment managers from taxes. These deductions would now sunset at the end of 2028.

"The IRS is increasing focus on non-compliant, high-income and high-wealth taxpayers, business partnerships and large corporations that make up a disproportionate share of unpaid taxes," the agency's new five-year plan promises.

"The IRS periodically announces special initiatives targeting high-net-worth individuals, but wealthy clients are often in the crosshairs of the IRS because of the complexity of their financial lives," says James G. McGrory, a partner with Armanino LLP in Philadelphia.

David A. Shuster, managing principal and director of tax controversy services at Friedman LLP's New York office, says however that audit rate statistics can be misleading (something confirmed recently by

the IRS commissioner). “There’s a greater lag after a higher-income taxpayer files a return and when that return gets picked up for audit, compared with when low-income taxpayer returns get picked up for audit or other questioning, such as for the [earned income tax credit], which is generally questioned immediately if at all,” Shuster says.

Wealthy clients who hold foreign assets, such as bank accounts, foreign trusts and foreign business interests, are especially at risk; penalties for not filing foreign information returns are severe. Wealthy individuals who own affiliated business entities—partnerships, S and C corps—and who “perhaps have significant intercompany activity may also be at risk,” McGrory says.

Other trouble areas include sole proprietorships and pass-through entities, gift tax returns and private foundations and the interactions that the high-net-worth individual has with them. “Seems like charitable contribution deductions, especially for conservation easements, are susceptible to higher audit probabilities,” Shuster says.

“Audits of taxable estates are also on the rise,” which can have a significant impact on an estate and its heirs, says David Levi, senior managing director at CBIZ MHM in Minneapolis. “Discounts for closely held businesses and other investments,” Levi says, “should be supported by quality appraisals that take into account both the asset being appraised as well as any limitations or other factors relevant about the ownership structure of the asset.”

The IRS generally audits back three years, but it can audit up to six years or longer. The statute of limitations on an IRS audit can get longer if the agency sees certain behaviors: the underreporting of income; the overstating of basis in an investment or asset; the omission of foreign income, gifts and assets; or the filing of a fraudulent return or failure to file a return at all.

“Audits of high-income taxpayers can occur closer to the end of the statute of limitations,” Levi says.

In some cases, the taxpayer will need to visit a local IRS office for an audit, says Jim Brandenburg, a Milwaukee-based tax partner at Sikich.