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Tax litigation risk increases for high net worth individuals

BY DAVID GANNAWAY

Federal tax authorities are on the hunt. Their sights are trained in particular on three categories of taxpayers: sole proprietors, officers of closely-held businesses and high net worth individuals.

Individuals who fall into one or more of these categories – for example, senior executives at a major corporation, officers of a family business or attorneys in private practice who have a complex array of personal investments – need to know they are at risk, and need to understand the risks (including civil audit and potential criminal prosecution).

Wealthy individuals are attractive to the IRS first, and most obviously, because of simple return on investment. A successful enforcement action against a wealthy taxpayer means more tax revenue for each enforcement dollar spent.

Economic downturn drives more fraud and more enforcement

There are several reasons why scrutiny has increased, and why wealthy individuals are the target.

The first and most obvious is that fraud is rising, as it always does in difficult economic times. Individuals want to make up their portfolio losses, and fall prey to 'too good to be true' schemes (the Madoff case is only the most famous of many examples). This is especially true of high net worth individuals, who have more losses to make up. Businesses desperate to maintain cash flow begin to cut corners as well.

At the same time, authorities are under their own kind of pressure. They are targeting any and all revenue that will help close the 'tax gap' – the gap between what taxpayers actually pay and what the US Internal Revenue Service believes they should pay. In an economic downturn, tax revenue has declined as a direct result of the drop in individual and corporate incomes. This has occured just as increased government spending on recovery programs increases the pressure on the shrinking revenue pool. Any additional revenue that can be found can help close the gap.

This is a recipe for heightened enforcement, enforcement that, in particular, targets individual taxpayers, who have the greatest discretion over how much tax to pay.

Underreporting is the biggest problem

The IRS identifies three causes for the tax gap: underreporting (not identifying one's full taxable income, via underreported receipts and overestimated expenses), underpayment (not paying the full amount of tax due) and nonfiling (failing to file a return and failing to pay the tax that would have been due).

Of these, underreporting is the biggest problem, in particular, underreporting by individuals. According to the IRS, total underreporting (of individual and business tax) constitutes 82 percent of the gross tax gap. Individual underreporting accounts for more than 50 percent of the gap. The other categories represent a smaller but still significant problem – underpayment is 10 percent of the gross tax gap, and nonfiling is 8 percent, according to the US Internal Revenue Service.

Large businesses generally do not underreport. They are tightly regulated. They are, in effect, under constant audit. Similarly, individual wage-earners usually do not underreport because, since they are subject to withholding, they do not have the opportunity.

High net worth individuals get most scrutiny

Instead, it is a subgroup of individuals who are highest on the IRS' radar: those who have high income and/or net worth, and who are responsible for reporting their own income and expenses. Included as well are officers of businesses – family-owned, S-corporations or partnerships – that are not subject to reporting requirements. And there are a limited number of wage-earners, very senior and highly compensated, whose investments open them to attention.

Return on investment drives enforcement strategies

Wealthy individuals are attractive to the IRS first, and most obviously, because of simple return on investment. A successful enforcement action against a wealthy taxpayer means more tax revenue for each enforcement dollar spent. Under new tax rates (the top bracket in the Obama Administration's tax plan is now 39.6 percent) a $1m judgment produces nearly $400,000 in tax revenue. Then there is the deterrent effect, meaning an enforcement against a prominent person will have a chilling effect on many others. By this strategy, enforcement against a senior surgeon or a CFO, would have more impact than, say, one against the minimum wage earner who claimed a questionable deduction.

Individuals should be cautious

If individuals fall into one or more of the high-risk categories, what steps can they take to protect themselves? The first is simply to recognise that if you fit into one or more of these categories, you are probably at risk.

The second is to be careful. Investment schemes and tax strategies that seem too good to be true probably are. High net worth individuals need to realise that they are likely to be targeted for questionable investment vehicles and that they or their accountants might be tempted to be too aggressive in reporting. The same holds true for businesses that are tempted to under report or under-withhold.

The third is to secure good counsel. This is true whether you are concerned about possibly being investigated, or whether you are already the target of an enforcement action. Importantly, an existing accountant or accounting team may not have the skills or experience necessary in an enforcement action. The best tax adviser may not be familiar with the ins and outs of an audit or a civil or criminal enforcement action, or know the subject matter in depth. The best team is often a mixed team – an accountant and an attorney working together.

To find good counsel requires research. Word-of-mouth is a good place to start. Get recommendations from friends and colleagues in similar circumstances. Then go beyond. Do due diligence. Investigate the size of the firm, its specialties and the backgrounds of its leadership team. Finally, conduct interviews. And as in any interview sequence, it is essential to listen and trust your instinct. If a candidate advises an action that reaches beyond common sense, run. ■

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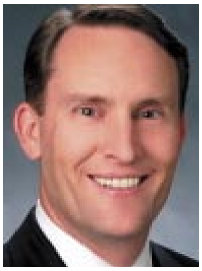

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