



## Knock Knock. It's the IRS.

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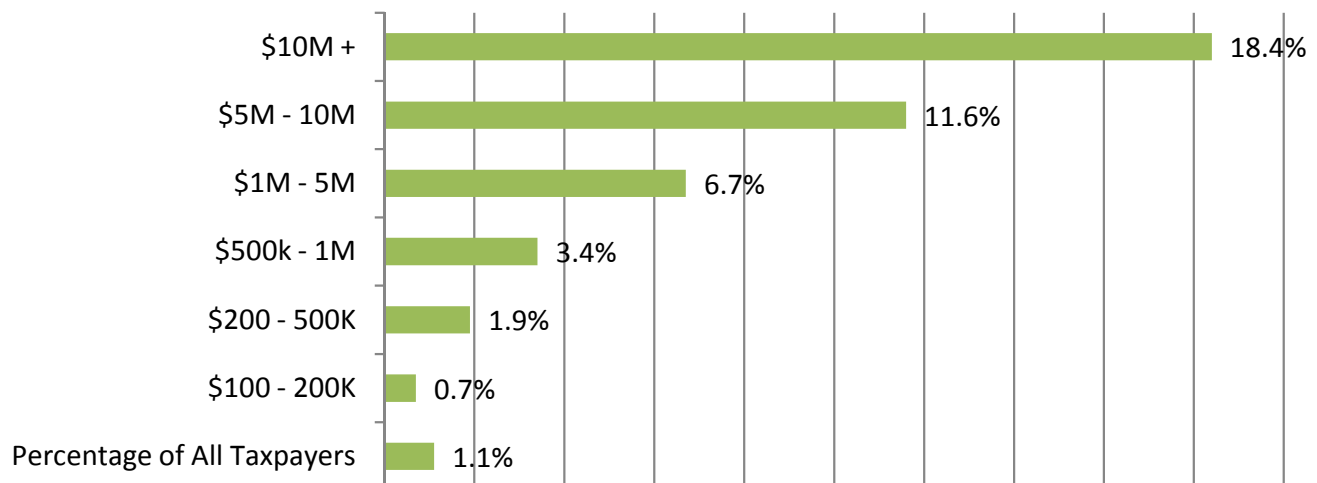
Many higher-wealth individuals are being told to prepare for more income tax audits by the Internal Revenue Service. Recent statistics seem to support that view. The IRS recently released its annual Data Book which summarizes audit and collection activities for Fiscal Year (FY) 2010. Not surprisingly, the IRS is focusing its audits on returns that will likely produce the most revenue for the U.S. Treasury.

Where do you stand with the IRS? Your questions asked and answered.

**Q: What are my odds of an IRS audit? How does my income level affect those odds?**

Overall, the audit rate for all individual tax returns in FY 2010 was 1.1%. A breakdown by adjusted gross income (AGI) follows:

### Percentage of Taxpayers Audited, by income level (AGI)



The increased chance of audit rises dramatically as AGI rises. The total returns in the top three categories (at least \$1 million of AGI) had an overall audit rate of 8.4%, which was considerably higher than the 6.4% for FY 2009. Those lucky enough to have \$10 million of income saw their audit rate skyrocket 73%, rising from an already high 10.6% to 18.4%.

**Q: Is it true the IRS now has a High Wealth Swat Team?**

A special unit, the Global High Wealth Industry Group, was created by the IRS in October of 2009. At that time, IRS Commissioner Shulman indicated the purpose of the Group was to focus its expertise and monitor tax compliance by high income individuals and their related enterprises. It is unknown as to who exactly is subject to examination by this unit, but when the IRS announced the August 2010 reorganization of its largest business division, it stated that the realigned Large Business and International division will continue to handle business entities with assets of \$10 million "as well as certain high wealth individuals." While this unit is relatively new, it represents a multi-year strategy by the IRS intended to examine certain individuals' complete network of business entities, legal arrangements and international activities.

**Q: What are the results to date from the Global High Wealth Group?**

According to information released by the Transactional Records Access Clearinghouse (TRAC) in April of this year, the High Wealth Group has only conducted 13 audits through March 31, 2011. It may also be surprising that only 78 Revenue Agents were assigned to the Group at the end of FY 2010. For the entire LB&I division, over 5600 agents were assigned. TRAC further indicated that the IRS 12-month audit plan included only 122 returns within the Global High Wealth Group. However, as the audit statistics show, many wealthy individuals are still being subjected to normal audits outside of this special IRS group.

**Q: Aside from AGI, how are tax returns selected for examination?**

An individual return is sometimes audited when a particular line item varies from the norm or the return is scored as particularly audit-worthy. The IRS computer program includes the Discriminant Inventory Function System (DIF), which assigns a numeric score to each tax return processed. The entire return may not be questioned, but is instead selected because of a specific deduction or a combination of two or three items reported on the return. Returns may also be randomly picked or chosen due to information received from Forms 1099 and W-2 that does not match the return. The IRS will receive over 2 billion information returns this year, and Congress continues to promote expanded information reporting as a productive way to increase tax revenues.

**Q: I have never been audited. What should I expect if my return is pulled?**

Historically, the IRS has used two types of audits for individual tax returns - correspondence audits and face to face audits. Face to face examinations typically take place in the local IRS office and are initiated when the IRS sends a letter requesting an office interview with the taxpayer to discuss the items at issue. The individual, or his appointed representative, will typically be asked a series of questions and be required to provide supporting documentation for specific deductions or transactions.

The statistics for FY 2010 indicate 78% of the individual audits were so-called correspondence audits. Although the percentage is less at the higher income levels, correspondence audits have become a major component within IRS enforcement. Correspondence audits are conducted by the IRS sending letters to individuals which require them to verify certain deductions or exemptions claimed on a return. Examples of items which can be verified by correspondence are itemized deductions such as interest, taxes, donations, and medical expenses. A taxpayer will normally have 30 days to respond and must generally provide supporting documents such as canceled checks or receipts. Provided your response is timely and includes explanations and supporting proof for the items requested, the IRS will normally not request more data but will make a determination of any tax owed based on the information provided.

## **Q: What about audits where the IRS digs deeper, or when conducted by the High Wealth Unit?**

One of the harshest examples of an actual IRS audit “document request” recently appeared in the publication Tax Notes. It was nine pages long and requested extensive information regarding sources of income, details of assets owned or rented (within the U.S. and internationally), liabilities, asset transfers to family members and third parties, copies of estate planning instruments, etc. It not only requested copies of investment partnership and S corporation K-1’s, but additionally required copies of other documents from the entity, evidencing ownership, distributions, and more. The IRS has also expanded its audit efforts in the estate and gift tax area by looking through local real estate records for unreported property transfers

### **Final Comments:**

During the last few years, the IRS has additionally made significant efforts and progress in finding taxpayers with unreported income in offshore accounts. Their second offshore voluntary compliance initiative is now underway and offers reduced penalties to affected individuals who comply with full disclosure rules by August 31, 2011. The Treasury Department is committed to reducing the nation’s “tax gap” by finding underreported income, as evidenced by Secretary Geithner’s comments before a House subcommittee in March. According to Geithner, a dollar invested in the IRS produced almost five dollars in tax revenue from enforcement efforts.

Faced with ongoing tax complexities and this increased scrutiny by the IRS, high wealth individuals should be diligent in their maintenance of required records and stay abreast of new tax developments through regular communication with their tax advisors.

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