

# IRS TAX AUDITS 2017 UPDATE

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In December 2016 Gary was interviewed by California CEO Magazine and RCBNNNews.org on the subject of Criminal Tax Evasion and IRS Tax Audits: Civil and Criminal Issues. This 4 part series, which has been published by [Lorman Education](#), can be viewed below:

[Criminal Tax Evasion - Part 1](#)

[Criminal Tax Evasion – Part 2](#)

[Criminal Tax Evasion – Part 3](#)

[Criminal Tax Evasion – Part 4](#)

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# IRS Tax Audits 2017 Update

## I - IRS Audit Statistics (Historic)

The [IRS 2012 Data Fact Book](#) reported during Fiscal Year 2012, (through 9/30/12) the IRS employed 97,941 employees (Budget \$12.1billion), collected \$2.5 trillion in taxes, processed 237.3 million tax returns.

The IRS 2011 audit activities are as follows:

1. Form 1040 - 143.4 million tax returns filed, audit rate 1.03%
2. Form 706 - 12,582 tax returns filed, 3,762 audited (29.9%). Estates between \$5 million and \$10 million audited nearly 60%, estates over \$10 million 100% audit rate.
3. Form 709 - 223,090 tax returns filed, 3,164 audited, (1.42%)
4. Form 1065 - 3,524,808 tax returns filed, 16,691 audited (.47%)
5. Form 1120S - 4,469,329 tax returns filed, 21,658 audited (.48%)
6. Form 1120 - 1,999, 266 tax returns filed, 32,701 audited (1.64%)
7. Form 1041 - 3,036,900 tax returns filed, 5,070 audited (.17%)
8. Processed 237.3 million federal tax returns
9. Collected \$2.52 trillion in taxes
10. Issued tax refunds: \$373.4 billion
11. Net tax collections: \$2.15 trillion

Since US government spends \$3.79 trillion there was \$1.27 trillion "revenue shortfall".

Largest source of IRS tax receipts was 55% (\$1.387 trillion) from individual estate and trust income taxes.

In 2013 the audit rates were as follows:

1. Individual audits less than 1% (.96%) i.e. 1 of every 104 tax returns
- 42 Income under \$200k, audit rate is .88% (less than 1%)
- 43 Income b/n \$200k-\$1m audit rate is 2.7% (1 out of 37)
- 44 Income over \$1m, audit rate is 10.85% (1 of 9)
- 45 For top income: b/n \$5-10m (16%) audit rate, over \$10m (24%) audit rate.

## II – Tax Year Update 2015

For Tax Year 2015, the IRS recently released IRS tax audit statistics:

1. In 2015, one in 143 US Taxpayers faced an IRS tax audit;
2. Those who make the median income (\$50,000-\$75,000) faced the lowest tax audit rates (i.e. one in 244);
3. Those making between \$1m-\$5m had a 5% chance of audit (one in 20);
4. Those making between \$5m-\$10m had a 10% chance of audit (one in 10);
5. Those making over \$10m had a 19% chance of audit (nearly one in 5).

The IRS is focusing resources on audits of the rich which yield more tax revenues than audits of those in the middle class or are affluent but make less than \$1m per year. For wealthy taxpayers with over \$10m in income, the IRS has a special tax audit division, The Wealth Squad (“Global High Wealth Industry Group”) founded in 2010 to audit high wealth individuals. The Wealth Squad looks at the complete financial picture of the individual taxpayers and the entities they own or control.

Under the IRS Wealth Squad’s audits, the taxpayer is subject to review of their individual tax returns (and spouse), tax returns for entities (where the individual has a “controlling interest”). In addition, the individual’s interest in partnerships, trusts, private foundations are subject to audit exam as well as gifts, trust distributions and “loans” from trusts/estates.

## III - IRS Tax Audit Rates (Prior Years)

In a groundbreaking study [TaxFoundation.org](http://TaxFoundation.org) released a study of IRS tax audits for the 2015 Fiscal Year (thru 9/30/15, the most recent tax year for which IRS tax audit statistics have been released), which revealed the following:

1. The overall IRS audit rate has dropped from 1.1% (2010), 1 in 90 taxpayers to .8% (2015) less than 1%, 1 in 120 taxpayers.
2. However, IRS tax audit rates have greatly increased for high-income

earners. For taxpayers at the higher income levels: between \$500k to \$1m (3.81%, 1 in 26 compared to approximately 3% for recent tax years); between \$1m-\$5m (8.42%, 1 in 12 compared to approx. 7% for recent tax years); \$5m-\$10m (19.44%, 1 in 5 compared to 11 % for recent tax years); \$10m over (34.69% 1 in 3 compared to 16 % for recent tax years).

3. Effective tax rates may be as high as 55% for “blended” Federal/CA tax rates based out phase-out for personal exemptions, itemized deductions and minimal or no pension contributions.

Tax projections include the following:

1. Income over \$500,000, tax is 40.4%: \$210,966 (\$137,330/Federal, \$45,375/ CA; \$17,261/ FICA);
2. Income over \$1m, tax is 45.45%: \$454,486 (\$317,123/Federal, \$108,352/CA; \$29,011/FICA);
3. Income over \$5m, tax is 50.02% \$2,501,188 (\$1,738,067/Federal, \$640,110/CA; \$123,011/FICA)
4. Income over \$10m, tax is 50.60% \$5,059,747 (\$3,514,125/Federal, \$1,305,110/CA; \$240,511/FICA).

#### IV - IRS Civil Tax Audits/Criminal Tax Cases (2017)

Regarding IRS Civil Tax Audits, the audit rate has declined for individual taxpayers (in 2007: 1.38m taxpayers audited, 2010: 1.58m, 2016: 1.03m taxpayers were audited which is 0.7% i.e. 1 in 143 risk) and for business taxpayers (Corporations, Partnerships and S-Corporations audit rate was 0.49% lowest level since 2004 (0.36%).

High Income Earners also saw a decline in IRS tax audits for taxpayers making over \$200k (1.7% audit rate), over \$1m in income (5.8% audit rate).

The decline in IRS audit rates is due to a reduced IRS budget (2010: \$12.2B; 2016: \$11.2B) and less employees in the IRS (between 2010-2016 the IRS lost more than 17,000 employees so now a little more than 80,000 people work at the IRS).



The IRS reported that in fiscal year 2016 they initiated 3,395 federal criminal tax cases thru the IRS/Criminal Investigation Division (which is the only federal law enforcement agency with jurisdiction over federal tax crimes). The focus of these cases included: money laundering, public corruption, cyber-crimes. For FY 2016, the IRS/CI conviction rate was 92%.

The IRS/CI investigates criminal violation of the Internal Revenue Code, which overlaps into related financial crimes e.g. money laundering which are subject to criminal prosecution by the US Dept. of Justice.

As stated by Commissioner of the IRS, John Koskinen: The IRS continues to work to ensure that everyone is playing by the same rules and paying their fair share (of tax).... The IRS is committed to fairly administering and enforcing the tax code, and our criminal investigation division plays a critical role in that effort”.

However, due to 3<sup>rd</sup> party information reporting, there is less opportunity for taxpayers to cheat on their taxes. The IRS collects information to verify taxpayer’s tax reporting including: Employers report wages, Banks report interest, Brokerages report sales/capital gains, and Lenders report mortgage interest.

As stated by the IRS Commissioner, “the IRS still audits over 1m tax returns per year... spinning the roulette wheel and risking an audit can be an expensive bet... considering unpaid tax, penalty and interest from an audit”.

IRS budget cuts may be illusory since the IRS collects 93% of US tax revenue. As stated by Tony Reardon (President of the National Treasury Employees Union, which represents IRS workers: “You cannot increase defense spending (as proposed by the new administration to increase defense spending by \$54B) and cut IRS funding at the same time. It does not add up...” which was echoed by Steven Mnuchin the new Secretary of the Treasury in his confirmation hearings.

For US taxpayers concerned with either IRS civil tax audits/ or criminal tax issues the keys are to maintain good records, have legal authority in the form of a tax opinion citing favorable law which supports the Taxpayer’s tax returns, and be professionally represented.

In the words of Mark Twain: "Do the right thing. It will gratify some people and astonish the rest."

## V - IRS Tax Audit Risks

On 12/19/16 Fox Business News published "[9 Tax Audit Red Flags for the IRS](#)" by Sean Williams.

As a background, the Tax Foundation found that the US Tax Code is now 10.1m words. The instructions to complete a basic Form 1040 are more than 100 pages long. Although historically the IRS only audits about 1% of the tax returns, greater risk of audit includes:

1. Filing a paper tax return (not e-tax return). The audit risk is due a greater chance of making a math error than online software. According to turbo tax, paper returns have a 21% error rate compared to 0.5% of e-filed returns, i.e. a 41 times greater chance of making an error and being audited by the IRS;
2. Claiming a home office deduction. Taking the deduction does not trigger the audit. The IRS looks at large home office deductions. The deduction is limited to space dedicated to your work and not your personal life;
3. High Earners. In 2014, the IRS increased the audit risk by 3x for those with adjusted gross income between \$100k-\$499,999; Audit Risk (2014): High Earners
  - a. \$1m (and over) 6.21%
  - b. \$5m (and over) 10.53%
  - c. \$10m (and over) 16.22%
4. Schedule C. Ongoing losses may trigger an IRS audit. The IRS considers a business to be engaged in a for-profit activity if it reports a profit in 3 out of the last 5 years. A business that regularly posts losses year after year may be classified as a hobby, which would wipe the net loss on the original tax return and may result in tax, penalty & interest;
5. Excessive Business Expenses are claimed, i.e. personal expenses are claimed as business deductions;
6. Excessive Charitable Contributions: The charitable contribution is excessive in light of the income e.g. \$50,000 income but claim a



\$15,000 deduction for charitable contributions. In addition, charitable contributions require documentation to confirm the contribution;

7. Failure to include Form 1099 income received e.g. freelance income, dividend/interest income. This income is automatically reported to the IRS so if you fail to include the income and report it on tax returns you increase your audit risk.

## VI - IRS Tax Audits: The Wealth Squad

For wealthy taxpayers with over \$10m in income, the IRS has a special tax audit division, the Global High Wealth Industry Group (the "Wealth Squad"). The IRS Wealth Squad falls under the IRS Large Business and International Division (formerly Large and Midsize Business Division). The Wealth Squad was formed in 2010 to audit "high wealth individuals" who make use of sophisticated business and investment arrangements with both complicated legal structures and tax consequences.

As stated by the Eleventh Circuit in *Ballard v. Commr.* 522 F.3d 1229 (11th Cir. 2008): "It is no surprise that a knowledgeable tax attorney would use numerous legal entities to accomplish different objectives. This does not make them illegitimate. Unfortunately such maneuvering is apparently encouraged by our present tax laws and codes."

In response the IRS created the Wealth Squad in 2010 to "take a holistic approach in addressing the high wealth taxpayer population; to look at the complete financial picture of high wealth individuals and the enterprises they control," according to the IRS Revenue Manual.

The Wealth Squad cases involve an individual's tax return and related income tax returns where the individual has a controlling interest. An individual's ownership interest in partnerships, trusts, corporations and private foundations may be examined. Gifts and distributions from trusts may also be subject to the IRS tax audit.

The IRS is seeking to take a unified view of the entire web of interrelated entities controlled by a high-wealth individual to discover the entire economic taxpayer picture and to assess the overall tax compliance. The IRS Wealth Squad looks at taxpayers with tens of millions of dollars in assets or

income to confirm whether they are in tax compliance. In egregious cases, the IRS civil tax audit division may refer either the taxpayers or the advisors or both to the IRS Criminal Investigation Division.

Under IRC 7602, the IRS has general authority to request evidence and information during an audit. The IRS will gather the evidence by submitting an Information Document Request Form 4564 (known as an IDR). If the taxpayer fails to respond the IRS may issue a summons for books and records (from either the taxpayer or their custodian of records). Under IRC 7602, the IRS summons may be used to ascertain the correctness of the taxpayer's return, to make a return, or to determine the liability of a taxpayer (see *US v. Powell*, 379 US 48, 57-58 (1964)).

If the taxpayer does not respond to the summons, the IRS may seek a court order from the US District Court for the district in which the person subject to the summons resides. If the taxpayer still does not respond to the summons the District Court judge may imprison the party required to respond to a summons.

The IRS has other "weapons" to gather evidence under an audit including:

1. Taxpayer interviews;
2. IRS tours of Taxpayer business operations; and
3. Examination of underlying taxpayer books and records including balance sheets, gross receipts or sales, and cost of goods sold.

In addition, the IRS team of experts may include specialized auditors with issue-specialized tax expertise, which includes IRS audit specialists flow-thru entities, estate and gifts, international examiners, and valuation experts. In response, taxpayer representatives should at the outset seek to limit the IRS tax audit to non-privileged records so as to avoid the waiver of any attorney-client privileges.

Under Treasury Dept. Circular 230 (which governs Tax Advisors who represent taxpayers before the IRS) tax counsel must promptly submit non-privileged records and requested information to the IRS. Tax counsel must notify the IRS of the location of requested records, information in third party possession and may not unreasonably delay the prompt disposition of any matter before the IRS (Circular 230, 10.23).

However, if any evidence or information is privileged it should be objected to at the outset of the IRS tax audit. If records are missing or are otherwise unavailable the IRS should be notified immediately. If information or records are purported to be in the possession of third parties who no longer have the records or are no longer accessible (i.e. they are no longer in the jurisdiction, are pre-deceased or otherwise) the IRS should be notified immediately.

A key audit strategy is to agree to reasonable audit expectations, time frames, and responses but at the outset narrow the scope and breadth of the audit by alerting the IRS to privilege objections, missing or otherwise unavailable records and non-responsive third party record keepers.

## VII - IRS Offshore Voluntary Disclosure Program: Declines and Withdrawals

Taxpayers with undisclosed offshore holdings who applied for the IRS Offshore Voluntary Disclosure Program (OVDP) through the pre-clearance process but were either denied access to the OVDP, or later withdrew from the program face increased risks.

On February 1, 2017 the IRS Large Business and International Division of the IRS released [a 13-item list](#) for issue-based examinations and concerns for tax compliance, which included IRS/ OVDP Declines/Withdrawals.

Under these new IRS/OVDP rules:

1. Anyone who opts out of the IRS/OVDP is subject to an immediate IRS civil tax audit of his or her tax returns and FBAR filings. Information that the taxpayer submitted in either the pre-clearance process or to the IRS/OVDP (subsequent to the pre-clearance but prior to withdrawal) may be evidence used against them.
2. The IRS filing was submitted without either transactional or use immunity. Upon submission, the Taxpayer waived constitutional objections including: the 5<sup>th</sup> amendment right against self-incrimination, 4<sup>th</sup> amendment right against unreasonable searches and seizures.
3. Increased IRS tax audits are portended for continued tax non-



compliance if the IRS receives information (not disclosed by the taxpayer) from 3<sup>rd</sup> parties including: foreign banks, foreign facilitators, or under treaty requests.

4. Much of this information is coming to the IRS based on implementation of the provisions of the Foreign Account Tax Compliance Act ("FATCA") by foreign financial institutions, or from listed foreign financial institutions who are either under settlement agreements with the US Department of Justice or are in settlement discussions (e.g. in Switzerland as of 1/25/17 145 foreign financial institutions have been "listed" by the IRS and if a taxpayer has an account with them their penalty includes a 50% account balance penalty paid up front upon submission of their IRS/OVDP offer along with tax, interest and other penalties).
5. Those US taxpayers who applied through for the IRS/OVDP through the pre-clearance process but were either denied access or withdrew from the program face a heightened risk of IRS civil tax audit, criminal tax investigation or IRS referral for US/DOJ criminal prosecution.

The IRS/OVDP for submissions made on or after July 1, 2014 require that all payments due be made up front at the time of the submission of the IRS/OVDP (see IRS Offshore Voluntary Disclosure Program Frequently Asked Questions and Answers 2014 ("IRS FAQ"). See IRS FAQ #1.1

Under the "7/1/14 IRS OVDP" (7/1/14 forward) a 50% offshore penalty applies if either a foreign financial institution at which the taxpayer has or had an account or a facilitator who helped the taxpayer establish or maintain an offshore arrangement has been publicly identified as being under investigation or as cooperating with a government investigation. See IRS FAQ #7.2 for a complete list of all 145 foreign financial institutions/facilitators as of 1/25/17 (published 1/31/17).

Under IRS FAQ #7.2, 23, 24:

For those taxpayers who request preclearance before they submit their offshore voluntary disclosure, under #23, the taxpayer must send detailed information to the IRS Criminal Investigation Lead Development Center (LDC) which includes:

1. Applicant identifying information including complete names, dates of birth, tax identification numbers, addresses and telephone numbers;
2. Identifying information of all financial institutions at which undisclosed OVDP assets (see FAQ # 35) were held including complete names (including DBAs and pseudonyms), addresses and telephone #s;
3. Identifying information of all foreign and domestic entities (e.g. corporations, partnerships, limited liability companies, trusts, foundations) through which the undisclosed IRS/OVDP assets were held by the taxpayer seeking to participate in the OVDP; this does not include any entities traded on a public stock exchange. Information must be provided for both current and dissolved entities. Identifying information for entities includes complete names including all DBAs and pseudonyms), employer identification numbers, addresses and the jurisdictions in which the entities were organized.
4. In the case of jointly filed tax returns, if each spouse intends to apply for the OVDP, each spouse should request preclearance.
5. Criminal investigation will then notify taxpayers or their representatives via fax whether or not they are eligible to make an offshore voluntary disclosure. It may take up to 30 days for Criminal Investigation to notify taxpayers or their representatives of the decision.

It should be noted that IRS pre-clearance does not guarantee a taxpayer acceptance into the IRS/OVDP. Taxpayers pre-cleared for OVDP must follow the steps outlined in IRS/FAQ #24 within 45 days from receipt of the tax notification to make an offshore voluntary disclosure. Taxpayers must truthfully, timely and completely comply with all provisions of the OVDP.

Under IRS FAQ #24, Taxpayers who make an offshore, voluntary disclosure must submit their Offshore Voluntary Disclosure Letter (and attachment) to the IRS (address as designated in Philadelphia, PA). IRS Criminal Investigation will review the Offshore Voluntary Disclosure Letter and notify taxpayers or their Representatives whether the offshore voluntary disclosures have been preliminary accepted as timely or declined (usually within 45 days of receipt of a complete Offshore Voluntary Disclosure Letter).

Once a taxpayer's disclosure has been preliminarily accepted by IRS Criminal Investigation as timely, the taxpayer must complete the submission and cooperate with the civil examiner in the resolution of the civil liability before the disclosure is considered complete.

Under IRS FAQ #24.1, where spouses both desire to participate in the OVDP, they may do so jointly or separately. If spouses make a joint submission, they must include all required information and documents for each spouse and clearly indicate the intention to disclose jointly. If spouses make separate submissions each spouse must complete and submit all required information and documents.

Under IRS/FAQ #25, if the Voluntary Disclosure is accepted, the IRS Criminal Investigation Division will instruct the taxpayer or his representative to submit the full voluntary disclosure to the IRS Austin campus within 90 days of the date of the timeliness determination. The Voluntary Disclosure submission must be sent in two separate parts:

1. Payment;
2. All documents as required under IRS/FAQ #25.

Under IRS/FAQ #7, the terms of the Offshore Voluntary Disclosure Program require that the taxpayers must:

1. Provide payment, documents
2. Co-operate in the voluntary disclosure process, including providing information on foreign accounts and assets, institutions and facilitators, and signing agreements to extend the period of time for addressing Title 26 liabilities and FBAR penalties.

Regarding payment it is now due with the submission of the disclosure. Under IRS FAQ #25, the payment to the Dept. of Treasury is in the total amount of tax, interest, offshore penalty, accuracy-related penalty, and if applicable, the failure-to-file and failure-to-pay penalties, for the voluntary disclosure period. These payments are advance payments; consequently any credit or refund of the payments is subject to the limitations of IRC Sec. 6511 (see IRS/FAQ #25). These total tax, interest and penalty payments are due up front with the application submission.



Under IRS/FAQ #7, the upfront payment includes the following penalties which may in the aggregate with tax and interest “wipe out” the account:

1. Pay 20 percent accuracy-related penalties under IRC Sec. 6662(a) on the full amount of the offshore-related underpayments of tax for all years;
2. Pay failure to file penalties under IRC 6651 (a) (1), if applicable;
3. Pay failure to pay penalties under IRC 6651 (a) (2), if applicable;

The big penalty is the Title 26 Misc. penalty. The payment, in lieu of all other penalties that may apply to the undisclosed foreign accounts assets and entities, including FBARS and offshore-related information return penalties and tax liabilities for the years prior to the voluntary disclosure period, a Misc. Title 26 offshore penalty equal to 27.5%, or 50% for those listed in FAQ #7.2, of the highest aggregate value of OVDP assets as defined in IRS/FAQ # 35 during the period covered by the Voluntary Disclosure.

The suspension of interest provisions of IRC Sec. 6404(g) do not apply to interest due under the OVDP.

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