

## Tax Notes

# IRS Targets High-Net-Worth Individuals & Closely-Held Businesses

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Federal and state tax authorities are swiftly pursuing three categories of taxpayers: sole proprietors, closely-held businesses (five or fewer owners) and high-net-worth individuals. Over the past year, the IRS has initiated audits of these types of individuals with the eye on fraud. Individuals who fall into one or more of these categories need to know they are at risk and need to understand the risks (including civil audit and potential criminal prosecution).

One of the IRS audit programs is called National Research Program (NRP). Taxpayers selected for this specific program are audited for every line item on their tax return. The NRP audit results are compiled and used to better assist the IRS in determining which taxpayers should be audited in the future.

The IRS is using data analytics to identify and select “high-priority work” which is basically designed to detect non-compliance and fraud. The IRS has identified employment taxes, international transactions, abusive micro-captive insurance arrangements and cryptocurrency transactions as enforcement priorities.

### Underreporting Is the Biggest Problem

The IRS identifies three causes for the tax gap: underreporting income (via diverted receipts and/or overstated expenses), underpayment (not paying the full amount of tax due) and non-filing (failing to file an income or employment tax 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 70% of the gross tax gap or \$352 billion. The other categories represent a smaller but still significant problem. Underpayment is \$50 billion or 11% of the gross tax gap and the tax due from non-filing is \$39 billion or 9%.

### 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 audit adjustment against a wealthy taxpayer means more tax revenue for each enforcement dollar spent. Under new tax rates (the top bracket for 2019 is 37%), a \$1 million audit adjustment produces \$370,000 in tax revenue.

The IRS Strategic Plan for FY 2018-2022 includes: “Investigate criminal violations of the tax code to enforce accountability and maximize deterrence.” In other words, criminal enforcement against a medical doctor, well-known celebrity or a CFO could potentially deter others from evading their taxes.

## Caution

Investment schemes and tax strategies that seem too good to be true probably are. High-net-worth individuals and celebrities need to realize 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 their filings.

Business owners of closely-held businesses have the greatest opportunity to under report income or claim false business expenses. The IRS is clearly aware of this. As described, the IRS is working hard to identify non-compliance through data analytics which produces more focused audits.

## Records Retention

Records are required to be maintained for the last three years of filed income tax returns. These records should include accountant/tax return preparation work papers to be able to reconcile the income reported and business expenses claimed on the returns. Further documentation includes: bank statements, sales invoices, vendor invoices and assets purchased/sold contracts to verify top line revenue and business expenses.

If there are issues with unreported top line revenue or false/personal expenses being claimed, a sole proprietor or corporation/partnership may file amended income tax returns to rectify the situation(s).

With employment taxes being a priority, it is recommended that business owners review [IRS Topic No. 762](#) with their tax accountant/return preparer to consider the common law rules outlined and relationships described.

## Contact Us

If you have any questions about this article or any other tax matters, please contact your client services partner or:

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