Exploring HOT IRS PRACTICE AND PROCEDURE ISSUES

By Michael G. Goller, J.D.

I AM OFTEN ASKED BY FELLOW PRACTITIONERS, *"WHAT'S GOING ON AT THE IRS?"* LET'S EXPLORE A NUMBER OF HOT IRS ISSUES AND CONCERNS.

THE IRS BUDGET

Over the past few years, Congress has dramatically cut the IRS' budget. In fiscal 2015 alone it was cut by more than $346 million. Since 2010, the IRS' budget has been cut by more than $900 million. At some point, Congress will increase IRS funding. The only question is when.

The Obama administration's fiscal 2016 request to Congress proposes a $2 billion increase in IRS funding.This funding would allow the IRS to hire more than 9,000 new employees.

It's anyone's guess what Congress will do. However, given that the audit rate has started to decline and the tax gap (the difference between what is owed and what is paid) has continued to increase, at some point IRS funding will be restored and the IRS hiring freeze will be lifted. This means that at some time there will be a big increase in IRS audit activity.

Regardless, while IRS funding may be down, a number of issues remain "hot."

AUDITS OF HIGH NET WORTH INDIVIDUALS

There has been a large increase in the number of audits of high net worth individuals. In 2009 the IRS created its Global High Wealth Industry Group (the "Wealth Squad").This group conducts audits of well-to-do individuals and their related trusts and entities.These audits often involve very detailed requests for information and usually cover a number of different issues.

Three issues that are common in high net worth audits:

SECTION 183 HOBBY LOSS ISSUES - These cases arise when a taxpayer treats a venture, i.e. a horse farm or an airplane activity, as a business activity. The IRS often argues that the activity is "not engaged in for profit," meaning that any losses are disallowed under Section 183. In these cases it's important to spend time documenting the business purpose of the venture.

PERSONAL USE OF AN AIRPLANE - If there's a business purpose, a business may own an airplane and deduct 100 percent of the costs of the airplane. An employee who uses the airplane for personal purposes reports that use as a taxable fringe benefit. In limited situations, the value of the fringe benefit is calculated at the Standard Industry Fair Level rate, i.e. the SIFL rate. The SIFL rate is often much lower than the actual cost of owning the plane. Thus, the employee pays very little tax.

This issue is a hot IRS audit target. Often there's a dispute over whether the employee's use of the airplane qualifies for the lower SIFL rate. Further, this issue is often raised in conjunction with a Section 183 hobby loss issue.

LOSS ISSUES IN GENERAL - No one likes to lose money. However, the rich look for "paper losses" in order to offset other income. Thus, issues like the passive loss rules (Section 469), the at-risk rules (Section 465) and basis issues remain hot audit issues.

CIRCULAR 230 ISSUES - The IRS continues to modify Circular 230 so that the grasp of this ethical code reaches more and more practitioners. Thus, it's critical that the tax practitioner understand the provisions of Circular 230 and how they impact day-to-day tax practice.

VALUATION CASES - Due to the large number of gifts that occurred at the end of 2012 (recall the uncertainty about the tax law at that time), the IRS is currently conducting an increased number of estate and gift tax audits. The issue in these cases is often a valuation issue.

When defending these cases, a solid contemporaneous valuation report is critical. There are, however, many traps for the unwary when obtaining and relying upon a valuation report.

THE EMPLOYEE/INDEPENDENT CONTRACTOR ISSUE - The employee/independent contractor issue is again a hot issue with both the states and the IRS. This is so for a number of reasons, including the fact that requirements in the Affordable Care Act do not apply if a business has fewer than 50 full-time employees.

Further, the IRS, states and Department of Labor now share information on this issue on a real-time basis. Additionally, there is again a proposal being made to Congress to limit the safe harbor available to the taxpayers under Section 530 of the Revenue Act of 1978.

CAPTIVE INSURANCE COMPANIES - Simply said, the IRS does not like these. Indeed, in early 2015 the IRS included captive insurance companies on its list of the "dirty dozen" tax shelters.

A legitimate captive insurance company, which provides legitimate insurance, can work in the appropriate circumstances. However, the IRS continues to believe that many of these are not legitimate. As such, these are popular audit targets.

CONCLUSION

Even though IRS funding has declined, it is still important that we as practitioners continue to recognize the risks to both ourselves and our clients. The best strategy to defend against an IRS attack is to know what issues are hot and then take the extra time and effort to plan and document positions that pertain to those issues in the most bulletproof manner as possible.

Michael G. Goller, J.D. is a shareholder at Reinhart Boerner Van Deuren, s.c. in Milwaukee. Contact him at 414-298-1000 or mgoller@reinhartlaw.com.

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