

How the IRS Is Probing the Rich

By Karen Hube

THE INTERNAL REVENUE SERVICE IS coming down hard on wealthy taxpayers these days—and not just those who have foreign accounts.

In an attempt to recoup some of the \$350 billion in taxes the federal government estimates is due each year but not collected, the IRS is going where the money is: to folks with fat bank accounts, pricey properties, big incomes, large investments and complex tax profiles.

While the audit rate for the general population of taxpayers was 1.1% last year, it was 8.4% for taxpayers with income of more than \$1 million, and 18.4%—up from 10.6% the year prior—for those bringing in \$10 million or more. With the crackdown on the wealthy still in its infancy—it was just last year that the IRS started ramping up its Global High Wealth Industry unit, staffed with the agency's most sophisticated auditors—the audit rate is likely to climb higher.

"We want to make sure we have a meaningful presence throughout the income spectrum," says Steve Miller, deputy commissioner for services and enforcement.

A traditional audit involves a single auditor reviewing a Form 1040, used by individuals to report annual income. But for a wealthy taxpayer "you can't just look at a 1040 and know what's going on," says Bryan Skarlatos, a tax attorney at Kostelanetz & Fink in New York.

Now, with its new wealth unit, "the IRS doesn't just come in with

one person—it's a team with expertise in a number of areas," says Alan Kufeld, a principal in the family-office group at the advisory firm Rothstein Kass in New York.

There are a number of triggers that may lead the IRS to home in on a taxpayer's returns. Here are some:

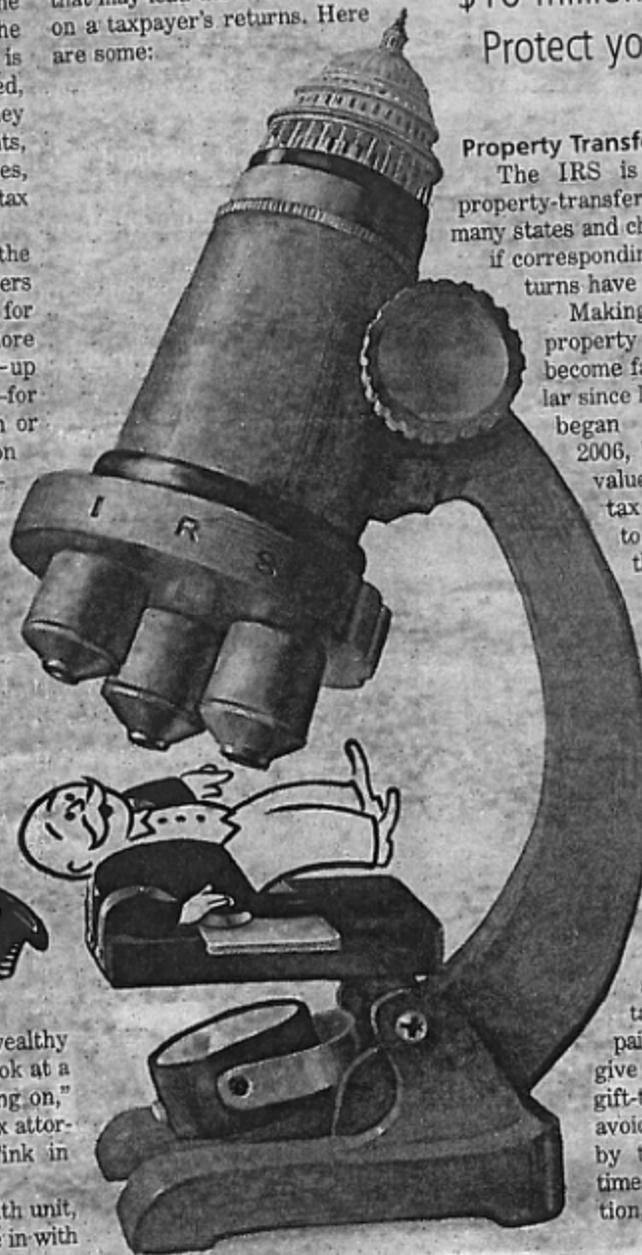
The feds are auditing nearly 20% of those earning more than \$10 million a year. Protect yourself.

Property Transfers:

The IRS is digging up property-transfer records in many states and checking to see if corresponding gift-tax returns have been filed.

Making a gift of property to heirs has become far more popular since housing values began declining in 2006, because lower values reduce the tax consequences to the giver and the heirs stand to enjoy any future appreciation of the property.

A gift-tax return must be filed for any gift valued at more than the annual \$13,000 gift-tax exclusion. But that doesn't necessarily mean that taxes must be paid. Taxpayers who give more than the gift-tax exclusion can avoid the 35% gift tax by tapping the one-time estate-tax exemption, which is much



higher.

For nine years through last year, you could use a total of \$1 million of estate-tax exemptions for gift-giving.

For this year and next year, the exemption is \$5 million or \$10 million for couples. Once the exemption is used up, you can give as much as \$13,000 to as many individuals as you like each year (\$26,000 for a couple) free of gift tax.

So for anyone who gave away property valued at more than \$1 million in recent years and didn't file a gift-tax return, the IRS may come looking to collect penalties and interest on unpaid taxes.

Certain Investment Losses:

The IRS is sniffing out false claims of investment losses by owners of Subchapter S corporations or partnerships.

When these folks invest in another, secondary business, the law prohibits using losses incurred from it to offset income in their Subchapter S corporation or partnership, unless they are actively involved in the secondary business.

Among other things, that means at least 500 hours of participation each year.

"You could be a full-time attorney who invested in a car wash as a 5% owner," says Neil Becourtney, a partner at accounting firm J.H. Cohn in Roseland, N.J.

"If you aren't involved on a regular basis and the car wash runs a loss," he says, "you can only use the losses to offset other passive income, but not active income from your business. Taxpayers are sometimes fast and loose when it comes to this, saying they were involved in a business when they weren't really."

Home-loan interest deductions:

Big deductions for interest on mortgages and home-equity loans are a major red flag.

Deductions for mortgage interest are allowable for as much as a combined \$1 million of total indebtedness on first and second homes, plus \$100,000 on a home-

equity loan in joint filings. "The IRS believes there are many situations where the limitation is not being adhered to," Becourtney says.

"If you take \$1.1 million in debt, at a 6% interest rate, that would be \$66,000 of interest. Any more than that starts to raise questions." When mortgage interest deductions exceed \$70,000, the IRS is likely to take a second look, he adds.

Foreign Income:

The IRS's well-publicized amnesty program for taxpayers with unreported foreign income ended Sept. 9, and taxpayers who run afoul of the rules on foreign-income reporting now risk not only stiff penalties but also jail time.

The IRS is going straight to banks and investment firms like Credit Suisse to demand the names of U.S. clients with foreign accounts.

Says Skarlatos of Kostelanetz & Fink: "Not only is the IRS looking at people who opened accounts in Switzerland, but in countries like India, Israel, Hong Kong and the Far East in general."

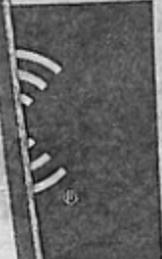
Big Spenders:

In a new program launched this year, the IRS is cross-checking taxpayers' reported incomes with their credit-card records.

So if you took a luxury world tour in a year you drew a modest income and left a trail on plastic, be prepared to defend your tax return. Through these credit-card checks, the IRS hopes to snag, among others, unscrupulous filers of Schedule C, used by taxpayers reporting profits and losses from businesses.

All in all, Schedule C filers are estimated to report just 57% of their income, leaving some \$68 billion in unpaid taxes each year.

In view of the uncollected taxes of every kind, and the IRS's estimate that for every dollar it spends on enforcement, it brings in as much as \$10, it's no wonder the agency's latest focus is on the big money. ■



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