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**If You Want Peace, Prepare for War: Audit Strategies for High Net Worth Individuals**

**By Patrick J. McCann, Jr.**

During a tumultuous year where the hits keep coming, high net worth individuals may find themselves the focus of unwanted attention from the Internal Revenue Service (IRS) as they move into the fourth quarter of the year. This summer Douglas O'Donnell, the Commissioner of the IRS's Large Business and International Division (LB&I), announced the IRS would begin a new campaign initiating several hundred audits of high net worth individuals. That announcement came quickly after a report[[1]](#endnote-1) by the Treasury Inspector General for Tax Administration that the IRS was not doing enough to focus its resources on high net worth individuals. The report estimated that such individuals owed billions of dollars in unpaid taxes that were not being properly pursued by the IRS. The new examinations announced by Mr. O'Donnell will be conducted by a specialized group of examiners in the Global High Wealth Industry Group at LB&I nicknamed "the Wealth Squad". The Wealth Squad specializes in taking a holistic approach and examining the types of complex financial transactions and holdings that are more common among high net worth individuals.

**Role Of The Wealth Squad**

As the Wealth Squad begins to send out notices to targeted high net worth individuals, their professional advisors need to be prepared to develop an effective strategy for representing their clients through the audit process and beyond. That strategy includes making a high level review of their clients business and financial holdings, identifying potential issues, developing the roles the respective professional advisors will play during the audit, and how to best respond to requests for documents or interviews with their clients. One of the most important items during the examination is to ensure that the taxpayer is protecting any privileged communications and preserving objections to the government's requests in the event of any future litigation. By developing this plan early on, the professional advisors give themselves adequate time to identify potential issues and develop strategies for addressing those potential issues. This allows them to be proactive rather than constantly reacting to the examining agent's requests and scrambling to catch up.

LB&I has an established examination process[[2]](#endnote-2) that outlines the phases of an LB&I examination and the steps that occur during each stage. Professional advisors should review the LB&I examination process to help them formulate their plan for representing their clients through the examination. As an initial matter, professional advisors to high net worth individuals need to make a thorough review of their client’s business and financial holdings and identify any areas upon which the government may be likely to focus. LB&I has a number of ongoing active campaigns[[3]](#endnote-3) that can provide advisors a road map for potential areas of sensitivity. Among those campaigns are issues related to offshore holdings and foreign transactions, syndicated conservation easement transactions, Section 831(b) captive insurance companies, private foundation abuses, and S corporation issues related to excess losses, built in gains, and shareholder distributions. By identifying these issues early, professional advisors are able to identify any other parties that may have information relevant to that issue and work to gather any relevant documents ensuring adequate time to review that information and develop a strategy for addressing the potential issue. However, professional advisors should not assume that a particular transaction will become an area of focus of the examination.

**What To Do When An Issue Is Identified**

Upon identification of the potential issues that may become a focus of the audit, a decision needs to be made as to who among the taxpayer's professional advisors is in the best position to handle the examination and interact directly with the IRS. Section 7521(c) grants the representative the right to handle any interview without the taxpayer present, absent a summons and the professional advisor should limit direct interaction between their client and the examiner. Generally, the taxpayer's CPA is in the best position and should handle the interaction with the Revenue Agent. However, if an examination is likely to include estate and gift tax items where legal issues predominate, an attorney should represent the taxpayer since the IRS will be using an Estate and Gift Tax Attorney to conduct the examination. Similarly, in large cases that are likely to end up in litigation, an attorney should be engaged early to help develop a strategy for the audit with an eye towards litigation. If there is any hint that anything in the audit could be construed as some form of fraud or misrepresentation by the taxpayer, everything must stop immediately, and an attorney who handles criminal tax defense needs to be engaged.

One of the most important aspects of an examination is to maintain privileges and preserve objections in the event of any future litigation. Section 7525(a)(1) extends limited protection for certain tax practitioner communications for non-criminal tax matters if such communication would have been privileged if it were a communication between a taxpayer and an attorney. If an attorney has been engaged, the parties should execute a *Kovel* agreement to extend the attorney-client privilege to the taxpayer's non-attorney professional advisors. Given the likely complexity of a high net worth taxpayer's business and financial holdings, it is likely that there could be a number of potential professional advisors that will be needed to assist in audit with whom *Kovel* agreements should be entered into to protect their communications related to the audit. The Section 7525 limitation to non-criminal matters is also why it is imperative to engage an experience criminal tax attorney at any suggestion that there could be a potential criminal tax issue.

Following the initial audit notification from the Wealth Squad, the examining agent is likely to begin making requests for certain documents related to the taxpayer and his business and financial holdings. Unlike a summons, an Information Document Request (IDR) has no statutory authorization outside of the general power of the IRS to examine returns. However, timely responses to IDRs help establish cooperation and reduce the likelihood that the government will feel the need to issue a summons. It is important during this stage to maintain objections to any requests and preserve privileges. Among the potential objections are that the requests are overly broad, unduly burdensome, or vague, that the request has provided inadequate time to comply, or that the documents are not within the taxpayer's possession, custody, or control. If the requests come in the form of a Summons the government must be able to establish that it was issued for a proper purpose, that the information that is sought is relevant to an existing examination, that all administrative and statutory procedures have been satisfied, and that the information is not already in the possession of the IRS. The IRS cannot compel taxpayers to waive privileges, however, any conduct by the taxpayer *or his or her representative* that is inconsistent with the maintenance of privilege can operate as a waiver. The overarching goal while representing a high net worth individual as part of an audit is to cooperate with the audit and the government's requests for documents while protecting your client by preserving objections and privileges. Cooperation does not mean waiving privileges, limitations periods established by the statute of limitations, or other rights that protect taxpayers.

**What’s Next**

High net worth individuals receiving audit notifications from the Wealth Squad should be prepared for a thorough examination of their business and financial holdings that includes their personal information along with the information of any entities in which they hold an interest, including any domestic or foreign corporations, partnerships, trusts, or charitable foundations. Their professional advisors need to be prepared by reviewing their clients' network of business and financial holdings and identifying potential issues that may arise during an audit. Using the resources published by LB&I, professional advisors can identify any potential issues that may fall under one of LB&I's active campaigns and work to develop a strategy for addressing that potential issue throughout the LB&I examination process. That strategy includes determining who is in the best position to represent client and serve as the fact of the audit. All communication should flow through that advisor and limit direct interaction with the client to the extent possible. All of this should be done with an eye towards potential future litigation. While future litigation is all about offense, the audit is about defense and protecting the client by preserving the client's privileges, objections, limitations periods, and other statutory protections.

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1. https://www.treasury.gov/tigta/auditreports/2020reports/202030015fr.pdf [↑](#endnote-ref-1)
2. https://www.irs.gov/pub/irs-utl/p5125.pdf [↑](#endnote-ref-2)
3. https://www.irs.gov/businesses/corporations/lbi-active-campaigns [↑](#endnote-ref-3)