

## **IRS Focus on High-Income and High-Wealth Individuals: An Update**

by Andrew R. Roberson, Michelle Marion, Garrett J. Hahn, and Tracey Spivey

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In this installment of Practically Speaking: Tax Controversy, the authors update their prior article on the IRS's renewed focus on audits of high-income and high-wealth individuals by discussing recent IRS activity and experiences in these audits.

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At the end of 2023 we examined the evolution of the IRS Global High Wealth Industry Group, the IRS's renewed focus on audits of high-income and high-wealth (HIHW) individuals, and identified issues one might expect to confront in an HIIHW audit.<sup>1</sup> Much has changed since then, raising many questions, including whether the IRS will continue to focus on HIIHW audits. But

regardless of whether the HIIHW audit rate increases, stays the same, or decreases (in light of the new administration's priorities, reductions in the IRS workforce, and cuts in IRS funding), HIIHW taxpayers and their advisers should continue to be prepared and maintain best practices to navigate these audits.

### I. Update on HIIHW Audits

As explained in more detail in our prior article, as part of the Inflation Reduction Act, the IRS received over \$45 billion in funding

<sup>1</sup> Andrew R. Roberson, Michelle Marion, and Garrett J. Hahn, "IRS Refocuses on Enforcement of High-Income and High-Wealth Individuals," *Tax Notes Federal*, Dec. 4, 2023, p. 1801.

specifically for enforcement efforts. However, as a result of the debt ceiling negotiations, more than \$20 billion of that funding was either rescinded or repurposed. And another \$20 billion has been frozen and will likely be rescinded.<sup>2</sup> So, what does this mean for IRS enforcement efforts in general, as well as HIHW audits?

Before the most recent cut in funding for IRS enforcement, the agency announced its intent to increase the HIHW audit rate, and it actively published results of its collection efforts from HIHW individuals.

In the agency's May 2024 annual update on its strategic operating plan (the IRS's blueprint outlining various plans since the passage of the IRA), the IRS announced that it would increase audit rates by more than 50 percent on HIHW individuals with total positive income exceeding \$10 million.<sup>3</sup> The announced increase was from an 11 percent audit rate for this HIHW population in 2019 to 16.5 percent by tax year 2026.

On September 6, 2024, the IRS reported that in the six months since announcing an initiative to pursue 125,000 HIHW taxpayers who had not filed a tax return since 2017, nearly 21,000 of those taxpayers filed returns, leading to \$172 million in taxes being paid.<sup>4</sup> The IRS also reported the recovery of over \$1.1 billion in delinquent tax debt from taxpayers with more than \$1 million in income and over \$250,000 in recognized tax debt.<sup>5</sup>

It is difficult to predict where HIHW audits will go from here given the reduced funding and the new administration's actions through the Department of Government Efficiency, which resulted in the termination of nearly 7,000 IRS employees in February 2025, and the acceptance of the Office of Personnel Management's deferred

resignation offer by another 4,000 to 5,000 IRS workers.<sup>6</sup> The terminations in February included IRS revenue agents in the Large Business and International and Small Business/Self-Employed enforcement divisions, each of which audits HIHW taxpayers.<sup>7</sup> The sudden nature of the reduction in workforce begs the question whether taxpayers will experience delays in the resolution of ongoing examinations following reassessments to new exam team members. Many partnership specialists hired by the IRS joined before the January 2024 hire date of probationary workers targeted by the February layoffs, such that the involvement of the new passthrough compliance unit in HIHW cases may not be as affected as other units involved in those cases; however, more staffing cuts appear to be on the horizon.<sup>8</sup>

Notwithstanding these developments, it is clear the IRS is continuing to focus on areas it perceives as high risk regarding the HIHW taxpayer population. With fewer resources, data analytics and targeted enforcement will be key to meeting the IRS's strategic objectives.

## II. IRS Campaigns

LB&I publishes a list of its active campaigns, which includes dozens of issues the division has identified as risk areas for tax compliance.<sup>9</sup> LB&I started using campaigns in 2017. When a new campaign is announced, LB&I identifies the practice area, lead executive, and point of contact, and provides a description of the purpose for the campaign.

We discuss three campaigns relevant to the HIHW taxpayer population: (1) the business aircraft campaign; (2) sports industry losses; and (3) the Self-Employed Contributions Act (SECA) tax. Our observations on each campaign are set forth below.

<sup>2</sup>For a more complete discussion, see Cady Stanton and Benjamin Valdez, "\$20B in IRS Enforcement Funds Set to Remain Frozen Into March," *Tax Notes Federal*, Dec. 23, 2024, p. 2442.

<sup>3</sup>IR-2024-130; Stanton, "Senate Passes Stopgap Stripping \$20B From IRS, Avoiding Shutdown," *Tax Notes Federal*, Mar. 24, 2025, p. 2265. In its May 2024 update to the strategic operating plan relating to the IRA, the IRS announced plans to triple large corporate audit rates, from 8.8 percent in 2019 to 22.6 percent in tax year 2026, and to increase large, complex partnership audits tenfold from 0.1 percent in 2019 to 1 percent in tax year 2026. IR-2024-130.

<sup>4</sup>IR-2024-233.

<sup>5</sup>Id.

<sup>6</sup>See Valdez, "IRS Begins Laying Off Thousands of Employees Amid Filing Season," *Tax Notes Federal*, Feb. 24, 2025, p. 1495; and Lauren Loricchio, "Tax Professionals Observe Impact of IRS Layoffs," *Tax Notes Federal*, Mar. 17, 2025, p. 2096.

<sup>7</sup>Additional impacts may be felt by taxpayers at the conclusion of an examination as the result of reductions in tax computation specialists and staff in the case closing units.

<sup>8</sup>See Valdez, "IRS to Pause Technology Modernization Work," *Tax Notes Federal*, Mar. 24, 2025, p. 2274.

<sup>9</sup>A list of LB&I's active campaigns can be found on the IRS's website.

## A. Business Aircraft Campaign

In February 2024 the IRS rolled out its LB&I campaign targeting personal use of business aircraft. This campaign focuses on ensuring that large corporations, large partnerships, and HIHW taxpayers comply with the relevant authority when claiming deductions for qualified business use and fringe benefit reporting for personal use. Accordingly, HIHW individuals and entities within their enterprise that hold private aircraft are potentially subject to additional scrutiny over business deductions related to the aircraft and the personal benefit an individual may derive from its use.

Under the business aircraft campaign, the IRS seeks to address, among other items: bonus depreciation expense, the appropriateness of deductions based on the use of aircraft, any leasing issues associated with the property, and the inclusion in income of the value of personal use of aircraft by the recipient. To the extent an aircraft is leased to another entity within an individual's enterprise, the IRS may also review whether that leasing activity is properly treated as a passive activity on the HIHW individual's personal tax return.<sup>10</sup>

In all these areas, recordkeeping is essential. First and foremost, flight logs and contemporaneous documentation of the business purpose for each passenger are crucial (including the relationship of any guests to a service provider). That documentation will support tax treatment and reporting on multiple fronts, such as the aircraft's predominant use in a qualified business for purposes of eligibility for bonus depreciation and the avoidance of depreciation recapture,<sup>11</sup> as well as the allocation of expenses between business and personal use. Moreover, to the extent that personal, mixed-use, or entertainment purposes are well documented, this will support the amounts reported as fringe benefits to service providers on Forms W-2 or

other information returns<sup>12</sup> or excluded as entertainment expenses under section 274.

Appropriate recordkeeping in the context of aircraft use by closely held entities reduces the potential for compliance risks in the areas discussed above. Therefore, the preparation of an audit-ready file that covers the foregoing items of information and documentation is conducive to efficient resolution of a business aircraft campaign examination.<sup>13</sup>

## B. Sports Industry Losses

In January 2024 the IRS announced an LB&I campaign targeting partnerships reporting significant losses within the sports industry. The campaign's stated intent was to ensure compliance with income and deduction provisions of the Internal Revenue Code. Few details were announced. However, in cases involving closely held sports franchises, the propensity for this campaign to be paired with an HIHW examination was clear. This is especially true considering other LB&I campaigns targeting losses in excess of basis, as well as excess distributions.

Despite the significant value some sports franchises represent and the positive cash flows they may generate, significant tax deductions may result from the amortization of franchise costs, player contracts, broadcasting contracts, and other intangibles. Because of this, a sports franchise partnership may generate large tax losses allocable to its partners that ultimately offset the income of HIHW taxpayers. Thus, this campaign implicates potential verification of the application of loss limitation rules under section 465 (at-risk limitations), section 469 (passive activity loss limitations), and section 461(l) (excess business loss limitations applying to individuals). For other deductions associated with sports franchises held through partnerships, another potential compliance risk may lie in the determination of the qualified business income

<sup>10</sup> Whether the leasing of an aircraft results in a passive activity depends on the facts and circumstances of the lease and whether that activity can be grouped with another trade or business activity constituting an appropriate economic unit and whether the appropriate activity grouping statements have been made. See reg. section 1.469-4, and Rev. Proc. 2010-13, 2010-4 IRB 349.

<sup>11</sup> See sections 168(k), 280F(b)(1), and 280F(b)(2).

<sup>12</sup> See reg. section 1.61-21 for valuation of employer-provided flights as taxable fringe benefits to service providers.

<sup>13</sup> For a detailed treatment of the IRS's business aircraft campaign, see Justin Donatello, Roberson, Rachel A. Garcia, and Kira Bivans, "Charting a Course Through the IRS's Business Aircraft Campaign," *Tax Notes Federal*, Oct. 23, 2024, p. 751.

deduction by individuals holding interests in those partnerships. This is because the regulations under section 199A include services performed in the field of athletics as a specified service trade or business.<sup>14</sup> Moreover, as amended, section 1031 no longer allows player contracts to qualify for like-kind exchange treatment. Therefore, under this campaign, the IRS will ensure appropriate gains are recognized on player trades.

Large partnerships holding sports franchises that are controlled by HIHW individuals fall within several general and specific areas of targeted enforcement. As is so often the case with taxpayers finding themselves in a confluence of targeted populations, fortune favors the prepared.

### C. SECA Tax

As relevant to the SECA campaign, the IRS continues to pursue some (albeit fewer) cases in which it believes partnership allocations should have been treated as net earnings from self-employment under section 1402(a), particularly in service partnerships but also in other operating partnerships. IRS victories in *Soroban Capital Partners*<sup>15</sup> and *Denham Capital Management*<sup>16</sup> have added more hazards to certain partnerships in which an individual is providing services to the partnership and exercising control in the day-to-day business activities but no portion of allocations to that individual are treated as net earnings from self-employment.<sup>17</sup>

Even when a partner receives a guaranteed payment, the IRS could take the position that the partner's entire distributive share is subject to self-employment tax if, by virtue of a functional analysis like the one undertaken by the Tax Court in *Denham Capital Management*, the partner is not

akin to a passive investor. Still, cases to date have focused on limited liability partnerships, limited partnerships, professional services limited liability companies, and professional limited liability partnerships deriving income primarily from services in which the limited partners had significant roles. They have not focused on partnerships in which the partners' allocable shares of income or loss are largely unrelated to their participation and the services performed on behalf of the partnership (that is, income related to returns on capital investment). Accordingly, in addition to functional analyses, some operating partnerships within a HIHW individual's enterprise should consider distinguishing the partnerships' business activities and income streams from those addressed in the cases cited above, which have income streams tied more directly to a partner's time, judgment, and expertise. It is also important to note that while the Tax Court applies *stare decisis* to the cases before it, appeals beyond the Tax Court may result in decisions that ultimately depart from the functional analysis applied by the Tax Court.

Taxpayers should also be aware of technical and procedural complications posed by SECA tax adjustments (a chapter 2 tax) in the context of partnerships subject to the centralized partnership audit regime created under the Bipartisan Budget Act of 2015, since BBA partnership audits apply only to chapter 1 taxes. Thus, care should be taken to ensure the IRS follows appropriate exam procedures at both the partnership and individual partner levels in those circumstances.

## III. Types of HIHW Examinations

Not all HIHW taxpayer examinations are the same. Some audits are conducted by LB&I while others are conducted by SB/SE. There are important differences depending on which division is handling the examination. Below we highlight some of these differences and include our own observations.

### A. LB&I Examinations

LB&I handles the largest and most complex examinations of taxpayers. Generally, its examinations involve one or more revenue agents as well as subject matter experts in various tax

<sup>14</sup> Reg. section 1.199A-5(b)(1)(viii) and (2)(viii).

<sup>15</sup> *Soroban Capital Partners LP v. Commissioner*, 161 T.C. 310 (2023).

<sup>16</sup> *Denham Capital Management LP v. Commissioner*, T.C. Memo. 2024-114.

<sup>17</sup> In *Sirius Solutions LLLP v. Commissioner*, No. 30118-21 (T.C. Feb. 20, 2024), the parties agreed that *Soroban* was precedential and stipulated to a decision in the IRS's favor. The taxpayer appealed to the Fifth Circuit, briefs were filed, and oral argument was held February 6. See Kristen A. Parillo, "IRS Limited Partner Argument Gets Cool Reception at Panel Hearing," *Tax Notes Federal*, Feb. 10, 2025, p. 1157. Additional cases of note in this area include *Renkemeyer, Campbell & Weaver LLP v. Commissioner*, 136 T.C. 137 (2011); and *Castigliola v. Commissioner*, T.C. Memo. 2017-62.

areas. In the HIHW context, an IRS examination handled by LB&I starts with the individual taxpayer's Form 1040 but, depending on the circumstances, it may expand to include other entities in which the individual has interests (that is, an enterprisewide audit). Further, LB&I generally focuses on specific areas it perceives to be high risk (or requests samples of various items) instead of examining all entries or reporting made on the tax return.

LB&I examination procedures that used to apply only to the largest corporations now also apply to the HIHW audits it handles, including the division's mandatory information document request procedures.<sup>18</sup> These IDR procedures, implemented in July 2013, generally prohibit revenue agents from issuing IDRs in final form before first providing a draft IDR and discussing the contents with the taxpayer or its representative. Moreover, LB&I examiners are required to work with taxpayers to discuss and determine a reasonable time frame for most IDR responses. Mandatory IDR enforcement procedures also apply to HIHW audits run by LB&I, providing the steps auditors must follow when an IDR response is delinquent.<sup>19</sup>

Importantly, the emphasis LB&I places on cooperation, responsiveness, and transparency in its audits<sup>20</sup> may influence how an HIHW audit is managed by an LB&I examiner.

As noted above, the defining feature of an enterprisewide audit is that numerous taxpayers are under audit simultaneously, which poses several challenges for taxpayers. The most obvious, perhaps, is the burden associated with the volume of IDR requests coming through the door. It is essential for the tax department, management team, or family office, as applicable, to stay organized. An IDR log, a best practice in most cases, becomes a necessity. We have seen teams lean heavily on advisers, hire individuals dedicated to the audit, or do a combination of the above to keep up with the seemingly constant IDR deadlines.

<sup>18</sup> LB&I-04-0613-004, "Large Business & International Directive on Information Document Requests (IDRs)" (June 18, 2013).

<sup>19</sup> *Id.*

<sup>20</sup> Publication 5125, "Large Business & International Examination Process" (rev. May 2023).

In these audits it is not uncommon for internal teams to be dealing with different groups of return preparers or advisers across the population of taxpayers subject to audit. While this may not be necessary or the desirable approach in all cases, we often see the best results when the different advisers work together as part of a larger team, sharing information and strategies, as permitted, to get the IRS comfortable with the returns at issue as quickly and efficiently as possible.

Handling an LB&I examination requires developing a relationship with each revenue agent or specialist that "owns" a particular issue or audit area. Problems can arise when an agent or specialist is unwilling to engage directly with the taxpayer or its representative, and the team coordinator is hands off on issues for which a specialist has primary responsibility. These problems can be compounded in enterprisewide audits, when numerous specialists may be assigned to the various taxpayers subject to audit across the overall structure, IDRs may be duplicative, and it is difficult to speak one-on-one with the specialist. Accordingly, it is important to develop a strong relationship with the team coordinator and ensure that access is allowed for the specialist to freely and openly discuss issues.

## B. SB/SE Examinations

Unlike LB&I examinations, SB/SE examinations of HIHW taxpayers may involve only one revenue agent and their manager. Moreover, these examinations may not be as issue-focused as an LB&I examination but rather may focus more on substantiation of tax return positions. For Schedule C or Schedule F activities, revenue agents may also require that they be allowed to conduct a site visit.

For example, in SB/SE examinations it is common to see an initial IDR that requests substantiation of many different items reported on the tax return, including: (1) copies of the tax return for the year under examination, as well as prior- and subsequent-year returns; (2) all bank account and credit card statements; (3) all Schedules K-1; (4) proof of payment and contemporaneous written acknowledgments for all claimed charitable contributions; (5) documentation related to any Schedule C

activities; and (6) documentation related to any Schedule F activities.

Taxpayers receiving broad requests for information should try to work with the revenue agent to see if they can decrease the amount of information required, either through a reduction in the requests or a sampling when a substantial amount of information has been requested. In our experience, some revenue agents are willing to work together on a representative sample of substantiation for a particular return item and, if the documents produced are sufficient, the agent will turn their focus to other issues on the return.

As noted above, SB/SE examinations are very different from LB&I examinations. We have found that it is important to maintain regular contact with an SB/SE revenue agent to ensure that the examination is moving forward and that there are no surprise adjustments. When legal disagreements are encountered, particularly in complex areas, it may be wise to request that the revenue agent's manager become involved. Unlike LB&I examination teams, SB/SE revenue agents are generally handling several examinations simultaneously and may not have the time necessary (through no fault of their own) to engage in the required research and attention to a complex issue.

### C. Areas of Focus in HIHW Examinations

We covered this in our prior article,<sup>21</sup> but it is worth summarizing the following 10 general areas of focus in HIHW examinations.

#### 1. Reportable transactions and campaigns.

These include syndicated conservation easements, microcaptive insurance, partnership and S corporation issues (distributions and losses exceeding basis), SECA tax, virtual currency, and offshore private banking.

#### 2. Schedule C or passthrough losses.

These include "hobby" losses, such as horse racing or breeding and private airplane and yacht charters. Entities with sustained losses over several years that reduce or offset income of an individual are almost always looked at, and extraordinary losses (that is, a potential large,

unusual, or questionable item) from a flow-through entity even for a single year can be an item of targeted review.

#### 3. Material participation.

The passive activity loss limitations under section 469 are a frequent examination target. The more entities and industries there are within an enterprise, the more likely this item of review will arise. Appropriate and accurate grouping elections are important in this context.

#### 4. Foreign-source income and assets, including financial accounts, foreign retirement accounts, and foreign trusts.

Examinations targeting egregious nonfilers and individuals who use foreign accounts to avoid the disclosure of offshore assets have been on the rise for many years. Substantial penalties are at stake for noncompliant taxpayers.

#### 5. Private foundations.

The IRS is interested in the use of private foundations by HIHW taxpayers. Areas of scrutiny include self-dealing issues, related-party transactions, contributions to nonpublic charities, and trustee and employee compensation.

#### 6. Charitable contributions.

Substantiation and valuation are often the key items examined, and the contributions can range from run-of-the mill gifts to local charities to higher-dollar items such as art donations and conservation easements.

#### 7. Meals and entertainment.

The IRS investigates whether deductions claimed for meals and entertainment should be disallowed under the guidance in section 274 and its regulations. Specific substantiation rules also apply for entitlement to claimed deductions.

#### 8. Business versus personal expenses.

The initial interview portion of the opening conference for selected enterprise entities will include questions about whether there are any aircraft, watercraft, or vehicles held by the entity and used in its trade or business and whether those assets are available for the personal use of the HIHW individual. These inquiries may also include questions about whether the entity has real property or leased properties subject to personal use by the HIHW individual.

<sup>21</sup>Roberson, Marion, and Hahn, *supra* note 1.

## 9. Related-party transactions.

The IRS will inquire about any contracts, agreements, or transactions between related parties in the HIHW individual's enterprise. The IRS has noted that the complexity of passthrough structures and the potential for income shifting or circular cash flows in closely held enterprises are an area of particular concern.

## 10. Gifts and bequests made or received.

The IRS will investigate any large gifts or bequests to ensure that proper reporting requirements have been met. For noncash transfers, valuation may become an area of focus.

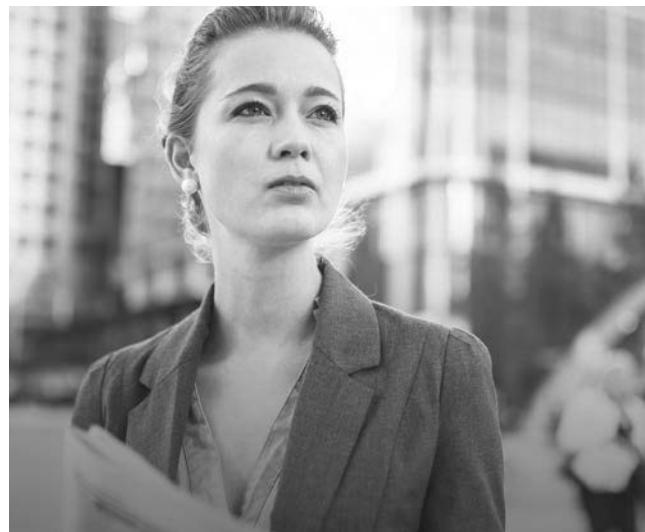
## IV. Conclusion

Over the last several years, the IRS has emphasized the importance of HIHW audits to its overall strategy.<sup>22</sup> Because that view has remained constant across different administrations, we believe the IRS will continue to prioritize audits of HIHW individuals (even if that prioritization looks different from how it was envisioned in 2022 with the IRA's passage). Accordingly, taxpayers that may fall into this HIHW population — admittedly a sliding scale, but one that now includes individual taxpayers making more than \$400,000 — should continue to be thoughtful about their return positions, consider whether they have exposure for positions taken on prior-year returns and their options for remediating such exposure, and address any gaps in documentation. ■

<sup>22</sup> See, e.g., memorandum from then-Treasury Secretary Steven Mnuchin to then-IRS Commissioner Charles P. Rettig (Feb. 10, 2020) (directing the IRS to audit a minimum of 8 percent of all high-income individual returns filed each year) [available as Appendix II to the Treasury Inspector General for Tax Administration report cited below]; letter from then-Treasury Secretary Janet Yellen to Rettig (Aug. 10, 2022) (directing the IRS to focus on high-end noncompliance and excluding from that definition households making under \$400,000 annually). While HIHW audits can be more demanding (measured by the number of hours auditors devote to the audit), the average amount of tax dollars assessed per hour of investment is higher and harder for those in tax administration to ignore. This is especially true for individuals with income of \$10 million or more. See, e.g., TIGTA, "The IRS Ceased Compliance With the \$10 Million Treasury Directive in Favor of an Overall Focus on High-Income Taxpayer Noncompliance," 2024-300-028 (June 20, 2024).

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