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IRS ISSUES

Foundations: IRS Launches Review Project

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About a decade ago, the Internal Revenue Service launched an initiative targeting "high net worth families." This project was designed to look well beyond just the individual 1040s of the nation's very wealthy to their related entities including private foundations. It "lasted a little while and then fizzled out a few years later," according to law professor Phil Hackney who was in the IRS Chief Counsel's Office at the time. This push apparently ended "… without much to show for itself."

But Professor Hackney and others – including the IRS itself – now tell us that the agency had planned (even before COVID-19 shut down most of the agency's operations for a few months) to "take another cut at this issue."

Probes of Foundations: Reasons

This effort "appears to be in reaction to various factors" including criticism (from a number of quarters) to disclosures that the IRS had, for several years, focused much of its audit activity on *lower-income* taxpayers instead of on the much more productive target of the financial elite.

In early March 2020, Treasury Secretary Steven Mnuchin appeared before the House Ways and Means Committee. Responding to questions by Rep. Judy Chu (D-CA) on this problem, Mnuchin said: "I have specifically directed the IRS commissioner to come up with a plan to increase the amount of funding so that we can audit more high-income earners, so that is specifically in our plan."

In addition to Congressional scrutiny of this odd audit strategy, there was a recommendation by a Treasury Department inspector general that the agency "… increase its focus on certain high-income taxpayers."

The recently announced project has also been described as "complement[ing] other initiatives at the IRS focused on high-income individuals, and those aimed at better understanding taxpayer behavior to improve future audit practice."

During the COVID-19 quarantine, enough activity continued – virtually – to produce evidence that the Internal Revenue Service "… is making good on that promise" by Secretary Mnuchin. At an NYU Tax Controversy Forum on June 18, 2020, Douglas O'Donnell, the Commissioner of the IRS Large Business and International ("LB&I") Division, told conference attendees in cyberspace that the agency will open "several hundred new audits involving high-income individuals" beginning at the previously announced July 15th reopening date.

These tax examinations will focus on the wealthy "who have a connection with at least one pass-through entity such as a partnership or S-Corporation, or a connection with a private foundation." The IRS's Global High Wealth Industry Group – known more colloquially as the "Wealth Squad" and housed within the LB&I Division – will take the lead on these audits. The enterprises targeted by the Wealth Squad typically "are generally controlled by individuals with assets or earnings in the ten of millions of dollars."

This new audit project will span several IRS divisions including the Tax-Exempt and Government Entities (TE/GE) Division that has responsibility for oversight of private foundations. Director Tamera Ripperda has announced that over "1,000 cases of private foundations that are connected to high income or high net worth individuals" have been identified and audit case files have been opened.

The Foundations Angle

So far, there seems to be "limited guidance" on the scope and extent of the examination of the private foundations connected with the targeted high-wealth individuals and families. But it's been reported that the Internal Revenue Service is "particularly interested in auditing whether those private foundations have engaged in prohibited 'self-dealing,' such as making loans to a disqualified person."

Of course, the definition of "self-dealing" within the Internal Revenue Code includes acts far broader than insider loans. It can include as well transactions between a private foundation and a disqualified person involving – just to name some: (1) the sale, exchange, or leasing of property, (2) providing goods, services, or facilities, (3) paying compensation or reimbursing expenses, or (4) transferring foundation income or assets to, or for the use of benefit of, a qualified person." There is also " indirect self-dealing" which includes transactions between organizations controlled by a private foundation.

Conclusion

Of course, the examinations may go well beyond issues of direct and indirect self-dealing to matters otherwise regularly raised in audits of private foundation.

And those who receive audit letters in connection with this new initiative should also understand that the private-foundation element – even if conducted by TE/GE agents – will be just a part of a more comprehensive examination of a target individual's financial picture.