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## INSIGHT: Athletes, Artists, and Audits—IRS Renews Focus on Global High-Wealth Individuals



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The Internal Revenue Service Global High Wealth Program announced via webcast on June 18 that it will be reviewing hundreds of high-income individuals' tax returns between July 15 and Sept. 30. Each review is expected to include both individual tax returns as well as the returns of related business entities, with a focus on "pass-through" entities and partnerships.

These reviews pose particular exposure for sports owners, athletes, entertainers, and others in these industries, who often have high incomes and other business interests conducted through pass-through entities.

### TRIGGERING EVENTS

The IRS's review comes at a confluence of several important trends.

First, the coronavirus (Covid-19) pandemic has caused governments to not only spend extraordinary amounts to combat the health and economic effects of the pandemic but also to have lost billions of dollars in tax revenues worldwide. [One report estimated that, as of mid-April, the state of New York alone was facing a shortfall of more than \\$10 billion in tax revenue.](#) The U.S. is no exception, and the federal government (along with state and local agencies) will soon be turning their attention to maximizing their ability to collect more tax revenue to shore up their coffers.

Second, the IRS has recently faced increased criticism due to a perceived failure to audit high-income individuals.

Third, recent amendments to the tax code—including the Bipartisan Budget Act of 2015 (BBA), which supplanted the regime for auditing partnerships, and the

Tax Cuts and Jobs Act of 2017 (TCJA), which dramatically altered key rules for U.S. taxation of income earned domestically and abroad—created complexities and planning opportunities that the IRS has only begun to investigate.

Adding to the above factors, [taxpayers in the sports and entertainment industries have long been a focus of IRS attention, and recent years have been no exception.](#) Thus, as it often is in sports and entertainment, the stage is set for a showdown.

### CONSIDERATIONS & INSIGHTS

#### Athlete and Entertainer Income Sources Make Them Likely Targets

Unlike the typical salaried employee, athletes, entertainers, and other performers often earn income outside of a fixed salary subject to wage withholding. For example, athletes may receive payments for endorsements of products or services, and for professional appearances. This income is generally not subject to withholding and potentially exposes individuals to IRS challenge as to how the income was reported and how much tax was due. Further, athletes may earn income through holding companies established for liability and financial security reasons.

This type of structure—high-income individuals, related business entities, and reporting positions subject to challenge—is arguably exactly what the Global High Wealth Program is targeting in its looming review. Further, opportunistic investors are increasingly eyeing prized sports assets and investments in the sports industry during the ongoing Covid-19 pandemic. Collapsing broadcast, game day, and commercial revenues has

forced sports federations, leagues, owners, and organizations into survival mode. Private equity firms and other investors are looking to make strategic acquisitions. This increased activity in the sports investment community is also likely to focus the Global High Wealth Program toward sports and entertainment figures as an area of audit opportunity.

## Changes in Tax Law Add Fuel to the (Audit) Fire

Recent material changes in tax law—via the TCJA and BBA—have left many holding-company and pass-through structures open to uncertainties, as implementation of the new laws is subject to new regulations, administrative interpretations, and other agency guidance, as well as being largely untested in the courts.

The Global High Wealth Program is likely to review high-income individuals' tax positions in light of these uncertainties to obtain a roadmap of how these individuals (and related entities) might be both complying with—and taking advantage of—the TCJA. Moreover, the economic ramifications of Covid-19 already have caused massive declines in tax revenue. The Global High Wealth Program necessarily will be incentivized to identify audit targets that may help ameliorate any shortfalls.

## Recent Guidance May Change the Game

To further complicate matters, the IRS may view its guidance with respect to compensation of athletes, entertainers, and similar performers to be clearer (and perhaps even more favorable) under U.S. tax law now than in recent years due to certain recent pronouncements. In the IRS's view, they may have no excuses left not to play the (audit) ball. For example, the IRS recently issued a revenue procedure, [Rev. Proc. 2019-18](#), providing a safe harbor for a professional sports team to treat certain personnel contracts and rights to draft players as having a zero value for determining gain or loss to be recognized for federal income tax purposes on the trade of a defined personnel contract or a draft pick.

Pre-TCJA, these trades were generally considered tax-deferred like-kind exchanges for purposes of tax code [Section 1031](#), such that extensive valuation exercises were not generally necessary. But, the TCJA changed the game in this area by restricting Section 1031 exchanges to only exchanges of real property. As a result, valuation of contracts or draft picks had become highly relevant and often contentious. The lack of clarity gave rise to the IRS releasing the Revenue Procedure, which was welcome guidance in light of the otherwise highly subjective valuation exercise and in some cases may even result in a more favorable tax position than subjecting a trade or exchange to Section 1031.

However, the Revenue Procedure has limited application and applies only to trades of personnel contracts or draft picks among teams in professional sports leagues. In addition, the Revenue Procedure does not apply to trades of a team for another team or a sale of a team. Perhaps most notably, the Revenue Procedure states that it does not preclude the examination and adjustment, if appropriate, of amounts reported in income in

connection with trades of personnel contracts or draft picks and that teams making trades and using the safe harbor must retain books and records to substantiate that all requirements under the Revenue Procedure have been met.

This taxpayer-favorable determination by the IRS may signal, though, that the IRS's gloves are off in terms of considering taxpayer positions that contract valuations or similar compensatory measures are unclear from a tax perspective, given that the IRS has issued recent guidance in this area. Moreover, a similar conclusion may be inferred with respect to the owners of the teams who may hold their ownership interest through a partnership or other flow-through structure and may fall under the Global High Wealth Program increased audit focus.

## GLOBAL HIGH WEALTH PROGRAM

The Global High Wealth Program was formed in 2009 to take a holistic approach in addressing tax compliance among high-wealth taxpayers. Its purpose was to look at the complete financial picture of high-wealth individuals and the enterprises they control—a departure from prior examinations that focused on just one tax return alone. Notably, the Global High Wealth Program was created shortly after the Organization for Economic Co-operation and Development's (OECD's) report titled *Engaging with High Net Worth Individuals on Tax Compliance*, which arose from joint participation and discussion between Australia, Canada, France, Germany, Ireland, Japan, England, U.S., and others. In recent years, international information-sharing in the audit context has accelerated.

At least [one early report](#) on the Global High Wealth Program suggested that the program had “not lived up to the fanfare with which it was announced.” But, the IRS certainly did not abandon the objective, and this latest initiative suggests the IRS intends to bolster it.

## Review Process

A Global High Wealth Program examination consists of a “key” case, generally the individual income tax return of the primary high-wealth individual at issue, and related income tax returns of business entities in which the individual has a controlling interest and significant compliance risk exists. A “controlling interest” may include significant ownership of or significant influence over an entity or multiple entities.

The enterprise case may include interests in partnerships, trusts, Subchapter S corporations, C corporations, private foundations, gifts, and other entity types. Personnel in the Global High Wealth Program work with personnel from other IRS business operating divisions to address noncompliance across the entire enterprise. When the IRS announced the initiative, then-IRS Commissioner Schulman explained that the Global High Wealth Program would “be dealing, for example, with private foundations and retirement plan assets which fall under Tax Exempt and Government Entities, and flow-through entities that are part of our Small Business/Self-Employed Division. We are talking about small businesses. . . medium-size businesses. . . large businesses. . . private companies. . . and very wealthy individuals who may have a myriad of holdings and sources of income beyond the obvious ones. There are

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income tax as well as estate and gift tax issues.” Thus, if an individual is subject to a Global High Wealth Program audit, the entire scope of their business entities—not just the largest ones—are subject to potential scrutiny.

## **WHAT YOU NEED TO KNOW**

While it is certainly not a foregone conclusion that sports and entertainment figures will be audited due to the Global High Wealth Program’s recent announcement, the risk is real and deserves attention—especially now. Recent legislation such as the BBA and TCJA has increased uncertainty, and Covid-19 and criticism of the IRS due to perceived failures to audit high-income individuals has increased pressure to pursue targets.

In this environment, sports owners, athletes, entertainers, and other high-income taxpayers in these industries are well advised not to “drop the ball” in seeking advice for what may come.

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## **Author Information**

*Morgan, Lewis & Bockius LLP partners Sarah-Jane Morin, Michael Kummer, and Thomas Linguanti represent clients in complex tax controversies, business transactions and fund formations, and litigation. This article is provided as a general informational service and it should not be construed as imparting legal advice on any specific matter.*