Increased Funding Would Support IRS Drive To Audit More Partnerships and Wealthy Individuals

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More — and more rigorous — IRS examinations are coming. The Biden administration is committed to closing the "tax gap" (the difference between taxes owed and taxes actually paid on time). Increased enforcement efforts are perceived to be a way to increase tax revenue without increasing rates.

In March 2021, a widely reported National Bureau of Economic Research (NBER) paper ("Tax Evasion at the Top of the Income Distribution: Theory and Evidence") estimated that the top 1% of households fail to report approximately 21% of their income. The paper concluded, "[O]ur results highlight that there is substantial evasion at the top which requires administrative resources to detect and deter." The paper estimated that additional enforcement efforts targeting the top 1% could collect as much as $175 billion annually without any increase in tax rates.

President Biden and Treasury Secretary Yellen want to ensure the IRS has the resources necessary to increase the number and thoroughness of examinations of corporations, large partnerships and high-net-worth individuals. The administration's first budget request seeks an increase of $900 million for tax enforcement, as part of a 10% boost in the IRS base budget and an $80 billion increase over 10 years. This follows on the heels of an IRS announcement last year of the Large Partnership Compliance Program, which includes a plan to examine 50% more partnerships in 2021 than in 2020. Partnership interests likely to face increased enforcement efforts include hedge funds and private equity funds, closely held businesses, and interests associated with estate planning.

These IRS examinations will now take place against a backdrop of media reports, touted by senior administration officials and prompted by the NBER report, that high-net-worth individuals (especially those with sole proprietorship or pass-through income from partnerships or S corporations) fail on average to report more than one-fifth of their income. One can expect the IRS to use aggressive efforts in conducting these examinations, such as obtaining information from banks and other financial institutions, and from foreign tax authorities. Recently, the IRS has pursued extraordinary efforts to obtain data on cryptocurrency transactions, and it regularly advertises its use of artificial intelligence to sort through data it compiles. In addition, the Biden administration is proposing changes in information reporting as part of its effort to reduce the tax gap.

Those who know that they have underreported their income should consider making a voluntary disclosure to address issues before any examination begins. Even those who believe that they have filed accurate returns should brace for examinations. Pass-through entities and individuals are less likely than large corporations to have the infrastructure to ensure that books and records are properly maintained and organized, and they are less likely to have experience defending themselves in IRS examinations. The time to prepare for these new, more rigorous IRS examinations is now.