IRS Will Use New Resources To Increase Scrutiny In 2023

By **Kathleen Saunders Gregor, Elizabeth Smith and Cait Leonard** (January 2, 2023)

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The new year promises to be a busy one for Internal Revenue Service enforcement.

In particular, a boost in funding for the IRS provided in the Inflation Reduction Act will bolster and expand the agency's enforcement ability.

The agency is set to dedicate new resources to its ongoing enforcement efforts against complex partnerships, corporations, high-net-worth individuals and those dealing in cryptocurrencies this year.

While the IRS' exact plans for the $80 billion of increased funding over the next 10 years are not yet known, at least $45 billion will be used to increase enforcement efforts.

The IRS has stated that the funds will be used to enhance data-gathering techniques, refine campaigns and adjust case assignment options to move away from geographic limitations.[1]

The IRS has provided insight into its enforcement goals for the coming year in recent months.

Here is what we expect to be on the horizon for the new year.

Data Gathering: Improved Technology and Expanded Filing Requirements

While the IRS has a sense of the types of issues it wants to audit, it first must identify entities and specific returns for audits.

Selection can be hampered by lack of data from tax returns, as well as limited capabilities at the IRS for analyzing big data using analytics and machine learning.

To that end, the Large Business & International, or LB&I, division of the IRS has included enhancing capabilities to receive and use data, as well as improving its forms to obtain better data from taxpayers, among its strategic goals in its 2023 annual focus guide.[2]

The IRS has taken significant steps to obtain better data from partnerships having cross-border activities.

In 2021, the IRS introduced Forms K-2 and K-3, which require partnerships to report myriad data regarding their foreign activities — as might relate to U.S. taxpayers — and their U.S. activities — as might relate to foreign taxpayers.

The IRS recently announced that it would not require partnerships without foreign activities or partners to prepare and submit these two forms.

But increased data only helps if the IRS can evaluate that information to target entities that are potentially not in compliance. The IRS' new funding from the Inflation Reduction Act provides over $25 billion for increased operational support, including improved technology.

One expected area of spending is improved data analytics technology that will allow the IRS to better identify taxpayers for issue-specific audits.

Specifically, the IRS integrated modernization business plan includes plans for the implementation of automated transactional processing with a focus on machine learning, artificial intelligence and automated software to assist in enforcement actions.[3]

These tools will streamline the IRS' ability to target and predict filing patterns, analyze returns and increase transparency of the return process.

For example, in 2021, the IRS successfully enhanced its return processing capabilities, increasing the ability to analyze data to assist the enforcement of established campaigns.[4]

Increased Focus on Partnership Compliance

LB&I's focus guide for this year identifies increased enforcement against pass-through entities and high-net-worth individuals as a strategic step in reducing the tax gap.

Increasing enforcement efforts against large, complex partnerships has been in the works for nearly a decade.

Beginning with 2018 tax returns, under the Bipartisan Budget Act, the IRS has had the ability to collect tax directly from a partnership, unless the partnership and its partners take certain steps to ensure the tax is otherwise paid by the partners themselves — thereby shifting the burden of collection from the IRS to the taxpayers.

The Inflation Reduction Act funding for tax enforcement enhances the IRS' efforts to train and organize examination teams with specialized knowledge to audit complex partnership structures.

The IRS' Global High Wealth Industry Group audits high-net-worth individuals who often invest through partnerships, which has led to increased enforcement relating to conservation easements, self-employment tax, and nonfiling of foreign entities.

The group frequently opens simultaneous audits of both high-net-worth individuals and the entities through which they invest.

The IRS also has the large partnership compliance program, based on a similar program for large corporations. The program is intended to audit some of the largest partnerships in a comprehensive fashion, not focusing on a single issue or topic.

Large partnerships are selected based on data analytics identifying those with the highest risk of noncompliance.

LB&I Compliance Campaigns

Many of the IRS' civil enforcement strategies have been formalized and centralized into LB&I's compliance campaigns. These campaigns impact all types of taxpayers, including corporations, partnerships, high-net-worth individuals and taxpayers dealing in virtual currency.

In addition to potentially launching new campaigns consistent with the LB&I focus guide's stated goal of addressing key compliance and emerging issues, we expect the IRS will focus examination efforts on several ongoing campaigns.

The following campaigns are in line with the IRS' goal of rooting out noncompliance by partnerships and high-net-worth investors.

Transactions in Partnership Interests

This trio of campaigns focuses on transactions relating to partners' bases in their partnership interests, including specifically on deductions of partnership losses in excess of partner basis, distributions in excess of partner basis and sales of partnership interests.

All three campaigns focus on partnership loss limitation rules and the application of partnership basis rules to calculation of gain. In addition, the IRS is seeking to identify taxpayers who fail to report partnership gain and/or misreport the type of gain.

Self-Employment Tax Exception for Limited Partner Interests

This campaign evaluates the extent and application of the exemption from self-employment tax for limited partners' distributive shares of partnership income.

The attention is on partnerships engaging in businesses that the IRS considers service based, including investment advisory firms.

Financial Service Entities and U.S. Trades or Businesses From Lending Activities

This campaign conducts audits evaluating whether financial service entities with lending activities are engaged in a U.S. trade or business. This affects credit-focused investment funds in particular, and often is an audit of such entities' withholding tax information reporting forms.

Corporate taxpayers will also be subject to scrutiny under many of LB&I's campaigns, including:

Corporate Foreign Tax Credit Compliance Campaign

This effort focuses on whether corporate taxpayers electing to use a foreign tax credit are within the limitations set forth in Internal Revenue Code Section 901. The IRS has noted that there are planned expansions to campaigns focusing on corporate foreign tax credit compliance.

Captive Services Provider Campaign

This campaign scrutinizes transfer pricing arrangements among foreign captive subsidiaries that perform services exclusively for the parent or other members of a multinational group.

Other ongoing LB&I campaigns we expect to be active in the new year apply more broadly to the following types of taxpayers.

FATCA Filing Accuracy

This campaign focuses on whether foreign financial institutions and certain other foreign entities satisfy their Foreign Account Tax Compliance Act reporting and withholding obligations.

Inbound Investment Compliance

A series of campaigns focused on inbound investment include:

- The adequacy of Foreign Investment in Real Property Tax Act reporting for gain and certain other income from U.S. real estate investments;

- Compliance with Forms 1042 and 1042-S filing requirements — often involving documentation of exemptions and rate reductions;

- Form 1120-F filing and general compliance — often an issue for non-U.S. feeder funds into U.S. partnerships; and

- Satisfaction of documentation and substantiation rules for applying nonresident alien treaty exemptions.

Cryptocurrency Enforcement

Investors in cryptocurrency and other digital assets can expect to seek increased civil and criminal enforcement this year.

On the civil side, LB&I has a civil cryptocurrency compliance campaign focused on whether taxpayers properly report their virtual currency.

The IRS has likewise prioritized further guidance on the tax treatment, validation and information reporting of transactions involving digital assets in the LB&I 2022-2023 priority guidance plan, released by the U.S. Department of the Treasury in November.[5]

The IRS Criminal Investigation division created the Office of Cyber and Forensics Services in 2021 to aid in investigations surrounding virtual currency.[6]

The division's annual report highlights a number of high-profile arrests, convictions and sentencing relating to tax crimes involving virtual currencies.

Furthermore, in 2022, the IRS had continued success in issuing John Doe summons to obtain records relating to U.S. taxpayers who fail to report and pay taxes on cryptocurrency transactions from banks and cryptocurrency exchanges.[7]

With the divisions plans to establish the Advanced Collaboration Data Center in fiscal year 2023, to provide centralized access to data and resources for CI division employees to combat cybercrimes, we expect the number of criminal enforcement actions relating to cryptocurrency this year to grow.[8]

In Sum

IRS enforcement will be active in this year. Taxpayers — particularly large corporations, complex partnerships and high-net-worth individuals — should expect more robust tax enforcement as the Inflation Reduction Act's funding is implemented, and the IRS executes its stated strategies.

Furthermore, taxpayers active in the virtual currency space should anticipate additional IRS guidance — combined with increased scrutiny — surrounding their transactions.

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[1] "FY2023 LB&I Strategic Goals" IRS, October 2022, https://www.irs.gov/pub/irs-pdf/p5319.pdf.

[2] "FY2023 LB&I Strategic Goals," IRS, October 2022, https://www.irs.gov/pub/irs-pdf/p5319.pdf.

[3] "IRS Integrated Modernization Business Plan," IRS, April 2019, https://www.irs.gov/pub/irs-pdf/p5336.pdf.

[4] "Annual Key Insights Report: Fiscal Year 2021 Successes and Accomplishments," IRS, April 2022, https://www.irs.gov/pub/irs-pdf/p5453.pdf.

[5] "2022–2023 Priority Guidance Plan," Department of the Treasury, November 4, 2022, https://www.irs.gov/pub/irs-utl/2022-2023-pgp-initial.pdf.

[6] "IRS: CI Annual Report 2022," IRS Criminal Investigation, November 2022, https://www.irs.gov/pub/irs-pdf/p3583.pdf.

[7] "IRS Obtains Court Order Authorizing Summons for Records Relating to U.S. Taxpayers Who Failed to Report and Pay Taxes on Cryptocurrency Transactions," United States Department of Justice, September 22, 2022, https://www.justice.gov/usao-sdny/pr/irs-obtains-court-order-authorizing-summons-records-relating-us-taxpayers-who-failed#:~:text=The%20John%20Doe%20summons%20directs,properly%20reported%20on%20tax%20returns.

[8] "IRS: CI Annual Report 2022," IRS Criminal Investigation, November 2022, https://www.irs.gov/pub/irs-pdf/p3583.pdf.