IRS Rolls Out Long-Planned Strategy Targeting Large Partnerships and High-Wealth Individual Taxpayers

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On September 8, 2023, Internal Revenue Service (IRS) Commissioner Danny Werfel announced the rollout of a coordinated enforcement strategy that will involve audits of returns filed by 75 of the largest partnerships operating in the United States. Other enforcement efforts will focus on compliance issues involving digital assets, as well as continued emphasis on reporting of offshore accounts and collection of back taxes owed by high-wealth individuals. Underpinning much of the new strategic effort is the use of artificial intelligence (AI) and other investments made possible by the long-term funding approved by Congress through the Inflation Reduction Act of 2022.

Partnership Audit Strategy

The IRS struggled for many years to develop a coherent approach to auditing partnership returns, in large part due to the difficulty in identifying the right returns to audit. When it identified partnership returns to audit, many cases resulted in only modest adjustments. In addition, outdated partnership audit rules under the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) were cumbersome, making the administrative process difficult for both the IRS and taxpayers to navigate. Given these difficulties, much of the IRS focus in recent years has been on a few limited issues, such as the application of self-employment taxes in the partnership context.

Congress addressed the TEFRA issues in 2015, enacting a new centralized partnership audit regime that generally applies to returns filed for periods commencing after 2017. The first few years subject to the new partnership audit rules are finally making their way into the audit and litigation process, and the IRS hopes to use these rules to streamline the audit of returns and collect additional taxes resulting from those audits.

Using AI, the IRS has identified returns of 75 partnerships with average assets of more than $10 billion that will be receiving audit notices by the end of this month. These partnerships include hedge funds, real estate investment partnerships, publicly traded partnerships and large law firms. The IRS has stated that it believes that these audits will encompass a range of subjects, including complex partnership issues, tax accounting and international tax. To move forward with this strategy, the IRS has recruited new auditors from outside the agency, and has moved auditors experienced with corporate tax matters to focus on this new segment.

The technology-enabled audit strategy that the IRS announced last week is expected to facilitate the ability of the IRS to learn more about compliance risks presented by complex partnerships, and to then build upon that learning to better focus broader audit activity in the years to come. In addition, the IRS expects to use AI to help identify linkages between partnerships and the individual taxpayers who control them, thereby leading the agency to expand its audit coverage of the wealthiest taxpayers in America.[1]

At the same time, the IRS announced that it will be using "compliance letters" to address potential noncompliance by partnerships with recently implemented reporting requirements, such as the Schedule M-3 (Net Income (Loss) Reconciliation for Certain Partnerships). Using technology to compare balance sheets with other items reported on partnership returns, the IRS will correspond with approximately 500 partnerships starting in October 2023, asking them to explain discrepancies in amounts reported from year to year on their returns.

[1] Understanding the intricacies of complex partnership structures has been a challenge for the IRS for decades. *See* Emily Black, Ryan Hess, Rebecca Lester, Jacob Goldin, Daniel E. Ho, Mansheej Paul and Annette Portz, *The Spiderweb of Partnership Structures* (Feb. 24, 2023).

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High-Wealth Focus

The IRS has been criticized recently for devoting more audit resources on low-income taxpayers than on the wealthiest taxpayers who some say may present greater compliance risk. The new strategy being rolled out is expected to address that criticism, and will focus on a range of potential compliance issues. Although the IRS has not publicized all of the details of its new strategy, the agency is expected to focus audit efforts on:

- Estate planning strategies designed to permit the tax-free transfer of wealth from generation to generation.
- Use of digital assets, including cryptocurrency, to disguise the creation and movement of wealth.
- Offshore bank, pension and investment structures, such as the recently announced effort focused on Malta-based pension programs.
- Other marketed tax avoidance or minimization programs, including continued emphasis on the use of conservation easements, captive insurance and other promoted strategies.

In addition, the IRS has identified some 1,600 taxpayers with total income of more than $1 million who collectively owe hundreds of millions of dollars in back taxes. Building off its success in collecting over $38 million from 175 high wealth taxpayers, the IRS plans to deploy collection efforts as part of its plan to address the gap between taxes owed and actual government receipts.

Somewhat surprisingly, in announcing its new enforcement strategy, the IRS used popular political language, stating that its efforts will focus on "the wealthy looking to dodge paying their fair share or promoters aggressively peddling abusive schemes." Presumably this language is intended to help shore up support among the public and in Congress for the agency to retain the remaining funding approved last year, some of which was already clawed back several months ago in connection with the debt-ceiling debate. Not coincidently, the IRS choreographed the rollout of its new strategy with a focused media campaign, resulting in widespread press coverage in recent days.[2]

What remains to be seen is how successful the IRS will be with this new strategy, and whether the agency can make enough progress quickly so that it can convince Congress to let it keep the remaining resources provided in the Inflation Reduction Act.

Our team has been following the agency's transformation efforts quite closely. For more information, please reach out to the authors, or your regular Skadden contacts.

[2] Alan Rappeport, "I.R.S. Deploys Artificial Intelligence to Catch Tax Evasion," *The New York Times* (Sept. 8, 2023); Eli Tan, "IRS To Use AI To Crack Down on Ultra-rich Taxpayers and Partnerships," *The Washington Post* (Sept. 8, 2023); Richard Rubin, "IRS, With AI Help, Readies Audits of Large Hedge Funds, Real Estate Firms," *The Wall Street Journal* (Sept. 8, 2023); Jacob Knutson, "IRS Will Use AI To Crack Down on Wealthy Potential Tax Violators," Axios.com (Sept. 8, 2023).

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