The Informed Board
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Skadden

The IRS Is Coming for Partnerships and High Net Wealth Individuals

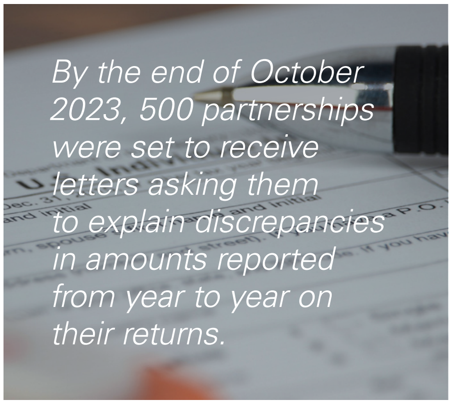
- The IRS is using artificial intelligence (AI) to focus audit efforts on complex partnerships and users of digital assets.
- New audit procedures allow the IRS to collect additional taxes directly from partnerships, unless the partnership decides to push out the liability to its investor-owners at the time of the audit.
- The IRS is also ramping up efforts to audit estate planning strategies designed to permit the tax-free transfer of wealth from generation to generation.

The Internal Revenue Service plans to deploy thousands of new hires to expand audits of partnerships and high net wealth individuals. As part of a larger transformation at the agency, it is using some of the $60 billion in supplemental funding provided by Congress to increase audit activity in areas that largely have been overlooked for many years.

Who Should Be Concerned?

The IRS is likely to focus on tax returns that have the greatest potential for audit adjustments that will yield more tax revenue. The staff does not need to devote audit time to returns that only reflect income from information returns such as wages, interest and dividends. Rather, we anticipate that the IRS will be looking for returns that might reflect complex planning, novel financial products or indicia of wealth, such as:

- Partnership returns that appear to involve tiered partnership structures. Unless the IRS is able to track what is happening at various levels in the structure, it will not know if income is being properly reported. The more complex the structure, the more likely the IRS will want to at least kick the tires through some audits.
- Investment vehicles, including partnerships and trusts, that do not withhold taxes on U.S. income earned through those vehicles by the foreign investors. If the IRS can show that withholding was required, it can try to recover the tax from the investors or from banks or withholding agents that may have had some responsibility.
- Estate or gift tax returns that appear to reflect low-tax or no-tax transfers of assets to younger generations. Whether through trust structures or aggressive valuation discounts, the IRS has its sights on structures and transactions that minimize taxes on intergenerational transfers.



- Individual returns that show the acquisition or trading of cryptocurrency or other digital assets. The IRS is trying to get its arms around the brave new world of cryptocurrencies, NFTs and similar products. Even if everything is fully disclosed, returns showing significant volumes (or amounts) of digital assets are likely targets for audits.

- Individual returns that reflect the ownership of private aircraft or yachts, donations of appreciated stock or donations of high-value artwork. Anything that smacks of wealth can attract attention, and in our experience tax return mistakes often abound in these areas, making it easy for the IRS to find additional taxes owed.

The IRS often tries to identify a few issues that might yield audit results (*i.e.*, more tax revenue), and then seeks returns to audit that implicate those issues. In the past it has done this by getting client lists from accountants or other tax advisers that provided the same advice to multiple clients. Now, using AI, the IRS is hoping to take advantage of data streams to connect the dots to find better returns to audit. This could include publicly available information pulled from press releases, Securities and Exchange Commission filings, news stories, blogs or social media, or from charitable giving reports issued by charities.

How Quickly Will the IRS Move on This Initiative?

It will take time for the IRS to hire thousands of new agents, but it is already moving forward with a number of new partnership audit efforts. For example, it announced plans to notify 75 partnerships with average assets of more than $10 billion that they will face new audits, with notices scheduled to go out by September 30, 2023. We anticipate that these partnerships will include hedge funds and private equity funds, renewable energy partnerships and publicly traded partnerships in various industries. And by the end of October 2023, another 500 partnerships were set to receive letters asking them to explain discrepancies in amounts reported from year to year on their returns.

To better coordinate and organize their efforts to audit partnerships and high net wealth taxpayers, the IRS is establishing a special work unit, in which existing employees and new hires will be housed, to focus on pass-through organizations, like partnerships. This work unit will also be looking at S corporation returns, so those entities should also be on the lookout for audit notices.

Although it will take time to hire, onboard and train the new hires, the IRS is already using AI to help select returns to audit. It is too soon to evaluate the effectiveness of this initiative, but presumably the IRS will only get better with experience using technology to focus its audit efforts.

What Can You Do To Prepare?

The first step in preparing for any IRS audit is to make sure that you are comfortable that your returns are prepared correctly. All too often we have seen the IRS find mistakes on returns that result in clients owing significant taxes, and sometimes penalties too. For example, if you are planning a charitable contribution, whether it is artwork, a conservation easement, shares in a private company, or something else that might be hard to value, it is critical that you get timely appraisals that will stand up to scrutiny. It is also important to make sure that you receive contemporaneous written acknowledgments of your donations from the donee organizations.

Paying attention to make sure that all of the required information is included with your return is also an absolute must. Because the failure to include required information with a return, such as a properly completed donee acknowledgment for charitable contributions, ordinarily cannot be fixed on audit, you need to make sure that everything is done right before your return is filed.

In addition, certain types of information absolutely must be disclosed. For example, over the past 15 years, thousands of taxpayers have learned the hard way that you can face steep penalties for failure to fully disclose offshore bank accounts. The IRS is still focused on those issues, but it is also honing in on digital assets so, if you have transactions involving them, make sure that they are properly disclosed.

If you are invested in partnerships, or are considering making a partnership investment, find out how the partnership plans to handle any IRS audits. Under rules that took effect only a few years ago, partnerships can elect to pay additional tax due from an IRS audit, or to push out the tax adjustments for past years to current partners. In other words, if you purchase an interest in a partnership in 2023, and the partnership gets hit with tax adjustments for 2022 or earlier years, you might get stuck with a part of the tax bill for periods that pre-date your ownership.

Last, and certainly not least, if you receive an audit notice, make sure that you have the right adviser in place to help guide you through the process. Although your long-time accountant might know all of the details of your return, he or she may not be the best person to represent you in an audit. It can be awkward for the return preparer to defend his or her work. In addition, we find that some advisers are not familiar with current audit trends, or ways that the IRS might work with you to resolve disputes quickly and quietly. Particularly when significant amounts might be at stake, bringing in someone who regularly handles complex audits can pay dividends in the long run.

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