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IRS Prioritizes Enforcement Against High-Wealth Taxpayers in the Inflation Reduction Act Strategic Operating Plan

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Is a new tide of audits rolling in? Since 2021, the Biden Administration has been promising significant increases in funding of the Internal Revenue Service (IRS)—a promise furthered by Congress's passage of the Inflation Reduction Act (IRA) in August 2022. Late last week, the IRS released its Inflation Reduction Act Strategic Operating Plan, outlining how the IRS plans to deploy the approximately $80 billion provided to it under the IRA. The Strategic Plan reiterates and expands the IRS's stated enforcement priorities—namely, increased audit activity for family offices, high-wealth individual taxpayers, large partnerships, and large corporations.

Background

In August 2022, the enactment of the IRA provided a roughly $80 billion increase in IRS funding over the next 10 years. This followed years of significant backlog and underfunding at the IRS, which has left the IRS struggling to successfully manage processing tax returns and auditing taxpayers. Specifically, there has been a significant decline in audits of individuals in higher income brackets, with an 86% decrease in audit rates from 2010 to 2019 for those earning $5 million or more each year.

$45.6 billion of the roughly $80 billion under the IRA has been earmarked for tax enforcement activities, such as hiring more enforcement agents, providing legal support to agents as they develop their cases, and investing in investigative technology to improve the IRS's audit selection process. In many ways, additional IRS resources are sorely needed. In our experience over the past few years, audits have consisted of generally smaller teams with less experience and more time pressure. Complex issues that require intensive factual background and an individualized analysis have often been harder to resolve, because audit teams and appeals rely more on IRS guidance and templates, with less flexibility. The matters going into the IRS Office of Appeals and litigation often tend to be less developed.

Treasury Secretary Janet Yellen has directed the IRS to use its new enforcement resources from the IRA to focus on "high-end noncompliance," such as auditing more high-wealth individuals, large corporations, and complex pass-throughs. Yellen further directed the IRS not to increase audits of individuals and small businesses earning $400,000 per year or less.

The increased IRA funding, however, is not free from controversy or political strife. Congressional Republicans, now in the majority in the House of Representatives, are determined to strip the IRS of its new funding under the IRA; for example, a bipartisan funding bill passed by Congress in December 2022 reduced the IRS's annual appropriations by $275 million.

The Strategic Plan

Following the IRA's passage, tax practitioners have been questioning how the IRS intends to use its additional enforcement dollars. The Strategic Plan explicitly prioritizes taxpayers with complex issues and tax returns when audit rates are minimal. The IRS has identified the following specific initiatives related to this objective:

1. **Expand enforcement for high-income and high-wealth individuals.** The IRS will increase enforcement against these individuals and will make the necessary resources available to do so given the size and complex nature of these tax filings.
   - The IRS will focus on hiring and training staff needed to achieve appropriate compliance coverage rates, including in the Independent Office of Appeals to resolve tax controversies and in the Office of Chief Counsel to support compliance and appeals and to litigate when necessary.
   - The IRS will also refine its approaches to high-income and high-wealth enforcement, and it will use data analytics to explore new treatments and interventions to address potential noncompliance and to resolve noncompliance issues.
2. **Employ centralized, analytics-driven, risk-based methods in its selection of compliance cases.** The IRS will establish a centralized function for compliance planning and strategy, build a unified compliance organization, establish a model for workforce allocation, centralize compliance analytics and models into one platform and develop a process for refining the platform, and improve its Whistleblower Program.
3. **Expand enforcement for large corporations and partnerships**. The IRS will focus on hiring staff to achieve appropriate compliance coverage rates for large corporations and partnerships. It will also develop new compliance treatments for large partnerships and improve existing tools for auditing them.
4. **Expand enforcement in other areas.** The IRS will hire staff to achieve appropriate compliance coverage in other needed areas, such as employment taxes, excise taxes, and estate and gift taxes. New enforcement approaches and compliance treatments will also be developed.

5. **Pursue enforcement for emerging issues.** The IRS will mobilize resources, improve detection, establish response processes, and hire staff to increase enforcement related to high-risk issues such as digital assets transactions, listed transactions, and certain international issues.

6. **Promote fairness in enforcement.** The IRS will develop procedures to regularly evaluate system fairness, improve enforcement practices to help ensure fairness, and hire staff to reach the goals.

Takeaways

Undoubtedly, family offices and high-wealth individuals can expect more aggressive and increased use by the IRS of its current enforcement tools, such as audits and penalties. Large partnerships and large corporations operating in multiple jurisdictions can expect similar treatment.

These new initiatives build upon tools already in use by the IRS. For example, the IRS's Criminal Investigative Division (CID) has pioneered the use of data analytics in identifying individuals for investigation and building cases against them, and the CID has been a leader in the exchange of information with international taxing authorities to coordinate enforcement efforts, particularly against high-net-worth individuals. With additional funding, the IRS intends to build upon this experience in the civil arena. Taxpayers under civil audit should expect that IRS examiners will have multiple new sources of information to draw from—with varying degrees of reliability. It is definitely a small world!

Further, in focusing on high-wealth individuals, we would expect the IRS to draw upon its experience with the Global High Wealth Industry Group. This group was formed in 2009 as part of the Large Business and International Division of the IRS to address the high-wealth population. (A similar initiative, the High Income High Wealth Strategy, was implemented by the Small Business/Self-Employed Division in 2010 but was ultimately disbanded.) In our experience, in its early years, the Global High Wealth initiative faced challenges in identifying appropriate taxpayers for audit and effectively examining their returns, but all indications are that the IRS has learned from this history.

In addition, the IRS is empowering its examiners to impose draconian penalties, which may result in audits becoming even more contentious and difficult to resolve. In April 2022, the IRS removed the requirement of executive approval for the assertion of economic substance penalties under 7701(o) of the Internal Revenue Code. Removing the requirement enables IRS auditors to assert these penalties more frequently, with only managerial approval required.

High-income taxpayers of all stripes should plan for increased enforcement by anticipating potential issues and identifying expected areas of dispute. Developing an audit strategy and carefully documenting transactions will help prepare for potential IRS action.

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