Alert | Tax Controversy and Litigation

September 2023

IRS Establishes New Special Work Unit to Concentrate on Large Partnerships As Part Of Its New Enforcement Effort Targeting High-Income Taxpayers

On Sept. 20, 2023, the Internal Revenue Service (IRS) announced that it will establish a new work unit in the Large Business & International (LB&I) division to concentrate on large or complex passthrough entities. This announcement comes as the IRS is getting ready to issue audit notices and compliance letters in the next few weeks to large partnerships and as it ramps up hiring and its focus on the partnership space. The new work unit will help the IRS implement its historic enforcement effort announced on Sept. 8, 2023, targeting high-income taxpayers and large complex partnerships. The IRS is aware that some high-income taxpayers are using complex passthrough structures to avoid paying income tax, and the Global High Wealth team will be closely aligned with this new unit. Passthrough entities include partnerships, limited liability companies, and S corporations. The consolidation of expertise in the new working unit will allow the IRS to understand these complex passthrough structures and more effectively target the abuses.

New Tax Enforcement Efforts Involving Partnerships and High-Income Taxpayers

The IRS's lack of funding for over a decade resulted in historic low audit rates for partnerships and high-income taxpayers. On Sept. 8, 2023, the IRS announced a multi-pronged approach to enhance enforcement for these taxpayers:

- **Expansion of the Large Partnership Compliance Program (LPC)** – The IRS plans to expand the LPC program, established in 2021 to examine the largest and most complex partnership returns, to include more large partnerships. The IRS is using artificial intelligence to identify potential compliance risk in areas involving partnership tax, international tax, general income tax, and accounting. By the end of September, the IRS plans to open examinations of 75 of the largest partnerships in the United States, in addition to the initial tranche of 50 LPC examinations which have been ongoing since the program's launch. The target partnerships will generally have more than $10 billion of assets and will represent a cross-section of U.S. industries, including hedge funds, real estate investment partnerships, publicly traded partnerships, large law firms, and others.
- **Issuance of Partnership Compliance Letters** – The IRS has identified partnerships with over $10 million of assets that have large ongoing discrepancies on their balance sheets. Many of these partnerships fail to attach statements to their returns explaining the difference. According to the IRS, these large discrepancies are strong indicators of potential noncompliance. To address these discrepancies, the IRS will send compliance letters to approximately 500 partnerships in October 2023. The IRS will evaluate the responses and initiate partnership audits where necessary.
- **High Wealth, High Balance Due Taxpayer Field Initiative** – The IRS will ramp up collection efforts on taxpayers who have total income exceeding $1 million, but more than $250,000 of tax debt. To this end, the IRS will be contacting over 1,600 taxpayers who meet these criteria.
- **Additional Priorities for FY2024**– The IRS will further target noncompliant high-income taxpayers through:
  - **Continued Focus on Digital Assets** – The IRS Virtual Currency Compliance Campaign demonstrated that 75% of the taxpayers identified through the production of records by digital currency exchanges were non-compliant with their tax reporting. The IRS will continue to identify these non-compliant taxpayers through the use of John Doe summonses and under recently issued broker reporting rules.
  - **Continued Scrutiny of FBAR Violations** – Notwithstanding the existing strong IRS focus on international tax compliance, the IRS has now identified hundreds of taxpayers who may have failed to file FBARs to report foreign financial accounts with balances exceeding $1.4 million. The IRS intends to audit the most egregious cases in FY2024.
  - **Labor Brokers** – The IRS has identified a tax scheme where construction contractors are issuing Forms 1099-MISC/1099-NEC payments to purported subcontractors that are actually shell companies. The shell companies either exchange the payments through money service businesses or return the payments to the construction contractors. The IRS has seen this tax scheme in Florida and Texas. The IRS will be initiating civil and criminal audits in this area.

New Passthrough Work Unit

Passthrough entities, including partnerships, limited liability companies, and S corporations, do not pay tax on their income. Instead, the income is passed through to the owners and taxed at their income tax rates. It is common for high-income taxpayers to set up complicated structures involving multiple passthrough entities. The complex structures allow some taxpayers to shield income from income tax. Previously, insufficient IRS funding has prevented the IRS from devoting resources to identifying and auditing taxpayers who are abusing the partnership tax provisions. Daniel Werfel, the IRS commissioner, explained that the IRS's investment in analytics, personnel, and technology will make it easier to identify instances of tax evasion in complex cases as these tax abuses were likely able to flourish because budget cuts limited IRS resources and staffing. The new passthrough work unit will be staffed by existing IRS employees and new hires announced by the IRS last week. The IRS expects that the new passthrough work unit will be in operation by the end of 2024. In the meantime, the IRS states that it will continue to step up its enforcement efforts involving passthrough entities.

Conclusion

LB&I's Global High Wealth Industry Group has existed for many years and has conducted many audits of high-net-worth individuals. These audits are difficult because these taxpayers often have multiple complex business structures involving multiple passthrough entities. The creation of the new passthrough work unit, which will work closely with the Global High Wealth team, and the IRS use of AI demonstrates that the IRS intends to use Inflation Reduction Act funding to shut down passthrough abuses that primarily benefit high-income taxpayers. Passthrough entities should start preparing for the IRS audit notices or compliance letters which may be forthcoming in the next few weeks.

Authors

This GT Alert was prepared by:

- Scott E. Fink | +1 212.801.6955 | finks@gtlaw.com
- Sharon Katz-Pearlman | +1 212.801.9254 | Sharon.KatzPearlman@gtlaw.com
- Courtney A. Hopley | +1 415.655.1314 | hopleyc@gtlaw.com

Additional Group Members:

- Jared E. Dwyer | +1 305.579.0564 | dwyerje@gtlaw.com
- G. Michelle Ferreira | +1 415.655.1305 | ferreiram@gtlaw.com
- Barbara T. Kaplan | +1 212.801.9250 | kaplanb@gtlaw.com
- Shira Peleg | +1 212.801.6754 | pelegs@gtlaw.com
- James T. Smith | +1 415.590.5104 | James.Smith@gtlaw.com
- Jennifer A. Vincent | +1 415.655.1249 | vincentj@gtlaw.com