

GEORGE A. HANI is a Member of the Tax Department with Miller & Chevalier in Washington, DC.

ROBERT J. KOVACEV is a Member of the Tax Department with Miller & Chevalier in Washington, DC.

Exam

Preparing for Heightened Tax Enforcement Under the IRS Strategic Operating Plan

By George A. Hani and Robert J. Kovacev*

On August 16, 2022, President Biden signed the Inflation Reduction Act (“IRA”). The IRA contained many wide-ranging tax provisions covering everything from energy tax credits to the corporate alternative minimum tax. It also reversed a decade-long decline in Internal Revenue Service (IRS) resources by providing \$80 billion in additional funding for the agency. This left the IRS in the unaccustomed position of having to decide how to spend this windfall. In response to Congressional inquiries asking for details, Treasury Secretary Yellen committed to publish a comprehensive plan for the IRA funding. On April 5, 2023, the IRS issued its long-awaited Strategic Operating Plan (the “Plan”) for implementing the IRA. The Plan sets forth a comprehensive overhaul of IRS technology, customer service, and enforcement. A centerpiece of the Plan is a new enforcement strategy, backed by \$45.6 billion in earmarked funding. Objective 3 of the Plan is titled, “Focus expanded enforcement on taxpayers with complex tax filings and high-dollar noncompliance to address the tax gap.” The Plan cannot be accused of hiding the ball: its intended targets are large corporations, large partnerships, and high-net-worth families. Combined with the Biden Administration’s stated goal of avoiding any increase of audits for individual taxpayers making less than \$400,000 a year, it is clear the IRS intends to devote most of the IRA funding to those targeted groups of taxpayers.

The IRS may not achieve all the objectives outlined in the Plan. On June 3, 2023, Congress enacted legislation raising the debt ceiling that included a \$1 billion clawback of the additional IRS funding. In addition, a “handshake deal” between President Biden and Speaker McCarthy would clawback another \$20 billion of the IRA funding. Those additional clawbacks will be decided by a future legislation, and could be more or could be less. It is also unclear at this point which function at the IRS will be impacted by the clawbacks, but it is likely that enforcement will bear the brunt of the clawback. Therefore, not all the proposed enforcement strategies may see the light of day. That being said, IRS executives have indicated that the clawback will not affect the implementation of the Plan in the near term. Even if the entire clawback draws down the enforcement budget, it remains an unequivocal truth that the IRS has \$25 billion in new dedicated enforcement funding at its disposal. The political backing

for using these funds to focus on large corporations, substantial partnerships, and high net worth families is equally incontrovertible.

It is no secret that IRS enforcement of those populations has suffered over the past several years. The Plan notes that the corporate audit rate fell from 10.5% in 2011 to 1.7% in 2019. The audit rates for high-net-worth families and large partnerships are even smaller (0.7% and 0.05% in 2019, respectively). The IRS has blamed these anemic enforcement rates on a lack of resources to deal with increasingly complex tax issues for these populations. Considering that the IRS budget was slashed by about 20% from 2010 to 2020, these results are unsurprising. As Commissioner Koskinen famously said, the IRS had to “do less with less.”

Not anymore. The resources so long denied the IRS are now at hand, even if reduced by a clawback. To be sure, the effects of the IRA funding will not be immediately apparent. It is widely expected that any uptick in enforcement will not be evident for at least two years. Indeed, the IRS has hinted that audit activity may actually decline in the short run as agents are trained and new systems are placed into service. Once those resources are online, even if lower than originally anticipated, taxpayers will definitely notice an increase in scrutiny.

There are seven specific enforcement initiatives set forth in the Plan. These include:

- Initiative 3.1, “Employ centralized, analytics-driven, risk-based methods to aid in the selection of compliance cases.” This initiative provides that the IRS “will develop a centralized, integrated approach to assess risk to inform the selection of cases and appropriate treatments.” This “centralized planning function will use risk analytics to prioritize and assign cases.” If all goes to plan, by fiscal year 2026 taxpayers will be selected for audit “by centralized compliance planning function using new analytics systems and refined risk-based case selection and routing.”
- Initiative 3.2, “Expand enforcement for large corporations.” Under this initiative, the IRS “will increase enforcement activities to help ensure tax compliance of large corporate taxpayers.”
- Initiative 3.3, “Expand enforcement for large partnerships.” This initiative seeks to increase the IRS’s ability to examine partnership returns, including by providing agents with enhanced training in partnership tax issues.
- Initiative 3.4, “Expand enforcement for high-income and high-wealth individuals.” This initiative expands the existing Global High Wealth program, which is

designed to use an “enterprise” approach to auditing high-net-worth families.

- Initiative 3.5 “Expand enforcement in areas where audit coverage has declined to levels that erode voluntary compliance.” These include employment and excise taxes, both of which the IRS believes pose significant compliance risks that have not been sufficiently addressed.
- Initiative 3.6, “Pursue appropriate enforcement for complex, high-risk and emerging issues.” This initiative seeks to direct IRS enforcement assets toward issues and taxpayers posing the highest compliance risk, using analytics to identify potential risk areas.
- Initiative 3.7, “Promote fairness in enforcement activities.” In this initiative, the IRS promises to “help promote fairness for all taxpayers by addressing noncompliance appropriately in a balanced manner.”

Summing up the enforcement initiatives set forth in the Plan, two clear themes are evident: centralization and data analytics. Those themes naturally complement each other, particularly in large-scale operations such as tax administration. In a centralized system, all data is stored, managed, and processed from a single location or system. This approach facilitates comprehensive and efficient data analysis as all relevant data is readily accessible in one place. It enables the use of sophisticated analytical tools that can handle large volumes of data to derive insights that would be impossible to glean from smaller, isolated datasets.

Centralization is not new to the IRS. In recent years, the IRS has moved increasingly to central control of enforcement priorities. For example, the IRS experimented with an Industry Issue Focus program, introducing tiered issues of increasing importance (and centralized direction). LB&I’s campaigns, fueled in part by priorities developed through data analytics, likewise demonstrated this centralizing trend. Other examples include the initiation and increased reliance on Schedule UTP and the Large Corporate Compliance program, all designed to use data to develop Service-wide priorities.

Effective data analysis relies on having access to extensive data pools. The larger the dataset, the more reliable the patterns, trends, and insights that can be drawn from it. This is particularly important in a context like tax administration, where the goal is to identify non-compliance. A comprehensive view of taxpayer behavior can only be achieved by analyzing a large dataset covering a broad spectrum of taxpayers.

This data will have to be evaluated by human IRS employees, who will be responsible for actually setting agency policy. This role will be filled by key officials selected by IRS senior executives. The priorities selected by these officials will reflect the view of IRS central management.

Once the data has been analyzed, the results are directed to field agents. These agents use the insights derived from the data analysis to guide their audit and investigation efforts. They do not need to conduct their own independent data analysis, which would be both impractical and inefficient. Field agents would need extensive training in data analytics, and even then, their access to data would be more limited, leading to potentially biased or flawed results.

Centralization also supports uniform tax administration. By analyzing data centrally and providing all field agents with the same insights, it helps ensure that similar taxpayers are treated similarly. This is essential for fairness and equity in tax administration. If field agents were conducting their own independent data analysis, there could be significant inconsistencies in the way taxpayers are treated, based on the differing abilities and biases of individual agents.

Moreover, centralization allows for the creation of standardized procedures and guidelines for handling and analyzing data. This promotes consistency in the administration and enforcement of tax laws, which is critical for maintaining public trust and compliance. It also provides safeguards against inappropriate disclosure of the underlying tax information.

While centralization may provide some benefits for tax administration, it may also complicate the resolution of tax issues for numerous taxpayers. The fundamental nature of a centralized, top-down approach to enforcement inevitably limits the autonomy of field agents in conducting audits and forces a one-size-fits-all approach regardless of the situations of individual taxpayers. This is precisely what happened with the IRS' previous experiments in centralization such as the tiered issues and LB&I campaigns.

Based on prior experience with central planning in examinations in the transfer pricing and research credit areas, it is likely that Information Document Requests (IDRs) would be centrally dictated rather than flexibly constructed by the field agents. This suggests that field agents would have less discretion in shaping those requests to match the unique circumstances and financial situations of individual taxpayers. A more standardized approach could result in less relevant or overly burdensome requests

for taxpayers, leading to frustration and inefficiencies in the audit process.

Moreover, under a centralized system, decisions about whether to reject or allow a tax position may be made on a global scale, based on policy decisions formulated in Washington. This may occur openly through published Notices setting forth the centrally approved position of the Service. It may also happen behind the scenes, with field agents taking orders from central planners without public disclosure on what positions to take. This one-size-fits-all approach could prove challenging for taxpayers, who may find that their particular circumstances are not adequately considered in these broad, policy-driven decisions.

This approach could result in an uptick in contested cases, with taxpayers feeling compelled to challenge adjustments *via* the IRS Independent Office of Appeals or in court. If a taxpayer is unable to rely on its unique factual position at the examination stage, it will be forced to do so in Appeals or in litigation because those forums are (or at least should not be) subject to the dictates of IRS central planners. This is likely to escalate the time and resources required to resolve tax issues and could lead to a backlog of cases, further complicating the tax administration process. Notably under the heading "What success would look like" for initiatives to increase audit coverage of large corporations, large partnerships, and high-net-worth individuals, the Plan identifies as a "key project" to "Increase staff in the Independent Office of Appeals to resolve tax controversies arising from enhanced compliance efforts," and "Increased Staff in the Office of Chief Counsel to support both compliance and appeals and to litigate cases when necessary." The Plan also notes that "first wave" of such hires has already begun.

As for the IRS data analytics program, little is publicly known. The IRS is understandably reluctant to reveal the factors that make a tax return more or less likely to be audited, lest taxpayers attempt to "game the system" to avoid detection. Even so, taxpayers can predict certain likely areas of scrutiny. As data analytics is rooted in statistical principles, it is reasonable to infer that statistical anomalies will attract greater attention. For instance, if a business claims research credits that noticeably surpass the standard claims of comparable corporations, it is likely that the IRS data analytics algorithm would identify this as an irregularity. Consequently, a taxpayer that has recently amplified its R&D operations in an attempt to outpace competitors, leading to a corresponding increase in research credits,

might reasonably anticipate additional scrutiny based on this factor alone.

Simultaneously, taxpayers must be prepared for the unforeseen. The IRS commands a vast reservoir of data that extends well beyond income tax returns. This includes financial statements, information returns, and data procured from international tax authorities. Unintentional discrepancies between reporting positions adopted in the United States *versus* those in other countries are likely to be more readily spotted, given the wide array of data at the IRS' disposal. This underscores the growing importance of maintaining consistent reporting practices for multinational corporations.

Particularly noteworthy is Initiative 3.5, which indicates a strategy for increasing scrutiny of excise and employment taxes. In particular, excise tax disputes tend to involve large sums and can be intensely fact specific. They also frequently involve industry-wide issues, so the IRS uses a coordinated approach to such cases. For example, the IRS has a policy group dedicated to air transportation excise taxes with the goal of ensuring consistent positions across the aviation industry. Taxpayers subject to significant excise taxes, particularly in the energy and transportation sectors, should likewise develop an industry-wide approach to anticipating and responding to IRS activity, to the extent feasible.

This may tempt taxpayers in high-scrutiny categories to postpone any preparations for IRS audit activity. This would be short-sighted. The best time for large businesses and high-net-worth families to prepare for increased IRS scrutiny is now. So what should taxpayers in the high-scrutiny categories do now? The first step is to acknowledge that higher scrutiny is coming. That includes preparing C-suite executives and other decision-makers for increased risk and making the case for growing in-house capacity. Taxpayers must also remember the first principle of tax controversy: substantiation is key. Many winnable tax disputes are lost because taxpayers fail to substantiate their positions. Maintaining an audit-ready file of transactions with potential tax implications both reduces the burden on taxpayers during an audit and

increases the chances of success in a dispute. Awareness of the IRS' new strategy suggests that taxpayers should be on alert for changes in the business that may trigger a statistical alert. Anything that creates a significant change in a taxpayer's usual profile or that sets a taxpayer apart from its peers could be flagged as an anomaly by an IRS algorithm, and taxpayers must be alert to such situations and prepare for additional scrutiny.

While the IRS may not achieve all the objectives outlined in the Plan, it is important to note that not all the proposed enforcement strategies may see the light of day. However, it remains an unequivocal truth that the IRS has \$45.6 billion in dedicated enforcement funding at its disposal. The political backing for using these funds to focus on large corporations, substantial partnerships, and high-net-worth families is equally incontrovertible.

Given these realities, such taxpayers must fully recognize that a surge in IRS scrutiny is inevitable. As a result, they should be proactive in preparing for this increased oversight. Implementing stringent internal controls, ensuring the accuracy and consistency of financial reporting, and maintaining comprehensive documentation can help these taxpayers respond effectively to IRS audits. Maintaining an audit-ready file substantiating any potentially controversial tax positions will be a necessity for taxpayers facing an energized and well-funded exam team. Already taxpayers are reporting that revenue agents have a new swagger and are more aggressive in identifying issues on the assumption that they will soon have new resources at their disposal.

Moreover, considering the potential complexities and challenges associated with IRS scrutiny, prudent will seek professional advice. Tax professionals can provide valuable guidance on compliance strategies and can assist in navigating the audit process.

While the details of future IRS enforcement strategies may be uncertain, the certainty of increased scrutiny for certain taxpayer groups is clear. Preparation, accurate and consistent reporting, and professional advice are critical for these taxpayers in the face of the heightened oversight that is sure to come.

ENDNOTE

* The authors can be reached at ghani@milchev.com and rkovacev@milchev.com.

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