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Exam

IRS' Enhanced Enforcement Efforts For Partnerships and High-Net-Worth Individuals

By George Hani, Matt Cooper, and Bryan Skarlatos*

I. Introduction

With the passage of the Inflation Reduction Act and increased Internal Revenue Service (IRS) budget, as well as the new procedures under the Bipartisan Budget Act of 2015, the IRS is significantly increasing its examination focus and other enforcement activities relating to partnerships and high-net-worth individuals. This emphasis was made abundantly clear in the IRS Strategic Operating Plan.[1] Recently, the IRS has made good on its promise and made structural and substantive announcements with respect to its partnership and high-net-worth individual enforcement efforts.

In September 2023, the IRS announced a new work unit—a special group to focus on large or complex passthrough entities, specifically partnerships and S-corporations.[2] The IRS said that the "new unit will leverage Inflation Reduction Act funding to disrupt efforts by certain large partnerships to use passthroughs to intentionally shield income to avoid paying the taxes they owe." The IRS intends for the new unit to help reverse the trend of sharp drops in audit rates during the past decade for high-income and high-wealth individuals, partnerships, and S-corporations. While the formal shift to the new unit would take time, the IRS continued to increase its passthrough compliance focus.

This new unit "officially started work," as recently announced by the IRS.[3] Previously, passthrough exams were divided between the Large Business & International (LB&I) division and the Small Business/Self-Employed (SB/SE) division based on the size of the entity. Going forward, revenue agents in passthrough field operations will be assembled into geographically based teams that are responsible for primary exams of passthrough entity returns. LB&I will be responsible for starting passthrough exams, regardless of entity size. SB/SE will continue to examine passthrough entities as part of a related exam of a tax return.

The official start of this new partnership unit follows over a year of announcements enhancing enforcement efforts with respect to partnerships and high-net-worth individuals. In September 2023, the IRS announced a sweeping effort to restore fairness in tax compliance by shifting more attention onto high-income taxpayers, partnerships, large corporations, and promoters abusing the tax laws.[4] The effort will be driven with the help of artificial intelligence (AI) and improved technology to identify sophisticated tax schemes. The IRS identified the following as key efforts: (1) major expansion in high-income/high-wealth and partnership compliance work, (2) targeting priority areas for compliance work in fiscal year (FY) 2024, and (3) ensuring audit fairness and protecting taxpayers from scams.

Recently, the IRS has made good on its promise and made structural and substantive announcements with respect to its partnership and high-net-worth individual enforcement efforts.

As part of this effort, the IRS has opened examinations of 76 of the largest partnerships in the United States.[5] These partnerships represent a cross-section of industries, including hedge funds, real estate investment partnerships, publicly traded partnerships, large law firms, and other industries, each of which, on average, has more than $10 billion in assets. The IRS also announced its focus on large partnerships with more than $10 million in assets to address discrepancies on the balance sheets. In early October, the IRS began mailing compliance letters regarding these discrepancies to 500 partnerships. Additionally, the IRS will prioritize high-income cases and will intensify work on taxpayers with total positive income above $1 million that have more than $250,000 in recognized tax debt. Revenue Officers will focus on these high-end collection cases in FY 2024.

In October 2023, the IRS detailed new initiatives using Inflation Reduction Act funding to (1) ensure large corporations and high-income, high-wealth individual taxpayers pay taxes owed; (2) improve taxpayer service; and (3) modernize core technology infrastructure.[6] To achieve the first objective, the IRS announced it would increase its large foreign-owned corporations transfer pricing initiative efforts, expand the large Corporate Compliance program, crack down on abuse of repealed corporate tax breaks, and prioritize high-income cases. To improve taxpayer service, the IRS announced the launch of the first phase of its business tax account online tool that will eventually allow business taxpayers to check their tax payment history, make payments, view notices, and authorize powers of attorney. As of now, the online business accounts are available only for unincorporated sole proprietors. The announcement also discussed the IRS's Document Upload Tool, which allows taxpayers to respond to notices online. Finally, regarding modernization of technology, the IRS announced that it continues to make significant progress scanning and e-filing paper returns.

II. Partnership Enforcement Efforts

A. Related Party Basis-Shift Transactions

Among the issues expected to be a focus of the new partnership unit is what the IRS has labeled "related party basis-shift" transactions. Basis adjustments have been a significant aspect of partnership taxation since the enactment of Subchapter K as part of the Internal Revenue Code of 1954. Transactions involving partnerships, including with related parties, routinely take those adjustments into account in order to properly reflect the single layer of tax contemplated by Subchapter K. In general, basis adjustments are designed to preserve, where possible, parity between a partnership's inside basis in its assets and each partner's outside basis in their partnership interest. For example, if a partner with zero basis in his or her partnership interest receives a distribution of property from the partnership and the property in the hands of the partnership had $100 of basis, the partner will have a zero basis in the distributed asset and the partnership's $100 of basis will be shifted to other partnership assets.

On June 17, 2024, Treasury and the IRS issued a notice of intent to publish proposed regulations, a revenue ruling, and a notice of proposed rulemaking, all aimed at preventing taxpayers from benefiting from basis-adjustment transactions that might otherwise be in compliance with Subchapter K of the Code in circumstances that the government views as inappropriate and unintended. The IRS described the guidance as focusing on "the inappropriate use of partnership rules to inflate the basis of the underlying assets without causing any meaningful change to the economics of their business."[7] According to the IRS press release, a "new dedicated group in the Office of Chief Counsel specifically focused on developing guidance on partnerships" will be formed. In addition, the new group "will work closely with a new passthrough work group being established in the IRS LB&I division that will be formally established this fall." Consistent with the guidance released in June 2024, on August 28, 2024, the IRS released a draft of Form 7217, *Partner's Report of Property Distributed by a Partnership*, intended to make it easier for the IRS to identify basis-shifting transactions between multiple partners and partnerships of a multi-year period.

Notice 2024-54 announced forthcoming Proposed Related-Party Basis Adjustment Regulations and Proposed Consolidated Return Regulations. The forthcoming proposed regulations purporting to address inappropriate application of Subchapter K basis-adjustment provisions applicable to distributions/transfers of partnership interests, where related parties create basis adjustments without economic substance. The Notice previews the creation of a new term—the "Related-Party Basis Adjustment" (RPBA). As described, the basis would still shift to a new asset under the applicable Code section (*e.g.*, Code Sec. 732, 734(b), or 743(b)), but that shifted basis will carry the moniker "RPBA" and the recovery of the RPBA, whether through depreciation or computation of gain or loss on sale, would be subject to special rules. The proposed regulations would apply mechanically in transactions involving related parties, without regard to taxpayer intent or whether the transactions are in fact abusive or lacking in economic substance. The regulations, once finalized, would have retroactive application, applying to taxable years ending on or after June 17, 2024 (the date the Notice was issued), and even if the relevant covered transaction was completed in a prior taxable year, giving rise to further potential challenges. The Notice cites as authority for the forthcoming proposed related party basis-adjustment regulations Code Secs. 482, 732, 734(b), 743(b), 755, and 7805 and as authority for the proposed consolidated return regulations Code Sec. 1502. Authority and scope challenges should be anticipated.

Concurrent with the release of Notice 2024-54, the IRS released Rev. Rul. 2024-14, which lays out the government's approach to challenging transactions prior to the forthcoming proposed regulations becoming effective. The revenue ruling states that the IRS will apply the codified economic substance doctrine to challenge three broad categories of related party "basis-shifting" transactions, including transactions that:

- Create inside/outside basis disparities through various methods, including the use of certain partnership allocations and distributions;
- Capitalize on the disparity by either transferring a partnership interest in a nonrecognition transaction or making a current or liquidating distribution of partnership property to a partner; and
- Claim a basis adjustment under Code Sec. 732(b), 734(b), or 743(b) resulting from a nonrecognition transaction or distribution.

Revenue rulings in general set forth the IRS' conclusion on the application of the law to the facts stated but do not have the force and effect of law. Accordingly, while the positions set forth in Rev. Rul. 2024-14 are expected to be asserted by the IRS on audit and may complicate resolution of cases in Appeals, taxpayers are not required to follow them and courts will—at most—give the ruling only a lower level of "*Skidmore*" deference, considering whether its interpretation of Subchapter K is thoroughly considered, well-reasoned, and consistent with prior IRS positions (all expected to be points of contention).

The third and final item of guidance released on June 17, 2024, included proposed regulations that would make four types of identified related party basis-shifting transactions "transactions of interest" under the reportable transaction provisions of Code Secs. 6011, 6111, and 6112 and regulations issued thereunder. Generally tracking the description of "covered transactions" identified in Notice 2024-54, the four identified types of proposed "reportable" transactions include:

- A partnership distributing property to a person who is a related partner in a current or liquidating distribution, where the partnership increases the basis of one or more of its remaining properties under Code Sec. 734(b);
- A partnership distributing property to a person who is a related partner in liquidation of the person's partnership interest (or in complete liquidation of the partnership), and the basis of one or more distributed properties is increased under Code Sec. 732(b));
- A partnership distributing property to a person who is a related partner where the basis of one or more distributed properties is increased under Code Sec. 732(d) and the related partner acquired all or a part of its interest in the partnership in a transaction that would have been reportable under the proposed regulations if the partnership had a Code Sec. 754 election in effect for the year of transfer; and
- A partner transferring an interest in a partnership to a related partner in a recognition or nonrecognition transaction where the basis of one or more partnership properties is increased under Code Sec. 743(b).

Reporting would be triggered by participating in the transaction of interest, and participation is defined to include distribution or receipt of property for which one of the applicable rules causes a basis shift but also subsequent realization of tax benefits associated with the shifted basis. The transactions of interest described in the proposed regulations target related party transactions, but the proposed regulations also provide that a "substantially similar" transaction (which would also trigger reporting) includes, but is not limited to, a transaction as described between unrelated partners but one or more of the unrelated partners is "tax indifferent."

It is important to note that this new reporting requirement is still just proposed. The related party basis-shift transactions will not require reporting until these proposed regulations are finalized, and the final regulations should be scrutinized at that point to determine their precise scope. There is a look-back rule in the reportable transaction regulations (Reg. §1.6011-4(e)(2)) that provides that if a transaction becomes a transaction of interest and a taxpayer engaged in such a transaction in a prior year for which the tax return has been filed but the statute of limitations is still open, reporting is required within 90 days of the transaction becoming a transaction of interest.

B. Partnership-Related Campaigns

IRS.gov lists several other campaigns focused on partnership issues.[8]

1. Sale of Partnership Interest Campaign

The "Sale of Partnership Interest" campaign seeks to "address taxpayers who do not report the sale or do not report the gain or loss correctly." Gain or loss from the sale of a partnership interest is generally reported as a capital gain or loss. If the partnership interest was held for more than one year, the long-term capital gain tax rate is usually 15 percent. Higher capital gains rates may apply if the partnership depreciated real property or has appreciated collectibles at the time of the sale or exchange of the partnership interest. Further, the gain is not always capital. If the partnership had inventory items or unrealized receivables (so-called "hot assets") at the time of the sale or exchange, a portion of the gain or loss will be ordinary gain or loss. Among the types of incorrect reporting the IRS is targeting is "reporting the entire gain as long-term capital gain" at the 15-percent rate.

2. SECA Tax Campaign

Another campaign is called the "SECA Tax" campaign. Unless an individual partner qualifies as a "limited partner" for self-employment tax purposes, the partner's distributive share is subject to self-employment tax under the Self-Employment Contributions Act (SECA). What constitutes a "limited partner" for employment tax purposes has been the subject of recent litigation. In *Soroban Capital Partners L.P.*,[9] the Tax Court held that the limited partner exception of Code Sec. 1402(a)(13) does not apply to a partner who is limited in name only. Determining whether a partner is a limited partner in name only requires an inquiry into the functions and roles of the limited partner. Because net earnings from self-employment is a partnership item, an inquiry into the functions and roles of a limited partner is a factual determination that underlies a partnership item that is properly determined in a Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) proceeding. At least three other cases are in litigation, and numerous others are still at administrative level.

3. Partnership Losses in Excess of Partner's Basis Campaign

In addition, the "Partnership losses in excess of partner's basis" is intended to ensure that "partners that report flow-through losses from partnerships must have adequate outside basis as determined pursuant to Code Sec. 705 to deduct the losses or else the losses are suspended per Code Sec. 704(d) to the extent they exceed the partner's basis in the partnership interest."

4. Taxable Asset Transaction—Matching Buyer and Sellers Campaign

Finally, the "taxable asset transaction—Matching buyer and sellers" campaign targets "LB&I business entities that either did not report a transaction on Form 8594 or Form 8883, or that reported the transaction inconsistent with the other party's reporting of the transaction." Under Code Secs. 1060 and 338(h)(1), taxable asset transactions require the transaction and certain information to be reported on either Form 8594 or Form 8883.

III. High-Net-Worth Individual Enforcement Efforts

The Global High Wealth (GHW) program brings together a specialized, experienced group of examiners focused on conducting audits of high-income/high-wealth taxpayers and their affiliates. The GHW program was created to take a holistic approach to addressing the high-wealth taxpayer population and to look at the complete financial picture of high-wealth individuals and the enterprises they control. These enterprises may include interests in partnerships, trusts, and Subchapter S and C corporations. GWH personnel will also review related gift or estate tax returns. GHW personnel work with personnel from other operating divisions within the IRS to address noncompliance across the entire enterprise.

The Director of Passthrough Entities is responsible for providing oversight of the GHW program. GHW is responsible for business and financial enterprises controlled by individuals with assets or income in the tens of millions of dollars.

The IRS identifies a GHW case in a number of ways.[10] First, LB&I agents use computations, including the DIF (Discriminate Function) score to determine the examination potential of enterprises controlled by high-wealth individual taxpayers. The taxpayers and their returns are given risk scores, and the returns with the highest risk indicators are subject to further risk assessment as described below. Second, LB&I agents also receive referrals from the LB&I field examinations and other business units and make an initial determination of whether further risk assessment is appropriate. Third, LB&I agents receive whistleblower claims from the whistleblower office and determine whether further risk assessment is appropriate. Fourth, LB&I agents identify issues that may warrant additional screening. These issues can be identified from field examinations and interactions with specialists in technical areas such as international compliance. As issues are identified, all taxpayers within the population are screened for such issues, and determinations are made regarding whether further risk analysis is appropriate.

Based on these inputs, the IRS conducts a risk assessment and then sends selected cases to the field for audit. In the risk assessment, revenue agents conduct a detailed analysis consisting of researching taxpayer forms and related data, identifying specific issues, observing trends, and consulting with industry and other tax specialists. The IRS has a special tool—known as yK-1—to discover and explore tax entities and their relationships. The yK-1 analyses for each taxpayer provide a holistic understanding of the taxpayer's entire enterprise. This includes the individual return, returns for all related entities, and related gifts and estate returns. The risk assessment also identifies large, unusual, or questionable items (LUQs) for all entities and returns in the enterprise. The LUQs can be based on the comparative size of the item, the absolute size of the item, the inherent character of the item, evidence of the intent to mislead, the beneficial effect of the manner in which the item was reported, relationship to other items, possible whipsaw effect on other taxpayers, and missing items.

After completing the risk assessment, agents determine whether the case will be included in the inventory for assignment to the field for audit.

A. Prominent and Recent GHW Issues and Campaigns

1. Business Aircraft Campaign

The IRS announced a campaign to audit the use of corporate jets.[11] The business aircraft campaign addresses compliance concerns related to the use of business aircraft by large corporations, large partnerships, and high-income taxpayers. The IRS will use advanced analytics and newly hired agents to more closely examine corporate use of jets. Areas of emphasis will include qualified business use, personal use, and fringe benefit inclusion. Deductions are typically allowed for the expenses of purchasing, maintaining, and operating corporate jets if the jet is used for business purposes. However, there are detailed rules about how the use of a jet must be allocated between business use and personal use. If the jet is used primarily for personal use, this can result in deductions being reduced or denied and can also trigger income inclusion by individuals using the jet.

Taxpayers and practitioners encountering an audit of the use of a corporate jet should take steps to prepare for the audit. First, review tax returns from prior years to determine the full extent of the issue. Second, identify and gather documents and information relevant to the use of the aircraft and the way in which it was reported on the tax return, including flight logs, other travel records, bookkeeping entries, and related email correspondence. Third, review documents and interview witnesses, including pilots, flight attendants, and travel companions, to determine personal and business use of the aircraft. This is a highly specialized area, so consider bringing in outside experts in aircraft use and accounting under the cloak of privilege to help analyze the issues.

2. Sports Industry Losses Campaign

On January 16, 2024, the IRS announced its sports industry losses campaign designed to identify and initiate specialized issue-based examinations of partnerships operating in the sports industry reporting significant tax losses.[12] Potential losses can include depreciation deductions relating to stadiums and other fixed assets, amortization of deductions for media rights, and player contracts. Taxpayers are subject to several limitations on their ability to use losses from investments in sports activities. This includes basis limitations, at-risk rules, excess business loss rules, and passive activity loss rules. Most sports-related investments are made through partnerships, which are part of the IRS' renewed focus on passthrough entities. Tips for representing taxpayers involved in an audit of losses related to an investment in a sporting activity.

A few tips for taxpayers and practitioners encountering a sports industry loss campaign are listed here. As above, first review prior year's returns to understand the full scope of the issue. Second, focus on documentation of investments, distributions, and basis. Third, reconstruct a diary of the taxpayer's involvement in the activity. Even after-the-fact reconstructions of daily activities can constitute evidence of active involvement and material participation.

3. Art Donation Campaign

As part of the dirty-dozen campaign, the IRS warned wealthy taxpayers about an increased scrutiny of charitable deductions for donations of art.[13] This increased scrutiny will focus on taxpayers who donate art to charities at inflated valuations. The IRS is also focusing on promoters who encourage taxpayers to buy art, often at discounted prices. The promoters then encourage the purchaser to donate the art to a charity after waiting at least one year to claim a tax deduction for an inflated fair market value, which is substantially more than they paid for the art. The amount that taxpayers are allowed to deduct for the art also depends on the use to which a charity will put the art. If the charity uses the art to further its charitable tax-exempt purpose, then taxpayers can generally deduct the fair market value of the art. However, if the charity does not use the art in furtherance of its tax-exempt purpose, the donor's deduction is limited to the lesser of either fair market value or cost basis. There also are special recapture rules if the charity sells the artwork within three years after the donation. IRS has a team of professionally trained appraisers who provide assistance and advice to the IRS and taxpayers on valuation issues in connection with works of art.

The defense of art donations presents some novel issues for taxpayers and practitioners to consider in defending the deductions. As always, review and analyze all records regarding the purchase valuation of the art. Also, consider obtaining one or more additional qualified appraisals to support the value of the art deducted on the tax return. Also, consider gathering documentation and other oral testimony regarding the use to which the charity put the art.

4. Digital Assets

IRS announced continued focus on digital assets.[14] Initial reviews reveal the potential for a 75-percent noncompliance rate among taxpayers identified through record production from digital currency exchanges. The IRS will continue to expand its efforts involving digital assets, including increased use of John Doe summons to digital currency exchanges and other third parties, as well as enforcing proposed regulations on broker reporting. IRS 2024 Strategic Operating Plan—the plan implements data analytics, case selection procedures, an additional enforcement stage, and recently implemented information reporting to detect and deter cryptocurrency tax evasion. Question on page 1 of IRS Form 1040 concerning digital assets asks whether the taxpayer received, sold, exchanged, or otherwise disposed of a digital asset during the year. This will also yield more audits. Any person who answers yes to the question on IRS Form 1040 and/or who held a digital asset as a capital asset and who sold, exchanged, or transferred it, must report the transaction on IRS Form 8949 (*Sale or Exchange of Capital Asset*) to determine capital gain or loss that must be reported on schedule D. In addition, payments to employees, independent contractors, or gifts of digital assets all must be reported. Payments of digital assets to foreign recipients may be subject to withholding.

Preparing for audit issues involving digital assets can also present unique considerations. Consider what information and records may exist at exchanges or other counterparties to the digital asset transaction. Also, consider issues of volatility and illiquidity that may be unique to the digital asset at issue. Finally, most advisors do not have the ability to review the blockchain, so consider bringing in outside experts under the cloak of privilege to identify and analyze transactions on the blockchain.

ENDNOTES

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1 Internal Revenue Service Strategic Operating Plan, FY2023-2031, issued August 5, 2023. *See also* Hani and Kovacev, *Exam, Preparing for Heightened Tax Enforcement under the IRS Strategic Operating Plan*, J. TAX PRACT. PROC., Summer 2023.

2 IR-2023-176, Sep. 20, 2023.

3 IR-2024-276, Oct. 22, 2024.

4 IR-2023-166, Sep. 8, 2023.

5 *See* IR-2024-276, Oct. 22, 2024.

6 IR-2023-194, Oct. 20, 2023.

7 Fact Sheet 2024-21.

8 *See www.irs.gov/businesses/corporations/lbi-active-campaigns*.

9 161 TC No. 12, Dec. 62,310 (2023).

10 *See* IRM 4.52.1 (Apr. 27, 2022) (Global High Wealth Program Processes and Procedures).

11 IR-2024-46, Feb. 21, 2024.

12 IRS LB&I compliance campaign (Jan. 16, 2024) (*www.irs.gov/businesses/corporations/irs-lbi-compliance-campaign-jan-16-2024*).

13 IR-2024-104, Apr. 10, 2024.

14 IR-2023-166, Sep. 8, 2023.