

Tax Controversy & IRS Audits



2023 has been a year of major developments in tax controversy. The Internal Revenue Service (IRS) and state agencies both deployed increased resources and technological tools to increase the number of taxpayers under audit or examination.

A tax controversy refers to a legal or administrative dispute between a taxpayer and a tax authority regarding the interpretation or application of tax laws. The IRS received significant additional funding for tax enforcement under the Inflation Reduction Act of 2022¹. It encompasses issues such as the underreporting of income, deductions or disputed tax liabilities. This year the IRS has intensified its efforts to audit high-net-worth individuals and large partnerships. Pursuant to this initiative, the IRS has created a new working group to

target large passthrough entities and their owners, which will include both existing employees and some of the thirty-thousand experienced agents the IRS is planning to hire².

The IRS has also announced plans to “open examinations of 75 of the largest partnerships in the U.S. that represent a cross section of industries including hedge funds, real estate investment partnerships, publicly traded partnerships, large law firms and other industries” by the end of September³. Furthermore, the service has announced that it has “identified ongoing discrepancies on balance sheets” involving numerous partnerships with over \$10 million in assets, and that it will send out notices to these taxpayers which may result in audits depending on the taxpayers’ responses to these communications. It is therefore advised that taxpayers with over \$10 million of assets coordinate with their tax advisors if they receive one of these “soft notices” to prevent or prepare for an IRS audit. The IRS is also expected to target many high-net-worth individuals through the partnerships in which they have interests in. This is particularly relevant as the service has been given a directive not to increase the number of audits targeting taxpayers earning less than \$400,000 a year⁴, so the additional targeting of partnerships opens these lower earners to the same possible audits.

¹ Inflation Reduction Act; P.L. 117-169, (Aug 8, 2022)

² IRS Newsroom, IRS, <https://www.irs.gov/newsroom/irs-to-establish-special-pass-through-organization-to-help-with-high-income-compliance-efforts-new-workgroup-to-blend-current-employees-and-new-hires-to-focus-on-complex-partnerships-other-key-areas> (last visited Sept. 26, 2023).

³ IRS Newsroom, IRS, <https://www.irs.gov/newsroom/irs-announces-sweeping-effort-to-restore-fairness-to-tax-system-with-inflation-reduction-act-funding-new-compliance-efforts> (last visited Sept. 26, 2023).

⁴ IRS Newsroom, IRS, <https://www.irs.gov/newsroom/irs-announces-sweeping-effort-to-restore-fairness-to-tax-system-with-inflation-reduction-act-funding-new-compliance-efforts> (last visited Sept. 26, 2023).

There have also been efforts to reduce the burden on taxpayers and expedite the audit process. The IRS appears to be implementing various reforms, including accepting a higher number of digital records and documents, thus facilitating quicker audits. Additionally, the agency introduced online communication platforms for taxpayers and auditors to interact, reducing the need for in-person meetings and more cumbersome methods of communication⁵. However, these customer services improvements will do little to alleviate the burden of taxpayers who may be facing a larger number of audits.

The IRS is also stepping up collaboration with foreign tax authorities to combat offshore tax evasion. The Organisation for Economic Co-operation and Development (OECD) Common Reporting Standard (CRS) and The Foreign Account Tax Compliance Act (FATCA) will also pose additional risks for taxpayers, as governments exchange additional financial information with other countries, making it more difficult for taxpayers to shelter assets abroad. Moreover, the service is putting an increased emphasis on the economic substance of risk allocation under the Transfer Pricing Agreement.

The IRS is not the only tax agency of which taxpayers must be aware. State and local tax authorities have also stepped up their audits, as they seek to cover the funding gaps caused by the end of COVID-19-related Federal funding. For example, Massachusetts has implemented a “Millionaires Tax,” targeting high-net-worth individuals. The Millionaires Tax imposes an additional 4% income tax on the portion of a taxpayer’s income which exceeds \$1,000,000⁶.

⁵ About IRS: Accelerating Digital Communications to Solve Pandemic Challenges and Improve the Taxpayer Experience, IRS, <https://www.irs.gov/about-irs/accelerating-digital-communications-to-solve-pandemic-challenges-and-improve-the-taxpayer-experience>

To prepare for the likelihood of increasing tax audits, taxpayers should work with their advisors to identify risks and prepare audit files so that they can quickly respond to and address any tax inquiries that may come their way. Steps that taxpayers can take include: 1) reviewing their last three tax returns for any discrepancies or significant changes that may be a red flag for a tax authority; and, 2) gathering and organizing all the relevant financial documents, including tax returns, receipts, bank statements and supporting records, ensuring they are complete and accurate. Once an audit file is assembled, a taxpayer must be alert for any communications coming from a revenue agency and respond within the allocated time-period so that tax controversy can be contained and resolved quickly.

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⁶ Mass. Articles of Amendment 44, Mass. Constitution Article XLIV, as amended by Ballot Question 1 of 2022, approved (Nov 6, 2022).