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In this article, Cullinan and Vasquez predict how the IRS will use the influx of funding from the Inflation Reduction Act to pursue specific enforcement-related initiatives, and offer suggestions for those taxpayers that may get caught up in what could be coming.

Cullinan was the acting IRS chief of staff when the Inflation Reduction Act was enacted and helped structure and staff the Inflation Reduction Act Transformation and Implementation Office. Since leaving the IRS's chief of staff office in November 2022, he has had little involvement with the agency's plans for the IRA funding, and any statements in this article about actions the agency may take regarding that funding are based on intuition and not on any direct insight or information.

The IRS released its Inflation Reduction Act (IRA, P.L. 117-169) strategic operating plan on April 6.[1] The plan contains seven enforcement-related initiatives, one of which (Initiative 3.6) is to "pursue appropriate enforcement for complex, high-risk and emerging issues" (the emerging issues initiative). This article makes some predictions on what that may look like and offers suggestions for those who may get caught up in what may be coming. We are not opining on the merits of any particular transaction — our goal is to tell you where we think the IRS is headed, and what that may mean for taxpayers who may become subject to audits and litigation down the road.

We focus on the emerging issues initiative because the IRS appears better positioned to make quick inroads in that space than it is for some of the plan's other enforcement-related initiatives. Over the last few years the IRS has placed a renewed emphasis on emerging issues, as shown by the creation of the Office of Promoter Investigations (OPI) and the Joint Strategic Emerging Issues Team (JSEIT), both of which should give the IRS a head start on its emerging issues initiative.

The IRS created the OPI and JSEIT partially in response to a changing compliance environment.[2] Some readers may recall the 1990s and early 2000s, when promoters (often specialized advisers, but sometimes law and accounting firms or bankers) marketed aggressive tax-saving strategies by word of mouth or referral networks. They mostly tried to do this quietly, but the IRS eventually caught on. Between 1998 and 2004 the IRS "listed" some 30 transactions. By definition, a listed transaction is one "which is the same as, or substantially similar to, a transaction specifically identified by the Secretary as a tax avoidance transaction for purposes of section 6011."[3] That designation carries various disclosure requirements, puts additional penalties at issue, and may extend the time that the IRS has to assess tax. That wave of listing notices led to a lot of IRS enforcement and litigation, criminal investigations, congressional investigations, and private party lawsuits. Suffice it to say that a lot of taxpayers (and promoters) got hurt — both civilly and criminally. Some promoters went to jail, and a number went out of business.

[1] IRS, "Internal Revenue Service Inflation Reduction Act Strategic Operating Plan FY 2023-2031," Pub. 3744 (Apr. 2023).

[2] Tom Cullinan helped design and create both the OPI and JSEIT.

[3] *See* section 6707A(c)(2).

Then, for a while, things got quiet. The IRS listed four more transactions between 2005 and 2008, then one in 2015 and one in 2017, but none since, although it recently proposed regulations to list another.[4] It would be naïve to think that that is all that's going on in the marketplace for tax savings strategies. If anything, the market has almost certainly expanded well beyond what it was in the late 1990s and early 2000s. While promoters used to worry about getting on the IRS's radar, in the past few years we've seen advertised "guaranteed four-to-one write-offs" in the back of financial and airline magazines. Taxpayers have heard extremely aggressive pitches on the radio, internet, and in person. They have gotten cold calls insisting that they qualify for the employee retention credit, to the tune of $26,000 per employee per quarter, and claiming that they have maximum eligibility for all employees for all quarters, while also conveniently forgetting to take into account any potentially required Paycheck Protection Program offsets. Things have also gotten far easier for taxpayers that are actively looking for more aggressive tax savings strategies. You used to have to "know a guy" to get beyond the basic tax savings devices (for example, bunch your deductions, contribute to your 401(k)), but now you can find a bevy of more aggressive strategies with a couple of internet searches — or the more aggressive strategies will find you.

The IRS knows this — or at least knows about some of it. And in a section of the emerging issues initiative titled "Where We Are Heading," the plan confirms that the reduced (by historical standards) enforcement activity for emerging issues is the result of a lack of resources and not knowledge:

> The IRS tracks many known, high-risk issues in noncompliance, such as digital asset transactions, listed transactions and certain international issues. These issues arise in multiple taxpayer segments, and data analysis shows a higher potential for noncompliance. Recent resource limitations have prevented the IRS from sufficiently examining these issues, while new issues that could significantly raise noncompliance and fraud schemes emerge each year, especially as new tax laws are enacted.[5]

So the plan tells us that the IRS intends to use some of its new funding to increase enforcement activities regarding these types of emerging issues. But what makes us think that we may see more tangible IRS enforcement activity on these issues before we see it for some of the other enforcement-related initiatives laid out in the plan?

For one thing, the plan itself seems to confirm that view. It lists two key projects for four of the enforcement initiatives, which are to expand enforcement actions targeting large corporations (Initiative 3.2), large partnerships (Initiative 3.3), high-income and high-wealth individuals (Initiative 3.4), and "areas where audit coverage has declined to levels that erode voluntary compliance" (Initiative 3.5). The first key project for all four of these initiatives involves hiring and training the staff needed to achieve compliance coverage rates. The second key project involves either developing or refining approaches and treatments.

The key projects associated with the emerging issues initiative, on the other hand, are quite different, not least because there are four rather than two. They set out to:

1. *Mobilize resources to focus on high-risk and emerging issues that have not received appropriate enforcement attention.* Increase enforcement pertaining to digital assets, listed transactions, certain international issues and any other key issues that emerge.
2. *Improve, expedite, and scale detection of emerging issues, including building stronger feedback processes from all parts of the IRS.* Reinforce and expand the IRS's strategic detection of issues and develop pathways for providing feedback on important emerging issues.
3. *Establish processes to respond more rapidly to emerging issues and develop treatments that can be deployed quickly and integrated into*

[4] REG-109309-22.

[5] IRS, *supra* note 1.

enforcement efforts. Develop and deploy new digital tools and analytics capabilities to respond to and enforce tax laws pertaining to emerging issues. Explore and pilot enforcement treatments for specific emerging issues. Refine existing tools and processes, such as audits, to adapt to a changing landscape and account for key emerging issues. Use improved analytics to identify patterns of noncompliance and apply the most appropriate treatment to each taxpayer situation.

4. *Hire, onboard, and train the staff needed to achieve appropriate compliance coverage rates.* Identify the optimal mix of employee skills and strategically focus hiring and training efforts to build a compliance workforce capable of detecting and responding to key emerging issues. Implement rapid, focused hiring and skills development to cover key issues for enforcement.[6] [Emphasis in original.]

Those key projects, at least when compared with the key projects listed under the other initiatives, suggest a closer state of IRS readiness.

A few other factors buttress our view that in the near term we may see more noticeable enforcement on emerging issues than some on the other initiatives:

- As discussed above, the IRS has previously done that type of work at scale — most recently in the 2000s on the last wave of emerging issues — so it has a playbook in hand.
- As discussed below, the IRS has already identified many promoted tax strategies that it has determined are abusive, some of which it has publicly identified.
- The amounts at issue can be quite large, potentially producing a large return on investment that may be of interest to the IRS's auditors (the Treasury Inspector General for Tax Administration and Government Accountability Office) and congressional appropriators.
- While in our experience the IRS does not do things for political reasons, it would seem difficult for even the most anti-IRS politician to criticize the agency for increasing enforcement against some of the most egregious transactions.
- The enforcement work may be easier to do than some of the other types of work contemplated by the plan. For example, it should be easier to train and deploy revenue agents to examine mass-marketed transactions that look alike (think son-of-BOSS in Notice 2000-44, 2000-36 IRB 1, from years ago) than more isolated and taxpayer-specific corporate and partnership issues.
- As noted above, the JSEIT would seemingly help the IRS hit the ground running on some of these key projects since it was created to bring together IRS resources to identify emerging tax compliance threats and to make treatment recommendations.

With that background, what are some of the things the IRS might focus more attention on? The first key project in the emerging issues initiative concerns "digital assets, listed transactions, certain international issues, and any other key issues that emerge." That would presumably include transactions that the IRS has already identified as potentially problematic, such as those included on the most recent iteration of the agency's annual "Dirty Dozen" list.[7] That list identifies several transactions that could see increased IRS enforcement:

- *Charitable remainder annuity trusts.* Charitable remainder trusts are irrevocable trusts that let individuals donate assets to charity and draw annual income for life or a specific period. The IRS alleges that these trusts can be misused by promoters, advisers, and taxpayers to try to eliminate ordinary income and/or capital gain on the sale of the property.
- *Monetized installment sales.* In these transactions, IRS-labeled promoters find taxpayers seeking to defer the recognition of gain on the sale of appreciated property and

[6] *Id.*

[7] IR-2023-71 (IRS "Dirty Dozen" list).

facilitate a monetized installment sale for the taxpayer.

- *Microcaptive insurance arrangements.* A microcaptive is an insurance company whose owners elect to be taxed on the captive's investment income. The IRS's position is that abusive microcaptives involve strategies that lack many of the attributes of legitimate insurance, such as risk distribution. According to the IRS, these structures can include implausible risks, failure to match genuine business needs, and in some cases potentially unnecessary duplication of the taxpayer's commercial coverages.
- *Syndicated conservation easements.* A conservation easement is a restriction on the use of real property. Generally, taxpayers may claim a charitable contribution deduction for the fair market value of a conservation easement transferred to a charity if the transfer meets the requirements of section 170. In the IRS's view, potentially abusive arrangements occur when participants attempt to obtain inflated tax deductions through syndicated arrangements.
- *Offshore accounts and digital assets.* The IRS scrutinizes attempts to hide assets in offshore accounts and those holding digital assets such as cryptocurrency. The agency identifies individuals who attempt to conceal income in offshore banks, brokerage accounts, digital asset accounts, and nominee entities. Asset protection professionals and IRS-labeled promoters continue to find U.S. persons to place their assets in offshore accounts and structures, purportedly saying they are out of reach of the IRS. The IRS can identify and track anonymous transactions of foreign financial accounts as well as digital assets.
- *Maltese individual retirement arrangements misusing a treaty.* These arrangements involve U.S. citizens or residents who attempt to avoid U.S. tax by contributing to foreign individual retirement arrangements in Malta (or potentially other host countries). The participants in these transactions often lack any local connection to the host country. According to the IRS, by asserting that the foreign arrangement is a pension fund for U.S. tax treaty purposes, the U.S. taxpayer misconstrues the relevant treaty provisions and improperly claims an exemption from U.S. income tax on gains and earnings in and distributions from the foreign individual retirement arrangement.
- *Puerto Rican and foreign captive insurance.* Under these arrangements, U.S. business owners of closely held entities participate in an insurance arrangement with a Puerto Rican or other foreign corporation in which the U.S. business owner has a financial interest. The U.S. business owner (or a related entity) claims a deduction for amounts paid as premiums for "insurance coverage" provided by a carrier, which reinsures the coverage with the Puerto Rican or other foreign corporation. The IRS has challenged some of these transactions as lacking the attributes of insurance.
- *ERC claims.* The ERC was part of the CARES Act, which was part of Congress's response to the COVID-19 pandemic. The goal of the ERC is to help employers maintain staff and keep workers employed. Unfortunately, the ERC has been abused nationwide. While there are millions of companies rightfully eligible for the ERC, many are not, and not all employers are eligible for all periods. Further, those that are eligible must determine the amount of potential reductions in ERC amounts by taking into account any PPP amounts received and forgiven. While not technically on the 2023 Dirty Dozen list yet (but still highlighted in the IRS notice), no less than four IRS notices have come out within the last two months regarding the ERC. Taxpayers should be aware of aggressive pitches from promoters that promise large, inappropriate refunds related to the ERC. The warning follows blatant attempts by promoters to con ineligible people into claiming the credit or expanding the period of eligibility beyond the true and legitimate eligibility period. The IRS highlighted these promotions by those who have been blasting ads on the radio and internet touting refunds involving

> ERCs, claiming that companies can receive $26,000 per employee in ERC funds. These promotions can be based on inaccurate information related to eligibility for and computation of the credit. Also, some of these advertisements exist solely to collect the taxpayer's personally identifiable information. Some scammers then use that information to conduct identity theft.

Some of the transactions described by the IRS have a consumer protection aspect (for example, the discussion of the ERC), whereas others have a harsher tone. Regardless, the IRS publishes the list to warn taxpayers of its views, and perhaps to discourage promoters — or at least make it harder for them to find willing buyers. Recently, the IRS Office of Professional Responsibility also got involved regarding the ERC to remind tax practitioners of their ethical obligations and due diligence requirements when helping clients to determine eligibility and file for the ERC. But those warnings from the IRS and the OPR only remain credible if the IRS backs them up with enforcement activity against those who engage in the transactions anyway, which is another reason that it would be reasonable to assume we will see more enforcement activity on these transactions.

Finally, the GAO, which shares responsibility for auditing the IRS with TIGTA, issued a report in December 2022 on abusive tax schemes.[8] One section of that report is titled "IRS Is Conducting Hundreds of Investigations of Promoters Involving Dozens of Types of Abusive Tax Schemes." In the same section, GAO reported that the "IRS was investigating over 40 types of abusive tax schemes involving promoters." The GAO confirmed that the list includes several transactions on the Dirty Dozen list, including, as the GAO described them, abusive syndicated conservation easements, abusive microcaptive insurance arrangements, abusive use of charitable remainder annuity trusts, abusive use of a tax treaty between the United States and Malta, and inappropriate use of monetized installment sales, plus one more area that was not among the Dirty Dozen — "improper claims of business research credits."

What might the enforcement activity look like? Obviously there will be more audits. But as we have recently seen, the IRS has other enforcement options, some of which may lend themselves to emerging issues, and some that would require far fewer resources than full-scale audit campaigns. The IRS can:

- pursue legislative solutions, as it did for syndicated conservation easements;
- issue "soft letters," as we recently saw for cryptocurrency and certain microcaptive insurance transactions;
- publish warnings (the multiple recent press releases on the ERC are a good example);
- change tax forms and instructions, as it recently did in requiring answers to questions about transactions involving digital assets;
- make criminal referrals;
- entice taxpayers to self-help (usually by getting them to amend returns) or otherwise seek to resolve the issue through some type of settlement initiative;
- "list" the transaction or make it a "transaction of interest," as it recently did for certain microcaptive insurance transactions;
- litigate, and even "designate" certain cases for litigation, meaning it will not settle them short of a full concession, to set judicial precedent;
- promulgate regulations or issue administrative or other forms of guidance;
- take other actions, such as the recent competent authority agreement between the United States and Malta that is relevant to the Malta pension planning transaction; or
- some combination of the above, plus whatever other actions we may have forgotten.

What should taxpayers do if they've already engaged in one or more of the transactions that the IRS has shown interest in? We've lost count of all the clients we've discussed those issues with, and the options will differ depending on whether the taxpayer has already reported the transaction on a return and, if so, whether the IRS has already started an audit.

[8] GAO, "Abusive Tax Schemes: Additional Steps Could Further IRS Efforts to Detect and Deter Promoters," GAO-23-105843 (Dec. 15, 2022).

If taxpayers have engaged in the transaction but have not yet claimed it on a tax return, they were likely aware of the IRS warnings and decided to proceed. Thus, it seems unlikely that these taxpayers will simply walk away. One option for taxpayers in this group may be to pursue the tax benefits through a protective refund claim, which may limit — but not necessarily eliminate — exposure to penalties. Relatedly, if a taxpayer applied for and possibly received ERC funds through a promoter and now that taxpayer is unsure whether he rightfully qualifies for the credit, an after-the-fact analysis can be performed by a qualified and independent tax professional to determine whether he is eligible. If the taxpayer is already under audit, he can expect a robust process that may lead to an IRS appeal and perhaps litigation. Some taxpayers make deposits or prepay the tax during this time to limit the potential interest cost on any additional tax that may be owed.

If the taxpayer has already reported the transaction on a return but is not yet under audit, he might have the option of amending the return to remove the transaction (in what the IRS calls a qualified amended return), which may also eliminate the risk of civil penalties. That option raises several issues, some technical, so taxpayers would be well advised to speak with a tax professional before taking that step. Some of the factors to consider might include:

- How strong is the reporting position? Some of the transactions listed above may be more legally defensible than others, and individual transactions of each type may also be more defensible than others. For example, many ERC claims are perfectly legitimate, as are some microcaptive insurance transactions. On the other hand, some of those are clearly abusive. Still others fall into a grey area that requires careful analysis.
- How strong is the taxpayer's penalty defense if the transaction is ultimately disallowed? Was a legal opinion secured?
- How much time does the IRS have left to open an audit? Are you sure you know? (The IRS is not afraid to take some aggressive positions on the statute of limitations, and it can unilaterally extend that time if it makes something a listed transaction. In the ERC space, Congress armed the IRS with a five-year statute of limitations for assessment under section 3134(l).)
- What is the taxpayer's comfort level? Is he sleeping at night?
- How much tax is at issue? What is the possible penalty?
- What did the taxpayer do with the tax savings?

All in all, the IRS is well armed with its additional funding to absolutely ramp up enforcement efforts in the areas that need to be targeted to promote effective tax administration. We know from the emerging issues and Dirty Dozen list what some of the enforcement efforts over the next few years will look like, and we can be sure that as additional tax strategies arise, more will be added to the list of enforcement priorities. ■