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Increasing IRS Audits in Information Reporting and Withholding Regimes

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There is a growing sentiment in the Capital that the IRS is in dire need of additional funding. Tasked with collecting tax and administering the nation's tax laws, IRS officials continue to highlight the agency's operational deficiencies and continue to renew requests for additional agency funding. Although it is unclear to what extent the IRS will receive additional funding in the near term, recent events indicate that a potential audit winter is on the horizon, and it could be long, cold, and harsh.

Recent government reports help shed light on some of these pressing issues, and in particular, highlight the need for additional IRS auditors. As reported in the United States Government Accountability Office's report on tax compliance dated May 2022, over the past decade, IRS audit rates have consistently declined with the largest decrease in audit rates among individual taxpayers with income of \$200,000 or more. The IRS attributes these declining audit rates to high attrition (i.e., the IRS's inability to hire, train and retain skilled workers), work disruptions (e.g., government shutdowns and the COVID-19 pandemic) and changes in tax law (which require auditors to spend more time researching new issues as they arise). To add fuel to the fire, the report also states that the IRS predicts that approximately 15 percent of its

current staff of auditors will retire within the next three years.

Moreover, despite the overall decline in agency funding over the past decade, one of the IRS's top priorities remains the modernization of its technologies and operating systems. On May 18, 2022, before the House Appropriations Committee, IRS Commissioner Charles Rettig reiterated that the IRS has been operating as a "paper-based organization" in a "digital world environment," and stressed the importance of consistent, timely, multi-year funding to allow for sufficient investment in the modernization of IRS technologies and operating systems.

As part of his written testimony, Rettig emphasized that current IT resources preclude the IRS from building adequate solutions for efficiently matching and reconciling data from multiple sources, which often leaves the IRS with manually (yes, manually) processing reporting information. As an example, Rettig highlights the IRS's lack of funding for the appropriate implementation of the Foreign Account Tax Compliance Act (FATCA), which was enacted in 2010 as part of the Hiring Incentives to Restore Employment (HIRE) Act to combat tax evasion by U.S. persons holding investments in offshore accounts. Rettig states that even if the IRS identifies potential non-compliance with FATCA, the IRS oftentimes does not have sufficient funding to pursue the information and ensure proper compliance.

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Although some tax commentators have suggested that the current IRS appears much less effective than it was even just a decade ago, many commentators expect things to change in the near future. The repeated call for additional agency funding by government officials (including proposed plans set forth by the Biden administration over the past several months to further equip the IRS with additional resources), coupled with the less-than-flattering statistics in recent government reports highlighting the IRS's current inefficiencies, all suggest that additional IRS funding is on the way. The expectation is that a significant portion of any additional funding would be allocated to (i) support a larger, more efficient, and highly trained audit team that can carry out enforcement activity and (ii) upgrade IRS technologies and operating systems. Furthermore, common sense suggests that the IRS will be inclined to invest their resources in items expected to produce the most amount of tax revenue relative to the expenditure. For example, with even meager investments made in upgrading current IRS technologies, the IRS should theoretically be able to efficiently detect discrepancies and identify trends of noncompliance by sorting through the information the IRS already collects from taxpayers (e.g., coordinating between the information provided on tax returns and information returns).

There are current steps that taxpayers may decide to take in anticipation of increased audits over the next few years, especially in the area of Form 1042, 1042-S and 1099 audits (tax returns and information reporting relating to amounts paid to, and withheld upon, U.S. and non-U.S. payees). An IRS audit of Forms 1042, 1042-S and/or 1099 will look to, in part, a taxpayer's onboarding, withholding, and reporting procedures. One aspect of such an audit that may be a primary focus of an IRS agent is the collection and validation of Forms W-8 and W-9 from non-U.S. and U.S. payees, respectively, since the accuracy and validity of such forms are crucial to the determination of the appropriate amount of U.S. withholding tax to be imposed on a payment, as well as the corresponding information reporting that may be required pursuant to the Internal Revenue Code. A taxpayer's receipt of an invalid or inaccurate Form W-8 or W-9 will likely impact such taxpayer's ability to impose the appropriate amount of withholding tax and conduct accurate information reporting.

In anticipation of increased audits, taxpayers are currently in the position to conduct internal reviews of such forms and, to the extent any failures are discovered, proactively take steps to remediate invalid forms. Even what some may consider to be an immaterial omission on a Form W-8 may be viewed by an IRS agent as an incomplete form, potentially resulting in underwithholding exposure, including associated penalties and interest. Similarly, taxpayers may proactively review existing remediation procedures in place to ensure controls for detecting and remediating incidences of "U.S. indicia" on Forms W-8 (e.g., a U.S. address) are working properly. Lastly, taxpayers may also proactively take steps to ensure that appropriate form validity procedures are in place. For example, a Form W-8BEN-E, certificate of status of beneficial owner, is generally only valid for a period of three complete years, after which point a new, updated form may be required to be obtained. Failure to resolicit and obtain an updated form upon the expiration of a form that is on file may result in the requirement to impose the maximum rate of withholding tax on future payments.

With the potential of increased IRS funding, which is expected to result in an influx of IRS agents and updated IRS technologies, it is likely that we will see increased IRS audits, especially for information reporting and withholding. Taxpayers should carefully consider what, if anything, they should do to survive the impending audit winter.