Anticipating Intensified Partnership Enforcement From IRS

By **Sharon Katz-Pearlman** (October 27, 2023)

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The Internal Revenue Service has begun to operationalize its April 2023 Strategic Operating Plan, laying out its vision for 2023-2031, a vision that has been made possible by the additional and extensive funding that the IRS received under the Inflation Reduction Act of 2022.

Although the funding was a political hot button, in the end, much of the $80 billion survived, and it will be put to good use in a variety of areas including modernization, customer service, hiring and enforcement activity.

Much of the funding will go toward hiring and enforcement, providing the IRS with the ability to finally bring in much-needed additional resources, train those resources, and then put them to work. With the announcement of new enforcement initiatives specifically focused on partnerships both large and small, as well as global high-wealth individuals, enforcement in these areas moves to a new level.

A clear example of this is the IRS' September announcement of the launch of a new group focused solely on pass-through entities, one component of its broader plan to increase compliance in this space, and the related high-wealth area.

Given the funding, the hiring yet to come and the anticipated training, practitioners and taxpayers should expect to see a steady increase in the number of partnership audits and adjustments.

In the introductory memorandum from Commissioner Daniel Werfel to Treasury Secretary Janice Yellen that accompanies the Strategic Operating Plan, the vision is explained as one that provides for a "world class customer service operation," an organization that is "rooted in modern technology" and an agency whose professionals have specialized skills "in place to unpack the complex filings of high-income taxpayers and large corporations and partnerships so Americans have confidence that all taxpayers, regardless of means, are doing their part to meet their responsibilities under our tax laws."

While much has been written about the critical technology and customer service aspects of the Strategic Operating Plan, the greatest interest has been on "unpacking the complex filings of high-income taxpayers and large corporations and partnerships."

These three types of taxpayers have long been focus areas for the IRS, but of the three, the IRS' "relationship" with partnership enforcement has been the most challenging, with a long and interesting history.

Until the enactment of the Bipartisan Budget Act of 2015, or BBA, containing new provisions for streamlining the IRS' partnership audit procedures, the process was governed by the Tax Equity and Fiscal Responsibility Act. TEFRA was enacted to help the IRS manage the difficulties inherent in auditing partnerships and to assist with the major problem of controlling the statutes of limitation for the multiple partner/investors in the partnership.[1]

TEFRA however, was not as helpful as lawmakers intended. Because a partnership is a flow-

through entity, the impact of an examination adjustment to Form 1065, U.S. Return of Partnership Income, was not felt by the partnership itself; rather the adjustments would flow through to the partners, and the IRS was responsible for collecting the tax from the individual partners, an extensive and often impossible task. Overall, TEFRA was difficult to implement, and the challenges of the TEFRA statute had a chilling effect on IRS partnership enforcement activity.

The realization of and concern over TEFRA's ineffectiveness and the IRS' seeming inability to audit partnerships began long ago. In 2014, the U.S. Government Accountability Office issued a report titled "Large Partnerships — With Growing Number of Partnerships, IRS needs to Improve Audit Efficiency," highlighting several of the problems with TEFRA.[2]

The GAO wrote of the challenges that auditors faced in implementing the provisions, and the difficulties encountered in identifying the tax matters partner and in managing the flow-through of the adjustments to the partners. Under TEFRA, the tax could not be assessed and collected at the partnership level, absent a partnership election to allow this, with almost no partnerships making this election.

While the GAO report specifically focused on large partnerships — defined as partnerships with $100 million or more in assets and 100 or more direct and/or indirect partners — the findings were consistent with concerns about the overall partnership audit rate, which had been declining for many years, despite the increasing number of partnership returns being filed. The GAO honed in on the oft-mentioned fact that partnership audits often resulted in a "no change" and noted that, while the number of large partnership return filings had tripled from 2002 to 2011, most of the few audits that occurred resulted in no change to the partnership's return.[3]

All of the report's recommendations focused on obtaining better audit coverage of large partnerships.

Over the next several years, partnerships continued to be top of mind for the IRS. Practitioners and taxpayers braced for increasing partnership audit activity, yet nothing changed. While the enactment of the BBA was a huge "win" for the IRS' ability to audit partnerships more easily, there was no immediate impact.

In March 2022, the Treasury Inspector General for Tax Administration released a report titled "Centralized Partnership Audit Regime Rules Have been Implemented; However Initial No-Change Rates Are High and Measurable Goals Have Not Been Established."[4] Considering the impact of the BBA provisions on the IRS' audit activity, TIGTA concluded that again, there was insufficient coverage and too many no-change letters.[5]

Finding that the IRS did not have goals or processes in place to appropriately measure their BBA partnership examination activity, TIGTA recommended an action plan to reduce the number of BBA audit no-change rates and suggested that if the no-change rates did not fall within an "acceptable range," then a study should be undertaken to determine why. IRS management disagreed, noting that setting a benchmark for a no change rate could violate the prohibition on imposing or suggesting production quotas.[6]

A similar recommendation to establish goals related to audit outcomes was similarly not agreed to for the same reason. The IRS agreed with the recommendation to monitor whether "push-outs" are properly reflected on the partner's returns.[7] In response to TIGTA's less-than-flattering report, the IRS provided a thoughtful, clear and appropriate response.[8]

The barrage of reports focused on the IRS' partnership audit activity continued. In July 2023, the GAO issued another report: "Tax Enforcement: IRS Audit Processes Can Be Strengthened to Address a Growing Number of Large Complex Partnerships."[9] The GAO again commented on the small number of partnership audits and the decline in coverage, noting that over 80% of the audits during the 2010-2018 period had resulted in no change — double the rate of no change results for corporate audits. The GAO was uncertain about the impact of the BBA, citing limited data.

In response to the findings, criticisms and recommendations, the IRS once again provided thoughtful, clear responses. It identified the additional funding from the Inflation Reduction Act as critical to the IRS' ability to examine more partnerships. It also provided good context to several of the GAO conclusions, noting that many of the report's conclusions relate to TEFRA audits, with procedures that simply did not work for large partnerships.

The IRS also made the point that since partnership examinations began with Form 1065, the tracking system reports the results at the partner level. So, the reported no-change may result from the fact that there was no adjustment at the partnership level, even though a change may have occurred on a related return. IRS is considering how it may capture this information to better reflect their activities.

The result of these reports and the decadeslong difficulties that the IRS has had with partnership audits has led to the recent announcement of a clear, well-funded, focused IRS partnership initiative with several component parts.

Heading into 2024, there are definite changes ahead, and businesses operating in partnership form will feel the impact.

First, the IRS has announced the expansion of LPC, to include an additional 75 large partnerships, bringing the LPC total to 125 large partnerships under audit.

As the first tranche of LPC examinations began in 2021, there is no data available on the success rate of those examinations, but the addition of another 75 large partnerships is a meaningful occurrence. The LPC partnerships are the very largest of the large — hedge funds, real estate investment partnerships, etc. — and have average assets of $10 billion or more. LPC is a critical part of the overall initiative, and as LPC matures and its procedures and processes better defined, more large partnerships should expect to be audited.

In early September the IRS issued additional guidance on the initiative, indicating that in addition to broadening its focus on partnership noncompliance and examinations, it is closely aligning these partnership enforcement efforts with those of the Large Business and International Division's global high-wealth group, which examines the returns of the very wealthiest U.S. filers.

The connection to partnerships is clear; wealthy people tend to invest in multiple partnerships. By aligning these two areas, the IRS' efforts will benefit from efficiencies created by the synergies and similarities among these two groups of taxpayers.

Looking ahead, not only will more partnerships be selected for audit, but high-wealth individuals can expect to experience more audit activity as well.

In early September, the IRS issued IR 2023-166, identifying new areas of focus for the IRS' evolving enforcement initiatives. In addition to the expansion of LPC, the IRS noted that the

75 additional partnerships were chosen using artificial intelligence to identify potential noncompliance risk. AI is critical to the IRS' initiative, as it plans to use AI and data and analytics to identify and select taxpayers for examination.

The IRS also announced the identification of approximately 500 partnerships, each with assets over $10 million, exhibiting balance sheet discrepancies. These partnerships have received compliance letters alerting them to the discrepancy that has been noted and asking for clarification. One may assume that many of these partnerships will enter the examination stream.

In late September, the IRS announced the creation of a new group within the Large Business and International Division to focus on large and complex partnerships. The creation of this group is meaningful, as is the announced hiring of an additional 3,700 LB&I examiners to assist with their efforts. Initially, the new group will be staffed with examiners from both LB&I and SBSE.

With these announcements, the IRS is finally pursuing the partnership enforcement activity that has eluded the agency for years. Armed with additional funding, hiring authority and AI, IRS partnership audit activity will certainly rise. The increase in partnership audits has already been felt, and BBA audits are no longer the rare curiosities as they were even a year ago.

Taxpayers who operate in partnership structure should begin reviewing their open year returns, ensuring that open and closing balance sheets align, and ensuring that their positions are well documented and sustainable.

Partnerships should also be considering whether an administrative adjustment request should be filed to correct any issues that are identified during the review. Other BBA requirements should be revisited, including confirming that the identified partnership representative is appropriate. Careful thought should be given to who might replace that representative once the partnership is contacted for audit, should a change be warranted.

The new initiatives are focused on a clear objective: identifying and examining partnerships that may be noncompliant and have previously escaped scrutiny. The coming wave of new examinations will likely be difficult to work through.

The partnership tax provisions of Sub-Chapter K are extraordinarily complicated, and the IRS recognizes the need for training and expertise in this area. That expertise will take time to develop, and taxpayers will need to be patient with the examination teams. Just as the audits of the new Tax Cuts and Jobs Act provisions have tested taxpayers' fortitude, so will these.

Given these developments, businesses should proceed cautiously and deliberately if they are contacted for audit. After so many years of criticism regarding its inability to effectively audit partnerships, the IRS is poised to begin anew. There is a tremendous amount of work for the IRS to do, but its clear, concerted efforts across the partnership universe will lead to a substantial increase in activity in the coming months and years.

Partnerships need to prepare for what is coming. And the IRS might consider licensing the use of the Jefferson Starship hit from the late 1980s as their partnership initiative theme song: "And we can build this dream together/ Standing strong forever/ Nothing's gonna stop us now." This might indeed finally be the case.

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[1] Prior to TEFRA, the IRS was required to obtain individual statute extensions from each partner to protect the statute and the government's ability to assess a deficiency. TEFRA provided an out for the Service, allowing it to extend the statute at the partnership level, extending the statute for all partners as to "partnership items", a defined term which has been subject to great debate over the years.

[2] See, https://www.gao.gov/assets/gao-14-732.pdf, GAO – 14 -732.

[3] See, https://www.gao.gov/assets/gao-14-732.pdf.

[4] See, https://www.oversight.gov/sites/default/files/oig-reports/TIGTA/202230020fr.pdf.

[5] TIGTA stated that as of the end of Fiscal Year 2021, the IRS has completed a total of 480 examinations, including the Tax Years 2016 through 2019. The IRS closed 376 (approximately 78 percent) of these partnership returns as a no-change. TIGTA concluded that this rate is high in comparison to the average no-change rate of 50 percent for all partnership returns for the same tax years, closed as of September 30, 2020.

[6] Id at page 14. See, Section 1204 of the IRS Restructuring and Reform Act of 1998. TIGTA did not agree with these conclusions.

[7] A "push-out" refers to the BBA provision which allows the partnership representative to "push out" the audit adjustments to its partners, rather than have the partnership itself make the payment. If the adjustment amount is "pushed-out", it becomes the individual partner's responsibility.

[8] In May 2022, the IRS issued updated Data Book information in several categories, including partnerships. The updated figures indicate that the partnership audit rate dropped from .5% of returns in 2010 to .1%, in 2017.[8] That is a 79.3% decrease in examination activity. This, while the number of partnership returns was increasing.

[9] See, https://www.gao.gov/assets/gao-23-106020.pdf (GAO-23-106020).