Additional Improvements Are Needed to Measure the Success and Productivity of the Partnership Audit Process

March 18, 2015

Reference Number: 2015-30-004

This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.

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ADDITIONAL IMPROVEMENTS ARE NEEDED TO MEASURE THE SUCCESS AND PRODUCTIVITY OF THE PARTNERSHIP AUDIT PROCESS

Highlights

Final Report issued on March 18, 2015

Highlights of Reference Number: 2015-30-004 to the Internal Revenue Service Commissioners for the Large Business and International and the Small Business/Self-Employed Divisions.

IMPACT ON TAXPAYERS

To report income for Federal tax purposes, partnerships are required to file a Form 1065, *U.S. Return of Partnership Income*, which shows the partnership's income, loss, gains, deductions, and credits. Partnerships are not taxed directly; instead, the partners are responsible for reporting their share of partnership items on their respective tax or information returns. The IRS's partnership audit process is intended to help ensure tax compliance among partners. However, due to the complexity of many partnerships, it is difficult for the IRS to evaluate the ultimate effect of its audit activity on the tax liability of partners.

WHY TIGTA DID THE AUDIT

This audit was initiated to identify the types of noncompliance the IRS has detected among partnerships and evaluate the progress the IRS has made toward addressing this noncompliance. The review addresses the major management challenge of Tax Compliance Initiatives.

WHAT TIGTA FOUND

The IRS has taken actions to help improve the partnership audit process; however, it does not know the extent of partnership tax compliance. While partnership audits have resulted in billions of dollars in partnership audit adjustments, the IRS does not know how much additional tax is ultimately assessed to the taxable partners as a result of the adjustments made to the partnership returns.

TIGTA also found that the IRS does not have a process to adequately measure the performance of the function responsible for assessing tax to certain partners. Improvements are needed to ensure that taxable partners are assessed the correct tax. Since Fiscal Year 2010, the IRS has failed to assess taxable partners approximately $14.5 million in taxes, interest, and penalties resulting from audits of partnership returns.

The lack of adequate performance measures and the fact that it has been more than 20 years since the IRS conducted a comprehensive compliance study on partnerships is a concern. Without this information, it is difficult to gauge the productivity and success of the IRS's partnership audit process. There have been legislative proposals designed to help streamline auditing large partnerships that may help mitigate some of the challenges of these audits.

WHAT TIGTA RECOMMENDED

TIGTA recommended that the IRS: 1) develop a strategy to measure the success and productivity of all partnership audits; 2) develop a system that will determine the amount of taxes assessed as a result of all partnership audits; 3) ensure that audit closing and assessment efforts are included in productivity measurements; 4) update audit report writing software to accommodate certain types of adjustments and calculations to avoid inaccurate assessments; and 5) coordinate with the Department of the Treasury to assess the impact that proposed changes to the tax laws would have on the IRS's partnership audit process.

In their response, IRS officials agreed with all five recommendations and stated that they plan corrective actions to address two of the recommendations. However, IRS officials stated that they could not commit to making the recommended improvements for the remaining three recommendations because of a lack of available funding. The IRS's Fiscal Year 2016 Budget Request did not include funding for a new system to address the issues discussed in this report. As such, the problems reported will remain and possibly increase in scope.

TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

March 18, 2015

MEMORANDUM FOR COMMISSIONER, LARGE BUSINESS AND INTERNATIONAL DIVISION
COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED DIVISION

FROM: Michael E. McKenney
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Additional Improvements Are Needed to Measure the Success and Productivity of the Partnership Audit Process (Audit # 201430027)

This report presents the results of our review to identify the types of noncompliance the Internal Revenue Service has detected among partnerships and evaluate the progress it has made toward addressing this noncompliance. This review addresses the major management challenge of Tax Compliance Initiatives.

Management's complete response to the draft report is included as Appendix V.

Copies of this report are also being sent to the Internal Revenue Service managers affected by the report recommendations. If you have any questions, please contact me or Matthew A. Weir, Assistant Inspector General for Audit (Compliance and Enforcement Operations).

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Abbreviations

AIMS	Audit Information Management System
CTF	Campus TEFRA Function
FY	Fiscal Year
GAO	Government Accountability Office
IRS	Internal Revenue Service
LB&I	Large Business and International
PCS	Partnership Control System
PY	Processing Year
SB/SE	Small Business/Self-Employed
TEFRA	Tax Equity and Fiscal Responsibility Act of 1982
TIGTA	Treasury Inspector General for Tax Administration

Background

A partnership[1] is a relationship between two or more entities or persons who join together to carry on a trade or business, with each partner contributing money, property, labor, or skill, and each expected to share in the profits and losses. In its most recent Statistics of Income Bulletin on partnerships, the Internal Revenue Service (IRS) reported that the number of partnerships has grown at an average annual rate of 4.4 percent between Tax Years 2002 and 2011.[2] As of Tax Year 2011, the number of partnerships and direct partners totaled about 3.3 million and 24.4 million, respectively. These partnerships reported assets of $20.6 trillion[3] and net income of $580.9 billion.

Although partnerships are required to file a Form 1065, *U.S. Return of Partnership Income*, which shows the partnership's income, loss, gains, deductions, and credits, partnerships are not taxed directly. Instead, the partners are responsible for reporting their share of partnership items on their respective tax or information returns.[4] Since the partnership distributes untaxed income, losses, credits, and other items to the respective partners, partnerships are commonly referred to as flow-through entities.

In the 1970s and early 1980s, some taxpayers began using partnerships as a vehicle to take advantage of unintended loopholes in the tax laws because partnership losses[5] can offset a partner's other income sources. The enactment of the Tax Equity and Fiscal Responsibility Act of 1982[6] (TEFRA) by Congress was intended, in part, to close some of the loopholes. For example, the TEFRA reduced the potential to use a partnership as a tax shelter by adding a section to the Internal Revenue Code that introduced various partnership penalties to deter the promotion of and investment in abusive tax shelters.

The TEFRA also resulted in revisions to the Internal Revenue Code statutory procedures, as well as to IRS internal administrative procedures, that affected how the IRS conducts audits of

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1 See Appendix IV for a glossary of terms.
2 IRS, *Statistics of Income Bulletin* (Fall 2013).
3 Assets are for those partnerships reporting balance sheet information.
4 Partnerships are required to provide a Schedule K-1, *Partner's Share of Income, Deductions, Credits, etc*., to the IRS and each of the partners. Schedule K-1 is unique to each partner as it shows the partner's share of the total partnership business activity. The partners are responsible for reporting the information from the Schedule K-1 on their respective tax returns, such as Form 1040, *Individual Tax Return,* if the partner is an individual or information returns, such as Form 1065, *U.S. Return of Partnership Income,* if the partner is another partnership.
5 The amount of partnership loss a partner may deduct is limited by basis rules, at-risk limitations, passive activity limitations, and limitations applicable to specific deductions.
6 Pub. L. No. 97-248, 96 Stat. 324 (codified as amended in scattered sections of 26 U.S.C.). For more information on the complete provisions of the TEFRA, see the Joint Committee on Taxation, JCS-38-82, *General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982* (Dec. 31, 1982).

partnerships that do not meet the TEFRA's small partnership exception.[7] The TEFRA defines the small partnership exception as those partnerships that have 10 or fewer partners and none of the respective partners are a flow-through entity.[8] For each partnership audit, the field examiner[9] must determine whether the partnership meets the TEFRA's small partnership exception. This determination must be made for each tax year under audit and is emphasized in IRS procedures as critically important for ensuring additional tax assessments, if any, resulting from an audit are valid under the tax law. Many of the statutory and administrative procedures required to initiate partnership audits are the same regardless of whether the partnership meets this exception.

For partnerships that do not meet the TEFRA's small partnership exception, the treatment of partnership items is determined at the partnership level in one unified audit (hereafter referred to as a "TEFRA audit"). Among other things, the TEFRA audit requirements provide that: 1) the partnership has a tax matters partner to serve as a primary representative with the IRS; 2) tax adjustments to the partnership are made in one audit and are binding to all partners; and 3) special notices are issued and additional statutory and administrative audit procedures are followed by the IRS at the beginning and end of the audits.

In 1982, the Joint Committee on Taxation stated that the rationale for these new TEFRA audit procedures was that:

> *…determination of the tax liability of partners resulted in administrative problems under prior law due to the fragmented nature of such determinations. These problems became excessively burdensome as partnership syndications have developed and grown in recent years. Large partnerships with partners in many audit jurisdictions result in the statute of limitations expiring with respect to some partners while other partners are required to pay additional taxes. Where there are tiered partnerships, identifying the taxpayer is difficult.*[10]

Although enactment of the TEFRA resulted in some improvements, the process for identifying the TEFRA partnerships' taxable partners is still administratively burdensome as there are tiered partnerships that often have hundreds to thousands of taxable partners. In addition, for TEFRA audits, the IRS generally has only one year from the date the partnership audit closes to assess taxes (or two years from the date the partnership audit closes to issue refunds) for the respective partners.[11] The Small Business/Self-Employed (SB/SE) Division's Campus TEFRA Function

[7] The TEFRA procedures also apply to partnerships if one or more of their partners are not domestic partners or if the partnership makes an election to be treated as a TEFRA partnership.
[8] For purposes of the small partnership exception, an estate of a deceased partner shall not be treated as a flow-through entity.
[9] Audits of partnerships typically involve a face-to-face audit by an IRS field examiner.
[10] See Joint Committee on Taxation, JCS-38-82, *General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982* p. 268 (Dec. 31, 1982).
[11] According to Internal Revenue Manual 4.31.3.10 (Oct. 1, 2010), a one-year date is a statute expiration date that affects a taxpayer's account as the result of a TEFRA audit.

(CTF), which operates out of the Ogden Campus in Ogden, Utah, and the Brookhaven Campus in Holtsville, New York, is responsible for identifying and linking TEFRA partnership returns to the taxable partners and assessing (or refunding) any associated taxes resulting from TEFRA audit adjustments. For TEFRA audits, substantially all of the administrative responsibilities, such as notifying partners, determining which partners' returns will be adjusted for the partnership adjustments, and calculating the tax impact (*e.g.*, additional tax or refund) of the adjustments, are shifted from the field examiners to the CTF.[12]

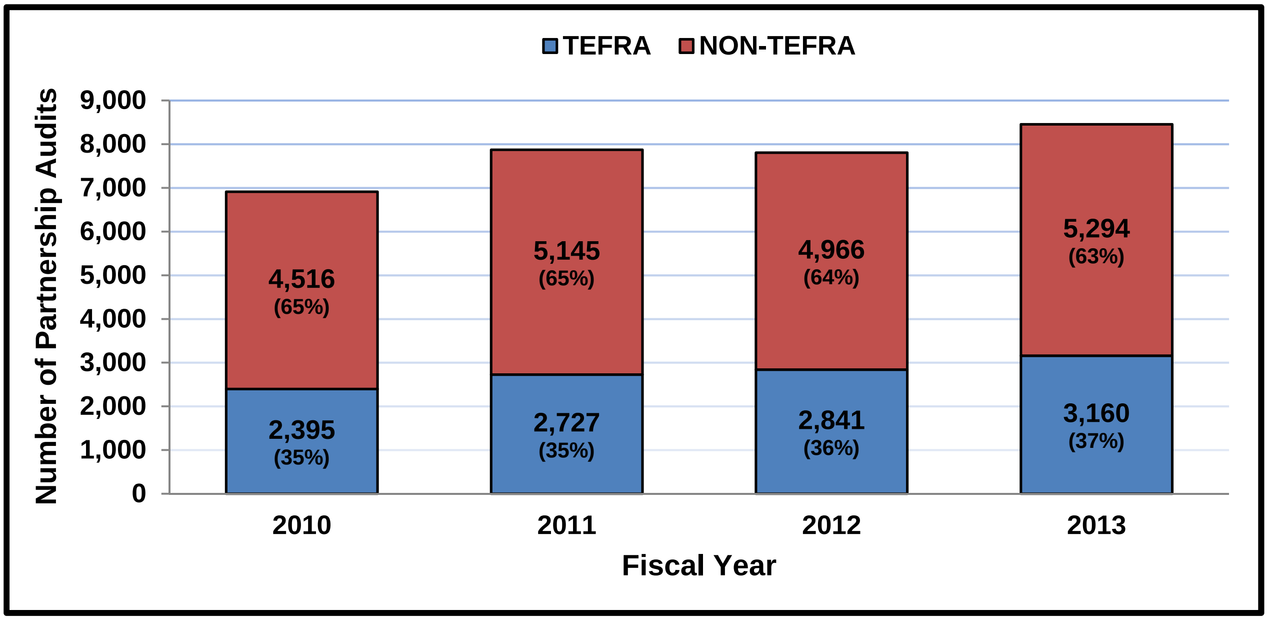
For those partnerships that meet TEFRA's small partnership exception, the associated audits (hereafter referred to as a "non-TEFRA audit") are in many ways like an audit of the individual partners. For example, each partner's return is audited separately, and the determination and treatment of partnership items for one partner are not binding on any other partner. As a result, the statute of limitations for assessment of taxes is tied to each partner's return. Therefore, during a non-TEFRA audit, the IRS must obtain a signed consent form from each partner to extend the statute of limitations to continue auditing the partnership return. For non-TEFRA audits, linkage between a partnership return and its partners is optional.[13] The field examiner may choose to control the partner returns and flow through any partnership adjustments to the partners' returns, thereby assuming responsibility that the CTF would otherwise perform.

Between Fiscal Years (FY) 2010 and 2013, field examiners from the Large Business and International (LB&I) and the SB/SE Divisions[14] completed 31,044 partnership audits, of which 11,123 (or about 36 percent) were TEFRA audits. During this time period, as noted in Figure 1, the proportion of TEFRA audits to non-TEFRA audits has remained relatively constant at slightly more than one-third of the partnership returns audited. The 11,123 TEFRA audits also represent approximately 1 percent of the 954,970[15] audits completed by the LB&I and SB/SE Divisions between FYs 2010 and 2013. Although this is a very small percentage of the total number of LB&I and SB/SE Division audits completed, the number of resources used to complete the TEFRA audits is substantial. For example, the number of hours charged to TEFRA and non-TEFRA audits that were closed during FYs 2010 through 2013 was approximately

[12] Although field examiners are required to use the CTF to flow the adjustments from TEFRA audits through to the partners, they also have the option to use the CTF for non-TEFRA audits. According to Internal Revenue Manual 4.31.1.5 (June 1, 2004), if the field examiner elects not to use the CTF for a non-TEFRA audit, the field examiner assumes responsibility for substantially all of the same functions as for TEFRA audits. Non-TEFRA audits do not have the same notice requirements or time frames, but the tiering, case control, and report preparation requirements still exist for the examiner. With non-TEFRA audits, if the field examiner does not use the CTF, the examiner assumes complete and total statute control for all related partners.
[13] The IRS's Office of Appeals will require linkage if the non-TEFRA audit has more than five partners or if any partners are flow-through entities. According to IRS officials, linkage is also required if the non-TEFRA audit has any partner outside of the Office of Appeals regional jurisdiction.
[14] Currently, the SB/SE Division is responsible for managing most of the programs and activities related to partnerships, although the LB&I Division generally serves partnerships with assets of $10 million or more.
[15] The 954,970 audits include audits of individuals, partnerships, corporations, S corporations, estates, trusts, and excise tax and exclude audits selected for training purposes.

2.47 million hours (which equals an average of approximately 297 full-time equivalents per year), and of this, approximately 1.57 million hours (about 63.5 percent or an average of approximately 189 full-time equivalents per year) were devoted to TEFRA audits. TEFRA audits take field examiners significantly more time to complete than non-TEFRA audits. Specifically, during FYs 2010 through 2013, the average TEFRA audit took field examiners from the SB/SE Division about 58 hours to complete compared to the 34-hour average for non-TEFRA audits. For field examiners from the LB&I Division, the average TEFRA audit took about 199 hours to complete compared to the 109-hour average for non-TEFRA audits.

Figure 1: Partnership Audits Completed During FYs 2010 Through 2013



Source: Treasury Inspector General for Tax Administration (TIGTA) analysis of an extract from the Audit Information Management System (AIMS) of partnership audits closed by field examiners from the LB&I and SB/SE Divisions. These do not include audits selected for training purposes.

This review was performed with information obtained from the LB&I Division Headquarters in Washington, D.C., and the field office in Farmers Branch, Texas; the SB/SE Division Headquarters in New Carrolton, Maryland, and the field office in Dallas, Texas; and the SB/SE Division CTF offices at the Ogden Campus in Ogden, Utah, and the Brookhaven Campus in Holtsville, New York, during the period March through September 2014. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

Results of Review

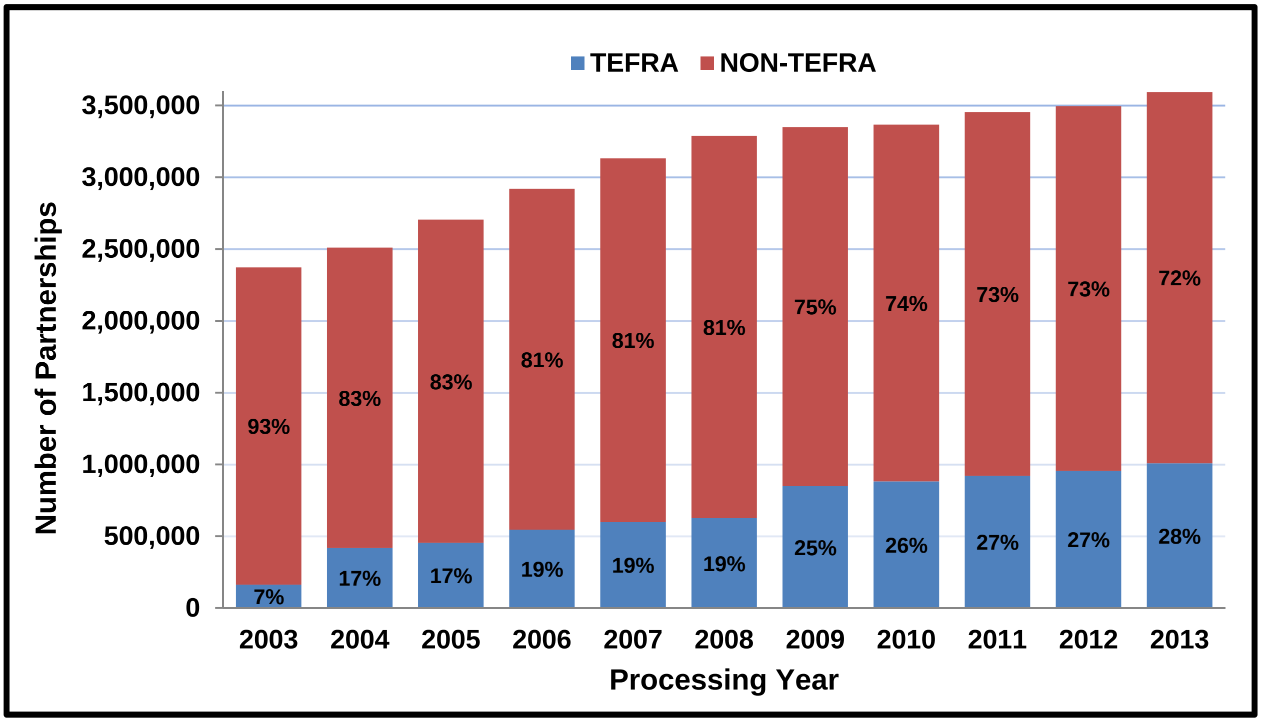
The IRS has taken actions to improve the partnership audit process; however, it does not know the extent of partnership tax compliance. While IRS audit productivity reports show that partnership audits have resulted in billions of dollars in partnership audit adjustments, the IRS does not know the total amount of additional taxes that are ultimately assessed to the taxable partners as a result of adjustments made to the partnership returns. The lack of adequate performance measures and the fact that it has been more than 20 years since the IRS conducted a comprehensive compliance study on partnerships is a concern. Without this information, it is difficult to effectively gauge the productivity and success of the IRS's partnership audit process. Our review of IRS records also found that since FY 2010, the IRS has failed to assess taxable partners approximately $14.5 million in taxes, interest, and penalties resulting from adjustments made to partnership returns.

Recent Actions Were Taken to Improve the Partnership Audit Process

Partnership filings have been steadily increasing, and TEFRA partnerships have grown at an even faster rate. As shown in Figure 2, although non-TEFRA partnership filings outnumber TEFRA partnership filings, the proportion of TEFRA partnership filings has increased substantially. For example, the percentage of TEFRA partnership filings as compared to non-TEFRA partnership filings has quadrupled from Processing Year (PY) 2003 to PY 2013. Specifically, TEFRA filings increased from 7 percent[16] of all partnership filings in PY 2003 to about 28 percent[17] in PY 2013.[18]

[16] In PY 2003, of the 2,372,053 partnership filings, 163,161 (6.9 percent) were TEFRA related.
[17] In PY 2013, of the 3,593,917 partnership filings, 1,008,000 (28 percent) were TEFRA related.
[18] According to the IRS, the increases between PYs 2003 and 2009 may not be a true representation because there was a change in its method for measuring TEFRA partnerships. These changes were based on specific revisions made to Form 1065 during this time period. However, the IRS confirmed that the percentages of TEFRA partnerships since PY 2009 are likely accurate.

Figure 2: Number of Partnership Filings for PYs 2003 Through 2013



Source: LB&I Division analysis supplied by the Planning, Analysis, Inventory and Research function.[19]

In June 2012, TIGTA reported[20] that despite some favorable audit trends, the number of no-change partnership audits was a concern. When partnership audits result in a no-change, it means that the field examiner did not make any partnership adjustments. As such, there was no tax impact to the partners. As shown in Figure 3, during FYs 2010 through 2013, 43 percent of the partnership audits closed resulted in a no-change. However, for the same time period, the no-change rate for TEFRA audits was higher (53 percent) than non-TEFRA audits (37 percent).

[19] Figure 2 data includes both LB&I and SB/SE Divisions combined.
[20] TIGTA, Ref. No. 2012-30-060, *Despite Some Favorable Partnership Audit Trends, the Number of No-Change Audits Is a Concern* (June 2012).

Figure 3: Partnerships Audit Closures During FYs 2010 Through 2013

Business Unit	Audit Type	Partnership Audits With No-Changes		All Other Partnership Audits		Total Partnership Audits	Percent No-Change
		Number	Percent	Number	Percent		
LB&I Division	TEFRA	3,197	49%	3,329	51%	6,526	
	Non-TEFRA	1,347	44%	1,688	56%	3,035	
	Total	**4,544**		**5,017**		**9,561**	**48%**
SB/SE Division	TEFRA	2,699	59%	1,898	41%	4,597	
	Non-TEFRA	6,034	36%	10,852	64%	16,886	
	Total	**8,733**		**12,750**		**21,483**	**41%**
Total	TEFRA	5,896	53%	5,227	47%	11,123	
	Non-TEFRA	7,381	37%	12,540	63%	19,921	
	Total	**13,277**		**17,767**		**31,044**	**43%**

Source: TIGTA analysis of an AIMS extract of partnership audits closed by field examiners from the LB&I and SB/SE Divisions. The data extract did not include audits selected for training purposes.

A comprehensive strategy was implemented to improve the IRS's partnership audit process

The LB&I and SB/SE Divisions initiated a Partnership Strategy[21] in July 2012 to improve the partnership audit process in light of the increase in partnership filings and complexities associated with auditing partnership returns. The Partnership Strategy created the following four teams that work toward the goal of improving the effectiveness and efficiency of partnership audits and expanding audit coverage:

- ***Workload Identification Team*:** Focuses on short-term and long-term improvements in the identification of partnership workload. This includes better selection of partnership returns with significant noncompliance and determination of criteria that can be used to identify and select groups of partnership returns that have common noncompliance indicators as well as provide the foundation for a long-term workload identification model for partnership returns.

[21] As a result of the limitations discussed later in this report, the Partnership Strategy uses the amount of positive dollars adjusted at the partnership level as the primary measure of partnership audit productivity. Based on TIGTA's review of the IRS's Partnership Strategy, the IRS is developing a variety of strategies based on specific characteristics of partnerships that were audited and applying them towards the selection of future audits. These methods assume that high adjusted positive partnership dollars translate to high generated taxes.

- ***Issue Identification Team*:** Addresses partnership compliance issues and develops guidance for field examiners. This team is also responsible for the identification of resolution strategies for the partnership compliance issues, including the need for published and administrative guidance.
- ***Flow-Through Specialist Team*:** Assesses current and future needs for flow-through technical specialists, with a goal of developing a plan for placing and using these specialists for audits that involve flow-through entities, *e.g.*, partnerships.
- ***TEFRA Team*:** Develops a variety of strategies to manage the increased TEFRA workload to ensure that efforts are not lost at the partner level (tax adjustments) due to resource limitations. Another goal of this team is to identify alternatives for better communications between field examiners and CTF operations to ensure that partnership audit closures are known well in advance.

As a result of the Partnership Strategy, the IRS has implemented various approaches to improve the effectiveness and efficiency of partnership audits. Specifically, the LB&I and SB/SE Divisions took the following actions:

- In February 2013, surveyed a sample of employees from the LB&I and SB/SE Divisions regarding their skills and experiences in examining partnership returns. Survey results indicated that employees desired additional training in both technical and administrative aspects of partnership audits and that support during the audit process could be improved.
- Developed an initial profile of the partnership filing population to identify: 1) groups of partnerships that may have compliance issues, 2) issues specific to industry type, and 3) filing trends to inform when legislative action is needed.
- Created a new reference tool for CTF tax examiners and field examiners that contains a list of issues and accounting treatments commonly encountered in partnership audits.
- Updated IRS Publication 541, *Partnerships*, with a dedicated section on TEFRA rules and procedures. This publication provides information for partnerships and partners by supplementing the instructions for Form 1065 and Schedule K-1. Prior revisions of this publication did not discuss the TEFRA.[22]
- Developed and implemented a series of risk assessment training courses to assist field examiners to better understand the associated risks of auditing partnerships involved in multi-tiered networks, whereby a flow-through entity, *e.g.*, partnership, S corporation, is itself a partner of another flow-through entity, leading to a situation in which income is allocated from one flow-through entity to another.

[22] IRS Publication 541, *Partnerships* (Rev. Dec. 2013).

- Developed and implemented a new training module – *How to Conduct a TEFRA Audit* – which covers the administrative procedures for working a TEFRA audit. The initial class was held in June 2013 and is strongly encouraged for IRS employees working partnership returns.

In addition to the Partnership Strategy, the IRS has also taken steps toward improving the identification of partners in multi-tiered networks. In a FY 2010 report, the Government Accountability Office (GAO)[23] highlighted the complexities of multi-tiered networks. For Tax Year 2008, the IRS estimated that more than one million partnership networks had two or more flow-through entities in their structure. To help identify the structure of multi-tiered partnerships, the IRS implemented the Tier Structure Tool in January 2012. The Tier Structure Tool produces three reports that include: 1) a detailed listing of the entire ownership structure including all linked flow-through entities, 2) a detailed listing of all the taxable partners in descending order of ownership percentage, and 3) a summary report providing a snapshot of key ownership structure statistics, including the total number of partners, number of tiers, and types of partners. In addition to providing detailed information about the ownership structure of a partnership during the audit, a Tier Structure Tool analysis is used by the CTF to aid in workload planning and audit decisions.

Furthermore, although the amount of partnership adjustments alone is not sufficient to accurately evaluate the overall productivity for partnership audits, it can be a useful indicator for identifying specific types of returns for audit. Both the LB&I and SB/SE Divisions have taken steps to better understand the various types of noncompliance among audited partnerships. As shown in Figure 4, these divisions track the frequency and magnitude of specific partnership audit adjustments. IRS officials stated that they use this type of data to make informed decisions for identifying partnership returns to audit. For example, the SB/SE Division used this information to develop Compliance Initiative Projects on partnership issues in regional areas.

[23] GAO, GAO-10-968, *Tax Gap – IRS Can Improve Efforts to Address Tax Evasion by Networks of Businesses and Related Entities* (Sept. 2010).

Figure 4: Top Partnership Audit Issues for the LB&I and SB/SE Divisions Based on the Number of Adjustments

Rank	Adjustment Description	Number of Adjustments	Average Adjustment Amount
	LB&I Division Top Adjustments for Calendar Year 2012		
1	Trade or Business (Deductible vs. Not Deductible)	107	$925,998
2	Gross Income vs. Not Gross Income	60	$4,857,763
3	Depreciation	55	$269,877
4	Capitalization & Inclusion in Inventory Costs of Certain Expenses	53	$473,118
5	Not Assigned a Specific Issue Area	35	$17,596,300
	SB/SE Division Top Adjustments for FY 2012		
1	Gross Receipts or Sales	1,800	$178,445
2	Other Deductions (No Schedule)	1,372	$69,351
3	Other Expenses	1,130	$60,483
4	Net Income (Loss) From Rental Real Estate	1,093	$23,915
5	Depreciation	1,012	$48,883

Source: LB&I and SB/SE Divisions analysis of data from the Examination Operational Automation Database. The LB&I Division tracks this information by calendar year, and the SB/SE Division tracks this information by fiscal year.

In addition, as noted in Figure 5, approximately $38.2 billion (91 percent) of the $41.8 billion in partnership audit adjustments[24] were from the LB&I and SB/SE Divisions' audits involving TEFRA partnerships. This type of information may be useful as the IRS continues with its ongoing Partnership Strategy efforts.

[24] According to the IRS, generally the total net audit adjustment amounts only include those to net income and do not include changes the IRS made to the balance sheet unless the changes ultimately have some tax effect.

Figure 5: Partnership Audit Adjustments During FYs 2010 Through 2013

Business Unit	Audit Type	Number of Audits	Percentage of Total	Net Audit Adjustments	Percentage of Total
LB&I Division	TEFRA	6,526	68%	$36,184,354,456	95%
	Non-TEFRA	3,035	32%	$2,057,781,507	5%
	Total	**9,561**	**100%**	**$38,242,135,963**	**100%**
SB/SE Division	TEFRA	4,597	21%	$1,990,977,983	56%
	Non-TEFRA	16,886	79%	$1,573,986,590	44%
	Total	**21,483**	**100%**	**$3,564,964,573**	**100%**
Total	TEFRA	11,123	36%	$38,175,332,439	91%
	Non-TEFRA	19,921	64%	$3,631,768,097	9%
	Total	**31,044**	**100%**	**$41,807,100,536**	**100%**

Source: TIGTA analysis of an AIMS extract of partnership audits closed by field examiners from the LB&I and SB/SE Divisions. The data extract did not include audits selected for training purposes.

Additional Improvements Are Needed to Measure the Success and Productivity of the Partnership Audit Process

The way that the IRS measures the success of its partnership audit process has changed very little since the GAO reported on this particular issue in FY 1980.[25] The GAO highlighted that the IRS does not accumulate data on the tax impact of partnership audit adjustments. Because the tax impact is unknown, the GAO explained that the "*IRS cannot adequately consider cost/yield ratios in planning the proper level of examination coverage for partnership returns*." In response to this GAO report, the IRS performed the agency's only comprehensive partnership compliance study to date, which was completed in FY 1991 using partnership returns filed in Calendar Year 1982.[26] Although the partnership compliance study acknowledged that analysis of the tax impact is a critical part of compliance measurement for partnerships, the study did not include such an analysis. We believe that without considering the net flow-through impact on the individual partners, the IRS will not be able to evaluate partnership compliance in a way that could help identify trends to select better partnership returns for audit and reduce the no-change partnership audit closure rate. According to an official from the IRS's National Research

[25] GAO (formerly known as the General Accounting Office), GAO/GGD-80-98, *The Internal Revenue Service Needs to Reconsider Its Examination Strategy for Certain Partnership Returns* (Sept. 1980).
[26] IRS National Research Program (formerly known as the Taxpayer Compliance Measurement Program), *TCMP Survey of Partnership Returns (Form 1065) Phase X, Cycle 1*, and *An Analysis of the Partnership Survey Phase X, Cycle 1* (Dec. 1990).

Program, which is responsible for measuring taxpayer compliance for different types of taxes, there are currently no plans to conduct a subsequent comprehensive compliance study on partnerships. The IRS informed us that the number of tiers that exist within the partnership population (*i.e.*, where partnerships are themselves partners in other partnerships) makes determining the proper statistical sample size for identifying the source of noncompliance very problematic.

A subsequent GAO report in FY 1995 questioned the reliability of using the IRS's FY 1991 study and stated that the extent of partnership compliance was still unknown, in part because the IRS did not have the data on the additional taxes partners were assessed as a result of the partnership audit adjustments.[27] The GAO recommended that the IRS develop plans to modify the AIMS to more fully reflect the results of partnership audits by including the tax assessments on the partners' income tax returns. IRS officials stated that the IRS would address the need for expanded data on partnerships and partners in its plans to modernize information systems, which was scheduled to be completed by Calendar Year 2001.[28] However, the information systems in place today still lack the ability to accurately measure the total taxes assessed as a result of partnership audits. The IRS has acknowledged this long-standing issue and, as discussed later in this report, has considered developing a new system that will be capable of tracking partnership adjustments through to all the respective partners, which could help determine the total taxes assessed as a result of partnership audits.

There are significant drawbacks in relying on partnership adjustments as a measure of productivity

The IRS's audit productivity indicators for partnerships and other flow-through entities are significantly different from productivity indicators used for audits of taxable entities, such as audits of individuals and corporations. The IRS's primary measure of audit productivity is the amount of recommended additional taxes. However, due to limitations with IRS systems and databases, this measure of audit productivity is not available for partnership audits. Instead, the IRS measures partnership audit productivity in terms of positive adjustments to partnership net income with the assumption that such adjustments generally result in additional tax assessments on the partners' tax returns.

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[27] GAO (formerly known as the General Accounting Office), GAO/GGD-95-151, *Tax Administration: IRS' Partnership Compliance Activities Could be Improved* (June 1995).

[28] GAO recently issued the following products in FY 2014 related to partnership compliance: GAO, GAO-14-379R, *Large Partnerships: Characteristics of Population and IRS Audits* (Mar. 2014); GAO, GAO-14-453, *Partnerships and S Corporations: IRS Needs to Improve Information to Address Tax Noncompliance* (May 2014); GAO, GAO-14-746T, *Large Partnerships: Growing Population and Complexity Hinder Effective IRS Audits* (Jul. 2014); and GAO, GAO-14-732, *Large Partnerships: With Growing Number of Partnerships, IRS Needs to Improve Audit Efficiency* (Sept. 2014). In one product, GAO-14-453, the GAO again concluded that the extent of partnership noncompliance remains unknown.

However, the unlimited variations in partnership structures and the tax profiles of the associated partners contribute to the difficulty of making generalizations about the tax impact of partnership audit adjustments. The number of partners and tiers as well as the unique features in each taxable partner's return all impact the final tax determination. For example, it is possible for a significant partnership audit adjustment to be spread across so many partners that the administrative cost of assessing and collecting the tax makes it unproductive. On occasion, the IRS has been faced with the challenge of securing a settlement agreement[29] at the partnership level because the millions of dollars in adjustments would have resulted in zero taxes after applying the assessment tolerance for taxable partners.[30] Even for situations in which the tax assessments for all partners are above tolerance, the range in total partner tax assessments could vary greatly, based solely on the tax brackets[31] of the associated partners. For example, a $2 million adjustment to net income for Tax Year 2013 could potentially result in total partner tax assessments of $792,000 if all of the partners were individuals in the maximum 39.6 percent tax bracket. However, it could be much less if most of the partners were individuals in lower tax brackets.

Although the IRS systems lack the ability to track the tax impact for each partnership audit,[32] when the CTF is involved, the net taxes assessed against partners can be quantified. For instance, as shown in Figure 6, CTF partner audit closures for FYs 2010 through 2013 resulted in net tax assessments of $871 million. The data indicate that the majority of CTF partner audit closures do not result in a tax adjustment. Of 111,952 closures for FYs 2010 through 2013 that the CTF completed for taxable partners, only 28,233 (or 25 percent) resulted in some form of tax adjustment, whether in favor of the IRS (additional tax) or in favor of the taxpayer (refund). Because CTF involvement is limited to audits controlled on the PCS (required for TEFRA audits, unless they are no-changed within 45 days of the start of the audit, and optional for non-TEFRA audits), the full extent of the tax impact for all partnership audits is unknown. In addition, due to limitations with the IRS systems and databases noted in this report, the IRS is unable to systematically determine which partnership audits resulted in the $871 million net tax assessments, thus preventing it from determining what type of partnership adjustments result in tax assessments or refunds at the partner level.

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[29] Some partnerships request to settle and pay tax deficiencies on behalf of their partners. When this occurs, the partnership must sign a Form 906, *Closing Agreement On Final Determination Covering Specific Matters*, and fully pay the amount due, which is computed by applying the highest marginal tax rate to the partnership audit adjustment.

[30] The IRS uniformly applies an assessment tolerance to each partner. Therefore, if the IRS determines that a potential assessment will fall below tolerance, the assessment will not be made. The IRS does not publically release the specific tolerance level.

[31] For Tax Year 2013, the marginal tax rates for individuals ranged from 10 percent to 39.6 percent.

[32] Both the AIMS and the PCS (which was designed to link the adjustments made to TEFRA partnership returns during TEFRA audits to the respective individual partner returns) lack the ability to track the tax impact as a result of each TEFRA audit.

Figure 6: CTF Audit Closures for FYs 2010 Through 2013

Campus	Closures of All Entities	Closures of Taxable Entities	Percentage of Closures of Taxable Entities	Closures of Taxable Entities With Tax Adjustments	Percentage of Closures of Taxable Entities With Tax Adjustments	Net Tax Assessments for Closures of Taxable Entities
Ogden	103,084	81,895	79%	18,372	22%	$520,508,802
Brookhaven	34,600	30,057	87%	9,861	33%	$350,798,219
Total	**137,684**	**111,952**	**81%**	**28,233**	**25%**	**$871,307,021**

Source: TIGTA analysis of an AIMS extract of CTF audit closures for FYs 2010 through 2013. These closures represent TEFRA partners and non-TEFRA partners controlled on the PCS and processed by the CTF.

The productivity of partnership audits will remain unknown unless improvements are made to IRS systems to track the actual tax impact of all partnership audit adjustments

At the time of our review, IRS officials informed us that they are planning to develop a new system, the Pass Through Inventory Management System, to replace the outdated PCS. However, the IRS had not received funding approval as of December 2014 for the design, development, and implementation of this system. According to the IRS, the primary reason for developing this new system is for processing, monitoring, and controlling the large amounts of data needed by the CTF to more effectively manage the TEFRA audit process. As with the old system, the new system will be required for inputting TEFRA audits and will be optional for non-TEFRA audits. However, unlike the PCS, the new system will also be designed to track adjustments from the partnership audit through the tiers to all the respective taxable partners.

Such a system could enable the IRS to capture meaningful data to determine what effect, if any, TEFRA audits have on reducing the Tax Gap. However, at the time of our review, the IRS did not have any plans to use this new system to capture and analyze the productivity of all non-TEFRA audits. Because TEFRA audits only account for a third of the IRS's partnership audit inventory, the full extent of the tax impact resulting from the IRS's partnership audits will remain unknown unless the new system (or something similar) is also required to be used for all non-TEFRA audits.

Recommendations

The Commissioner, LB&I Division, and the Commissioner, SB/SE Division, should:

Recommendation 1: Coordinate with the Director, Office of Research, Analysis, and Statistics, to develop a strategy to measure the success and productivity of all partnership audits (both TEFRA and non-TEFRA). This may include, but is not limited to, the amount of the audit adjustments and the taxes assessed (or refunds issued) for the partners.

> ***Management's Response:*** IRS management agreed with this recommendation and stated that the Office of Research, Analysis, and Statistics is attempting to gather compliance characteristics. However, this effort will not include an estimate of productivity because the IRS's systems are not able to track specific partnership adjustments through to the taxable partners. A working team with the Office of Research, Analysis, and Statistics and the LB&I and SB/SE Divisions will be established to develop a better understanding of the extent and nature of partnership misreporting and the effectiveness of examinations in detecting the misreporting.

Recommendation 2: Work with the Chief Technology Officer to develop a system capable of determining the amount of taxes assessed as a result of all partnership audits (both TEFRA and non-TEFRA).

> ***Management's Response:*** IRS management agreed with this recommendation and stated that a more robust system may assist in better identification of high-risk inventory. As such, requests for system improvements have been submitted each year starting in FY 2010. IRS management also stated that, unfortunately, after the IRS's annual evaluation of information technology needs based on labor, financial factors/constraints, and feasibility, legislative changes and regular system maintenance expend most of IRS's available resources. While IRS management will continue to pursue funding, they stated that they cannot commit to the recommended system improvements at this time.

> ***Office of Audit Comment:*** We believe it would be of significant value for the IRS to track the actual tax impact of partnership audits because, without doing so, the productivity of partnership audits will remain unknown. Although the IRS's FY 2016 Budget Request (dated February 2, 2015) includes $16.2 million to improve audit coverage by increasing the number of agents with specialized experience in partnership law and strengthening enforcement activities related to TEFRA partnerships, it did not specifically include funding for a new system to address the issues discussed in this report. Accordingly, the IRS has not taken steps to improve the tracking of the results of its partnership audits so that it can make the best use of its resources devoted to this area.

Controls Over the Measuring and Processing of Partnership Audit Results Need to Be Enhanced

During TEFRA audits, field examiners do not open and close audits on each of the respective partners as they would for non-TEFRA audits. Instead, the responsibility for assessing the partners associated with TEFRA audits is transferred to the CTF. The process for identifying the TEFRA partnerships' taxable partners is administratively burdensome given the growing trend of complex partnership structures. Although the IRS has taken a number of steps to improve the efficiency and effectiveness of closing TEFRA audits, we determined that the CTF does not have a system in place to adequately measure functional performance, which could impact CTF program management and budget decisions. Adequate performance measures and indicators are essential for comparison among other IRS programs and functions. As discussed in the GAO *Standards for Internal Control in the Federal Government*, agencies have a responsibility to validate the propriety and integrity of such performance measures to ensure effective performance assessments.[33]

The CTF plays a critical role in the TEFRA partnership audit process

While field examiners are responsible for conducting the audit of a TEFRA partnership, the CTF is responsible for assessing taxes (or issuing refunds) to the individual partners, resulting from the audit of a TEFRA partnership.[34] To assess taxes (or issue a refund), the CTF must secure each taxable partner's individual return and control it on the PCS. Because the tax is paid by the partners rather than the partnership, the CTF at times has to identify hundreds to thousands of partners associated with one partnership. The CTF must often identify several tiers of flow-through entity partners before identifying the actual taxable partners. Once the taxable partners are identified and their tax returns are secured, the CTF must then determine the tax impact of each partner's share of the TEFRA partnership adjustments and calculate the tax effect after considering a variety of factors including, but not necessarily limited to, carryback and carryforward issues for each respective partner, tax laws specific to the particular tax year of the return (the CTF open inventory as of the end of FY 2013 currently includes partnership audits of tax years dating back to the 1970s), and the materiality of the tax assessment itself.

The CTF's involvement in a TEFRA audit typically coincides with the initiation of the partnership audit itself. Specifically, within 60 days of a field examiner initiating a TEFRA partnership audit, the examiner is required to notify the CTF that a partnership audit is underway so it can begin the time consuming process of identifying and linking the respective partners in

[33] GAO (formerly known as the General Accounting Office), GAO/AIMD-00-21.3.1, *Standards for Internal Control in the Federal Government* (Nov. 1999).

[34] Generally, the CTF divides its workload according to the IRS operating division responsible for the partnership audit. Administrative support for LB&I Division TEFRA audits is centralized at the Ogden Campus in Ogden, Utah, while the Brookhaven Campus in Holtsville, New York, is responsible for supporting the SB/SE Division's TEFRA audits.

the PCS,[35] as well as obtaining the appropriate tax returns for each partner and attempting to identify which partners will be assessed taxes or be due a refund if the partnership audit results in adjustments to the partnership's return. Even if the partnership audit results in no adjustments, the CTF is still responsible for notifying the partners[36] that the partnership was audited and there were no changes.[37] According to the IRS, it is revisiting the effectiveness of this requirement as part of an ongoing Lean Six Sigma study to evaluate the procedures for auditing a TEFRA partnership.

Respected authorities in the area of internal revenue taxation have recognized the issues that the CTF must handle as the number of TEFRA partnerships grows. Specifically, both the U.S. Tax Court and the Joint Committee on Taxation have highlighted a variety of challenges that the CTF faces to efficiently perform its duties as partnerships increase in size and complexity. For example, a July 2013 U.S. Tax Court Memorandum Opinion[38] included the following description:

> *First, unlike a corporate or an individual income tax proceeding where the examination is directly of the taxpayer's return, a TEFRA proceeding is conducted at the partnership level, and yet the partnership is not liable for the tax. The partners who are ultimately liable for the tax can change from year to year. Thus, adjustments resulting from a partnership proceeding relating to one taxable year may affect a completely different set of taxpayers from those who owned an interest in that same partnership in another year…In TEFRA cases, it is the service centers* [campuses] *that are generally responsible for issuing notices. Because partnerships may involve multitiered structures and passthrough* [also known as flow-through] *partners, the IRS must often trace through this structure to reach the ultimate taxpayers.*

[35] The PCS establishes an electronic linkage between a partnership and its underlying partners. When a partnership audit is controlled on the PCS, the administrative functions, including the issuance of all notices, recognition of the actions required within the proper time frames, and the proper resolution of all of the related partner audits are transferred from the field examiner to the CTF unless the audit is no-changed within 45 days of the start of the audit.
[36] The CTF is required to send the Notice of Beginning of Administrative Proceeding to each notice partner using certified mail within 30 days of receipt of the linkage package from field examiners. A linkage package contains information that the CTF needs to link a notice partner to a partnership on the PCS. If the partner has a 1 percent or more interest in the profits of the partnership, or if the partnership has one hundred or fewer partners, then the partner is a notice partner. Non-notice partners are those partners holding less than a 1 percent profit interest in a partnership with more than 100 partners. The Tax Matters Partner is responsible for providing copies of all notices to the non-notice partners.
[37] The IRS performs these linkages to reduce the risk of potential barred assessments occurring in the event that the audit results in adjustments.
[38] Taurus FX Partners, LLC v. Commissioner, T.C. Memo 2013-168 p. 14 (2013).

Similarly, the Joint Committee on Taxation underscored the importance of considering the cost/benefit of tracking down the taxable partners in a June 2012 publication:[39]

> *The resolution of a partnership item separately for each of thousands of partners of a large partnership is unlikely to be cost effective. Administrative costs of thousands of separate letters from the IRS to partners, for example, could overwhelm the amount of revenue picked up from the adjustment of a partnership item or a group of partnership items. Similarly, the benefit to any one partner of receiving a refund of a miniscule portion of a partnership item may not be worth the administrative costs associated with delivering a tiny refund separately to each of thousands of partners.*

During our meetings with CTF officials, it was apparent that they were consistently seeking ways to overcome the challenges of their role in the partnership process and improve their operations, such as implementing the Tier Structure Tool to help determine the ownership structure of a partnership, trying to develop a new partnership system to more effectively manage the TEFRA program, and most recently obtaining approval from IRS Counsel to stop issuing refunds to partners as a result of partnership audits.[40] Although the IRS, and the CTF in particular, have taken a number of steps to improve the efficiency and effectiveness of closing TEFRA audits, additional actions are needed to further improve the CTF's operations.

Additional improvements are needed to adequately measure CTF performance and determine audit results

At the end of FY 2013, there were approximately 185,000 partner returns in the CTF's open inventory. This included partner returns associated with open partnership audits that were either awaiting closure by the field examiners or the results of judicial proceedings, *e.g.*, tax court. It also included partner returns associated with closed TEFRA audits that were pending a tax determination by the CTF prior to the one-year assessment statute date. According to CTF officials, a partner return may be associated, *i.e.*, linked, with several partnership audits. These partner returns remain in the CTF's open inventory until all associated partnership audits have closed and the CTF has processed all associated adjustments affecting a specific partner for a given tax year.

For example, if Partner A is linked to four audited partnerships, Partner A will remain in the CTF's open inventory until all four partnership audits have closed and the CTF has made all associated partner adjustments and tax computations to Partner A's individual tax returns. In this example, the CTF audit report writers could potentially prepare as many as four separate audit

[39] Joint Committee on Taxation, JCS-2-12, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* p. 624 (June 2012).
[40] The IRS is evaluating the organizational feasibility of notifying partners to file amended returns for their refunds, which will be processed by the IRS's Submission Processing function and the CTF will no longer have any involvement with the refunds.

reports for Partner A, one for each of the four partnership audits to which the partner was linked for a given tax year. However, the CTF's performance measurements would consider this as only one partner audit closure instead of four. Even if the four audit reports span several fiscal years, the CTF will receive credit for only one closure in the fiscal year of the final closure. The other three closures are considered partial closures and are not included in performance measurements. This highlights the unusual nature of the CTF's workload when compared to the general audit environment, in which there is typically one audit report associated with an audited taxpayer for a given tax year. Therefore, in terms of audit closures, the CTF's performance measurements when compared to other IRS audit functions are potentially understated.

As a result, the IRS does not know the total number of partner audit closures completed by the CTF. The performance measurement, as previously explained and shown in Figure 7 below, credits the CTF for only one closure per partner for a given tax year. The reason for the CTF closure understatements can be attributed to a limitation of the AIMS, which calculates the audit results for a partner only when the final adjustment is made from all associated partnership audits. For example, for FYs 2011 through 2013, although the AIMS count of CTF partner audit closures averaged 35,271 per year, CTF officials estimate that the yearly average is actually 66,521 (about 89 percent more than the AIMS count).[41] Without adequate performance measurements, it is difficult to effectively set performance goals for the CTF as well as ensure that the CTF has an appropriate number of resources.

Figure 7: CTF Partner Audit Closures by Fiscal Year

Closure Type	FY 2011	FY 2012	FY 2013	Total	Average
Final	22,957	41,266	41,591	105,814	35,271
Partial	36,107	32,624	25,018	93,749	31,250
Total	59,064	73,890	66,609	199,563	66,521

Source: TIGTA analysis of an AIMS extract of CTF audit closures and estimated partial closures provided by the CTF. These closures represent TEFRA partners and non-TEFRA partners processed by the CTF.

Improvements are needed to ensure that taxable partners are assessed the correct tax resulting from TEFRA audits

Strong controls over the processing and posting of audit results are critical for ensuring that any additional taxes owed, based on the audits of partnerships, are assessed. However, since FY 2010, the IRS identified instances when it improperly processed at least 89 audits that resulted in the CTF failing to assess approximately $14.5 million in taxes, interest, and penalties. Existing IRS controls did not detect issues with these partner assessments until after the statute expiration date had already expired. As a result, the IRS is prohibited, *i.e.*, barred, from assessing additional tax to correct these errors. Of the 89 audits that resulted in barred

[41] The CTF has informally tracked the number of closures not included in the AIMS count since FY 2011.

assessments, 37 (41.6 percent) were a result of CTF audit report writer errors in making the tax assessments. Barred assessments for these 37 audits totaled $7.9 million, or about 55 percent of the CTF's total barred assessment amount. According to CTF officials, the Report Generation Software that the CTF audit report writers primarily use to create their audit reports does not support making assessments on older tax year returns, *e.g.*, 1970s and 1980s, which may still be in process if there is pending litigation. In these instances, the audit report writers did not have the added support of automated software controls preprogrammed with the applicable tax laws as they would have when preparing reports for the more recent tax years.

CTF officials also stated that the report writing software does not have the ability to automate certain types of adjustments for TEFRA partners. A variety of adjustments must be manually calculated on spreadsheets before entering the results into the report writing software. For example, we were informed that CTF audit report writers have had difficulty calculating the impact of the Alternative Minimum Tax, as well as the tax on a child's investment income, using the report writing software. As a result, the CTF has resorted to using stand-alone spreadsheets to calculate the appropriate flow-through adjustment amounts. These manual computation procedures increase the risk that improper adjustments may be made, which may result in taxpayers being assessed more or less taxes than they should have been assessed.

Recommendations

The Director, Campus Reporting Compliance, SB/SE Division, should:

Recommendation 3: Work with the Chief Technology Officer to develop a system capable of ensuring that audits of each individual partner's return closed by the CTF are captured and included in performance measurements.

> ***Management's Response:*** IRS management agreed with this recommendation and stated that such a system may assist in better quantification of TEFRA audits. As such, IRS management has requested the necessary funding for this system. Unfortunately, after the IRS's annual evaluation of information technology needs based on labor, financial factors/constraints, and feasibility, legislative changes and regular system maintenance expend most of the IRS's available resources. While IRS management will continue to pursue funding, they cannot commit to the recommended system improvements at this time.
>
> ***Office of Audit Comment:*** As we noted previously, the IRS's FY 2016 Budget Request includes additional resources to expand the coverage of partnership audits, including TEFRA audits. However, the budget request did not include system improvements needed to effectively allocate its resources. As such, the problems we have reported will remain and possibly increase in scope.

Recommendation 4: Evaluate whether it would be cost beneficial to develop and implement updates to the CTF audit report writing software in an effort to better accommodate certain types of adjustments and calculations.

> ***Management's Response:*** IRS management agreed with this recommendation and stated that they will review the need for software updates as funding becomes available.

Legislative Proposals to Streamline the Partnership Audit Process May Address Some of the Challenges of Auditing Large Partnerships

To help address the difficulty in auditing large partnerships, the President's FY 2013 budget proposal[42] included a legislative proposal to streamline audit and adjustment procedures for large partnerships. Specifically, any partnership with 1,000 or more partners during the partnership's taxable year would be considered a "required large partnership," which for IRS audit purposes, would be treated similar to a corporation.[43]

While the TEFRA requires the IRS to send tax bills to the partners who were partners in the tax year under audit, the large partnership proposal would give the IRS the authority to flow through any audit adjustments to the current partners (rather than identifying the partners that existed during the tax year under audit). This shifts the burden of responsibility from the IRS, and the CTF in particular, to the partnerships themselves, which would then be responsible for incorporating any audit adjustments in the Schedules K-1 that are issued to the affected partners. The partnership could also elect to pay any deficiency itself via an imputed underpayment. According to the Joint Committee on Taxation, the imputed underpayment is generally calculated by netting the adjustments to the income and loss items of the partnership and multiplying that amount by the highest tax rate.

The Joint Committee on Taxation published the following regarding its analysis of the required large partnership proposal:

> *Finding all the partners of very large partnerships, particularly in the case of tiered partnerships, is a difficult obstacle to auditing them, one that Congress noted in 1982 in enacting the TEFRA audit rules and that remains today. Arguably, though the number of direct and indirect partners in some partnerships is many tens of thousands under current business practice, the tax law has not kept up and does not currently require reporting of their identities or even the number of them in audit situations. The proposal arguably addresses the toughest problem of auditing partnerships by requiring all passthrough partners to report*

[42] Office of Management and Budget, *Analytical Perspectives, Budget of the U.S. Government, Fiscal Year 2013* p. 210 (2012). See also: Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals* p. 254 (Feb. 2012).
[43] The same required large partnership proposal was subsequently included the President's budget proposals for FYs 2014 and 2015.

> *at least the number of partners so that both the partnership and the IRS have a record of it.*[44]

While this proposal appears to be a positive step towards reducing the increasing workload of the CTF, we believe that the CTF will continue to face difficulties with assessing taxes for partnerships with fewer than 1,000 partners and/or with other flow-through entities as partners, as the identification of tiered partners alone will remain a significant challenge. Although the IRS's Chief Counsel coordinated with the Department of the Treasury's Office of Tax Policy on the drafting of this proposal, IRS officials did not perform any analyses of available data to determine the adequacy of the 1,000-partner threshold or the impact it would have on the IRS's partnership audit process.

Because partnerships with over 1,000 partners represent less than 1 percent of the total partnership universe,[45] the IRS should consider performing an analysis to determine the extent that the proposal will resolve some of the TEFRA audit issues. For example, at TIGTA's request, the IRS's Office of Research, Analysis, and Statistics, analyzed the 11,123 TEFRA audits closed between FYs 2010 and 2013 and found that the overwhelming majority of these audits, at least 9,351[46] (or 84 percent), have fewer than 500 partners. These 9,351 audits also accounted for approximately $31.5 billion (82 percent) of the $38.2 billion in audit adjustments for TEFRA audits closed during FYs 2010 through 2013. While these estimates have not yet been subjected to validation procedures, they indicate that the 1,000-partner threshold may only address a small percentage of the TEFRA audit problems.

More recently, in February 2014, the House Ways and Means Committee issued an alternative proposal to completely replace the TEFRA audit procedures.[47] Instead of treating partnerships with 1,000 or more partners as corporations for audit purposes, this proposal would set the threshold for a large partnership much lower. Specifically, the proposed legislation would apply to all partnerships that had more than 100 partners or a partner that is another flow-through entity. Once the IRS has reviewed a partnership's return and determined that specific items need to be adjusted, the IRS would be given the authority to pass the "reviewed year" (*i.e.*, the audited tax year adjustments) onto the current partners of the partnership and the partnership itself would pay the tax. According to an analysis performed by the Joint Committee on Taxation, this

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[44] Joint Committee on Taxation, JCS-2-12, *Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal* p. 624 (June 2012).
[45] The IRS estimate was provided by the Office of Research, Analysis, and Statistics. Neither TIGTA nor the IRS validated the accuracy of this analysis.
[46] There were an additional 1,129 audits for which the IRS could not readily determine the number of partners; therefore, the number of audits that had less than 500 partners could be greater than 9,351.
[47] Tax Reform Act of 2014, Discussion Draft, p. 676 (Feb. 21, 2014). For more information, see the Joint Committee on Taxation, JCX-14-14, *Technical Explanation of the Tax Reform Act of 2014, A Discussion Draft of the Chairman of the House Committee on Ways and Means to Reform the Internal Revenue Code: Title III — Business Tax Reform* p. 249 (Feb. 26, 2014).

proposal is estimated to generate $13.4 billion over 10 years.[48] Based on the analysis by the IRS's Office of Research, Analysis, and Statistics mentioned above in this report, this proposal would have a much greater impact in mitigating some of the challenges of auditing large partnerships.

Recommendation

Recommendation 5: The Commissioner, LB&I Division, and the Commissioner, SB/SE Division, should coordinate with the Department of the Treasury's Office of Tax Policy and the IRS Office of Research, Analysis, and Statistics to analyze the impact that the proposed tax law changes related to TEFRA audits would have on the IRS's partnership audit process.

> ***Management's Response:*** IRS management agreed with this recommendation and stated that the Office of Research, Analysis, and Statistics will complete an analysis of partnership data for the purpose of understanding how many partnership structures will be affected by proposed tax law changes. The results of the analysis will be used to determine the potential impact to the IRS's partnership audit process.

[48] Joint Committee on Taxation, JCX-20-14, *Estimated Revenue Effects of the "Tax Reform Act of 2014"* p. 10 (Feb. 26, 2014).

Appendix I

Detailed Objective, Scope, and Methodology

The objective of this review was to identify the types of noncompliance the IRS has detected among partnerships[1] and evaluate the progress the IRS has made toward addressing this noncompliance. To accomplish this objective, we:

I. Analyzed the type and extent of noncompliance addressed by the IRS's partnership audit process.

   A. Determined the types of noncompliance associated with partnerships by reviewing pertinent literature and conducting interviews with IRS officials.

   B. Obtained an AIMS extract and conducted an analysis of partnership audits closed by field examiners (non-training) for FYs 2010 through 2013 to determine whether the audits resulted in adjustments. Specifically, we:

      1. Identified the number of partnership audits closed.

      2. Identified the total net audit adjustments recommended.

      3. Identified the number of TEFRA and non-TEFRA partnership audits closed.

      4. Identified the number of partnership audits that resulted in a no-change.

      5. Identified the total hours charged by field examiners to complete the partnership audits.

      6. Validated closed AIMS data by comparing our extract to figures obtained from the IRS's Examination Program Monitoring report for FYs 2010 through 2013. We determined that the data used in our review were sufficiently reliable to perform our audit analysis.

   C. Requested and analyzed the IRS's Examination Operational Automation Database information on the specific line items adjusted for the partnership audits. We did not perform audit tests to assess the validity of this data.

   D. Requested and analyzed reports from the IRS on the total number of TEFRA and non-TEFRA partnership filings. We did not perform audit tests to assess the validity of this data.

[1] See Appendix IV for a glossary of terms.

II. Assessed the progress the IRS is making to address the types of noncompliance identified among partnerships.

A. Evaluated the status, scope, and accomplishments of the joint LB&I and SB/SE Divisions' Partnership Strategy.

B. Interviewed designated IRS officials and subject matter experts to further discuss any additional improvements the IRS has made to addressing partnership noncompliance.

III. Identified the steps the IRS has taken to enhance the accomplishments of the IRS's partnership audit process and determined what additional actions could be taken to further improve the process.

A. Evaluated how the IRS currently measures partnership audit productivity and identified any areas of concern and opportunities for improvement.

B. Evaluated the productivity of the CTF responsible for processing the partner adjustments related to TEFRA partnership audits. Specifically, we:

1. Obtained an AIMS extract and conducted an analysis of partner closures performed by the CTF for FYs 2010 through 2013.

2. Validated the closed AIMS data by comparing our extract to figures obtained from the Campus Operation Business Results reports for FYs 2010 through 2013. We determined that the data used in our review were sufficiently reliable to perform our audit analysis.

3. Requested a barred assessment listing for the CTF for FYs 2010 through 2013 and evaluated this information for trends and recurring issues regarding partner tax assessments.

IV. Reviewed proposed legislation addressing partnership audits and evaluated the potential impact on the IRS's partnership audit process. Specifically, we:

A. Analyzed the provision in the President's FY 2013 budget proposal to streamline audit and adjustment procedures for large partnerships. Specifically, any partnership with more than 1,000 partners during the partnership's taxable year would be considered a "required large partnership" which, for IRS audit purposes, would be treated similarly to a corporation.

B. Analyzed the provision in the Proposed Tax Reform Act of 2014 Discussion Draft to treat any audited partnership that had more than 100 partners (or a partner that is another flow-through entity) similar to a corporation.

C. Interviewed the IRS Chief Counsel to determine whether the IRS or the Department of the Treasury provided any input or performed any analyses for the proposed legislations impacting the IRS's audit of partnerships.

Internal controls methodology

Internal controls relate to management's plans, methods, and procedures used to meet their mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance. We determined that the following internal controls were relevant to our audit objective: IRS policies, procedures, and practices for examining partnership returns. We evaluated these controls by reviewing source materials, interviewing management, reviewing audit case files, and researching taxpayer accounts.

Appendix II

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Appendix III

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Director, Examination, Small Business/Self-Employed Division SE:S:E
Director, Campus Reporting Compliance, Small Business/Self-Employed Division SE:S:CCS:CRC
Director, Planning Analysis Inventory and Research, Large Business and International Division SE:LB:P
Chief Counsel CC
National Taxpayer Advocate TA
Director, Office of Legislative Affairs CL:LA
Director, Office of Program Evaluation and Risk Analysis RAS:O
Office of Internal Control OS:CFO:CPIC:IC
Audit Liaisons:
- Commissioner, Large Business and International Division SE:LB
- Commissioner, Small Business/Self-Employed Division SE:S
- Director, Office of Research, Analysis, and Statistics RAS
- Chief Counsel CC

Appendix IV

Glossary of Terms

Alternative Minimum Tax – A tax imposed to reduce the tax advantages derived from preferential treatment given to certain individuals and corporations that do not pay tax on income derived from certain sources or enjoy special deductions. This tax on modified taxable income plus tax preferences is paid if and to the extent it exceeds a taxpayer's regular tax.

Audit Information Management System – A computer system used to control returns, input assessment/adjustments into the Master File, and provide management reports.

Barred Assessment – A situation that occurs when a tax assessment is not made within the prescribed statute time period, which leads to a loss of tax revenue.

Campus (formerly called Service Center) – An IRS location that can include operations for processing returns and conducting activity for compliance, customer account services, and customer assistance.

Campus Operation Business Results Reports – These reports are used to brief the SB/SE Division Commissioner on a monthly basis and provide year-to-date information on resource usage and inventory activity for major operational program objectives.

Campus TEFRA Function – An IRS function located in the Ogden and Brookhaven Campuses that provides support for field personnel when flow-through (also known as pass-through) entity audits are linked via the PCS.

Compliance Initiative Projects – Any activities involving contact with specific taxpayers within a group, using either internal or external data to identify potential areas of noncompliance within the group, for the purpose of correcting the noncompliance that meet the mission, standards, and resources of the IRS.

Direct Partners – A partner that owns a direct interest in a partnership.

Examination Operational Automation Database – A database that provides data that tracks examination results by issue. This data is captured by the LB&I and SB/SE Divisions for all partnership audits.

Field Examiner – In the context of this report, a field examiner is a revenue agent who conducts an examination of the taxpayer's books and records on the taxpayer's premises. In general, field examiners conduct face-to-face audits that deal with complex tax issues on business returns, *e.g.*, sole proprietors, corporations, partnerships.

Fiscal Year – Any yearly accounting period, regardless of its relationship to a calendar year. The Federal Government's fiscal year begins on October 1 and ends on September 30.

Flow-Through Entity – An entity that functions as a conduit (such as S corporations, partnerships, and certain trusts) for purposes of income tax liability and payments. These entities file information returns and the entities' shareholders (or beneficial owners) report their pro-rata share of the gross income and are liable for any taxes due.

Full-Time Equivalent – The total number of regular straight-time hours worked, *i.e.*, not including overtime or holiday hours worked, by employees divided by the number of compensable hours applicable to each fiscal year. Annual leave, sick leave, compensatory time off, and other approved leave categories are considered "hours worked" for purposes of defining full-time equivalent employment. Generally, one full-time equivalent is equal to 2,080 staff hours.

Indirect Partner – Any person or entity holding an indirect interest in the partnership through one or more flow-through partners.

Internal Revenue Code – Title 26 of the United States Code enacted by Congress containing all relevant rules pertaining to Federal tax law. This includes estate, excise, gift, income, payroll, and sales taxes.

Internal Revenue Manual – The single, official source of IRS instructions to staff. Instructions to staff are procedures, guidelines, policies, delegations of authority, and other such instructional materials relating to the administration and operation of the IRS.

Lean Six Sigma – *Lean* is a time- and value-based process improvement philosophy designed to eliminate waste and non–value-added activities. *Six Sigma* is a business process improvement method that uses data and facts to produce bottom-line measurable results through reduction in process variation.

Master File – The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.

Non-TEFRA Audit – In the context of this report, any partnership audit that meets TEFRA's small partnership exception. The audit is in many ways like an audit of the individual partners. For example, each partner's return is audited separately, and the determination and treatment of partnership items for one partner is not binding on any other partner.

Partnership – A relationship between two or more entities or persons who join together to carry on a trade or business, with each partner contributing money, property, labor, or skill, and each expecting to share in the profits and losses. The term "partnership" includes a limited partnership, syndicate, group, pool, joint venture, or other unincorporated organization, through or by which any business, financial operation, or venture is carried out, that is not a corporation, trust, estate, or sole proprietorship.

Partnership Control System – A computer system used to link and control flow-through returns and their partners. It interfaces with the AIMS and the Master File. It is used to control returns subject to TEFRA examination procedures, control TEFRA statutes, and generate required statutory correspondence for TEFRA partners as well as other notices and letters pertinent to the program. It is also used to control certain returns not subject to TEFRA examination procedures.

Processing Year – The calendar year in which the tax return is processed by the IRS.

Report Generation Software – The software program utilized in the IRS's audit process to: 1) compute corrected tax, interest, and penalties and to generate audit reports; 2) create various forms and letters; 3) allow tax examiners and reviewers to document their actions and findings; and 4) process and archive audit results.

Tax Equity and Fiscal Responsibility Act of 1982 – Established unified audit rules applicable to all but certain small partnerships. Under these rules, the IRS may challenge the reporting position of a partnership by conducting a single administrative proceeding to resolve issues concerning partnership items with respect to all partners. Partnership items are those items that are more appropriately determined at the partnership level than at the partner level, as provided by regulations.

Tax Gap – The estimated difference between the amount of tax that taxpayers should pay and the amount that is paid voluntarily and on time.

Tax Year – A 12-month accounting period for keeping records on income and expenses used as the basis for calculating the annual taxes due. For most individual taxpayers, the tax year is synonymous with the calendar year.

TEFRA Audit – In the context of this report, any partnership audit that does not meet TEFRA's small partnership exception. The IRS may challenge the reporting position of a partnership by conducting a single administrative proceeding to resolve issues concerning partnership items with respect to all partners. Partnership items are those items that are more appropriately determined at the partnership level than at the partner level, as provided by regulations.

TEFRA Procedures – The Internal Revenue Code statutory procedures and IRS internal administrative procedures that are required to be followed during audits of entities that do not meet TEFRA's small partnership exception.

Tier – A flow-through entity that passes through items for partners, shareholders, or beneficiaries that is itself a partner, a shareholder, or a beneficiary of a flow-through entity.

Tier Structure Tool – A computer program that provides detailed information about the ownership structure of a partnership under audit. It is used by the CTF to aid in workload planning and audit decisions. Field agents also have access to this program or can contact someone to use it for risk analysis purposes.

Appendix V

Management's Response to the Draft Report

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

COMMISSIONER
SMALL BUSINESS/SELF-EMPLOYED DIVISION

DEC 18 2014

MEMORANDUM FOR MICHAEL E. MCKENNEY
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Karen Schiller
Commissioner, Small Business/Self Employed Division

SUBJECT: Draft Audit Report – Additional Improvements Are Needed to Measure the Success and Productivity of the Partnership Audit Process (Audit #201430027)

Thank you for the opportunity to review the subject draft report regarding the IRS' partnership audit process. We appreciate your acknowledgment of our efforts to independently seek improvements to the process and the systems that support it.

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) created a unified partnership audit procedure for all partnerships (other than those that met the "small partnership" exception). The law and the resulting administrative processes were sufficient to deal with the small number of partnerships in existence at that time, most of which were relatively simple in structure. Over 30 years have passed since TEFRA's enactment and the landscape of partnerships as an operating vehicle has changed and expanded dramatically. In 1982, the enactors of TEFRA could not have anticipated the current complex nature and multi-tier entity structures that are utilized today as investment vehicles to raise and allocate capital. In addition to increased complexity, there has been an expansion in the total number of partnerships. Indeed, in just the past decade, the total number of partnership return filings increased by 47% and now exceed 3.6 million in filings. Notwithstanding the complexity and structuring of these entities and the administrative constraints of applying TEFRA to today's partnerships, the IRS had more than 156,000 open partner audits in the Ogden Campus at the end of FY 2013 that require our resources to process.

The evolution of partnerships since the creation of TEFRA has impacted our ability to efficiently process partner adjustments related to large partnership audits. A change in legislation is needed to address the tax administration problems that these entities create. Absent a legislative change, the IRS has formed a partnership council to address the most pressing issues in TEFRA partnership tax administration. The aim of the council is to develop, operationalize, and oversee TEFRA policy and administrative matters. To date, the council has conducted an evaluation using a Lean Six Sigma approach of the current tax administrative policy

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and procedures and has considered the TEFRA partnership filings which are currently in the examination pipeline. The evaluation has resulted in a plan with the following objectives: 1) Reduce the number of insignificant TEFRA linkages, 2) Develop a streamlined approach to establishing future partner linkages for TEFRA examinations, and 3) Improve internal administrative processes associated with TEFRA. Once operationalized, each objective will be evaluated for effectiveness and the partnership council will meet periodically to consider TEFRA partnership tax administration with a goal of ensuring continuous improvement.

We agree with your findings, though much of what you recommend requires funding. We acknowledge the need for systems that will allow us to assess the productivity of partnership examinations. We have requested funding for such systems for several years, and will continue to do so in the event our budget situation changes. Until such time as funding is secured, we will continue to do what we can to improve the process where possible.

We concur that incorporating improvements to eliminate the work-around processes we have now will increase efficiency. Requests for improvements are submitted each year but have been denied due to competing priorities, such as legislative changes and regular system maintenance. We will continue to make improvements where we can.

Attached is our response to your recommendations. If you have any questions, please contact me, or a member of your staff may contact Shenita Hicks, Director, Examination, Small Business/Self Employed at (240) 613-2849.

Attachment

Attachment

RECOMMENDATION 1:
Coordinate with the Director, Office of Research, Analysis and Statistics, to develop a strategy to measure the success and productivity of all partnership audits (both TEFRA and non-TEFRA). This may include, but is not limited to the amount of the audit adjustments and the taxes assessed (or refunds issued) for the partners.

CORRECTIVE ACTION:
Research, Analysis and Statistics (RAS) is attempting to gather compliance characteristics from data as recommended by Government Accountability Office (GAO) audit report GAO-14-453, however, this effort will not include an estimate of productivity. Our systems do not allow us to track specific partnership adjustments through to the taxable partners. A working team with RAS, LB&I and SB/SE will be established to address the GAO recommendation and develop a better understanding of the extent and nature of partnership misreporting and the effectiveness of examinations in detecting the misreporting.

IMPLEMENTATION DATE:
September 15, 2015

RESPONSIBLE OFFICIAL(S):
Director, Examination, SB/SE Division
Director, Planning, Analysis, Inventory, and Research, LB&I Division

CORRECTIVE ACTION MONITORING PLAN:
We will monitor this action as part of our internal management control process.

RECOMMENDATION 2:
Work with the Chief Technology Officer to develop a system capable of determining the amount of taxes assessed as a result of all partnership audits (both TEFRA and non-TEFRA).

CORRECTIVE ACTION:
We agree a more robust system may assist in better identification of high risk inventory. As such, requests for system improvements have been submitted each year starting in 2010. Unfortunately, after our annual evaluation of Information Technology (IT) needs based on labor, financial factors/constraints and feasibility, legislative changes and regular system maintenance expend most of our available resources. While we will continue to pursue funding, we cannot commit to the recommended system improvements at this time.

IMPLEMENTATION DATE:
N/A

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RESPONSIBLE OFFICIAL(S):
N/A

CORRECTIVE ACTION MONITORING PLAN:
N/A

RECOMMENDATION 3:
Work with the Chief Technology Officer to develop a system capable of ensuring that audits of each individual partner's return closed by the Campus TEFRA Function (CTF) are captured and included in performance measurements.

CORRECTIVE ACTION:
We agree such a system may assist in better quantification of TEFRA examinations. As such, we have requested the necessary funding for this system. Unfortunately, after our annual evaluation of IT needs based on labor, financial factors/constraints and feasibility, legislative changes and regular system maintenance expend most of our available resources. While we will continue to pursue funding, we cannot commit to the recommended system improvements at this time.

IMPLEMENTATION DATE:
N/A

RESPONSIBLE OFFICIAL(S):
N/A

CORRECTIVE ACTION MONITORING PLAN:
N/A

RECOMMENDATION 4:
Evaluate whether it would be cost beneficial to develop and implement updates to the CTF audit report writing software in an effort to better accommodate certain types of adjustments and calculations.

CORRECTIVE ACTION:
While we believe it may be cost beneficial to develop and implement updates to the software, we have previously submitted updates for other improvements. Due to funding, we have been unable to implement the requested changes. At such time as funding becomes available, we will again review the need for updates.

IMPLEMENTATION DATE:
N/A

RESPONSIBLE OFFICIAL(S):
N/A

CORRECTIVE ACTION MONITORING PLAN:
N/A

RECOMMENDATION 5:
Coordinate with the Department of the Treasury's Office of Tax Policy and the IRS Office of Research, Analysis, and Statistics to analyze the impact that the proposed tax law changes related to TEFRA audits would have on the IRS's partnership audit process.

CORRECTIVE ACTION:
Research Analysis and Statistics (RAS) will complete an analysis of partnership data for the purpose of understanding how many partnership structures will be impacted by proposed tax law changes. The results of the analysis will be used to determine the potential impact to our partnership audit process.

IMPLEMENTATION DATE:
March 15, 2016

RESPONSIBLE OFFICIAL(S):
Director, Examination, SB/SE Division
Director, Pre-Filing and Technical Guidance, LB&I Division
Director, Research Analysis and Statistics (RAS)

CORRECTIVE ACTION MONITORING PLAN:
IRS will monitor this corrective action as part of our internal management system of controls.