



*Improvements Are Needed to Ensure That  
Procedures Are Followed During Partnership  
Audits Subject to the Tax Equity and  
Fiscal Responsibility Act of 1982*

**September 26, 2014**

**Reference Number: 2014-30-082**

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.

**Redaction Legend:**

1 = Tax Return/Return Information

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## HIGHLIGHTS

### **IMPROVEMENTS ARE NEEDED TO ENSURE THAT PROCEDURES ARE FOLLOWED DURING PARTNERSHIP AUDITS SUBJECT TO THE TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982**

## Highlights

**Final Report issued on September 26, 2014**

Highlights of Reference Number: 2014-30-082 to the Internal Revenue Service Commissioners for the Large Business and International and Small Business/Self-Employed Divisions.

### **IMPACT ON TAXPAYERS**

The enactment of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) by Congress resulted in revisions to the Internal Revenue Code and the IRS's administrative procedures for conducting audits of partnerships. There are many reasons for the IRS to ensure that procedures are followed. Most importantly, procedural errors can affect the validity of the tax assessments, infringe on taxpayer rights, and result in improper disclosures of tax information.

### **WHY TIGTA DID THE AUDIT**

This audit was initiated to determine whether audits of partnerships subject to the TEFRA are initiated in accordance with applicable statutory and administrative procedures. The review is part of our Fiscal Year 2014 Annual Audit Plan and addresses the major management challenge of Taxpayer Protection and Rights.

### **WHAT TIGTA FOUND**

TIGTA reviewed a statistically valid sample of 35 partnership audits subject to the TEFRA that were closed during Fiscal Year 2012 and identified 22 audits that were not conducted in accordance with one or more applicable TEFRA procedures. Specifically, TIGTA found that:

- (1) minimum tests were not always documented to determine whether TEFRA procedures should have been used to examine the partnership

- (2) necessary checks were not always documented to ensure that the Tax Matters Partner was qualified to represent the partnership;
- (3) some Forms 2848, *Power of Attorney and Declaration of Representative*, did not contain the required information that allows disclosure of tax return information; and
- (4) some Letters 1787, *Notice of Beginning of Administrative Proceeding*, were not issued timely. When the sample results are projected to the population of 2,698 TEFRA audits closed during Fiscal Year 2012, TIGTA estimates that approximately 1,696 TEFRA audits were not conducted in accordance with one or more applicable TEFRA procedures.

A combination of factors contributed to the errors that TIGTA identified, and additional actions are needed to ensure that audits of partnerships are conducted in accordance with applicable TEFRA procedures.

### **WHAT TIGTA RECOMMENDED**

TIGTA recommended that the Commissioners, Large Business and International and Small Business/Self-Employed Divisions, ensure that the additional control procedures implemented to monitor whether examiners timely submit control documents are working as intended and that interim guidance is issued to clarify when examiners are required to submit the necessary control documents. In addition, TIGTA recommended that quality reviews be revised to monitor the examiners' compliance with all applicable statutory and administrative procedures and that the results of such reviews be used to provide feedback to the first-line managers and examiners. Finally, TIGTA recommended that the IRS take steps to hold first-line managers accountable for ensuring that TEFRA audits are conducted in accordance with all procedures.

In their response to the report, IRS officials agreed with all of our recommendations and plan to take corrective actions.



TREASURY INSPECTOR GENERAL  
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY  
WASHINGTON, D.C. 20220

September 26, 2014

**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 – Improvements Are Needed to Ensure That  
Procedures Are Followed During Partnership Audits Subject to the Tax  
Equity and Fiscal Responsibility Act of 1982 (Audit # 201330038)

This report presents the results of our review to determine whether audits of partnerships subject to the Tax Equity and Fiscal Responsibility Act of 1982<sup>1</sup> (TEFRA) are initiated in accordance with applicable statutory and administrative procedures. The review is included in our Fiscal Year 2014 Annual Audit Plan and addresses the major management challenge of Taxpayer Protection and Rights.

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

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 Bryce Kisler, Acting Assistant Inspector General for Audit (Compliance and Enforcement Operations).

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<sup>1</sup> Pub. L. No. 97-248, 96 Stat. 324 (codified as amended in scattered sections of 26 U.S.C.).



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## *Abbreviations*

AIMS	Audit Information Management System
CTF	Campus TEFRA function
FY	Fiscal Year
IRM	Internal Revenue Manual
IRS	Internal Revenue Service
LB&I	Large Business and International
NBAP	Notice of Beginning of Administrative Proceeding
PCS	Partnership Control System
SB/SE	Small Business/Self-Employed
TEFRA	Tax Equity and Fiscal Responsibility Act of 1982
TIGTA	Treasury Inspector General for Tax Administration
TMP	Tax Matters Partner



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## *Background*

A partnership<sup>1</sup> is a relationship between two or more entities or persons who join 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. Although partnerships are required to file a Form 1065, *U.S. Return of Partnership Income*, which shows the partnership's income or loss, partnerships are not taxed directly. Instead, the partners are responsible for reporting their share of a partnership's income or loss on their respective income tax returns.<sup>2</sup> Because the partnership distributes untaxed income, losses, credits, and other items to the respective partners, partnerships are commonly referred to as flow-through entities.

Since Tax Year 2002, the number of partnerships has grown at an average annual rate of about 4 percent. In its most recent Statistics of Income Bulletin, the Internal Revenue Service (IRS) reported that for Tax Year 2011, the number of partnerships and direct partners totaled about 3.3 million and 24.4 million, respectively.<sup>3</sup> The IRS also reported that partnerships claimed assets of \$20.6 trillion and net income of \$580.9 billion.

Because partnership losses<sup>4</sup> can offset the partners' income from other sources, in the 1970s and early 1980s, some taxpayers began using partnerships as a vehicle to take advantage of unintended loopholes in the tax laws. Enactment of the Tax Equity and Fiscal Responsibility Act of 1982<sup>5</sup> (TEFRA) by Congress was intended, in part, to close some of the tax loopholes. For example, the TEFRA reduced the potential to use a partnership as a tax shelter by adding various partnership penalties to the Internal Revenue Code<sup>6</sup> in an effort to deter the promotion of and investment in abusive tax shelters.

The TEFRA-related revisions to the Internal Revenue Code also affected how the IRS conducts audits of partnerships that do not meet the TEFRA's small partnership exception.<sup>7</sup> The TEFRA defines the small partnership exception as those partnerships that have 10 or fewer partners and

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<sup>1</sup> See Appendix VI for a glossary of terms.

<sup>2</sup> For each partner, partnerships are required to provide a Schedule K-1, *Partner's Share of Income, Deductions, Credits, etc.*, to the IRS and the respective partners. The Schedule K-1 is unique to each individual partner as it shows the partner's share of the total partnership business activity. The individual partners are responsible for reporting the information from the Schedule K-1 on their respective individual tax return.

<sup>3</sup> IRS, *Statistics of Income Bulletin* (Fall 2013).

<sup>4</sup> 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.

<sup>5</sup> Pub. L. No. 97-248, 96 Stat. 324 (codified as amended in scattered sections of 26 U.S.C.).

<sup>6</sup> Internal Revenue Code Sections 6221 through 6234.

<sup>7</sup> 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).



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none of the respective partners is a flow-through entity (e.g., S corporations, other partnerships, or Limited Liability Companies that filed partnership returns).<sup>8</sup> For each partnership audit, the examiner must determine whether the partnership meets the TEFRA's small partnership exception. This determination must be made for each tax year under audit, can involve multiple steps, and is emphasized in IRS procedures as being critically important for ensuring additional tax assessments, if any, resulting from an audit are valid under the tax law.

Many of the TEFRA procedures required to initiate partnership audits are the same regardless of whether the partnership meets the TEFRA's small partnership exception. For those partnerships that meet the TEFRA's small partnership exception, the 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 is not binding on any other partner. Additionally, the statute of limitations for assessment of taxes is tied to the individual partners' returns. Therefore, for the IRS to extend the statute of limitations to facilitate completing the audit of a partnership return, the IRS must obtain a signed consent form from each partner. For non-TEFRA audits, the examiner is typically responsible for identifying and linking the partnership audit to the respective partners' returns, which includes assessing (or refunding) any associated taxes resulting from the non-TEFRA audit adjustments.<sup>9</sup>

For partnerships that do not meet the TEFRA's small partnership exception, the treatment of partnership items is determined at the entity level in one unified audit (hereafter referred to as a "TEFRA audit"). For TEFRA audits, the examiners are required to perform a number of procedures to ensure that the audits are conducted in accordance with the TEFRA statutory requirements. To guide and assist its examiners and other personnel in complying with the TEFRA statutory requirements, the IRS developed a set of administrative procedures that are reflected in the Internal Revenue Manual (IRM). These statutory and administrative procedures are hereafter referred to as "TEFRA procedures." Among other procedures, TEFRA audits must be conducted in accordance with all of the following TEFRA procedures.

- **Identify a qualified Tax Matters Partner (TMP).** To meet this statutory requirement, the IRS instructs its examiners to determine if a TMP was designated for each return under audit and whether such TMP(s) is qualified. The examiners are required to complete job aid Form 13828, *Tax Matters Partner (TMP) Qualification Check Sheet*, to determine whether the TMP(s) is qualified. If the TMP(s) is deemed unqualified, the examiner is required to complete the job aid Form 13827, *Tax Matters Partner (TMP) Designation Check Sheet*, to ensure that a proper TMP is designated. As the designated representative of the TEFRA partnership, the TMP performs several important duties that may include

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<sup>8</sup> TEFRA procedures also apply to partnerships if one or more of the partners are not domestic partners or if the partnership makes an election to be treated as a TEFRA partnership.

<sup>9</sup> There are situations that may require the Campus TEFRA Function (CTF) to link the non-TEFRA audit to the respective partners' returns.



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entering into formal agreements with the IRS, which will bind certain partners<sup>10</sup> in the partnership to any additional tax assessments resulting from the audit. Consequently, if a TMP is not properly qualified, agreements entered into on behalf of the partnership may not be valid under the tax law.

- ***Provide the partnership with official notification by mail that the IRS is beginning a TEFRA audit.*** To meet this statutory requirement, the IRS instructs its examiners to forward by mail Letter 1787, *Notice of Beginning of Administrative Proceeding* (NBAP), to the TMP. The IRS also established an administrative procedure to require that the NBAP be issued by certified mail before the start of the examination (*i.e.*, before reviewing the taxpayers books and records).<sup>11</sup> This administrative procedure was designed to ensure that the IRS meets the statutory requirement of issuing the NBAP 120 days before Letter 1830, *Notice of Final Partnership Administrative Adjustment*, is issued to the TMP.
- ***Add special statements to the Power of Attorney and Declaration of Representative form.*** To meet this statutory requirement, the IRS instructs its examiners to ensure that special statements are added to Form 2848, *Power of Attorney and Declaration of Representative*,<sup>12</sup> when it involves a TEFRA partnership.
- ***Submit control documents needed for establishing the TEFRA audit on the IRS Partnership Control System (PCS) after issuing the Letter 1787 to the TMP.*** To meet this IRS administrative requirement, examiners are required to submit control documents to start the process of linking the TEFRA partnership return to the respective individual partner returns in the PCS. This linkage is required for all TEFRA audits open after 60 days. The IRS uses the PCS to generate and issue TEFRA notices, such as the Letter 1787, to the notice partners associated with the TEFRA partnership.

In a Fiscal Year (FY) 2006 Treasury Inspector General for Tax Administration (TIGTA) report,<sup>13</sup> we reported that audits of partnerships often do not follow all procedures required by the TEFRA. This audit was initiated, in part, to follow up on the corrective actions taken in response to our prior report.

This review was performed with information obtained from the Large Business and International (LB&I) Division Headquarters in Washington, D.C., and the Small Business/Self-Employed (SB/SE) Division Headquarters in New Carrollton, Maryland, during the period November 2012

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<sup>10</sup> A partner who is a non-notice partner (*i.e.*, a partner who has a less than one percent interest in the profits of a partnership with more than 100 partners) may be bound by any formal agreement that is entered into by the TMP.

<sup>11</sup> The issuance of the NBAP on the same day that the taxpayer's books and records are reviewed would meet this administrative requirement.

<sup>12</sup> The same Form 2848 is used to designate a power of attorney in all audits.

<sup>13</sup> TIGTA, Ref. No. 2006-30-106, *Examinations of Partnerships Often Do Not Follow All Procedures Required by the Tax Equity and Fiscal Responsibility Act of 1982* (Jul. 2006).





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through March 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.



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## *Results of Review*

While management controls have been developed to help examiners in conducting TEFRA audits, our review of a statistically valid sample<sup>14</sup> of TEFRA audits found that about two-thirds of them were not conducted in accordance with one or more TEFRA procedures. There are important reasons for the IRS to ensure that procedural errors, such as the ones we identified, are avoided. More importantly, procedural errors can affect the validity of the tax assessments, result in improper disclosures of tax information, and infringe on taxpayers' rights.

### ***Controls Have Been Developed to Help Examiners Conduct Partnership Audits***

The IRS relies on its examiners and first-line managers to ensure that TEFRA audits are properly conducted in accordance with both statutory and administrative procedures. To assist examiners and first-line managers in meeting this responsibility, the IRS has developed and implemented a number of policies, procedures, and management controls.

### ***Procedures were revised to require examiners to complete job aids to ensure that TEFRA procedures are followed***

The IRM is an important control component because it contains the official compilation of detailed instructions and explanations of the statutory and administrative procedures for examiners to follow in conducting TEFRA audits. Although there are similarities in the procedural requirements for TEFRA and non-TEFRA audits, there are additional statutory and administrative procedural requirements that make initiating a TEFRA audit more detailed and can place greater burden on examiners. Given that the IRM is voluminous and the requirements are spread throughout different sections, the IRS consolidated applicable IRM requirements into check sheets (commonly referred to as "job aids") for the examiners to complete during their audits.

During our FY 2006 review of the examiners' compliance with TEFRA procedures, we found that although the available job aids covered some of the TEFRA procedures, examiners were not required to complete them. As a result of our prior report findings and recommendations, Examination function management in the LB&I and SB/SE Divisions revised the IRM in Calendar Year 2008 to require examiners to complete, and include in partnership audit files, the following job aids:

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<sup>14</sup> Our statistically valid sample was a simple random sample.



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- **Form 13813, *Partnership Procedures Check Sheet***, is required for all partnership (TEFRA and non-TEFRA) audits. Among other things, this check sheet is used by the examiner to document whether the partnership is subject to the TEFRA and outlines the TEFRA procedures that need to be completed. Given that the circumstances of the partnership may change from year to year, the examiner must determine whether the partnership meets the TEFRA's small partnership exception for every tax year return under audit and, as a result, a separate Form 13813 is required for each tax year.
- **Form 13814, *TEFRA Linkage Package Check Sheet***, is required for all TEFRA audits that are linked in the PCS and is used by the examiner to ensure that the proper procedures are followed when submitting the PCS Linkage Package. Form 13814 must be completed and submitted when linking a partnership audit in the PCS. However, if the examiner submits the PCS Linkage Package electronically, the examiner would be required to submit either Form 14090, *TEFRA Electronic Linkage Request Check Sheet (LB&I)*, or Form 14091, *TEFRA Electronic Linkage Request Check Sheet (SB/SE)*, depending on whether the audit is being conducted by the LB&I or SB/SE Divisions, respectively.<sup>15</sup>
- **Form 13827, *TMP Designation Check Sheet***, is required for all TEFRA audits when a TMP must be designated and is used by the examiner to ensure that proper procedures are followed when a new TMP must be designated by the TEFRA entity or by the IRS.
- **Form 13828, *TMP Qualification Check Sheet***, is required for all partnership audits subject to the TEFRA and is used by the examiner to ensure that the general partner or member-manager identified as the TMP is properly qualified and his or her status as TMP has not terminated. Given that the circumstances of the partnership may change from tax year to tax year, the examiner must determine whether the TMP is qualified for every tax year return under audit and, as a result, a separate Form 13828 is required for each tax year.

***A number of training courses and advisories were provided to examiners and first-line managers to emphasize the importance of following TEFRA procedures***

All examiners who perform partnership audits are required to take training specifically related to the TEFRA. These training courses cover topics such as flow-through adjustments, issuance of the NBAP, PCS linkage, and other TEFRA procedures. We reviewed the training materials that were provided to examiners during FYs 2010 through 2013 and found that the training materials generally provided an adequate overview of the TEFRA procedures. In addition to the TEFRA training courses, the IRS created an internal TEFRA website that provides a one-stop resource for examiners and managers to use to guide them through initiating and conducting partnership

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<sup>15</sup> Form 13814 was applicable during the time our sample audits were closed; however, Form 13814 was replaced by Forms 14090 and 14091.



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audits. The website provides an overview of the TEFRA procedures and contains links to TEFRA guidance in the IRM as well as job aids, PCS linkage guidance and forms, and previously provided training materials. Further, the importance of following TEFRA procedures is periodically emphasized to examiners and managers in the Technical Digest newsletter, a monthly publication by the SB/SE Division's Technical Services function, as well as in LB&I and SB/SE Divisions' e-mail advisories.

***Additional Controls Are Needed to Ensure That Procedures Are  
Followed During Partnership Audits***

Although examiner compliance with all four TEFRA procedures has improved since our FY 2006 report, overall compliance with the TEFRA procedures still remains a concern. Specifically, our review found that 22 (63 percent) of the 35 FY 2012 TEFRA audits were not conducted in accordance with one or more TEFRA procedures.<sup>16</sup> IRS officials who reviewed the audit case files agreed with the conclusions we reached in all 22 TEFRA audits. When the sample results are projected to our population of 2,698 closed TEFRA audits, we estimate that one or more TEFRA procedures were not followed in 1,696 TEFRA audits.<sup>17</sup> It is important for the IRS to ensure that examiners comply with all applicable TEFRA procedures.

***Compliance with TEFRA procedures has significantly improved since our last review***

As shown in Figure 1, our review of a statistically valid sample of 35 TEFRA audits closed during FY 2012 found that there have been significant improvements in the examiners' compliance with all four of the TEFRA procedures that were tested during our prior review of TEFRA audits closed during FYs 2004 and 2005.

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<sup>16</sup> In a FY 2006 TIGTA report, we reported that 33 (55 percent) of 60 audits closed during FYs 2004 and 2005 were not completed in accordance with one or more required procedures.

<sup>17</sup> See Appendix IV. We are 95 percent confident that the number of audits that were not conducted in accordance with one or more TEFRA procedures is between 1,212 and 2,119.



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**Figure 1: Comparison of the Procedural Errors  
Identified During Our Reviews of Partnership Audits**

<b>Procedural Errors</b>	<b>FYs 2004 and 2005 Closed Audits<sup>18</sup></b>		<b>FY 2012 Closed Audits</b>	
	<b>Errors</b>	<b>%</b>	<b>Errors</b>	<b>%<sup>19</sup></b>
Minimum tests were not documented in audit case files (Form 13813 was applicable for FY 2012 audits) to determine whether TEFRA procedures should be used to examine the partnership return.	<b>33</b>	<b>55%</b>	<b>**1**</b>	<b>**1**</b>
Necessary checks were not documented in audit case files (Form 13828 was applicable for FY 2012 audits) to ensure that the TMP was qualified to represent the partnership for tax matters arising from the audit.	<b>23</b>	<b>38%</b>	<b>6</b>	<b>17%</b>
Form 2848 did not contain required information that allows disclosure of tax return information to designated individuals or organizations.	<b>25</b>	<b>42%</b>	<b>4</b>	<b>13%<sup>20</sup></b>
NBAPs were either not issued or the issuance was not timely.	<b>31<sup>21</sup></b>	<b>52%</b>	<b>15<sup>22</sup></b>	<b>43%</b>
<b>Total Number of Sampled Closed Audits Reviewed.</b>	<b>60<sup>23</sup></b>		<b>35</b>	

Source: TIGTA Ref. No. 2006-30-106 and analysis of our statistically valid sample of 35 TEFRA audits closed during FY 2012.

<sup>18</sup> The 60 sampled audits evaluated during our prior audit were selected from a population of 2,441 partnership audits closed between October 1, 2003, and June 30, 2005.

<sup>19</sup> The error rates shown in Figure 1 are exclusive to our statistically valid sample of 35 partnership returns that were audited by the IRS and closed during FY 2012. Therefore, any errors found in the related year returns associated with our statistically valid sample of returns are not included in the Figure 1 error rates. Instead, we have presented them in Appendix V.

<sup>20</sup> The Form 2848 error rate for the FY 2012 sampled audits was calculated using a sample size of 30, as that was the number of sampled audits for which a Form 2848 was applicable (*i.e.*, only 30 of the 35 sampled audits had a designated power of attorney).

<sup>21</sup> These 31 errors included instances in which the NBAPs were issued after the partnership records were examined as well as instances in which the audit file did not contain evidence that NBAPs were issued.

<sup>22</sup> These 15 errors include only instances in which the NBAPs were issued after the partnership records were examined, as all of the 35 audit case files included evidence that an NBAP was issued.

<sup>23</sup> Our FY 2006 review of a sample of 60 closed FYs 2004 and 2005 audits included partnerships that were subject to TEFRA and some that were not subject to TEFRA. For those partnerships that met the TEFRA's small partnership exception, two of the procedures (qualification of the TMP and issuance of the NBAP) would not have been applicable. Therefore, the FYs 2004 and 2005 error rates for these two procedures may be higher than what is actually shown in Figure 1 and, as a result, the FY 2012 compliance rates with these two procedures would be an even more substantial improvement. Given that our FY 2006 report did not specify how many met the TEFRA's small partnership exception, we calculated the error rate for these two procedures by using the total number (60) of sampled audits we reviewed as we know that the error rates were at least 38 percent (23/60) and 52 percent (31/60).



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**Examiners did not always determine whether the TEFRA procedures should be used to examine partnership returns**

To the IRS’s credit, the error rate decreased by almost 100 percent for the TEFRA procedure that requires examiners to document the minimum tests that were taken to determine if TEFRA procedures should be used to examine a partnership return (Form 1065). Specifically, during FY 2006, we reported a 55 percent error rate. This is a stark contrast to the \*\*1\*\* percent error rate identified in our sample of FY 2012 closed audits.

However, in addition to our statistically valid sample of 35 TEFRA audits closed during FY 2012, we reviewed a judgmental sample<sup>24</sup> of 30 partnership audits closed during FYs 2011 through 2013 and found instances in which the examiners did not determine whether TEFRA procedures should be used. Specifically, we found, and the IRS agreed, that examiners in  
\*\*\*\*\*1\*\*\*\*\*  
\*\*\*\*\*1\*\*\*\*\*  
\*\*\*\*\*1\*\*\*\*\*  
\*\*\*\*\*1\*\*\*\*\*<sup>25</sup>\*\*\*\*\*  
\*\*\*\*\*1\*\*\*\*\*  
\*\*\*\*\*1\*\*\*\*\*  
\*\*\*\*\*1\*\*\*\*\*.

Failing to identify that a partnership is subject to the TEFRA and completing the audit without following the TEFRA procedures could result in invalid tax assessments as well as infringe on the taxpayers’ rights since required procedures, both statutory and administrative, were not followed. We notified the IRS of these \*\*\*\*\*1\*\*\*\*\*  
\*\*\*\*\*1\*\*\*\*\*  
\*\*\*\*\*1\*\*\*\*\*  
\*\*\*\*\*1\*\*\*\*\*  
\*\*\*\*\*1\*\*\*\*\*.

**Steps to ensure that the TMPs were qualified to represent the partnerships were not always documented**

Since our last review, the error rate has decreased by over one-half for the TEFRA procedure that requires examiners to document the steps performed to ensure that the TMP was qualified to represent the partnership for tax matters arising from the audit.

<sup>24</sup> A judgmental sample is a nonstatistical sample, the results of which cannot be used to project to the population. We performed aggregate-level data analysis to identify this judgmental sample. See Appendix I for additional details regarding the methodology for this analysis.  
<sup>25</sup> Although the Form 13813 is required, the examiner can also use the online TEFRA determination tool, print the results, and include it in the audit case file.



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Necessary checks were not documented in audit case files (Form 13828 applicable for FY 2012 audits) to ensure that the TMP was qualified to represent the partnership for tax matters arising from the audit. Almost one out of every five audits (17 percent) was lacking documentation for the TMP's qualifications. Although the IRS agreed that the necessary checks were not documented for six (17 percent) of the 35 FY 2012 TEFRA audits we reviewed, without contacting the partnerships, neither TIGTA nor the IRS would know whether the TMPs were in fact qualified. Therefore, it is important that the examiners document their conclusions in the audit case files. An unqualified TMP representing the partnership for tax matters arising from the audit could result in invalid tax assessments,<sup>26</sup> improper disclosures of tax information, and potential barred assessments.<sup>27</sup>

**Power of attorney forms lacked TEFRA-specific information**

The error rate for the TEFRA procedure that requires the examiner to ensure that TEFRA-specific information is included on the Form 2848 decreased by more than two-thirds since our last review.<sup>28</sup> Although the error rate for this procedure for FY 2012 closed audits was relatively low at 13 percent, it is still important that examiners ensure that the Form 2848 is properly completed to reduce the risks of invalid tax assessments, improper disclosures of tax information, and potential barred assessments.

A properly completed Form 2848 is necessary to ensure that the partnership's tax information is provided only to those authorized to receive such information. When the Form 2848 is not properly completed, the form is invalid and the individual listed as the power of attorney on this form is not authorized to represent the taxpayer. For example, if the power of attorney is not authorized and extends the statute to assess taxes on behalf of the partnership, then there is a risk that the statute extension may be invalid. This invalid statute extension, in turn, could result in barred assessments if the IRS does not obtain a valid extension to assess the taxes prior to the assessment statute date expiring.

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<sup>26</sup> A non-notice partner may be bound by any formal agreement that is entered into by the TMP only when specific language is included on the TMP agreement authorizing the TMP to bind non-notice partners. When a TMP is not properly qualified, formal agreements authorized by the TMP may not be valid under the tax law for the non-notice partners.

<sup>27</sup> The qualification of a TMP is important to ensure that the partnership's tax information is provided only to those authorized to receive such information. If the IRS does not obtain a valid agreement to the tax assessments prior to the assessment statute date expiring, the audit could result in barred assessments.

<sup>28</sup> The Form 2848 error rate for FY 2004 and 2005 audits, as noted in Figure 1, may have been much higher than 42 percent as the form is applicable only for those audits for which a taxpayer designates a power of attorney. Given that our FY 2006 report did not specify how many of the audits involved a power of attorney, we calculated the error rate by using the total number (60) of sampled audits we reviewed and know that the error rate was at least 42 percent (25/60).



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**Required notices of beginning of administrative proceeding were not timely issued**

Our review found that in 15 (43 percent) of the 35 FY 2012 closed audits, the examiners did not issue the NBAP in accordance with one of the IRS's administrative procedures. Specifically, the examiner is required to issue the NBAP prior to beginning an audit of a partnership return, which, according to the IRM,<sup>29</sup> is when the examiner begins reviewing the partnership's books and records. For these 15 audits, we found that the examiners issued the NBAPs four days to 135 days after reviewing the books and records.

Although the 43 percent error rate identified during this review was a slight improvement from the 52 percent error rate identified during our prior review, the fact that the NBAPs are still being issued untimely in almost one out of every two TEFRA audits is concerning. More importantly, procedural errors, such as examiners issuing the NBAP after reviewing books and records, puts the IRS at risk of not meeting a statutory requirement. Specifically, as noted earlier, the requirement to issue the NBAP prior to reviewing the books and records was implemented to help ensure that the IRS meets the statutory requirement of issuing the NBAP 120 days before Letter 1830, *Notice of Final Partnership Administrative Adjustment*, is issued to the TMP. When the IRS fails to comply with this timeline, there is risk of invalid tax assessments.<sup>30</sup> Therefore, timely issuance of the NBAPs is important to help protect revenue for the Treasury Department.

**Improvements are needed to ensure that the PCS linkage packages are timely submitted**

In addition to the four TEFRA procedures shown in Figure 1, IRS administrative procedures require examiners to submit PCS linkage packages to initiate the time-consuming process of identifying and linking the respective partners in the PCS. This process involves the CTF obtaining the appropriate tax returns for each partner, identifying which partners may be assessed taxes or due a refund, and computing the amount that will be assessed or refunded if the partnership audit does in fact result in adjustments to the partnership's Form 1065.

To assess taxes (or issue a refund), the CTF must open and close an audit for each taxable partner's individual return. This process requires a number of manually performed procedures, which often can be extremely cumbersome given the growing trend of complex partnership structures. Given that the individual partners pay tax on their share of the partnership income, the CTF at times has to identify hundreds to thousands of partners associated with one partnership. Specifically, the CTF must often identify several tiers of flow-through entity partners before identifying the actual taxable partners. Once the taxable partners are identified

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<sup>29</sup> IRM 4.31.2.2.5.1(4) (Jun. 20, 2013).

<sup>30</sup> A taxpayer could challenge a proposed tax assessment in tax court and win his or her case based on this procedural error. According to IRS officials, they are aware of at least one case, *JT USA LP v. Commissioner*, 131 T.C. No. 7 (Oct. 6, 2008), in which an untimely NBAP issuance resulted in the taxpayers winning their case against the IRS.





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and their tax returns are secured, the CTF must determine each partner's share of the TEFRA adjustments and calculate the tax effect.

Our review of a sample of FY 2012 closed TEFRA audits found that the PCS linkage packages were either not submitted or were not submitted timely in 14 (54 percent) of the 26<sup>31</sup> audits in which the PCS linkage was applicable.<sup>32</sup> It is important for the examiner to submit the linkage package timely to reduce the risk of potential barred assessments occurring. Specifically, 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.<sup>33</sup> As a result, the IRS implemented a requirement for examiners to submit the PCS linkage packages within a certain number of days of the NBAP issuance (*i.e.*, the start of the examination). Although the IRS confirmed that the requirement was for examiners to submit the PCS linkage packages within 60 days of the NBAP issuance, we found that the IRM guidance available to examiners for our sample audits included conflicting requirements.

For example, although one section of the IRM<sup>34</sup> stated that the PCS linkage should be submitted within 60 days of the NBAP issuance, two other IRM sections<sup>35</sup> stated that the PCS linkage was mandatory for all TEFRA audits open<sup>36</sup> after 60 days. In addition, the check sheet (Form 13813), which outlines all the steps for auditing partnerships, stated that the PCS linkage package should be submitted 45 days after the NBAP is issued. The lack of clear guidance may have created some confusion and resulted in examiners submitting the PCS linkage packages untimely.<sup>37</sup> However, the lack of clear guidance does not explain why PCS linkage packages were not submitted for several audits<sup>38</sup> that have been open from 109 to 400 days.<sup>39</sup>

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<sup>31</sup> Our sample of 35 included nine audits for which PCS linkage was not required. For instance, the examiner closed the audit before the audit was opened for 60 days. Therefore, the PCS linkage package error rate for the FY 2012 sample audits was calculated using a sample size of 26, as that was the number of sampled audits for which PCS linkage was applicable.

<sup>32</sup> Our FY 2006 review did not test whether the examiners submitted PCS linkage packages timely; therefore, Figure 1 does not include this information.

<sup>33</sup> According to IRM 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 examination.

<sup>34</sup> IRM 4.31.2.2.6.2.1 (Oct. 1, 2010).

<sup>35</sup> IRM 4.31.2.2.6.2 (Oct. 1, 2010) and IRM 4.31.2.2.6.2.4 (Oct. 1, 2010).

<sup>36</sup> An audit is considered open when it begins (which is when the examiner begins to review books and records). The NBAP must be mailed before the start of an audit (*i.e.*, before the examiner reviews books and records).

<sup>37</sup> Six of the 14 audits with PCS linkage procedural errors had a PCS linkage package submitted untimely. For three of the six audits, the PCS linkage packages were submitted between 78 and 97 days after the audit was opened. For the remaining three audits, the PCS linkage packages were submitted between 130 and 198 days after the audit was opened.

<sup>38</sup> For eight of the 14 audits with PCS linkage procedural errors, the examiner did not submit the required PCS linkage package. For three of these eight audits, there was less than 60 days between the NBAP issuance date and the examination closure date. However, for these three audits, the NBAP was issued untimely (*i.e.*, after the examiner reviewed the books and records). Had the NBAP been issued timely, there would have been more than 60 days between the NBAP issuance date and the examination closure date.



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The guidance that was applicable for our sampled audits was established during FY 2010. However, the IRS has since made a number of revisions to the IRM. Therefore, we also evaluated the current guidance available to examiners and found that there continues to be inconsistencies in the IRM. Specifically, we identified at least three separate PCS linkage requirements in the current IRM: within 60 days,<sup>40</sup> after 60 days,<sup>41</sup> and after 90 days.<sup>42</sup> We discussed the inconsistent and conflicting guidance with IRS officials. They stated that they were currently reevaluating the PCS linkage requirement as part of an ongoing Lean Six Sigma study. The study is to determine whether all TEFRA audits, especially those that may result in no adjustments, should be linked within 60 or 90 days given the time-consuming process of identifying the individual partners and the challenges faced by the CTF. The IRS officials stated that they plan to revise the IRM to clarify the PCS linkage requirement once a decision is made as a result of the study. Given that current guidance is conflicting, the IRS should issue interim guidance to ensure that examiners are submitting the PCS linkage packages timely.

In addition, during our review, the IRS designed a new process to help ensure that the examiners' PCS linkage packages are submitted timely. Specifically, the Audit Information Management System (AIMS) and the Examination Return Control System were revised during January 2014 to include a new field for the NBAP issuance date. As of July 2014, the IRS had drafted revisions to the IRM that will outline the guidance for examiners to input the NBAP issuance date. IRS officials stated that the NBAP issuance date in the Examination Return Control System will be monitored to ensure that partnership audits are timely linked in the PCS. If properly implemented, this new process should help to ensure that the PCS linkage packages are timely submitted, which should reduce the risk of the IRS violating the taxpayers' rights to timely notification of audit results as well as better ensure that the IRS has sufficient time to assess taxes (or issue refunds) for the respective partners.

**The examiners' use of job aids and first-line managerial involvement on the required job aids could be improved**

Our review found that a combination of factors contributed to the procedural errors we identified. As a result, we believe that several actions can be taken by the IRS to improve compliance with the TEFRA procedures. For instance, the IRS implemented several job aids as a result of TIGTA's 2006 audit report; however, as shown in Figure 2, our review of a statistical sample of 35 TEFRA audits closed during FY 2012 found that the required job aids were not always used or there was a lack of documentation showing managerial involvement.

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<sup>39</sup> For four of 14 audits, there were adjustments to the partnerships' Forms 1065 ranging from \$126,707 in favor of the taxpayer to \$8,630,000 in favor of the IRS. We found that the PCS linkage packages for those four audits were submitted between 78 and 130 days after the partnership audit was open.

<sup>40</sup> IRM 4.31.2.2.7.2.1 (Jun. 20, 2013).

<sup>41</sup> IRM 4.31.2.2.7.2.4 (Oct. 1, 2010).

<sup>42</sup> IRM 4.31.2.2.1 (Jun. 20, 2013).



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**Figure 2: Examiner Use of Job Aids and Documentation  
of Managerial Involvement on the Required Job Aids**

Required Job Aids	Audits for Which the Required Job Aids Were Not Included in the Audit Case Files			Audits for Which Managerial Involvement Was Not Evident on the Required Job Aids Included in the Audit Case Files		
	Required Job Aid Was Not Included	Applicable Audits	%	Managerial Involvement Was Not Evident	Applicable Audits	%
Form 13813	0	35	0%	11	35	31%
Form 13828	4	35	11%	9	31	29%
Form 13827	**1**	9	**1**	**1**	7	**1**

Source: Analysis of our statistically valid sample of 35 TEFRA audits closed during FY 2012.

Although managerial involvement is required to be documented on these job aids,<sup>43</sup> we did not consider the audit an exception, in Figure 1, when the lack of managerial involvement was the only issue that we identified. First-line managerial reviews are an important control in monitoring the quality of the work performed by the examiners. Therefore, the first-line manager should review the job aids to ensure that these forms are appropriately completed and included in the audit file as well as to provide examiners with feedback for specific areas of improvement. In addition, first-line managerial review of all TEFRA job aids would help the managers in providing timely and constructive feedback to the examiners during the ongoing TEFRA examination as well as during the midyear and annual performance evaluations.

**Performance feedback and TEFRA-specific commitments could help better ensure compliance with TEFRA procedures**

Another factor that may have contributed to the procedural errors is the lack of meaningful performance feedback to examiners and TEFRA-specific commitments<sup>44</sup> to first-line managers.

<sup>43</sup> The IRM that was applicable during the time our sampled audits were closed required management involvement; however, the requirement needed more clarification. We brought this issue to the attention of the IRS and they confirmed that management involvement was required for our sampled audits and have since updated the IRM to provide more clarification on this requirement.

<sup>44</sup> At the first-line manager level, the performance management system requires that, at the beginning of each fiscal year, first-line managers coordinate with their respective Territory managers to set forth commitments in their individual performance plans.



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TIGTA,<sup>45</sup> the Government Accountability Office,<sup>46</sup> and the U.S. Merit Systems Protection Board<sup>47</sup> have all previously reported that performance feedback can be a very effective tool in helping employees understand and meet their responsibilities. It also provides opportunities to give meaningful and constructive feedback on performance, pinpoint and address performance gaps, and hold employees accountable for following management directives and delivering results. As the following excerpt from the U.S. Merit Systems Protection Board report to the President and Congress summarizes, continually monitoring and providing feedback to employees is a critical component of performance management. Performance feedback can be a very effective tool in helping employees understand and meet their responsibilities.

*This component, more than any other, can give employees a sense of how they are doing and can motivate them to be as effective as possible. Ideally, through these ongoing interactions between employees and supervisors, employees learn how their work fits into the goals of the work unit and how it contributes to the larger mission of the agency.*

To get a better understanding of the types of performance feedback being provided to examiners conducting TEFRA audits, we reviewed FYs 2011 through 2013 performance appraisals for a small judgmental sample of 10 examiners.<sup>48</sup> We found that although nine of the 10 examiners' performance evaluations mentioned the TEFRA, such as, *you continue to learn TEFRA and partnership procedures*, this quality of feedback does not emphasize to these examiners the importance of following TEFRA procedures or provide any specific guidance on how they can better conduct a TEFRA audit. Only one of the examiners' appraisals included feedback about the examiner's compliance with TEFRA procedures and areas in which the examiner could improve regarding following TEFRA procedures. For example, this examiner's performance feedback noted, *"Need to do TEFRA linkage."* We believe that specific feedback on compliance with each TEFRA procedure may improve examiners' compliance with TEFRA procedures.

Additionally, we reviewed the FYs 2011 through 2013 commitments for a small judgmental sample of 10 first-line managers<sup>49</sup> and found that none of the first-line managers received any specific commitments related to the TEFRA. Commitments are intended to provide the basis for linking the first-line managers' critical job responsibilities with the IRS's balanced measures and strategic goals and holding them accountable for their individual and team performances. To realize these benefits, the commitments are to be related to at least one critical job responsibility.

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<sup>45</sup> TIGTA, Ref. No. 2011-30-084, *Additional Steps Are Needed to Better Ensure Audits Are Expanded to Prior and/or Subsequent Year Returns When Substantial Taxes May Be Owed*, p. 14 (Sept. 2011).

<sup>46</sup> Government Accountability Office (formerly known as the General Accounting Office), GAO/AIMD-00-21.3.1, *Standards for Internal Control in the Federal Government*, p. 8 (Nov. 1999).

<sup>47</sup> United States Merit Systems Protection Board, *The Federal Workforce for the 21<sup>st</sup> Century: Results of the Merit Principles Survey 2000*, p. 24 (Sept. 2003).

<sup>48</sup> Five of the 10 examiners were associated with our exception cases.

<sup>49</sup> Six of the 10 first-line managers were associated with our exception cases.



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They should also, according to the IRS,<sup>50</sup> specifically describe the actions to be taken, include a deadline, indicate an expected result, and include some means of measurement. Given that first-line managers are responsible for ensuring that partnership audits are conducted in compliance with TEFRA procedures, we believe that it is important for first-line managers to be held accountable.

**Quality reviews of TEFRA audits should be improved**

Improvements are needed to ensure that quality reviews are being performed for each TEFRA audit and that the reviews are expanded to test compliance with all TEFRA procedures. In our FY 2006 report, we noted that quality reviews were not being performed to determine whether TEFRA procedures were followed. Specifically, we reported that although the LB&I Division's quality reviews evaluated how well examiners adhered to TEFRA procedures, the SB/SE Division's quality reviews did not include such evaluation. In response to our prior recommendations, the IRS developed a TEFRA Checklist to be used by the SB/SE Division's Technical Services function reviewers and revised the IRM in October 2010 to require every TEFRA audit, which includes those completed by both the LB&I and SB/SE Divisions, to be quality reviewed. According to IRS officials, the results of these quality reviews are used to identify problem areas and the types of training courses that are needed. However, we found that these reviews are not always performed. For instance, our sample of 35 audits closed during FY 2012 found that three (9 percent) audits were not quality reviewed by the Technical Services function.

The results of our review of 35 sampled audits also found that the quality reviews could be improved. Although the results of these reviews are tracked, compiled, and analyzed based on 14 elements related to the TEFRA procedures, we found that IRS quality reviews do not test for every TEFRA procedure. For example, we identified 15 audits for which the NBAP was issued after the examiners started their review of partnership records. Although \*\*1\*\* of these 15 audits were reviewed by the Technical Services function, the quality reviews did not find any issues with the timing of the NBAP issuance. The reason for the discrepancy between our results and the IRS's results could be attributed to the fact that the IRS's FY 2012 quality reviews did not test whether the NBAPs were issued timely. Instead, the IRS's FY 2012 quality reviews, as well as the FY 2014 quality reviews, tested whether the NBAPs were issued with the correct information and via certified mail. Given that examiners are required to issue the NBAP prior to examining partnership records, the quality reviews should test the examiners' compliance with this procedure and provide feedback accordingly.

The NBAPs are required to be issued before the examiner reviews books and records to ensure that taxpayer rights are protected. Adding more TEFRA elements to the quality reviews would

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<sup>50</sup> See, for example, the IRS Human Capital Office guide entitled, *Writing Performance Commitments "A Reference Guide for Managers and Management Officials"* (Oct. 2005).



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help better ensure that TEFRA procedures were followed as well as provide the IRS with meaningful performance results to provide to both the examiners and first-line managers.

## **Recommendations**

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

**Recommendation 1:** Issue interim guidance to ensure that the examiners timely submit control documents needed for establishing TEFRA audits on the PCS.

**Management's Response:** IRS management agreed with this recommendation and stated that they will issue joint interim guidance to ensure that the examiners timely submit control documents needed for establishing TEFRA audits on the PCS.

**Recommendation 2:** Ensure that the additional control procedures implemented to monitor whether examiners submitted control documents needed for establishing TEFRA audits on the PCS are working as intended and will effectively address the issues we identified in this report.

**Management's Response:** IRS management agreed with this recommendation and stated that they will issue a joint memorandum to first-line managers and examiners directing them to populate the Examination Return Control System with the date the NBAP was mailed. IRS management also plans to create reports to monitor whether the control procedures are working as intended. If the IRS finds that the control procedures are not working as intended, it will investigate the breakdown in the communication, procedures, or report output and correct the issue as necessary.

**Recommendation 3:** Ensure that the required job aids are timely reviewed by the first-line managers and the review results are documented and used to provide examiners feedback regarding their compliance with the TEFRA procedures.

**Management's Response:** IRS management agreed with this recommendation and stated that they will issue a joint memorandum for first-line managers detailing the requirement for documentation under the TEFRA procedures. After the issuance of the joint memorandum, the IRS has plans to conduct an analysis to evaluate the completion of the required job aids. Based on the results, the IRS will consider other options, such as targeted training.

**Recommendation 4:** Ensure that quality reviews performed by the SB/SE Division's Technical Services function are revised to monitor the examiners' compliance with all required procedures and that the reviews are performed for each TEFRA audit. The results of the reviews should also be disseminated to appropriate IRS employees so the results can be used to provide feedback to the first-line managers and the examiners regarding their compliance with the TEFRA procedures.



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**Management's Response:** IRS management agreed with this recommendation and stated that the "Reviewer Check Sheet" for the quality reviews will be updated to include a review of the NBAP issue date and that the information captured will be summarized and disseminated to appropriate employees to provide feedback to the first-line managers and the examiners regarding their compliance with TEFRA procedures.

**Recommendation 5:** Take steps to hold first-line managers accountable for ensuring that TEFRA audits are conducted in accordance with all TEFRA procedures.

**Management's Response:** IRS management agreed with this recommendation. Specifically, to ensure that TEFRA audits are conducted in accordance with all TEFRA procedures, IRS management stated that SB/SE Division management will require TEFRA training for first-line managers and LB&I Division management will issue TEFRA-specific commitments to first-line managers.



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## Appendix I

### *Detailed Objective, Scope, and Methodology*

The overall objective of this review was to determine whether audits of partnerships subject to the TEFRA are initiated in accordance with applicable statutory and administrative procedures. To accomplish this objective, we:

- I. Determined whether the IRS implemented corrective actions in response to TIGTA's FY 2006 report<sup>1</sup> and whether such actions adequately addressed our prior findings.
- II. Identified the policies, procedures, and controls that the LB&I and SB/SE Divisions have in place to guide examiners in following applicable statutory and administrative procedures when initiating audits of partnership returns subject to the TEFRA. This was accomplished by interviewing IRS officials, reviewing the IRM, and researching the IRS's internal website.
- III. Obtained an extract from the AIMS<sup>2</sup> of FY 2012 audits for partnership cases (AIMS Activity Code 480 through 483) closed by revenue agents<sup>3</sup> (Employee Group Code less than 2000). This extract included a total of 7,597 records. To identify only the TEFRA audits, we filtered the data to obtain those records for which the TEFRA Code field in the AIMS was equal to "Y." We excluded closed audits that were considered training returns (*i.e.*, Special Project Code field equal to 0204) and Coordinated Industry Cases (*i.e.*, Coordinated Industry Case field equal to 1) from our population. This analysis identified a total of 2,698 TEFRA audits.
- IV. Validated the data obtained in Step III by comparing it to the Integrated Data Retrieval System and the IRS's Statistics of Income Table 37. Specifically, we reconciled a judgmental sample<sup>4</sup> of 10 audits from our population of closed FY 2012 audits of partnership returns to verify that the audits were in fact closed during FY 2012. Based on our sample, we determined that the data were reliable for purposes of this report.
- V. Selected and reviewed a statistically valid (simple random)<sup>5</sup> sample of 35 TEFRA closed audits from the population of 2,698 TEFRA audits to determine whether TEFRA procedures were followed. Our statistically valid sample of 35 TEFRA closed audits was

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<sup>1</sup> TIGTA, Ref. No. 2006-30-106, *Examinations of Partnerships Often Do Not Follow All Procedures Required by the Tax Equity and Fiscal Responsibility Act of 1982* (Jul. 2006).

<sup>2</sup> See Appendix VI for a glossary of terms.

<sup>3</sup> Revenue agents are the examiners who conduct audits of partnership returns; therefore, we limited our extract to only those audits conducted by revenue agents.

<sup>4</sup> A judgmental sample is a nonstatistical sample, the results of which cannot be used to project to the population.

<sup>5</sup> A statistically valid sample was used for this step so that the results could be projected to the population.





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selected using a 90 percent confidence level,  $\pm 13.4$  percent precision rate, and 62.86 percent occurrence rate<sup>6</sup> as discussed with TIGTA's contracted statistician. A statistically valid sample was taken because we wanted to estimate the number of audits that were not conducted in accordance with one or more TEFRA procedures for the population of 2,698 TEFRA audits.

- VI. Obtained and reviewed a judgmental<sup>7</sup> sample of 30 partnership audits closed during FYs 2011 through 2013 to identify whether examiners appropriately determined when TEFRA procedures should be used. To identify the 30 audit case files, we analyzed the AIMS data and identified partnership audits closed during FYs 2011 through 2013 that were coded as non-TEFRA and compared the non-TEFRA audits to the IRS's Schedule K-1, *Partner's Share of Income, Deductions, Credits, etc.*, data to identify partnerships that issued more than 10 Schedules K-1 to more than 10 partners for the tax year return(s) under audit.
- VII. Determined how LB&I and SB/SE Division management utilized the quality reviews conducted by the SB/SE Division's Technical Services function and obtained the most recent review results (FYs 2010 through 2013) to determine if areas of improvement were identified and whether corrective actions were taken by management to address any weaknesses.
- VIII. Obtained and reviewed the training materials that were provided to examiners during FYs 2010 through 2013 to determine the amount and type of TEFRA training received.
- IX. Selected a judgmental sample of 10 revenue agents from our sample of TEFRA audits to determine whether they received any type of feedback related to conducting TEFRA audits during their mid-year and end-of-year appraisals or during any type of review process.
- X. Selected a judgmental sample of 10 first-line managers from our sample of TEFRA audits and evaluated their performance expectations to determine if there were any commitments/expectations related to the TEFRA.

### **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

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<sup>6</sup> We originally contemplated a sample size larger than 35 based on a 50 percent occurrence rate; however, due to very limited audit resources, we set our initial sample size to 35. TIGTA's contracted statistician advised us that due to the very high error rate, we could decide to stop sampling and that it would not impact the validity of our statistical sample.

<sup>7</sup> Judgmental samples were used for this step, as well Steps IX and X, because we did not intend to project the results of these tests to the entire population.



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for measuring, reporting, and monitoring program performance. We determined 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.



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## **Appendix II**

### *Major Contributors to This Report*

Nancy Nakamura, Assistant Inspector General for Audit (Compliance and Enforcement Operations)  
Ranee Cook, Acting Assistant Inspector General for Audit (Compliance and Enforcement Operations)  
Frank Dunleavy, Acting Assistant Inspector General for Audit (Compliance and Enforcement Operations)  
Bryce Kisler, Acting Assistant Inspector General for Audit (Compliance and Enforcement Operations)  
Glen Rhoades, Director  
Alan Lund, Audit Manager  
Michelle Philpott, Audit Manager  
Tina Fitzsimmons, Lead Auditor  
Debra Mason, Lead Auditor  
Carole Connolly, Senior Auditor  
Alberto Garza, Senior Auditor



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## **Appendix III**

### *Report Distribution List*

Commissioner C

Office of the Commissioner – Attn: Chief of Staff C

Deputy Commissioner for Services and Enforcement SE

Deputy Commissioner, Large Business and International Division (Domestic) SE:LB

Deputy Commissioner, Large Business and International Division (International) SE:LB:IN

Deputy Commissioner, Small Business/Self-Employed Division SE:S

Director, Campus Compliance Services, Small Business/Self-Employed Division SE:S:CCS

Director, Examination, Small Business/Self-Employed Division SE:S:E

Director, Pre-Filing and Technical Guidance, Large Business and International Division  
SE:LB:PFTG

Director, Technical Services, Small Business/Self-Employed Division SE:S:E:TS

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



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## Appendix IV

### *Outcome Measure*

This appendix presents detailed information on the measurable impact that our recommended corrective actions will have on tax administration. This benefit will be incorporated into our Semiannual Report to Congress.

#### **Type and Value of Outcome Measure:**

- Taxpayer Rights and Entitlements – Potential; 1,696 TEFRA audits<sup>1</sup> may not have been conducted in accordance with one or more TEFRA procedures (see page 7).

#### **Methodology Used to Measure the Reported Benefit:**

Our outcome calculation methodology for the audit exception cases included the following steps:

- We selected a statistically valid sample of 35 audits from the 2,698 closed FY 2012 Form 1065, *U.S. Return of Partnership Income*, audits that were coded as TEFRA.
- We identified 22 TEFRA audits for which the examiners did not follow one or more applicable TEFRA procedures.
- Based on our sample error rate of 62.86 percent, we estimated that the number of audits that were not conducted in accordance with one or more of the TEFRA procedures to be approximately 1,696 (2,698 x 62.86).<sup>2</sup> When an audit is not conducted in accordance with the required TEFRA procedures, these procedural errors can affect the validity of the tax assessments, infringe on taxpayer rights, and result in improper disclosure of tax information.<sup>3</sup>

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<sup>1</sup> See Appendix VI for a glossary of terms.

<sup>2</sup> We are 95 percent confident that the number of audits that were not conducted in accordance with one or more TEFRA procedures is between 1,212 and 2,119.

<sup>3</sup> As noted in Appendix I, during the initial phase of our review we selected a sample of 35 TEFRA closed audits using a 90 percent confidence level. The 90 percent confidence level was only used as a guide to determine our overall sample size. When we projected our final results, we used a 95 percent confidence level. Both the selection and projection confidence levels are independent of each other.



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**Appendix V**

*Procedural Errors Identified in Related Tax Years*

The error rates shown in this report are exclusive to our statistically valid sample of 35 closed FY 2012 TEFRA audits<sup>1</sup> of partnership returns. When the IRS audits more than one return concurrently (*i.e.*, the IRS will often audit the prior and subsequent year returns in addition to the return that was originally selected for audit), each return examined is considered one audit. To ensure the validity of our sample and projections to the population in Figure 1 of the report, we included only the errors for the sample years selected as part of our statistically valid sample of 35 audits. For 16 of those 35 audits, the examiners audited more than one year concurrently and the errors found in those related year returns are presented in this appendix.

***Procedural Errors Identified During Our Review  
of the Related Years of the Partnership Audits***

<b>Procedural Errors</b>	<b>Number of Errors Identified in the 16 Multiyear Audits</b>
Minimum tests were not documented to determine whether the TEFRA or non-TEFRA procedures should be used to examine the partnership.	**1**
Necessary checks were not documented on Form 13828, <i>Tax Matters Partner (TMP) Qualification Check Sheet</i> , to ensure that the TMP was qualified to represent the partnership for tax matters arising from the audit.	**1 <sup>2</sup> **
Form 2848, <i>Power of Attorney and Declaration of Representative</i> , did not contain required information that allows disclosure of tax return information to designated individuals or organizations.	**1 <sup>3</sup> **
Letters 1787, <i>Notice of Beginning of Administrative Proceeding</i> , were issued after partnership records were examined.	7 <sup>4</sup>
PCS linkage package was not submitted or submitted timely within 60 days of NBAP issuance.	5 <sup>5</sup>

*Source: Analysis of additional related tax returns audited from our initial statistically valid sample of 35 TEFRA audits closed during FY 2012.*

<sup>1</sup> See Appendix VI for a glossary of terms.

<sup>2</sup> The Form 13828 was applicable in each of the 16 related tax year audits.

<sup>3</sup> The Form 2848 was applicable in 13 of the 16 related tax year audits.

<sup>4</sup> The NBAP was applicable in each of the 16 related tax year audits.

<sup>5</sup> The PCS linkage package error rate for the related tax year examinations was calculated using a sample size of 13 because that was the number of related tax years in which PCS linkage was applicable.



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## Appendix VI

### *Glossary of Terms*

**Activity Code** – A three-digit code in the AIMS that categorizes classes of returns. For example, Activity Code 481 corresponds to a Form 1065, *U.S. Return of Partnership Income*, with 10 or fewer partners and gross receipts of less than \$100,000.

**Audit Information Management System (AIMS)** – A computer system used to control returns for audit, input assessments/adjustments to the Master File, and provide management reports.

**Barred Assessment** – A situation that occurs when a legal tax assessment is not made timely within the prescribed period for assessment. This leads to a loss of revenue to the IRS, even though any credits on the “barred” module may be placed in the Excess Collection Fund.

**Campus** – IRS location that can include operations for processing returns and conducting activity for compliance, customer account services, and customer assistance.

**Campus TEFRA Function (CTF)** – IRS function located in the Ogden, Utah, and Brookhaven, New York, Campuses that provide support for field personnel when flow-through (also known as pass-through) entity cases are linked via the PCS.

**Coordinated Industry Case** – The name given to the program that conducts the examination of large corporations that are pre-identified based on special selection criteria.

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

**Examination Returns Control System** – An automated inventory management system used to requisition tax returns, assign returns to examiners, change codes (such as status and project codes), and charge time. It can be used to control work that is not controlled on the AIMS, such as preparer penalties. It also provides real-time information in the form of screens and reports for management of the SB/SE and LB&I Divisions.

**First-Line Manager** – A group manager in the Examination function responsible for supervision of IRS examiners.

**Fiscal Year (FY)** – 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.



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**Integrated Data Retrieval System** – IRS computer system capable of retrieving or updating stored information. It works in conjunction with a taxpayer’s account records.

**Internal Revenue Code** – Title 26 of the U.S. 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 (IRM)** – The single official source of IRS instructions to staff. Instructions to staff are procedures, guidelines, policies, and delegations of authority, and other such instructional materials relating to the administration and operation of the IRS.

**Limited Liability Company** – A business entity organized in the United States under State law. Unlike a partnership, all of the members of a Limited Liability Company have limited personal liability for its debts. A Limited Liability Company may be classified for Federal income tax purposes as a partnership, corporation, or an entity disregarded as separate from its owner by applying the rules in Title 26 of the Code of Federal Regulations Section 301.7701-3. If a Limited Liability Company has at least two members and is classified as a partnership, it generally must file Form 1065. Generally, a Limited Liability Company classified as a partnership is subject to the same filing and reporting requirements as partnerships.

**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-Notice Partner** – A partner who owns less than a 1 percent interest in the profits of a partnership that has more than 100 partners. The TMP is responsible for providing copies of all notices to the non-notice partners.

**Non-TEFRA Audit** – In the context of this report, any partnership audit that meets TEFRA’s small partnership exception. Therefore, the audit is in many ways like an audit of the individual or corporate 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.

**Notice Partner** – In partnerships with 100 partners or less, all partners are notice partners. In a partnership with more than 100 partners, all partners owning at least a 1 percent interest are notice partners. A notice partner is entitled to receive notice of the beginning and conclusion of the TEFRA partnership proceedings.

**Partnership** – A relationship between two or more entities or persons who join 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. It 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 on that is not within the meaning of the regulations under Internal Revenue Code Section 7701, a corporation, trust, estate, or sole proprietorship.





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**Partnership Control System (PCS)** – A real-time system used to link and control flow-through returns and their investors. 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 investors 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.

**Power of Attorney** – A power of attorney is a legal instrument that gives legal authority to another person (called an attorney-in-fact) to make property, financial, and other legal decisions for the principal.

**Revenue Agent** – Employees in the Examination function who conduct face-to-face audits of more complex tax returns such as businesses, partnerships, corporations, and specialty taxes (*e.g.*, excise tax returns).

**S Corporation** – A corporation that elects to pass corporate income, losses, deductions, and credits through to their shareholders for Federal tax purposes. Shareholders of S corporations report the flow-through of income and losses on their personal tax returns and are assessed tax at their individual income tax rates. This allows S corporations to avoid double taxation on the corporate income. S corporations are responsible for tax on certain built-in gains and passive income at the entity level. To qualify for S corporation status, the corporation must meet the following requirements: (1) be a domestic corporation; (2) have only allowable shareholders (including individuals, certain trusts, and estates, and may not include partnerships, corporations, or nonresident alien shareholders); (3) have no more than 100 shareholders; (4) have only one class of stock; and (5) not be an ineligible corporation (*i.e.*, certain financial institutions, insurance companies, and domestic international sales corporations).

**Simple Random Sample** – A probability sample (*i.e.*, statistical sample) in which each sampled item of a given population has an equal chance of being selected. The sample results can be projected to the population.

**Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA)** – 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 Matters Partner (TMP)** – TEFRA rules establish the TMP as the primary representative of a partnership in dealings with the IRS. The TMP is a general partner designated by the partnership or, in the absence of designation, the general partner with the largest profits interest at the close of the taxable year. If no TMP is designated, and it is impractical to apply the largest profits interest rule, the IRS may select any partner as the TMP.



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**Tax Shelter** – A tax strategy or scheme that shelters income from normal taxation. Depending on the facts and legal analysis, a specific transaction or scheme may represent either lawful tax avoidance or unlawful tax evasion. Those tax shelters resulting in tax evasion are known as abusive tax shelters.

**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, it is any partnership audit that does not meet the 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 partnerships that do not meet the TEFRA’s small partnership exception.

**Territory Manager** – Responsible for planning, organizing, coordinating, monitoring, and directing their respective programs through subordinate managers who are geographically dispersed throughout the assigned territory.



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**Appendix VII**

*Management's Response to the Draft Report*




COMMISSIONER  
SMALL BUSINESS/SELF-EMPLOYED DIVISION

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

SEP 09 2014

MEMORANDUM FOR MICHAEL E. MCKENNEY  
DEPUTY INSPECTOR GENERAL FOR AUDIT

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

SUBJECT: Draft Audit Report – Improvements Are Needed to Ensure That  
Procedures Are Followed During Partnership Audits Subject to  
the Tax Equity and Fiscal Responsibility Act of 1982 (Audit  
#201330038)

Thank you for the opportunity to review your draft report titled: "Improvements Are Needed to Ensure That Procedures Are Followed During Partnership Audits Subject to the Tax Equity and Fiscal Responsibility Act of 1982, (TEFRA)". Your review of TEFRA audits closed during FY 2012 found significant improvements in the examiners' compliance with all four of the TEFRA procedures tested during the prior FY 2006 review of TEFRA audits.

We appreciate your recognition of the progress IRS has made in developing controls to help examiners conduct Partnership Audits. We are proud of our accomplishments, particularly, development of TEFRA training courses, creation of an internal TEFRA website, and enhancements to TEFRA job aids and Partnership Control System (PCS) linkage forms. We have also written several relevant Technical Digest newsletters and Front-Line articles, all implemented subsequent to your FY 2006 report.

We agree with your recommendations. Based on your suggestions, we will identify and make the appropriate revisions to improve timeliness on controls and guidance for examiners and managers. We recognize the importance for the IRS to ensure that procedures are followed and will continue our efforts to improve the quality of partnership audits subject to the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA).

We have attached a response outlining our planned corrective actions. 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



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Attachment

**Recommendation 1:**

The Commissioner, LB&I Division, and the Commissioner, SB/SE Division, should issue interim guidance to ensure that the examiners timely submit control documents needed for establishing the TEFRA audit on the PCS.

**Corrective Action:**

We will issue joint interim guidance to ensure that the examiners timely submit control documents needed for establishing the TEFRA audit on the PCS.

**Implementation Date:**

September 15, 2015

**Responsible Officials:**

Director, Technical Services, Examination, SB/SE  
Director, Pre-Filing & Technical Guidance, LB&I

**Corrective Action Monitoring Plan:**

The IRS will monitor this corrective action as part of our internal management of control.

**Recommendation 2:**

The Commissioner, LB&I Division, and the Commissioner, SB/SE Division, should ensure that the additional control procedures implemented to monitor whether examiners submitted control documents needed for establishing the TEFRA audit on the PCS are working as intended and will effectively address the issues we identified in this report.

**Corrective Actions:**

1. We will issue a joint memorandum to first-line managers and agents directing them to populate the Examination Return Control System (ERCS) with the date the Notice of Beginning of Administrative Proceeding (NBAP) was mailed. The NBAP date entered on ERCS will populate the Audit Information Management System (AIMS).
2. Subsequent to the NBAP date(s) being reflected on ERCS/AIMS, we will create reports to monitor whether the control procedures are working as intended. If they are not working as intended, we will investigate the breakdown in communication, procedures, or report output and correct as necessary.

**Implementation Dates:**

1. September 15, 2015
2. September 15, 2016



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**Responsible Officials:**

Director, Technical Services, Examination, SB/SE  
Director, Planning, Analysis, Inventory and Research, LB&I

**Corrective Action Monitoring Plan:**

The IRS will monitor this corrective action as part of our internal management of control.

**Recommendation 3:**

The Commissioner, LB&I Division, and the Commissioner, SB/SE Division, should ensure that the required job aids are timely reviewed by the first-line managers and the review results are documented and used to provide examiners feedback regarding their compliance with the TEFRA procedures.

**Corrective Actions:**

1. We will issue a joint memorandum for first-line managers detailing their requirements for documentation under the TEFRA procedures.
2. After the issuance of the joint memorandum, we will conduct an analysis to evaluate the completion of the required job aids. We will consider other options, such as targeted training, based on the results.

**Implementation Dates:**

1. September 15, 2015
2. September 15, 2016

**Responsible Officials:**

Director, Technical Services, Examination, SB/SE  
Director, Pre-Filing and Technical Guidance, LB&I

**Corrective Action Monitoring Plan:**

The IRS will monitor this corrective action as part of our internal management of control.

**Recommendation 4:**

The Commissioner, LB&I Division, and the Commissioner, SB/SE Division, should ensure that quality reviews are revised to monitor the examiners' compliance with all required procedures and that the reviews are performed for each TEFRA audit. The results of the reviews should also be disseminated to appropriate IRS employees so that the results can be used to provide feedback to the first-line managers and the examiners regarding their compliance with TEFRA procedures.



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3

**Corrective Action:**

The "Reviewer Check sheet" will be updated to include a review of the NBAP issue date. The information captured will be summarized and disseminated to appropriate employees to provide feedback to the first-line managers and the examiners, regarding their compliance with TEFRA procedures.

**Implementation Date:**

September 15, 2015

**Responsible Officials:**

Director, Technical Services, Examination, SB/SE  
Director of Pre-Filing and Technical Guidance, LB&I

**Corrective Action Monitoring Plan:**

The IRS will monitor this corrective action as part of our internal management of control.

**Recommendation 5:**

The Commissioner, LB&I Division, and the Commissioner, SB/SE Division, should: Take steps to hold first-line managers accountable for ensuring that TEFRA audits are conducted in accordance with all TEFRA procedures.

**Corrective Actions:**

1. SB/SE will require TEFRA training for first-line managers to ensure that TEFRA audits are conducted in accordance with all TEFRA procedures.
2. LB&I will issue TEFRA specific commitments to first-line managers to ensure that TEFRA audits are conducted in accordance with all TEFRA procedures.

**Implementation Dates:**

1. March 15, 2016
2. November 15, 2015

**Responsible Officials:**

1. Director, Technical Services, Examination, SB/SE
2. Deputy Commissioner (Domestic) LB&I

**Corrective Action Monitoring Plan:**

The IRS will monitor this corrective action as part of our internal management of control.