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IRS Partnership Enforcement Ramps Up

BY GREG ARMSTRONG, OSSIE BOROSH, TOM GREENAWAY, AND TOM KANE

Historically, the IRS showed mixed success with its partnership audit program. Both the Congressional Government Accountability Office and the Treasury Inspector General for Tax Administration have challenged the IRS to do a better job auditing partnerships, especially large partnerships. For years, the IRS has committed to do just that. 2021 is the year that the IRS may finally deliver on its commitment. Partnerships and their advisors should get ready.

Background

In 1982, Congress enacted the Tax Equity and Fiscal Responsibility Act (TEFRA) partnership audit procedures to establish a unified process for determining tax attributable to partnership items. Under TEFRA, adjustments to partnership items were determined in a single proceeding conducted at the partnership level. Any tax attributable to those adjustments was assessed and collected on a partner-by-partner basis. While TEFRA provided a unified procedure for adjusting partnership items (and for determining any partner challenges to such adjustments), TEFRA still required the IRS to identify the ultimate partners affected by those adjustments and determine and collect each partner's tax liability separately, on a year-by-year basis. TEFRA was widely credited with helping control the widespread partnership tax shelters of the early 1980s while providing due process to partners.

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The steady increase in size, scale and numbers of partnerships began to undercut the effectiveness of the TEFRA partnership regime, as the IRS struggled to trace through multiple tiers of entities to identify, assess, and collect from large numbers of individual and corporate partners. The partnership audit coverage rate has perennially hovered at or below 0.05%, and the no-change rate (that is, returns examined without any proposed adjustments) has been about 50%. These partnership statistics compare unfavorably to more general IRS enforcement numbers, which have also declined over the past several years.

In 2013, Congress requested that the Government Accountability Office (GAO) investigate the IRS's approach to auditing large partnerships under the TEFRA procedures. The GAO report concluded that the IRS audits few large partnerships, most audits resulted in no change to the partnership's return, and when there were changes, the aggregate amount of adjustments was small. See U.S. Gov't Accountability Office, Large Partnerships: With Growing Number of Partnerships, IRS Needs to Improve Audit Efficiency, 13 (2014) (GAO-14-732). The GAO report prompted multiple legislative proposals seeking to address the shortcomings of the TEFRA regime.

Congress enacted the Bipartisan Budget Act of 2015 to repeal TEFRA and replace it with the BBA centralized partnership audit regime, generally effective for taxable years beginning in 2018. Like TEFRA, the BBA provides for the determination of partnership adjustments at the partnership level, but unlike TEFRA, it also empowers the IRS to assess and collect tax attributable to those adjustments from the partnership itself. The partnership may ''push'' the adjustments out to its part-

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ners, but it is the partners rather than the IRS who must pass through the adjustments and determine the resulting tax liability, thereby alleviating some of the administrative burdens created for the IRS by the TEFRA rules.

With these new rules, Congress gave the IRS several structural advantages. For instance, under the BBA, the default is that the audited partnership is liable for any imputed underpayment resulting from adjustments to partnership-related items. In calculating the imputed underpayment, adjustments that are favorable often cannot be netted against unfavorable adjustments, and they must be taken into account in the adjustment year. The partnership's liability for an imputed underpayment is calculated by applying the highest applicable rate for the reviewed year (either the individual or the corporate rate, whichever is higher) to the combined adjustments. This results in an imputed underpayment that likely exceeds the amount of tax that would be due from the partners if the partnership and its partners had originally reported the items as adjusted by the audit. Although partnerships may be able to reduce the amount of the imputed underpayment through special modification procedures, those procedures are limited, cumbersome, subject to the IRS's discretion, and may only partially correct the effect of the overinclusive imputed underpayment calculation.

As mentioned above, the BBA provides an alternative mechanism for paying the imputed underpayment by allowing partnerships to push out adjustments to partners, who calculate and include an ''additional reporting year tax'' on their return for the year that includes the date the partnership furnishes the push-out statement (the ''reporting year''). However, this option is subject to an interest rate that is 2% higher than the rate generally applicable under the default payment at the partnership level. Also, in the event that the adjustment pushed out to a partner is favorable and would result in a decrease in tax, the IRS takes the position that a partner is entitled to a refund *only to the extent* that the partner has overpaid taxes for the reporting year. The practical effect of the IRS position is that favorable adjustments, in many cases, will not give rise to the full refund amount the partner would otherwise expect, and nothing in the guidance appears to provide the partner a carryover or carryback of the otherwise permanently lost tax benefit.

Moreover, the scope of items that can be audited at the partnership level is extremely broad. ''Partnership-related items'' include any items shown or required to be shown on a partnership return or required to be maintained in the partnership's books and records that may affect any person's Chapter 1 income tax liability. The ''Partnership Representative'' holds the sole power to act on behalf of the partnership in a partnership audit and is the only person that the IRS is required to communicate with—other partners do not have any rights under the statute or regulations to participate in the audit.

Just this month the IRS and Treasury proposed new BBA regulations regarding the treatment of special enforcement matters and other items, if finalized in their proposed form, would apply retroactively to Nov. 20, 2020. Among other things, the proposed regulations would provide the IRS with authority to change the audit rules for hot-button partnership issues like penalties and statutes of limitation, *after* a partnership return has been filed and selected for examination. Presumably the IRS would elect to change the audit rules midstream only to its advantage, and generally to the disadvantage of the partnership and its partners.

As part of the regulatory project implementing the BBA regime, the IRS and Treasury responded to the GAO and TIGTA critiques: ''[T]he IRS intends to increase the number of partnership audits for both partnerships that are subject to the centralized partnership audit regime and partnerships that have elected out of the partnership audit regime.'' REG-136118-15. Budget constraints and the 2017 tax reform implementation forced the IRS to defer this commitment. The structural changes surveyed above show that the IRS may finally be ready to follow through on its promise to audit more partnerships.

IRS Ramps Up Enforcement

The IRS is starting a concerted enforcement effort to address partnership issues. This effort appears to be different from past attempts. For one thing, many IRS leaders are publicly committing to this effort, across the organization, in a well-coordinated way. Just as importantly, the IRS is implementing structural changes to its enforcement program, especially in its Large Business & International division, which audits taxpayers with more than $10 million in assets.

In March 2020, an IRS official announced that the IRS was in the early stages of developing a program for large partnerships similar to its Large Corporate Compliance Program. The LCC Program subjects some of the largest and most complex corporations to in-depth and often continuous examinations. In early October 2020, the same IRS official publicly stated that the Large Partnership Program would likely debut in early 2021, and that, like the LCC Program, the IRS will use data analytics in selecting an entity for audit. In the LB&I Fiscal Year 2021 Focus Guide (Publication 5319, 10/2020), released at approximately the same time, LB&I more formally announced that it intended to implement in FY2021, as a major program priority, an expansion of the LCC Program to partnerships.

As noted above, the IRS plans to use data analytics in selecting large partnerships for audit under the forthcoming initiative. E-filed partnership returns feed directly into the Service's data analytics programs. (In 2019, the Taxpayer First Act, Public Law 116-25, amended tax code Section 6011(e) to enable the IRS to require more partnerships to e-file Form 1065.) The IRS is using machine learning and artificial intelligence to support LB&I's strategic goal of identifying more productive work for employees.

LB&I is also devoting significant resources to its Global High-Wealth Program: LB&I is intent on increasing its coverage of these taxpayers, with an emphasis on their connected business entities that almost always include partnerships. In addition, LB&I is currently engaged in hiring experienced tax professionals with expertise with pass-through tax issues. The IRS leadership commitment, personal outreach, and recruiting efforts going into this hiring initiative are all unprecedented.

In addition to the initiatives described above, the IRS has recently significantly enhanced required reporting for partnerships. For example, for the 2019 taxable year, partnerships were required to report negative tax

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capital accounts, and beginning in the 2020 taxable year, partnerships are required to report all partners' tax capital accounts. New enhanced reporting is now required with respect to Section 704(c) built-in gains and losses, certain information with respect to a sale or exchange of a partnership interest, as well as many new items relating to new provisions enacted in the Tax Cuts & Jobs Act (TCJA). In addition, questions have been added to the forms regarding disguised sales and transfers of partnership interests that may have been subject to new Section 864(c) (regarding transfers from foreign partners), among other questions. Further, the IRS plans to roll out detailed Schedules K-2 and K-3 standardizing reporting of international items. These new required information disclosures clearly reflect the IRS's intent to make Form 1065 and its accompanying schedules more useful to the IRS in its partnership compliance enforcement efforts. All these structural changes show that the recent partnership enforcement push is not just a fad.

What Is the IRS Targeting?

What is the IRS looking for when selecting partnerships for audit? Here's just a few items, many of which are coordinated enforcement campaigns (Partnership Campaign Items):

- High-income nonfilers, many of whom receive partnership Schedules K-1 and other information returns
- Failure to properly include deferred offshore management and incentive fees (Section 457A)
- Whether management fees paid by private equity portfolio companies should be recast as constructive dividends (Section 162)
- Transfer pricing adjustments on related-party loans and other controlled transactions (Section 482)
- Whether distributions to limited partners and members of LLCs and LLP should be subject to self-employment tax
- Whether management and incentive fee waivers should be respected for tax purposes
- Partnerships that stop filing returns

LB&I's active Compliance Campaign inventory also includes a Compliance Campaign focused on the TCJA. The TCJA includes several partnership provisions that are subject to review by the IRS on audit, including the qualified business income deduction, limitations on excess business losses for taxpayers other than C corporations (since partially repealed by the CARES Act), the taxation of carried interests for managers of private-equity and hedge funds, and the treatment of disposition of partnership interests by foreign persons.

The transparency and clarity the IRS is bringing to this enforcement effort suggests that the IRS may not be either patient or forgiving with partnerships with material compliance failures the IRS discovers through its audit program. Systemwide, the IRS has been stepping up its efforts around asserting accuracy-related penalties. Unfortunately, penalties distort the economics of any discussion around partnership tax audit adjustments, almost all of which are timing items to one degree or another.

What Partnerships Can Do

Tax professionals can talk to partnerships and their business advisors about recent developments regarding partnership audits to help them understand the actions that can be taken prior to the IRS starting an audit. In the event a partnership receives a Notice of Selection for Examination (Letter 2205-D) from the IRS, partnerships should reach out to well-informed advisors right away to discuss potential courses of action. For example, note that a partnership still may file an administrative adjustment request (an ''AAR'') for a taxable year after receiving this notice, but it is barred from filing an AAR once the IRS has sent the next notice, a Notice of Administrative Proceeding. In addition, if the IRS selects a tax year eligible for early election into the BBA regime, the partnership will have only 30 days to make an early election, if warranted.

Before receiving any IRS notices, partnerships may also consider undertaking ''health checks'' of current and prior year partnership tax returns to be sure that the IRS Partnership Campaign Items and other basic items, including, for example, tax capital accounts, Section 704(b) capital accounts, Section 704(c) reporting and Section 743(b) step-up amounts and allocations are properly calculated and reflected on those previously-filed returns.

In addition, partnerships may also consider confirming that allocations, accounting methods, and other complicated partnership-level tax calculations are correct. Timing may become important if necessary adjustments are found: partnerships may need to file AARs *before* the IRS initiates a centralized audit. Properly fixing these items as part of an IRS examination may be difficult as the IRS controls the examination process and the partnership representative is the only person authorized to communicate with the IRS. The ''health checks'' we suggest may have the added benefit of helping the partnership with scrutiny from others—such as from a buyer's or investor's due diligence team.

Conclusion

Partnerships—especially large partnerships—should get ready for a knock on the virtual door from the IRS. Well-advised tax professionals help partnerships and their business advisors understand the BBA rules, document agreements, fix problems, highlight key events and deadlines, build a team, build a strategy, model out alternatives, and work towards more favorable outcomes.

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