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LARGE PARTNERSHIPS

Growing Population and Complexity Hinder Effective IRS Audits

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GAO-14-746T

GAO Highlights

Highlights of GAO-14-746T, a testimony before the Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs, U.S. Senate.

Why GAO Did This Study

Businesses organized as partnerships have increased in number in recent years while the number of C corporations (i.e. those subject to the corporate income tax) has decreased. The partnership population includes large partnerships (those GAO defined as having $100 million or more in assets and 100 or more direct and indirect partners). Their structure varies. Some large partnerships have direct partners that are partnerships and may bring many of their own partners into the structure. By tiering partnerships in this manner, very complex structures can be created with hundreds of thousands of direct and indirect partners. Tiered large partnerships are challenging for the Internal Revenue Service (IRS) to audit because of the difficulty of tracing income from its source through the tiers to the ultimate partners.

GAO was asked to study the challenges large partnerships pose for IRS. GAO describes the number of large partnerships and their assets, IRS's large partnership audit results and the challenges IRS faces in auditing these entities, and options for addressing these challenges. GAO analyzed IRS data on partnerships, reviewed IRS documentation, interviewed IRS officials, met with IRS auditors in six focus groups, and interviewed private sector lawyers knowledgeable about partnerships.

What GAO Recommends

GAO makes no recommendations but will issue a report later in 2014 assessing IRS's large partnership audit challenges. IRS provided technical comments, which were incorporated.

View GAO-14-746T. For more information, contact James R White at (202) 512-9110 or whitej@gao.gov.

July 22, 2014

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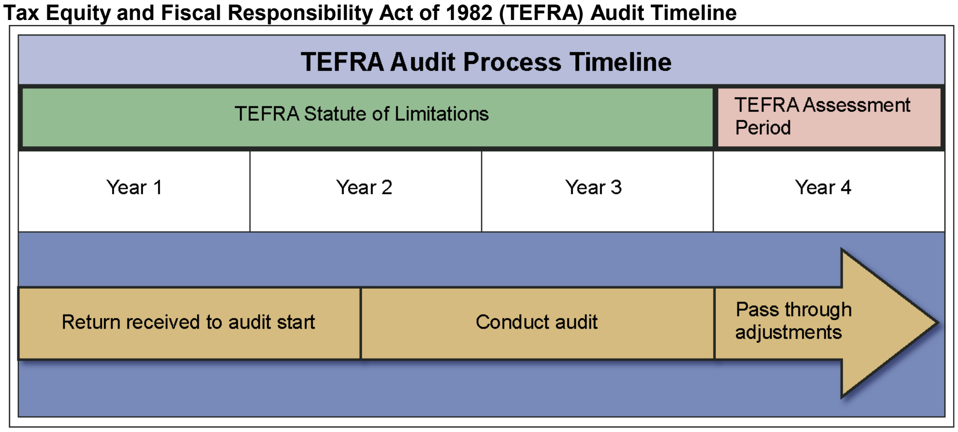
What GAO Found

Internal Revenue Service (IRS) data show, from tax years 2002 to 2011, the number of large partnerships more than tripled. According to IRS officials, many large partnerships are hedge funds or other investment funds where the investors are legally considered partners. Many others are large because they are tiered and include investment funds as indirect partners somewhere in a tiered structure. According to IRS data, there were more than 10,000 large partnerships in 2011. A majority had more than 1,000 direct and indirect partners although hundreds had more than 100,000. A majority also had six or more tiers.

IRS audits few large partnerships—0.8 percent in fiscal year 2012 compared to 27.1 percent for large corporations. Of the audits that were done, about two-thirds resulted in no change to the partnership's reported net income. The remaining one-third resulted in an average audit adjustment to net income of $1.9 million. These minimal audit results may be due to challenges hindering IRS's ability to effectively audit large partnerships. Challenges included administrative tasks required by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) and the complexity of large partnership structures due to tiering and the large number of partners. For example, IRS auditors said that it can sometimes take months to identify the person who represents the partnership in the audit, as required by TEFRA, reducing the time available to conduct the audit. Complex large partnerships also make it difficult to pass through audit adjustments across tiers to the taxable partners.

Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) Audit Timeline



Source: GAO analysis of IRS data and documentation. | GAO-14-746T

Note: A 3-year statute of limitations governs the time IRS has to complete partnership audits, according to the audit procedures enacted in TEFRA. The first stage is the period from when a return is received until IRS begins the audit. The second stage is the period in which IRS conducts the audit. The third stage is when IRS assesses the partners their portion of the audit adjustment.

IRS cannot resolve some of the challenges because they are rooted in tax law, such as those required by TEFRA. Congress and the Administration have proposed statutory changes to the audit procedures for partnerships, such as requiring partnerships to pay taxes on net audit adjustments rather than passing them through to the taxable partners. In addition, IRS has implemented some changes to its large partnership audit process, such as understanding the complexity of large partnerships and selecting returns for audits.

The Honorable Carl Levin
Chairman
The Honorable John McCain
Ranking Member
Permanent Subcommittee on Investigations
Committee on Homeland Security and Governmental Affairs
United States Senate

Chairman Levin, Ranking Member McCain, and Members of the Subcommittee:

I am pleased to be here today to discuss the growing number and complexity of large business partnerships—those with 100 or more direct and indirect partners and $100 million or more in assets.[1] I will also discuss the Internal Revenue Service's (IRS) large partnership audit results as well as the challenges IRS faces in auditing these entities, and options for addressing these challenges.

Partnerships are pass-through entities that generally do not pay taxes themselves on income (unlike C corporations which pay corporate income tax), but instead, pass income or losses through to their partners, who must include that income or loss on their income tax returns. Large partnerships can have very complex structures. Since partnerships may be partners in other partnerships, their structures may include tiers or levels of partnerships. Some have dozens of tiers with hundreds of thousands of direct and indirect partners (partners in a lower-tier partnership are indirect partners in higher tiers). Businesses may have legitimate reasons to set up such tiered networks, such as isolating one part of a business from liabilities or losses of another part. However, partnership networks can also be used to evade taxes. IRS faces the daunting task of verifying that income is properly reported for tax purposes as it passes through the tiers and is ultimately distributed to the direct or indirect partners responsible for making tax payments.

[1]Direct partners are partners that have a direct interest in the large partnership during the tax year. Direct partners may include taxable (such as a corporation or individual) and nontaxable partners (such as a partnership) that also have direct partners. Indirect partners are partners that have an interest in a partnership through interest in another partnership or other form of pass-through entity.

My testimony today builds on a body of work on large partnerships, including an interim report we issued in March 2014 as well as a recently issued report on all partnerships.[2] We are doing broader, ongoing work on large partnerships and plan to issue a report in fall 2014 but will discuss some preliminary findings today. The fall report will provide a more in-depth analysis of IRS data on large partnerships, IRS's audit challenges, and the potential steps to mitigate them.

There is no statutory, IRS, or industry-accepted definition of a large partnership. Throughout this statement, we define a large partnership as having 100 or more direct and indirect partners and $100 million or more in assets. This definition is consistent with how IRS identifies certain partnerships based on the number of partners and asset size.[3]

A partnership has become the tax entity of choice for many businesses in recent years. IRS's strategic plan for 2014-2017 notes that businesses with U.S. tax obligations are increasingly adopting more complex structures, shifting away from C corporations and moving towards pass-through entities, such as partnerships. Between tax years 2002 and 2010, the number of businesses organized as a partnership rose 45 percent from about 2.2 million to 3.2 million. In contrast, the number of C

[2]GAO, *Large Partnerships: Characteristics of Population and IRS Audits,* GAO-14-379R (Washington, D.C.: Mar. 19, 2014) and GAO, *Partnerships and S Corporations: IRS Needs to Improve Information to Address Tax Noncompliance,* GAO-14-453 (Washington, D.C.: May 14, 2014).

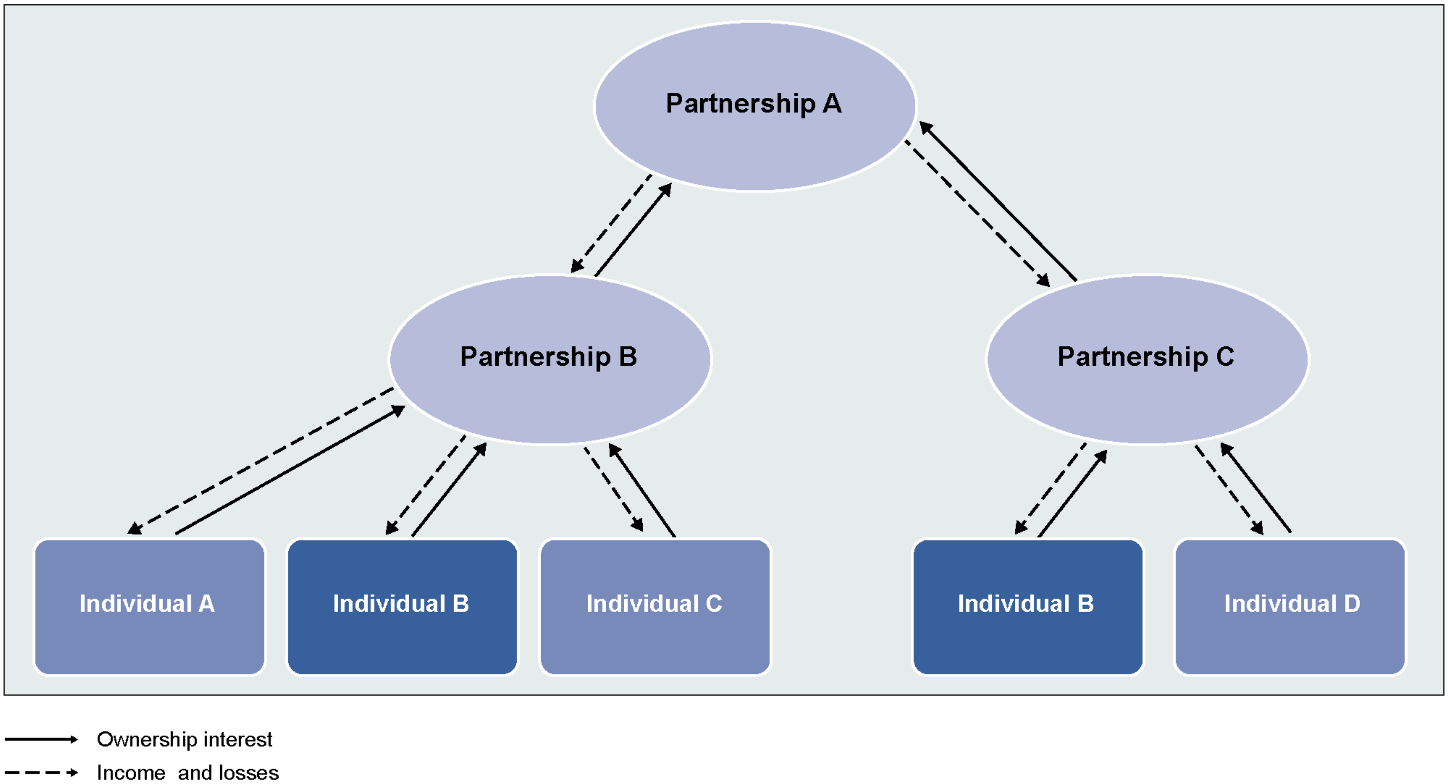
[3]For our March 2014 report, we defined a large partnership as having 100 or more direct partners and $100 million or more in assets based on IRS data available on direct partners in the Business Return Transaction File. For this testimony and our ongoing work, we expanded the partner threshold to 100 or more direct and indirect partners and $100 million or more in assets after identifying an IRS data source that captures the number of indirect partners, the Enhanced Large Partnership Indicator file. This is consistent with how IRS defines large partnerships for an ongoing improvement effort. We used the "$100 million or more in assets" threshold because it is consistent with how IRS's annual study of partnership tax returns being filed segregates partnerships by asset size. See IRS Statistics of Income, *Partnership Returns, 2011* (Washington, D.C.: Fall 2013).

corporations decreased about 14 percent from 1.9 million to 1.6 million over the same time period.[4]

Because of tiering, measuring the number of unique partners, the assets, and the income of a large partnership is complicated. For example, in figure 1, partnership B has three direct individual partners, and partnership C has two. Partnerships B and C are direct partners in partnership A, which also gives A five indirect partners of which four are unique. Adding up the income (or assets) of partnerships A, B, and C would result in double counting of income among the partnerships because income from partnership A is divided between partnerships B and C as it passes through to these unique partners.

[4]Internal Revenue Service, “Partnership Returns: Selected Balance Sheet and Income Statement Items, Tax Years 1999-2011, Historical Table 11,” *Statistics of Income (SOI) Bulletin*, accessed June 3, 2014, http://www.irs.gov/uac/SOI-Tax-Stats-Historical-Table-11 and Internal Revenue Service, “Returns of Active Corporations, Form 1120 and 1120S, Tax Years 2002-2010,” *Corporation Complete Book,* accessed April 4, 2014, http://www.irs.gov/uac/SOI-Tax-Stats-Corporation-Complete-Report. All estimates derived from samples have 95 percent confidence intervals that are within +/- 10 percentage points of the estimate itself, unless otherwise specified. Calculating percentage changes of numbers presented above may not equal those we present due to rounding.

Figure 1: Example of Partnership Structure with Tiers, and Direct and Indirect Partners



Source: IRS documentation. | GAO-14-746T

If a separate large partnership, call it D, with 1,000 partners, were to buy partnership C's ownership interest in A, then partnership A would itself become a large partnership. It would then have two direct partners and 1,003 indirect partners.

We analyzed data on the number and characteristics of large partnerships and what IRS knows about the cost and results of audits of large partnership returns.[5] We reviewed IRS documentation and our recent reports on partnerships. Finally, we interviewed a number of IRS officials, held six focus groups with IRS auditors that had worked on audits of large partnerships, and interviewed private sector lawyers knowledgeable about partnerships. The results of the analyses of focus group data are not generalizable to all IRS audits and do not necessarily represent the official viewpoint of IRS. Instead the results were used to identify themes in conjunction with the other forms of data we analyzed. To determine data reliability, we reviewed relevant documentation, interviewed knowledgeable IRS officials, and electronically tested the data to identify obvious errors or outliers. We determined that the data were sufficiently reliable for the purposes of this report. Our prior reports include a detailed description of our scope and methodology.

Our prior reports and ongoing work was conducted 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 objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

[5]Data cover partnerships that filed Form 1065, U.S. Return of Partnership Income and had 100 or more direct and indirect partners and $100 million or more in assets. Our data on the number and characteristics of partnerships are from the Enhanced Large Partnership Indicator (ELPI) file and Business Return Transaction File while audit data are from the Audit Information Management System. Data in the ELPI file may be incomplete because the file is based on data from Schedule K-1s, which partnerships use to report their partners' share of the partnership's income, deductions, and other items to the partners. In general, the amounts of tiering shown represent minimums and entity counts are approximate. See GAO-14-453.

Large Partnerships Have Grown in Number, Size, and Complexity Since 2002 with Hundreds Now Having More Than 100,000 Partners

According to IRS data, between tax years 2002 to 2011, the number of large partnerships more than tripled from 2,832 to 10,099. Over the same time, total assets of large partnerships more than tripled to $7.49 trillion. However, these numbers suffer from the double-counting complexities illustrated in figure 1. For comparison, our interim report on large partnerships, which defined large partnerships as those with 100 or more direct partners and $100 million or more in assets, found that over the same time period the number of large partnerships more than tripled, from 720 in tax year 2002 to 2,226 in tax year 2011. Similarly, total assets tripled to $2.3 trillion in tax year 2011.[6]

Without an accepted definition of a large partnership, there is not necessarily a right or wrong answer of whether direct and indirect partners should be included. Direct partners do not capture the entire size and complexity of large partnership structures. Accounting for indirect partners does, but it also raises the issue of double counting discussed above. Given the size and complexity of large partnerships, IRS does not know the extent of double counting among this population.

Large partnerships, especially those in higher asset brackets, are primarily involved in the finance and insurance sector.[7] For example, in 2011, 73 percent of large partnerships reported being involved in the finance and insurance sector and the majority of large partnerships that reported $1 billion or more in assets were in this sector. IRS data also showed that almost 50 percent of large partnerships with 100,000 or more direct and indirect partners reported being in the finance and insurance sector.

According to IRS officials and data, many of these entities are investment funds, such as hedge funds and private equity funds, which are pools of assets shared by investors that are counted legally as partners of the

[6]This included a small number of large partnerships that filed a form 1065-B, U.S. Return of Income for Electing Large Partnerships. See GAO-14-379R.

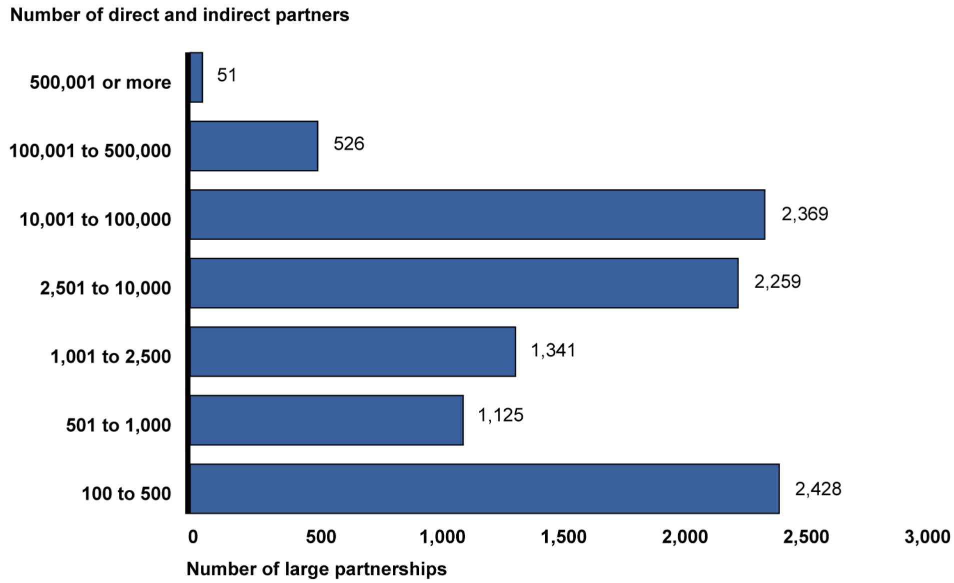
[7]Industry classifications are based on the North American Industry Classification System (NAICS). NAICS codes are self reported by businesses and judgment may be needed to determine the most appropriate NAICS code.

large partnership.[8] Being investment vehicles, these funds tend to invest in other partnerships, as well as other types of business entities. One IRS official said that these investments can affect the partner size of other partnerships based on where they choose to invest (e.g., buying an interest in other partnerships). For example, if an investment fund with a million partners chose to invest in multiple small operating partnerships, such as oil and gas companies organized as partnerships, all of those partnerships would count as having more than a million partners as well. One IRS official said the partnerships with more than a million partners increased from 17 in tax year 2011 to 1,809 in tax year 2012. The official attributed most of the increase to a small number of investments funds that expanded their interests in other partnerships. If in the future those investment funds choose to divest their interests in other partnerships, the number of large partnerships would decrease significantly. Although the reasons for the changes are not clear, from tax years 2008 to 2010, the number of large partnerships with 500,000 or more direct and indirect partners changed from 70 in 2008 to 1,088 in 2009, and decreased to 70 in 2010.

IRS data on large partnerships also show their complexity, as measured by the number of partners and extent of tiering, or levels, below the large partnership. Almost two-thirds of large partnerships in 2011 had more than 1,000 direct and indirect partners, although hundreds of large partnerships had more than 100,000. See figure 2 for more detail.

[8] Hedge funds and private equity funds are generally available only to institutions and individuals able to make investments in excess of $200,000. Aside from the fund managers, who guide the investment strategy and are general partners, the funds partners would be comprised of individual and institutional investors who contribute capital but have no say in investment or management decisions and are the limited partners. See CRS, *Taxation of Hedge Fund and Private Equity Managers,* RS22689 (Washington, D.C.: Mar. 7, 2014). We also issued a report that discussed the use of financial derivatives by these types of entities and the tax implications involved. See GAO, *Financial Derivatives: Disparate Tax Treatment and Information Gaps Create Uncertainty and Potential Abuse,* GAO-11-750 (Washington, D.C.: Sept. 10, 2012).

Figure 2: Number of Large Partnerships by Number of Direct and Indirect Partners, Tax Year 2011



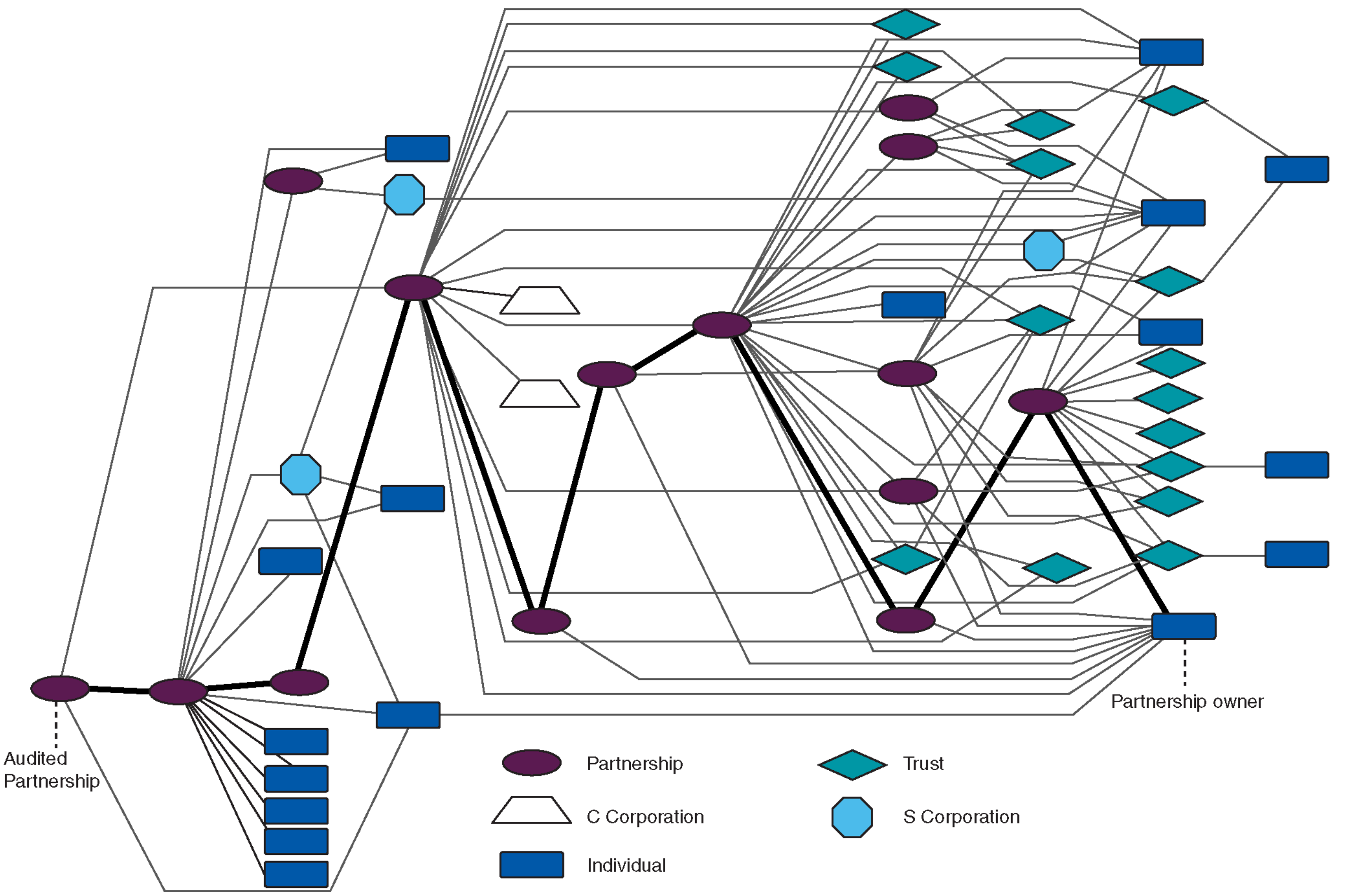
Source: GAO analysis of Enhanced Large Partnership Indicator (ELPI) file and Business Return Transaction File, Compliance Data Warehouse. | GAO-14-746T

Note: For our data set from the ELPI file, IRS traced indirect partners through the first 10 tiers. After that, it stopped if the ownership percentage in the large partnership dropped below 0.00001 percent. To the extent this ownership percentage was changed, the size and number of large partnerships may change.

In 2011, about two-thirds of large partnerships had at least 100 or more pass-through entities in the partnership structure. Because almost all large partnerships tend to be part of multitiered networks, their partners could be spread across various tiers below those partners that have a direct interest in the partnership. For example, in 2011, 78 percent of the large partnerships had six or more tiers.

Determining the relationships and how income and losses are allocated within a large partnership structure through multiple pass-through entities and tiers is complicated. For example, in figure 3, the allocation from the audited partnership on the far left side of the figure crosses eight pass-through entities along the bold path before it reaches one of its ultimate owners on the right. This path also may not be the only path from the audited partnership to the ultimate owner.

Figure 3: Example of Partnership Structure



Source: GAO analysis of IRS documentation. I GAO-14-746T

Note: Figure 3, adapted from IRS documentation, is an illustration of a hypothetical, complex partnership structure, which shows the relationship between various types of entities. In IRS's example, the allocation of income and losses from the audited partnership on the far left side of the figure crosses eight pass-through entities, all of which are partnerships themselves, along the bold line before it reaches one of its ultimate partnership owners on the right side.

While figure 3 appears complex, it has only 50 partners and 10 tiers. Large partnership structures could be much more complex. In 2011, as noted above, 17 had more than a million partners. According to one IRS official, there are several large partnerships with more than 50 tiers.

IRS Audits Few Large Partnerships Due to Challenges Presented by the Complexity of Both the Audit Procedures and the Large Partnership Structures

IRS Audits Large Partnerships at a Much Lower Rate than Large Corporations and the Audits Produce Minimal Results for Audit Time Spent

IRS audits few large, complex partnerships. According to IRS data, in fiscal year 2012, IRS closed 84 field audits of the 10,143 large partnership returns filed in calendar year 2011—or a 0.8 percent audit rate.[9] This is the same audit rate we found for fiscal year 2012 in our interim report, which defined large partnerships as having 100 or more direct partners and $100 million or more in assets.[10] The audit rate for large partnerships remains well below that of C corporations with $100 million or more in assets, which was 27.1 percent in fiscal year 2012. See table 1.

Table 1 also shows that most large partnership field audits closed from fiscal years 2007 through 2013 did not find tax noncompliance. In 2013, for example, 64.2 percent of the large partnership audits resulted in no change to the reported income or losses. In comparison, IRS audits of C

[9]IRS defines the audit rate as the number of returns audited in a fiscal year divided by the number of returns filed in the previous calendar year. In fiscal year 2013, IRS completed 95 field audits but we did not have 2012 calendar year filings at the time of our analysis to compute the audit rate. The audit rate does not include an activity known as Campus audits because they are not audits of the books and records of large partnerships. Instead, Campus audits are an administrative process in which the related partners' returns are linked, or connected, to the large partnership return being audited in the field. This linking facilitates passing through any audit adjustments as a result of the field audit to the taxable partners. Even though these steps generally do not include any audit work, IRS counts the pass-through activity as an audit of each affected partner return. For information on Campus audits, see GAO-14-379R.

[10]See GAO-14-379R.

corporations with $100 million or more in assets had much lower no change rates. For example, audits of large corporations had a no change rate of 21.4 percent in 2013.

Table 1: Audit Rate and No Change Rate for Large Partnerships and Large Corporations, Fiscal Years 2007 to 2013

	Fiscal Year						
	2007	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**
Large Partnerships							
Audit Rate	0.5%	0.6	0.6	1.4	0.7	0.8	N/A
No Change Rate	85.3	77.8	82.6	51.6	77.0	66.7	64.2
Large Corporations							
Audit Rate	20.6	21.4	20.8	20.6	23.1	27.1	27.4
No Change Rate	16.2	22.1	18.6	18.7	20.4	27.2	21.4

Source: GAO analysis of IRS data book and Audit Information Management System (AIMS), Compliance Data Warehouse (CDW). I GAO-14-746T

Note: For any large partnership, the number of audited returns closed in a given fiscal year may include returns from multiple tax years. Calendar year 2012 partnership filings were not available in the ELPI file when we did our analysis to compute the audit rate for fiscal year 2013. For partnerships, the no change rate means that the audits made no changes to the partnership's reported income, loss, deductions, or credits reflected on the tax return or Schedule(s) K-1 for partners. The no change rate for corporations means that the audits made no changes in the tax liability reported on the corporate tax return (e.g., tax, penalties, or refundable credits).

When the field audits of large partnership returns did result in changes, the changes to net income that the audits recommended were minimal in comparison to audits of large corporations, as shown in table 2.[11] This could be because positive changes on some audits were cancelled out by negative changes on other audits. In 3 of the 7 years, the total adjustments from the field audits were negative. That is, they favored the large partnerships being audited. This did not occur for audits of large corporations. See table 2.

[11]For pass-through entities, such as partnerships, which are nontaxable entities, audit adjustments are recommended changes to the entities' reported net income, after accounting for losses, deductions, or credits reflected on the return or Schedule(s) K-1. For taxable entities, such as corporations, audit adjustments are additional recommended tax liability in the form of taxes, penalties, or changes to refundable credits. Our recent work highlighted that partnerships' recommended audit adjustments may be double counted if they are passed through multiple tiers. See GAO-14-453.

Table 2: Total and Average Recommended Audit Adjustments to Net Income for Large Partnership and to Additional Taxes for Large Corporate Field Audits Closed by IRS, Fiscal Years 2007 to 2013 (in millions of dollars)

	Fiscal Year						
	2007	2008	2009	2010	2011	2012	2013
Large Partnerships							
Total	$ (99.2)	(46.4)	22.5	75.7	569.5	160.4	(370.4)
Average	(2.9)	(1.0)	0.5	0.6	9.3	1.9	(3.9)
Large Corporations							
Total	21,967	22,595	26,864	22,824	22,984	15,952	14,895
Average	5.2	5.0	5.6	5.1	4.7	2.8	2.4

Source: GAO analysis of IRS data book and AIMS, CDW. I GAO-14-746T

In terms of audit costs, the number of days and hours spent on the audits of large partnerships in fiscal year 2013 has increased since fiscal year 2007, but varied from year to year in the interim, as shown in table 3.[12] In contrast, the audit days and hours spent on audits of large corporation are decreasing while obtaining audit results that are noticeably better than those of large partnership audits.

Table 3: Audit Time Measures for Field Audits of Large Partnerships and Large Corporations, Fiscal Years 2007 to 2013

	Fiscal Year						
	2007	2008	2009	2010	2011	2012	2013
Large Partnerships							
Average field hours charged	139	383	164	104	255	255	409
Average days from field audit open to audit closure	467	382	381	307	341	513	555
Large Corporations							
Average field hours charged	791	724	694	694	580	521	496
Average days from field audit open to audit closure	709	658	601	585	556	536	598

Source: GAO analysis of IRS data from AIMS, CDW. I GAO-14-746T

Note: These audit time measures do not cover all of the costs of large partnership audits, such as the time IRS spends passing through audit adjustments at the Campus.

[12]The time spent on large partnership field audits includes time spent examining the books and records of the large partnership return as well as time spent following the Tax Equity and Fiscal Responsibility Act of 1982 audit procedures.

IRS does not track its audit results for large partnerships and therefore does not know what is causing the results in tables 1, 2, and 3.[13] Consequently, it is not clear whether the results are due to IRS selecting large partnerships that were tax compliant versus IRS not being able to find noncompliance that did exist.

Several Challenges Related to Complexity Hinder IRS's Audits of Large Partnerships

The high no change rates and minimal adjustment amounts for IRS audits of large partnerships may be due to a number of challenges that can cause IRS to spend audit time on administrative tasks, or waiting on action by a large partnership or IRS stakeholder rather than doing actual audit work. Under the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA),[14] the period for auditing partnerships does not expire before 3 years after the original due date of the return or date of return filing, whichever is later.[15] IRS on average takes approximately 18 months after a large partnership return is received until the audit is started, leaving on average another 18 months to conduct an audit, as illustrated in figure 4.[16]

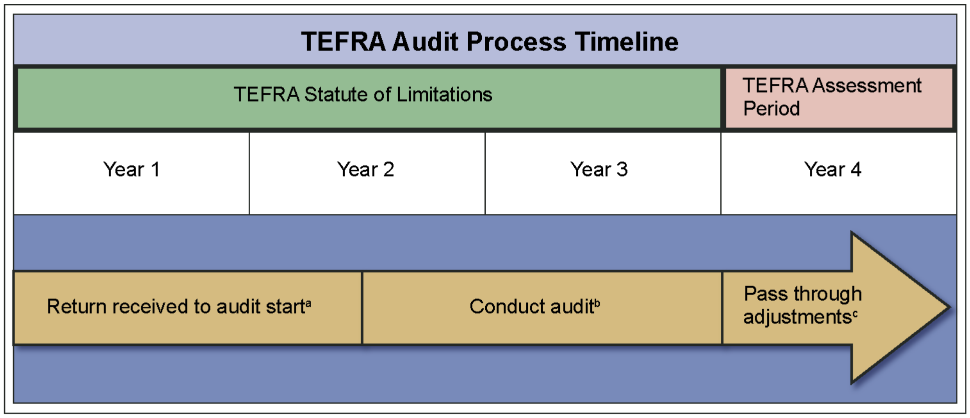
[13]According to IRS officials, IRS also does not know the reasons for variations in audit results for other types of tax entities.

[14]Pub. L. No. 97-248 , §§ 401–407, 96 Stat. 324, 648–671 (1982). TEFRA established unified audit procedures for covered partnerships and, as amended, are found generally at Internal Revenue Code sections 6221 through 6234. A partnership would fall under the TEFRA audit procedures if at any time during the year it had (1) more than 10 partners or (2) certain types of partners (e.g., another partnership, a Limited Liability Company (LLC) which files as a partnership or is treated as a single member LLC disregarded for federal tax purposes, any type of trust, a nominee, a nonresident alien individual, and a S corporation).

[15]26 U.S.C. § 6229(a). Assessments of taxpayers are generally subject to a 3-year statute of limitations. 26 U.S.C. § 6501(a). This provision of TEFRA can extend, but never shorten the statute of limitations. According to IRS officials, it does audit partnerships covered by TEFRA beyond the 3-year timeframe established in section 6229 in cases where the statute of limitations under section 6105 has yet to expire for one or more partners.

[16]Although partnerships do not pay taxes directly, they do file a Form 1065, U.S. Return of Partnership Income, and this is what IRS would audit.

Figure 4: Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) Audit Timeline



Source: GAO analysis of IRS data and documentation. | GAO-14-746T

Notes: A 3-year statute of limitations governs the time IRS has to complete partnership audits, according to the audit procedures enacted in TEFRA.

[a]In fiscal year 2013, the stage in which the large partnership return is received by IRS until it starts the large partnership audit took IRS on average 1.4 years.

[b]In fiscal year 2013, the stage in which IRS conducts a large partnership audit took IRS on average 1.5 years.

[c]The period in which partners of the large partnership are assessed their portion of the audit adjustment is generally completed by IRS within 1 year.

Once a large partnership audit has been initiated, it falls under the TEFRA audit procedures. Congress enacted the TEFRA audit procedures in response to concerns about IRS's ability to audit partnership returns. According to the congressional Joint Committee on Taxation (JCT), the complexity and fragmentation of partnership audits prior to TEFRA, especially for large partnerships with partners in many audit jurisdictions, resulted in the statute of limitations expiring for some partners while other partners were required to pay additional taxes as a result of the audits.[17] TEFRA addressed these issues by altering the statute of limitations and requiring each partner of a partnership to report certain items like income, consistent with how the partnership reports them. However, according to IRS officials and in focus groups we held with IRS auditors, using the TEFRA procedures to audit large, complex partnership structures present a number of administrative complexities for IRS. These complexities may

[17]JCT, *General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982*, JCS-38-82, (Washington, D.C.: December 1982).

reduce the time IRS spends on actual audit work, adversely affecting IRS audit results for large partnerships. For example, one of the primary challenges for doing large partnership audits under TEFRA that IRS focus group participants reported was identifying the Tax Matters Partner (TMP). The TMP is the partnership representative who is to work with IRS to facilitate a partnership audit. The responsibilities of the TMP include (1) supplying IRS with information about each partner, (2) keeping the partners of the partnership informed and getting their input on the audit, and (3) executing a statute of limitations extension, if needed. Without being able to identify a qualified TMP in a timely manner, IRS may experience delays during large partnership audits.

IRS focus group participants cited numerous examples of difficulties in identifying the TMP. One difficulty is that the TMP can be an entity, not a person. If an entity is designated as the TMP, IRS has to track down an actual person to act as a representative for the TMP.[18] Focus group participants said that some large partnerships do not designate a TMP or designate an entity as TMP to delay the start of the audit, which would limit the audit time remaining under the statute of limitations.

Entities will often be elusive about designating the TMP. The entities will use this tactic as a first line of defense against an audit.

Source: IRS focus group participant. I GAO-14-746T

The burden for ensuring that the TMP meets the requirements of TEFRA largely falls on IRS. Time spent identifying a qualified TMP, according to IRS focus group participants, could take weeks or months. As shown in figure 4, IRS has a window of about 1.5 years to complete large partnership audits. A reduction of a few months from the 1.5 years IRS has to complete large partnership audits means that the time IRS has for the audit would be markedly reduced.

Another challenge TEFRA poses is determining the extent to which IRS passes through audit adjustments to the taxable partners in a large partnership structure. In that large partnerships are nontaxable entities, TEFRA requires that audit adjustments be passed through to the taxable partners, unless the partnership agrees to pay the related tax at the partnership level. To pass through the audit adjustments to the taxable

[18]If an entity is designated as the TMP, the partnership has the option of designating a TMP representative on Form 1065.

partners, IRS has to first link, or connect, the partners' returns to the partnership return being audited. However, IRS officials said linking a large number of partners' returns can be a significant drain on IRS's resources. If a large partnership has hundreds or thousands of partners at multiple tiers, the additional tax owed by each partner as a result of large partnership audit may not be substantial enough to be worth passing through once those partners' returns are linked.[19] If the audit adjustment is lower than a certain level, IRS will not pass it to the taxable partners; and the time and resources spent linking the partners' returns, and preparing a plan to pass through the audit adjustment to certain taxable partners' returns, becomes effectively meaningless.

Aside from the TEFRA challenges, another challenge involves the complexities arising from large partnership structures, which hinder IRS's ability to identify tax noncompliance with complex tax laws. For example, IRS officials reported having difficulty in identifying the business purpose for the large partnerships or in determining the source of income or losses within their structures (i.e. knowing which entity in a tiered structure is generating the income or losses). Without this information, it is difficult for IRS to determine if a tax shelter exists, an abusive tax transaction is being used, and if income and losses are being properly characterized.

> I think noncompliance of large partnerships is high because a lot of what we have seen in terms of complexity and tiers of partnership structures… I don't see what the driver is to create large partnership structures other than for tax purposes to make it difficult to identify income sources and tax shelters.

Source: IRS focus group participant. I GAO-14-746T

To help IRS auditors better understand the complexity of the TEFRA audit procedures and the large partnership structures, various IRS stakeholders and specialists are to provide support during the audit. However, IRS focus group participants stated that they do not have the needed level of timely support. These include TEFRA coordinators to help with the TEFRA audit procedures, IRS counsel to help navigate the TEFRA audit procedures and provide input on substantive tax issues, and specialists who have expertise in a variety of areas. The support provided

[19] As long as adjustments exceed a tolerance on a certain amount, IRS passes through the adjustments to the taxable partners. Due to the sensitive nature of the tolerance levels, IRS does not make them public.

by IRS stakeholders is important because many IRS focus group participants said that their knowledge of partnership tax law was limited and they may only work on a partnership audit once every few years.

The challenges identified by IRS are not recent occurrences but may have grown over time as the number and size of large partnerships has grown. For example, in 1990, the Department of the Treasury (Treasury) and IRS reported that applying TEFRA to large partnership audits resulted in an inefficient use of limited IRS resources.[20] They cited a number of reasons for the inefficient use of resources, such as having to collect and review information on a large number of partners and the difficulty of passing through audit adjustments to those partners.

IRS Has Limited Ability to Fully Address Challenges

IRS by itself cannot fully address the tax law and resource challenges in auditing large partnership returns. For example, IRS cannot make the structures or laws less complex and cannot change the TEFRA audit procedures in statute. In addition, IRS has recently experienced budget reductions, constraining the resources potentially available for large partnership audits.[21]

Despite these limitations, IRS has initiated efforts that may help address the challenges auditing large partnership returns. First, IRS can sometimes use a closing agreement to resolve an audit under the TEFRA audit procedures, if both IRS and the partnership agree to its terms. This agreement allows the tax owed from the net audit adjustment at the highest marginal tax rate to be collected at the partnership level, meaning IRS does not have to pass through the audit adjustments to the taxable partners. IRS does not track the number of closing agreements but IRS officials said that IRS enters into relatively few. IRS officials are encouraging audit teams to pursue closing agreements for large partnership audits. However, closing agreements come with challenges because the partnership must be willing to agree and the IRS review process can be extensive.

[20]See Treasury and IRS, *Widely Held Partnerships: Compliance and Administration Issues – A Report to Congress*, (Washington D.C.: Mar. 30, 1990).

[21]GAO, *Internal Revenue Service: Absorbing Budget Cuts Has Resulted in Significant Staffing Declines and Uneven Performance,* GAO-14-534R (Washington, D.C.: Apr. 21, 2014).

Aside from closing agreements, the IRS efforts affect steps IRS takes at the beginning of an audit—such as understanding the complexity of large partnerships and selecting returns for audits. However, IRS has not yet determined the effectiveness of these efforts.

The Chairman of the House of Representatives Committee on Ways and Means and the Administration have also put forth proposals to address some of challenges associated with the TEFRA audit procedures.[22] While the proposals differ somewhat and apply to partnerships with different numbers of partners, both would allow IRS to collect tax at the partnership level instead of having to pass audit adjustments through to the taxable partners.

In our ongoing work on large partnerships, we are assessing options for improving the large partnership audit process and, if warranted, will offer reforms for Congress to consider and recommendations to IRS.

Chairman Levin, Ranking Member McCain, and Members of the Subcommittee, this completes my prepared statement. I would be pleased to respond to any questions that you may have at this time.

Agency Comments

We provided a draft of this testimony to IRS for comment. IRS provided technical comments, which were incorporated, as appropriate.

[22] The Chairman of the House of Representatives Committee on Ways and Mean's proposal would apply to partnerships with more than 100 direct partners, or if any partner is itself a partnership. See Joint Committee on Taxation (JCT), Technical Explanation of the Tax Reform Act of 2014, A Discussion Draft of the Chairman of the House Committee on Ways and Means To Reform the Internal Revenue Code Title III – Business Tax Reform, JCX-14-14, (Washington, D.C.: Feb. 26, 2014). The Administration's proposal would apply to partnerships with 1,000 or more direct and indirect partners. See Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2015 Revenue Proposals*, (Washington, D.C.: Mar. 2014).

Contact and Acknowledgements

If you or your staff have any questions about this testimony, please contact me at (202) 512-9110 or whitej@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this statement. GAO staff who made key contributions to this testimony included Tom Short, Assistant Director, Vida Awumey, Sara Daleski, Deirdre Duffy, Robert Robinson, Cynthia Saunders, Erik Shive, Albert Sim, A.J. Stephens, and Jason Vassilicos.

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