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New IRS Large Partnership Audits Coming, This Time With AI Help

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Seeing continued compliance issues involving large partnerships, the IRS has announced another audit initiative, this time assisted by artificial intelligence, warn KPMG's Ossie Borosh, Tom Greenaway, Greg Armstrong, and Justin Donatello.

In a "sweeping historic effort" to "restore fairness in tax compliance," the IRS recently announced it will focus more attention and resources on partnerships, the wealthy, and other high earners that have seen sharply decreasing audit rates in the past decade and to utilize artificial intelligence to "help IRS compliance teams better detect tax cheating, identify emerging compliance threats, and improve case selection tools."

Specifically, the IRS stated in IR-2023-166 (Sept. 8, 2023), that it would by the end of September send notices of examination to 75 partnerships with an average of $10 billion in total assets, and during October send an additional 500 "soft notices" to partnerships with over $10 million in assets and tax returns showing discrepancies in the millions of dollars between end-of-year balances and beginning balances the following year. According to the announcement, the IRS believes this discrepancy is an indicator of potential non-compliance. The IRS said the selected taxpayers did not attach required statements explaining their differences. Partnerships receiving the notices may be added to the audit work stream, depending upon their response.

Prior to the most recent, AI-assisted initiative, the IRS's Large Business and International Division ("LB&I") also pursued several open audit campaigns targeting partnerships that are, or have:

- High-income non-filers, many of whom receive Schedules K-1 from pass-through entities;
- Financial service entities engaged in a U.S. trade or business (offshore lending);
- Distributions in excess of a partner's basis;
- Partnership losses in excess of a partner's basis;
- Self-employment (SECA) tax;
- Sales of partnership interests; and
- Transfer pricing adjustments on related-party loans and other controlled transactions (I.R.C. §482).

In April 2023, the IRS used a new statistical model to identify 150 large partnership returns from 2021 for potential audit, contingent upon hiring and training efforts related to Inflation Reduction Act (IRA) funding, according to a Government Accountability Office (GAO) report, *IRS Audit Processes Can Be Strengthened to Address a Growing Number of Large, Complex Partnerships* (July 2023), which stated further that the IRS plans to double audit coverage for partnerships with $10 million or more in assets by fiscal year 2025 compared to fiscal year 2021.

The IRS has also devoted significant new resources to its Global High-Wealth Program, and it increased its audit rate on high-income individuals. In IR-2023-166, the IRS stated that it would be contacting 1,600 high-income earners who it says owe millions of dollars in taxes. The IRS audit coverage of these taxpayers often involves concurrent audits of their connected business entities, which often include partnerships.

Our experience with these audits shows that the IRS is still developing its audit tools and techniques, as the GAO report confirmed.

Partnerships and their advisors are well advised to prepare.

Expanding Large Partnership Audits

The new wave of partnership audits is the latest round of an expansion that began in 2021, when the IRS launched the Large Partnership Compliance (LPC) program to identify returns for examination based on certain criteria indicating potential non-compliance. To conduct those exams, the IRS began training and deploying experienced revenue agents on partnership and other flow-through issues. Additionally, the IRS hired tax professionals with private-sector expertise in pass-through tax issues to assist with these enforcement efforts. Behind the scenes, the IRS created practice units, specialist cadres, and job aids to guide new hires and existing personnel through complex pass-through and procedural issues.

Congress enacted the Bipartisan Budget Act of 2015 ("BBA") to create a new centralized partnership audit regime. The BBA provides for the determination of partnership adjustments at the partnership level, and it also empowers the IRS to assess and collect tax attributable to those adjustments from the partnership itself. With these new rules, Congress gave the IRS several structural advantages. For instance, under the BBA's default rules, any "imputed underpayment" resulting from an audit almost always will exceed 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—sometimes dramatically so. Although partnerships may be able to reduce the amount of the imputed underpayment through the modification procedures, those procedures do not address all fact patterns and can be cumbersome. And although a "push out" election allows the partnership to shift the tax impact of the audit adjustments to the partners instead of the partnership, the tax paid by the partners is, in the audit context, subject to a higher interest rate than normal and complications can arise for tiered structures when implementing push-out adjustments.

Additionally, the scope of items that can be audited at the partnership level is broad. A "partnership-related item" includes any item shown or required to be shown on a partnership return or required to be maintained in the partnership's books and records that is relevant in determining any person's Chapter 1 income tax liability. Relevance for this purpose is itself defined broadly to reach any item or amount that affects any person's chapter 1 income tax liability, without regard to whether there is an actual tax impact on any particular person. For example, the characterization of debt as recourse rather than nonrecourse is a partnership-related item, even if under the facts and circumstances that characterization does not matter to any of the partners.

Note that §6031(b) generally requires partnerships that are required to file a return to "furnish to each person who is a partner or who holds an interest in such partnership as a nominee for another person at any time during such taxable year a copy of such information required to be shown on such return as may be required by regulations." Reg. §1.6031(b)-1T goes on to require that the partnership must provide, to the extent provided by form or the accompanying instructions, any additional information that may be required to apply particular provisions of subtitle A of the Code to the partner with respect to items related to the partnership. Given the increasing volume of information required to be furnished to partners under various new regulations, forms and instructions, the scope of potential "partnership-related items" is quite broad.

The IRS also gained a structural advantage through the introduction of the "Partnership Representative" as the person who has the sole authority to act on behalf of the partnership for purposes of the BBA rules. The Partnership Representative (and in the case of an entity partnership representative, the Designated Individual) 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. Any decisions made by the Partnership Representative are binding on all the partners in the partnership, including decisions to extend the statute of limitations, to agree with adjustments made by the IRS, and to elect to push out the adjustments to the partners.

As part of the regulatory project implementing the BBA regime, the Department of the Treasury (Treasury) and the IRS committed to increase the number of partnership audits. Budget constraints and other issues forced the IRS to defer this commitment until recently. The IRA provided the IRS with approximately $80 billion of additional appropriation, $45.6 billion of which was designated for enforcement activities through the end of fiscal year 2031, and the Treasury and the IRS identified large partnerships as an enforcement priority. The IRA appropriations were reduced as part of the debt ceiling negotiations earlier in 2023, but the IRS has stated its enforcement plans and priorities remain the same regardless of that reduction.

The IRS outlined its intended use of the IRA funds in Publication 3744, IRA Strategic Operating Plan (FY 2023-2031), released in April 2023. Objective 3 of that plan calls for the IRS to "focus expanded enforcement on taxpayers with complex tax filings and high-dollar noncompliance to address the tax gap" and resolves to "increase the focus on segments of taxpayers with complex issues and complex returns where audit rates are minimal today, such as those related to large partnerships, large corporations, and high-income and high-wealth individuals…." The explanation notes that these enforcement efforts are anticipated to be facilitated by data analysis tools developed pursuant to Objective 4 of the plan. That objective sets forth the initiative to "[d]eliver cutting-edge technology, data, and analytics to operate more effectively."

Last month, after its announcement on the additional audits, the IRS announced a new recruiting initiative seeking to hire 3,700 higher-graded revenue agents to help conduct them. The IRS also recently announced a new work unit to be housed within the Large Business and International Division ("LB&I") to establish a special

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area to focus on large or complex pass-through entities. It is anticipated to formally begin operations in late 2024, eventually including professionals from both LB&I and the Small Business/Self Employed division as well as from the new hiring initiative.

While implementing the initiatives described above, the IRS also has, in the past few years, significantly altered and enhanced required reporting for partnerships, to feed better information into its audit selection models. All of these changes significantly augmented and standardized the amount of partnership information reported to the IRS and to partners. For example, beginning in the taxable years:

- 2019, partnerships were required to report negative tax capital accounts,
- 2020, partnerships were required to report each partner's tax capital account, and in
- 2021, the IRS required detailed Schedules K-2 and K-3, standardizing the reporting of international items.

New and enhanced reporting is also required with respect to, for example, §704(c) built-in gains and losses, as well as many provisions enacted in the Tax Cuts and Jobs Act (TCJA). In addition, new questions and schedules have been added to the forms regarding complex issues like disguised sales, carried interest, and transfers of partnership interests, among other items.

Most recently, a draft Schedule K-1 for the 2023 filing season was released, showing a revision to required information regarding reported liabilities allocated to partners. Specifically, draft Schedule K-1 includes a new question, question K3, asking taxpayers to check a box if any of the liabilities reported are subject to guarantees or other payment obligations by the partner. The questions refer the filer to instructions for further information, but draft instructions have not yet been released.

Fewer Audits of Large Partnerships

In tax year 2019, the number of large partnerships was 20,052—marking a nearly 600% increase since 2002, according to the aforementioned GAO report, defining large partnerships as those with $100 million or more in assets and 100 or more total partners (still less than 1% of 3.8 million total partnerships). Eighty-four percent of these large partnerships reported providing finance and insurance services or real estate and rental leasing and as of 2019, held an average of $818 million in assets.

Historically, the IRS's audit coverage rate for large partnerships has been low and getting lower, from 1.4% in 2007 to 0.3% in 2019, according to the GAO report. From 2007 to 2018, it took just under three years from the filing of a large partnership's return to the conclusion of an audit of the large partnership. The IRS spent on average about 1.7 years, and the IRS examiners charged on average 345 hours, to complete a large partnership audit. These statistics align with our experience.

The percentage of large partnership audits resulting in no change to the return from tax years 2010 to 2018 was more than 80%, double the no-change rate of large corporate audits, according to the report. Further, for audits that did result in a change, the average adjustment was negative $264,000, compared to $4.5 million average positive adjustment to tax liability in large corporate audits over the same period. In response to these statistics, IRS officials attributed the declining audit rate to resource constraints. The report notes that the IRS's full-time equivalents devoted to examination and collection work declined almost 30% from 2007 to 2019. In addition, the IRS cited other factors as contributing to the high no-change rate, including the complexity of partnership structures, the unfamiliarity of staff with the new BBA audit procedures, the lack of specialist staff with knowledge of partnership tax law, and more generally, the complexity of partnership tax law.

The GAO noted that the BBA audit procedures summarized above simplify the administrative burden on the IRS—mostly by shifting that burden to partnerships and their partners—but the data in scope for the report was too limited to further assess the impact of these new rules.

More About Statistical Models

The GAO report examined and evaluated IRS statistical models used in assessing overall noncompliance risk and selecting returns for audit. The report explains that the IRS generally runs its statistical models twice per year. IRS classifiers review and select flagged returns based on the number of planned audits, determine whether audits should be done in person or through correspondence, and identify specific potential noncompliance issues for audit consideration.

The GAO report details two statistical models that the IRS uses to select partnerships for audit. The "Partnership Model" generally identifies compliance risks by comparing items across groups and multiple tax years, with IRS staff then weighting the results and classifying the risks according to their assessment of the importance of each comparison and sending "high risk" returns to classifiers for additional review. According to the GAO report, the IRS used this model for LB&I's population of tax year 2020 returns, and 400 large partnership audits were underway as of April 2023.

The new "Large Partnership Compliance Model" used to review the 2021 returns as mentioned above is considered an AI system by the IRS, using multiple indicators of risk for noncompliance based on accounting

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rules, tax law, and a machine learning algorithm, according to the GAO report. IRS subject matter experts determine the degree of importance with respect to certain metrics, and the return scores are weighted according to these determinations. Return scores are weighted according to the degree of importance assigned to each metric by the IRS's subject matter experts. Finally, the results are combined and used to classify the risk of noncompliance for each return at levels ranging from very low to very high.

The GAO included certain criticisms of the IRS's models in its report and generally offered suggestions as to how the IRS could improve its audit selection models.

Conclusion

Responding to the GAO report, Deputy IRS Commissioner Doug O'Donnell stated: "Taxpayers and their advisors would be well served to review their tax positions and ensure they are in a supportable posture as the IRS looks to significantly increase its commitment to this important component of tax administration." Partnerships—especially large partnerships—should get ready for a notice from the IRS. The heightened information requirements and enforcement initiatives underscore the importance for all partnerships of a continued focus on careful and complete compliance. Experienced tax professionals can help taxpayers understand the BBA rules, highlight key events and deadlines, consider potential partnership return amendments through the administrative adjustment request process, build a team, build a strategy, model out alternatives, document agreements and positions, and generally work towards reaching favorable outcomes.

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