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# *Exam*

## *IRS Takes Steps to Improve Partnership Audit and Enforcement*

By George A. Hani and Marissa J. Lee*



## I. Introduction

The Internal Revenue Service ("IRS") continues its efforts to enhance partnership audit and enforcement through its latest compliance program, specific-issue campaigns, and other projects. While these efforts have been underway for several years, the IRS announced that it expects to use some of the additional funding from the Inflation Reduction Act to add new personnel and technology to support such efforts.[1]

## II. Background

### A. Bipartisan Budget Act of 2015

The Bipartisan Budget Act of 2015 ("BBA") re-designed the centralized partnership audit regime intended to facilitate the IRS audits of partnerships.[2] This regime replaced the procedures under the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") and became effective for tax years beginning in January 2018.[3] The shift from TEFRA to BBA was driven in large part due to the relatively low rate of partnership audits, widely believed to be due to the complexity of TEFRA and the requirement that the IRS must collect any additional tax at the partner level. Under BBA, the IRS audits (and raises proposed adjustments) at the partnership level but also assesses and collects taxes in addition to interest and penalties at the partnership level.[4]

BBA provides that partnerships follow certain requirements when filing or amending their tax returns. Partnerships must appoint one partnership representative who has the sole authority to act on behalf of the partnerships in an IRS proceeding under Code Sec. 6223.[5] All partners are bound by the partnership representative's actions. Eligible partnerships may elect to opt out of the regime. Code Sec. 6221(b) specifies that a partnership is eligible to opt out only if it has 100 or fewer partners that are individuals, C corporations, foreign entities that would be treated as C corporations were they domestic, S corporations, or estates of deceased partners. If the IRS makes adjustments to any partnership-related item resulting in an "imputed underpayment," partnerships pay this imputed underpayment in the year the adjustments are made.[6] Alternatively, partnerships may elect to push out audit adjustments and payments to partners. Code Secs. 6226(b) and (c) have the partners determine tax based on their respective share of partnership adjustments and become liable for any applicable interest subject to a two-percentage point increase following the election and penalties. BBA's default rules assigning tax computation and payment responsibilities to partnerships, not partners, aim to streamline the IRS audit and enforcement process. In July 2020, the IRS rolled out Internal Revenue Manual ("IRM") provisions for the "Centralized Partnership Audit Regime (BBA) Field Examination Procedures."[7]

### B. Large Partnership Compliance Program

To address continued low partnership audit and adjustment rates for the first few years following BBA, the IRS launched the Large Partnership Compliance ("LPC") pilot program in October 2021.[8] This program closely tracks the Large Corporate Compliance ("LCC") program initiated in May 2019, and the two programs focus on audit selection of large and complex partnerships and corporations with high compliance risks.



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The IRS' interim guidance explains the LPC pilot program in four parts of the case selection process: (1) identification, (2) modeling and classification, (3) exam procedures, and (4) feedback. The IRS' Large Business and International ("LB&I") Division first identifies certain partnership returns among those indicating more than $10 million in assets and determines a threshold for large partnerships, based on data analytics similar to the ones used in the LCC program and adjusted for partnership-specific characteristics. LB&I uses its modeling and classification tools to further review these returns. Once the LPC cases are selected, LB&I follows the exam procedures that are generally similar to those concerning other large taxpayers and the LCC program. LB&I notes certain procedural differences for the LPC cases. Examiners may not survey (or pass returns in lieu of conducting audits) because the information obtained from these audits could improve the case selection. They conduct a different risk assessment, based on issues provided using the classification tool and subject matter support. They provide detailed feedback on the issues. Through the LPC pilot program, the IRS is developing more effective use of its staff, specialists, and technology in its partnership audits.

## III. Areas of Increased Audit and Enforcement Interest

### A. LB&I Active Campaign Areas

Since January 2017, LB&I has organized its enforcement efforts around "campaigns" that identify specific tax issues with a perceived high risk of non-compliance.[9] Each campaign is typically designed to identify (and select for audit) taxpayers whose return is likely to present the issue with which the IRS has concerns about compliance. A full examination will not necessarily always occur, as each campaign could invoke one or more other "treatment streams," such as revising an IRS form or its instructions, publishing additional IRS guidance, outreaching to practitioners, taxpayers, or tax software vendors, or sending a soft letter notifying taxpayers about possible non-compliance and an opportunity to file an amended return. LB&I has four active campaigns focused on partnership tax issues: (1) partnership losses in excess of partner's basis, (2) distribution in excess of partner's basis, (3) sale of partnership interests, and (4) self-employment tax and limited partner exception.[10]

#### *1. Partnership Losses in Excess of Partner's Basis*

This campaign, announced on February 7, 2020, targets perceived non-compliance for reporting flow-through losses from a partnership. A partner's distributive share of partnership loss is allowed only to the extent of the adjusted basis of such partner's interest in the partnership (*i.e.*, outside basis) at the end of the partnership year in which the loss occurred, as computed under Code Sec. 705. If the partner's share of the loss exceeds the basis, the excess amount is suspended and may be carried over for deduction in the next tax year in which the partner has basis available per Code Sec. 704(d). In addition to ensuring that basis adjustments (and particularly special allocations) have been properly tracked by the partner and the partnership, audits in this area often focus on the portion of the outside basis attributable to the partner's share of any liabilities. In addition to being limited by outside basis, a flow-through loss may be limited based on (1) the "at-risk" rules under Code Sec. 465, (2) the passive activity loss rules under Code Sec. 469, (3) the excess business loss rules under Code Sec. 461(l), and (4) capital loss limitations.

### *2. Distribution in Excess of Partner's Basis*

Announced in August 2022, this campaign focuses on liquidating and non-liquidating distributions, rather than flow-through losses. A distribution by a partnership to a partner does not result in gain recognition, except to the extent any money distributed exceeds the adjusted basis of such partner's interest (*i.e.*, outside basis) in the partnership immediately before the distribution under Code Sec. 731(a). The focus of the audit can be expected to be the same as or similar to the above campaign.

### *3. Sale of Partnership Interest*

Among the early campaigns announced in March 2018, this campaign focuses on the proper reporting of gain or loss on the sale of a partnership interest. Gain or loss from a partner's sale of partnership interest must be recognized and is the difference between the sales proceeds received and the partner's tax basis in the interest at the time of the sale. Generally, the gain or loss on the sale of a partnership interest results in capital gain or loss. If the partnership holds Code Sec. 751 assets relating to unrealized receivables and inventory items (so-called "hot assets"), a portion of the gain or loss will be ordinary gain or loss. Erroneous reporting often involves characterizing the entire gain as long-term capital gain (usually taxed at 15 percent) when a portion of the gain should be ordinary gain or taxed at the higher capital gain rates of 25 or 28 percent.

### *4. Self-Employment Tax and Limited Partner Exception*

Also announced in March 2018, this campaign is a long-standing campaign and followed the IRS victory in *Renkemeyer, Campbell & Weaver LLP v. Commissioner*,[11] involving whether a partner's distributive share is subject to self-employment tax under the Self-Employment Contributions Act ("SECA"). SECA is inapplicable if the partner qualifies as a "limited partner" under Code Sec. 1402. Certain partners, including service partners in service partnerships organized as state-law limited liability partnerships, limited partnerships, and limited liability companies, may not qualify as the "limited partners" exempt from the SECA tax. In *Renkemeyer*, attorney partners who actively participated in a Kansas LLP were found to not be limited partners for purposes of Code Sec. 1402(a)(13). A similar issue is currently before the Tax Court in *Soroban Capital Partners LP v. Commissioner*.[12]

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Audit adjustments of the SECA tax in the partnership context raise interesting procedural complications. The BBA regime applies only to taxes imposed on Subtitle A, Chapter 1—Income Taxes. SECA is imposed by Chapter 2, so technically, any adjustments to SECA should not be part of a BBA audit. If a BBA audit results in partnership adjustments that impact the amount of SECA tax owed, examiners are instructed to identify the relevant partners and "link" BBA audit to an audit of the individual in order to collect any additional SECA tax at the partner level.[13] Thus, persons managing a BBA audit should make sure to coordinate with any partners that could be implicated. Similarly, audits at the partner level (particularly those that raise the limited partner issue noted above) could also trigger a "link" and a BBA audit of the partnership.

## B. Increased Reporting Could Lead to Increased Audits

As another effort to strengthen its audit and enforcement efforts, the IRS has modified reporting requirements related to partnership tax returns.

### *1. Form 1065, Schedule K-1, Tax Basis Capital Account*

The IRS updated the information required to be included on Form 1065, Schedule K-1. Beginning in the tax year 2020, for purposes of reporting partners' capital accounts, a partnership must use the transactional approach for the tax basis method.[14] Previously, partnerships could report partners' capital accounts on some other basis, such as generally accepted accounting principles ("GAAP"). As described in the October 22, 2020 IRS News Release for the draft of revised instructions for the tax year 2020, this prescribed tax basis method is the method already used by most partnerships.[15] Under the method, a partnership determines each partner's contributions, each partner's share of partnership net income or loss, the withdrawals and distributions made to the partner, and other increases or decreases to the partner's capital account in a manner "generally consistent with figuring the partner's adjusted tax basis in its partnership interest (without regard to partnership liabilities), taking into account the rules and principles of Code Secs. 705, 722, 733, and 742."[16] The IRS adds that partnerships that have not historically used the tax basis method and maintained partners' capital accounts under the tax basis method in the partnership books and records may recompute the partners' beginning tax basis capital account balance for only the tax year 2020, using one of four methods: the tax basis method, the modified outside basis method, the modified previously taxed capital method, or the Code Sec. 704(b) method.[17]

In Notice 2021-13, the IRS provides penalty relief for the transition in the tax year 2020.[18] A partnership is not subject to a penalty under Code Secs. 6698 (failure to file partnership return), 6721 (failure to file correct information returns), or 6722 (failure to furnish correct payee statements) due to the inclusion of incorrect information in reporting its partners' beginning capital account balances on the 2020 Schedules K-1 if the partnership shows taking ordinary and prudent business care in following the 2020 Form 1065 Instructions to report its partners' beginning capital account balances using one of the four methods specified in the instructions (and in the preceding paragraph of this article). The IRS defines "ordinary and prudent business care" as the standard of care that a reasonably prudent person would use under the circumstances in the course of its business in handling account information. The same relief treatment applies to the inclusion of incorrect information in reporting its partners' ending capital account balances on Schedules K-1 in the tax year 2020 or its partners' beginning or ending capital account balances on Schedules K-1 in tax years after 2020 to the extent the incorrect information is attributable solely to the incorrect information reported as the beginning capital account balance on the 2020 Schedule K-1. This penalty relief is in addition to the reasonable cause exception to penalties for any incorrect reporting of a beginning capital account balance. Furthermore, the IRS waives any accuracy-related penalty under Code Sec. 6662 for any tax year with respect to any portion of an imputed underpayment attributable to the inclusion of incorrect information in a partner's beginning capital account balance reported by the partnership for the tax year 2020. Such penalty relief is designed to facilitate the transition using the tax basis method going forward.

### *2. Form 1065, Schedules K-2 and K-3, Items of International Tax Relevance*

The IRS released draft instructions for tax year 2020 filings in October 2022 requiring partnerships with foreign activities or partners to complete new Schedules K-2 (*Partners' Distributive Share Items—International*) and K-3 (*Partner's Share of Income, Deductions, Credits, etc.—International*) and attach the schedules to Form 1065, effective for tax years starting in 2021.[19] Schedules K-2 and K-3 provide partnerships a standardized format for reporting international tax items to the IRS and partners.[20] The items include the information related to foreign tax credit, interests in foreign entities or distributions from foreign corporations, and foreign partners' U.S. effectively connected income.[21] Schedule K-2 is an extension of Schedule K of Form 1065 and reports all partners' shares of the partnership's international tax items. Schedule K-3 is an extension of Schedule K-1 of Form 1065 and provides information regarding each partner's share of the partnership's international tax items reported on Schedule K-2. Partners must include the information reported on Schedule K-3 on their tax returns.

The IRS extends penalty relief to certain partnership taxpayers.[22] Notice 2021-39 provides that taxpayers will not be assessed a penalty for any incorrect or incomplete reporting on Schedules K-2 and K-3 for the tax year 2021 if they show a good-faith effort to comply with the requirements to the satisfaction of the Commissioner. The IRS explained the need for this transition relief given the schedule additions and requirements are yet unfamiliar to taxpayers. In determining good faith, the IRS considers the extent to which a partnership taxpayer made changes to its systems or partnership agreement and coordinated with partners to obtain information relevant for filing the schedules. The IRS asks whether the taxpayer applied reasonable assumption when such information is not obtained.

Additionally, the IRS has an exception for certain domestic partnership taxpayers filing Schedules K-2 and K-3. The draft instructions on Schedules K-2 and K-3 state that for the "domestic filing exception" to apply, a taxpayer must meet all of the four criteria with respect to the tax year 2022.[23]

- The domestic partnership either has no foreign activity or, if it has foreign activity, such foreign activity is limited to (a) passive category of foreign income, (b) upon which not more than $300 of foreign income taxes allowable as a credit under Code Sec. 901 are treated as paid or accrued by the partnership, and (c) such income and taxes are shown on a payee statement furnished by the partnership.
- All the direct partners in the domestic partnership are U.S. citizens and resident alien individuals, domestic estates, or domestic trusts.
- Partners receive a notification from the partnership no later than two months before the tax filing due date without extension. The notification must state that partners will not receive Schedule K-3 from the partnership unless the partners request the schedule.
- The partnership does not receive a request from any partner for Schedule K-3 information on or before the date one month before the due date.

The IRS may make further changes to the Schedule K-2 and K-3 reporting requirements after reviewing comments on the draft instructions that were due on November 8, 2022.

## IV. Conclusion and Next Steps

The IRS is committed to improve the quantity and quality of its partnership audits and has enacted various initiatives. The IRS has adopted BBA rules shifting tax liability from partners to a partnership, refined its audit selection process supported by new technology and more personnel, taken issue-based audits and other compliance measures, and required more standardized and detailed tax reporting. As the IRS continues to iron out the implementation details, partnerships and partners should pay close attention to follow-up developments and changes related to the IRS audit and enforcement.

### ENDNOTES

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1 Publication 5319, *FY2023 LB&I Strategic Goals* (Rev. Oct. 2022), *www.irs.gov/pub/irs-pdf/p5319.pdf*.

2 Pub. L. 114-74, §1101, 129 Stat. 584, 625–38 (2015); Staff of the J. Comm. on Taxation, *General Explanation of Tax Legislation Enacted in 2015*, J. Comm. at 51–82 (Print 2016).

3 Pub. L. 97-248, §402, 96 Stat. 324, 648–69 (1982).

4 Publication 541, *Partnerships* (Rev. Mar. 2022), *www.irs.gov/publications/p541#en_US_202203_publink100016687*; Dep't of Treasury, IRS, *BBA Centralized Partnership Audit Regime* (Oct. 25, 2022), *www.irs.gov/businesses/partnerships/bba-centralized-partnership-audit-regime*.

5 All "Section" and "§" references are to the Internal Revenue Code of 1986, as amended (the "Code"), or the Treasury regulations promulgated thereunder.

6 Code Sec. 6225; Reg. §301.6225-1.

7 IRM 4.31.9 (Sep. 26, 2022).

8 Treasury Inspector Gen. for Tax Admin., *Centralized Partnership Audit Regime Rules Have Been Implemented; However, Initial No-Change Rates Are High and Measurable Goals Have Not Been Established*, 2022-30-020 (Mar. 17, 2022); Theodore D. Setzer, *Memorandum for All Large Business and International Division Employees: Interim Guidance on Implementation of the Large Partnership Compliance Pilot Program*, LB&I-04-1021-0017 (Oct. 21, 2021).

9 Dep't of Treasury, IRS, *IRS Announces Initial Rollout of Large Business and International Campaigns* (Jan. 31, 2017), *www.irs.gov/businesses/irs-lbi-compliance-campaigns-jan-31-2017*.

10 Dep't of Treasury, IRS, *Large Business and International Active Campaigns* (Aug. 17, 2022), *www.irs.gov/businesses/corporations/lbi-active-campaigns*.

11 136 TC 137, Dec. 58,543 (2011).

12 Docket Nos. 16217-22 and 16218-22.

13 *See* IRM 4.31.9.6 (Oct. 29, 2021).

14 Draft 2021 Instructions for Form 1065 (Nov. 24, 2021), at 31; 2020 Instructions for Form 1065 (Feb. 5, 2021), at 31.

15 Dep't of Treasury, IRS, *IRS Releases Draft Form 1065 Instructions on Partner Tax Basis Capital Reporting* (Oct. 22, 2020), *www.irs.gov/newsroom/irs-releases-draft-form-1065-instructions-on-partner-tax-basis-capital-reporting*.

16 Draft 2021 Partner's Instructions for Schedule K-1 (Form 1065) (Jan. 10, 2022), at 7.

17 2020 Instructions for Form 1065 (Feb. 5, 2021), at 31-32.

18 Notice 2021-13, IRB 2021-6, 832.

19 Draft 2022 Form 1065, Schedules K-2 and K-3 Instructions (Oct. 25, 2022); Draft 2021 Form 1065, Schedules K-2 and K-3 Instructions (Aug. 25, 2021).

20 Dep't of Treasury, IRS, Schedules *K-2 and K-3 Frequently Asked Questions (Forms 1065, 1120S, and 8865)* (Oct. 26, 2022), *www.irs.gov/businesses/schedules-k-2-and-k-3-frequently-asked-questions-forms-1065-1120s-and-8865*.

21 Draft 2021 Form 1065, Schedules K-2 and K-3 Instructions (Aug. 25, 2021), at 3.

22 Notice 2021-39, IRB 2021-27, 3.

23 Draft 2022 Form 1065, Schedules K-2 and K-3 Instructions (Oct. 25, 2022), at 3.



  