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New IRS Unit Leverages AI to Step Up Partnership Audits; Hundreds of New Inquiries Expected

The IRS's simmering concern with pass-through entities is heating up, with IRA funds earmarked for increased personnel, AI, and other resources for partnership audits.

Key Points:

- As partnerships have grown in number, size, and complexity, the IRS has faced challenges in effectively auditing them. While the Bipartisan Budget Act of 2015[1] (BBA) overhauled the partnership audit rules, their effectiveness is largely untested.
- The IRS plans to use recently increased funding to (i) create a new partnership-focused unit, (ii) initiate a pilot program to leverage artificial intelligence (AI) for return selection, (iii) audit the nation's largest partnerships, and (iv) expand the use of compliance letters for potentially high-risk partnerships.
- These developments will have significant implications for large, multi-tiered, and publicly traded partnerships, which should prepare for both broader and more pointed scrutiny from IRS Exam.

Audits to Come for Large Partnerships

Large partnerships — including those that issue more than 100 K-1s annually and have more than $100 million in assets — should prepare for increased and enhanced IRS enforcement efforts under the BBA audit regime. Seeking to reverse a decades-long decline in partnership audit rates, the IRS recently announced that it would open 75 new large partnership audits and mail compliance letters to another 500 partnerships.[2] Partnerships in the IRS's sights should ensure that their partnership documentation reflects alignment of partners and the designated Partnership Representative on BBA audit or pre-audit strategy. Agreeing on information-sharing and decision-making protocols among stakeholders and updating partnership agreement language — including giving attention to how any potential tax adjustment (the "imputed underpayment") will be paid — are all key steps to avoiding BBA audit pitfalls.

As part of its partnership audit enforcement campaign, the IRS also announced the creation of a new, partnership-focused examination group.[3] The IRS clearly intends to reverse several trends in its historical handling of partnership returns. As shown in Table 1, below, while the total number of partnership returns filed increased by almost 50% between 2010 and 2020, the number of audits successfully closed declined by an order of magnitude. This has caused the audit rate for large partnerships to drop during the same period from 1.4% to 0.3%, and the audit rate for all partnerships to drop from half a percent to less than 1/20th of a percent — meaning the vast majority of all partnerships have avoided IRS scrutiny entirely for the last decade or more. Perhaps even more concerning for the IRS, the number of audits that

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remain "in process" each year has steadily increased, suggesting that, for those partnerships that *are* audited, the examinations are taking longer than ever to close.

TABLE 1: Partnership Audits by Year, 2010–20

Tax year	Partnership returns	Audits closed	Audits in process	Audit percentage, all partnerships	Audit percentage, large partnerships[4]
2010[5]	3,248,481	15,385	345	0.5	1.4
2011[6]	3,285,177	15,407	198	0.5	1.4
2012[7]	3,388,561	11,432	259	0.3	0.9
2013[8]	3,460,699	10,247	240	0.3	0.8
2014[9]	3,611,255	10,013	377	0.3	0.4
2015[10]	3,715,187	7,813	548	0.2	0.2
2016[11]	3,763,117	6,698	1,055	0.2	0.2
2017[12]	3,905,335	3,611	1,152	0.1	0.2
2018[13]	4,010,200	1,234	1,498	0.1	0.3
2019[14]	4,152,992	796	2,473	0.1	0.3
2020[15]	4,645,903	47	1,260	< 0.05	Not reported

The plunging audit rate results from historically inefficient audit procedures applied to increasingly complex partnerships, as well as from budget and personnel limitations imposed on the IRS in the 2000s and 2010s.[16] However, the passage of the BBA and significantly increased funding from the Inflation Reduction Act of 2022[17] (IRA) have bolstered IRS resources for enhanced partnership audit enforcement programs (in addition to expanded IRS scrutiny of large corporations and high net worth individuals). A clear IRS goal is for the audit rates for partnerships and other pass-through taxpayers to increase dramatically.

Why the Focus on Large Partnerships?

Addressing perceived non-compliance by large partnerships is one area in which the IRS feels it can make big improvements. The IRS's focus on large partnerships is a response to the explosive growth in the number, size, and complexity of partnerships over the past two decades, and the difficulty in auditing the largest of them. The number of the largest and most complex partnerships has soared: there are more than *five times* as many large partnerships today as there were two decades ago.[18]

Moreover, these sprawling partnership structures have historically presented outsize obstacles to effective compliance efforts, which the largely untested BBA audit regime seeks to remedy. Under the TEFRA[19] partnership audit regime that preceded the BBA, merely identifying the responsible tax partner ("tax matters partner") or addressing administrative interventions by individual partners could cause significant delays in audits. Under TEFRA, the IRS was responsible for computing and notifying each partner of its individual share of any adjustment and its respective tax deficiency at the end of the partnership audit. This, in turn, afforded each individual partner the opportunity to begin an entirely new process to contest how the partnership adjustment affected its particular tax situation. These and other administrative complexities faced by the IRS were exacerbated for multi-tiered partnerships, in which

many of the partners are themselves pass-through entities. The burden of collecting deficiencies from ultimately liable individual partners in a complex partnership also proved at times insurmountably challenging. The result was a steadily declining, and largely hamstrung, partnership audit program.

To address these problems, Congress enacted a new partnership audit regime as part of the BBA, effective for most partnerships beginning with taxable year 2018.[20] The BBA audit rules curtail partner involvement in the audit process, centralize partnership decision-making authority in a Partnership Representative, require that the partnership itself pay any imputed underpayment by default, and force onto the partnership the responsibility for allocating or pushing out the cost of the imputed underpayment to partners. These significant procedural changes were intended to simplify the audit and collection process for the IRS, but the resulting rules are arguably more complex than the partnership audit rules they replaced, present a daunting learning curve for the IRS, and create significant new headaches for taxpayers.

How Can Partnerships Minimize BBA Headaches?

Partnerships caught up in the IRS's expanded partnership audit program may not be familiar with the BBA audit rules and the unique risks they present. For instance, under the BBA, the Partnership Representative — who is designated on each year's tax return and cannot be changed before an audit has commenced — binds all partners through its actions during an audit, regardless of any state law or contractual provisions contained in the partnership and operating agreements to the contrary.[21] And there is no right of action against the IRS to contest or get relief from the binding decisions of the Partnership Representative. At the same time, individual partners no longer have any right to notice or participation in the partnership audit process under the BBA and are bound by the results of the partnership-level audit.[22]

To ensure that partners are adequately informed of audit issues and to prevent Partnership Representatives from taking rogue action without the risk of significant legal consequences, partnership and operating agreements that have not yet been amended should be updated to include explicit controls on, and procedures for, a Partnership Representative during an audit. Such controls and procedures may include, among other provisions:

- requirements for the Partnership Representative to provide audit correspondence and responses to partners;
- rules for securing partner approval before certain actions are taken; and
- requirements for partners to provide information and documents when requested.

Such mechanisms may include an express right of action against the Partnership Representative (for actions taken in violation of the controls/procedures) as well as indemnification provisions to protect the Partnership Representative (for actions take in accordance with the agreement's terms).

Also introduced under the BBA audit rules is the default requirement that the partnership itself pay any imputed underpayment.[23] If a partnership directly pays an imputed underpayment, it can create tension between partners in the tax year of payment ("adjustment year partners") and partners in the tax year that is subject to review ("reviewed year partners") — since an adjustment year partner could end up responsible for additional taxes for a tax year in which it was not a partner. And a reviewed year partner could escape economic responsibility for its share of the imputed underpayment entirely if it is no longer a partner in the year of payment.

This tension can be resolved through "make-whole," indemnification, or similar provisions in the partnership or operating agreement, or through provisions requiring the partnership to "push out" the adjustment to reviewed year partners for payment. The BBA's "push out" provisions relieve the partnership itself from paying the imputed underpayment, and instead require it to provide statements to each reviewed year partner showing the partner's share of the imputed underpayment and obligating the partner to pay that amount to the IRS.[24] These provisions eliminate the potential unfairness of the "partnership pays" default mechanism, but at the cost of significant administrative complexity for the partnership, as well as a two-percentage point increase to the underpayment interest the IRS calculates on the additional amounts owed by the reviewed year partners. Given these trade-offs, partnerships should agree in advance on how to handle the question of who will pay the imputed underpayment, and under what circumstances (e.g., for a *de minimis* imputed underpayment, it may be better to have the partnership pay to avoid the burden of preparing hundreds or thousands of push-out statements).

These are just two of the more prominent features of a BBA audit, among other complexities. Other options, like "pull in" rules,[25] which enable partnerships to have individual reviewed year partners pay their share without certain complicated elections, are still evolving. From intricate timing issues to evolving processes like the "pull in" rules and untested provisions that may generate litigation challenges, the BBA is full of hazards for the unwary, and potential opportunities for the savvy.

What Steps Is the IRS Taking to Increase the Number of Audits?

Given these hazards, taxpayers may wonder how the IRS is selecting partnerships for audit, and whether their partnership is likely to come under IRS scrutiny. In addition to increasing its internal expertise and communications with the formation of a new partnership unit, the IRS is using data analytics and some forms of AI to identify those returns that may be most fruitful to audit.[26] These new technological tools enhance those previously employed in the IRS Large Business and International (LB&I) division's Large Partnership Compliance program. LB&I leadership has explained that it selected the first set of audit targets recently initiated based on a combination of partnership size and an algorithm's identification of likely compliance issues.

The IRS has also announced a campaign to send at least 500 compliance letters to partnerships.[27] Short of an actual audit, this type of low-touch compliance-check correspondence is designed to elicit further taxpayer explanations of return items that may not be fully explained on the face of the partnership return, such as large balance sheet discrepancies from the end of one tax year to the beginning of the next. This initial limited outreach by the IRS takes far fewer resources than an examination. A clear and complete response may provide an opportunity to avoid a costly audit. Of course, the compliance letter dialogue could ultimately result in the start of a full audit as well.

Conclusion

The IRS is increasingly focused and sophisticated in identifying high-risk returns and selecting those returns for audit in its newly funded efforts to close the tax gap — which is the difference between what taxpayers should owe under the tax laws and what the IRS ultimately collects. The growth of large partnerships and pass-through entities over the last two decades has presented significant enforcement challenges for the IRS. Now the IRS appears to have the funding, personnel, technology, and improved procedures and processes that it needs to enhance the scope and effectiveness of its large partnership audit program. Large partnerships should familiarize themselves with the BBA audit rules and prepare to manage the audit process proactively.

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Endnotes

[1] Bipartisan Budget Act of 2015 § 1101, Pub. L. No. 114-74, 129 Stat. 584, 625 (codified as amended at 26 U.S.C. §§ 6221-6241).

[2] I.R.S. News Release IR-2023-166 (Sept. 8, 2023).

[3] I.R.S. News Release IR-2023-176 (Sept. 20, 2023).

[4] U.S. Gov't Accountability Off., GAO-23-106020, Tax Enforcement: IRS Audit Processes Can Be Strengthened to Address a Growing Number of Large, Complex Partnerships 22 (2023).

[5] U.S. Internal Revenue Service, 2020 Data Book 44 (2021). All data in this table come from the 2020 IRS Data Book and the 2022 IRS Data Book, except for the column addressing audit percentages of large partnerships, the data for which come from the GAO report cited in endnote 4 .

[6] U.S. Internal Revenue Service, 2020 Data Book 43 (2021).

[7] U.S. Internal Revenue Service, 2022 Data Book 44 (2023).

[8] *Id.* at 43.

[9] *Id.* at 42.

[10] *Id.* at 41.

[11] *Id.* at 40.

[12] *Id.* at 39.

[13] *Id.* at 38.

[14] *Id.* at 37.

[15] *Id.* at 36.

[16] U.S. GOV'T ACCOUNTABILITY OFF., GAO-23-106020, TAX ENFORCEMENT: IRS AUDIT PROCESSES CAN BE STRENGTHENED TO ADDRESS A GROWING NUMBER OF LARGE, COMPLEX PARTNERSHIPS 10 (2023).

[17] Inflation Reduction Act of 2022, Pub. L. No. 117-169, 136 Stat. 1818.

[18] U.S. GOV'T ACCOUNTABILITY OFF., GAO-23-106020, TAX ENFORCEMENT: IRS AUDIT PROCESSES CAN BE STRENGTHENED TO ADDRESS A GROWING NUMBER OF LARGE, COMPLEX PARTNERSHIPS 10 (2023).

[19] Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 324.

[20] Bipartisan Budget Act of 2015, at § 1101(g)(1).

[21] I.R.C. § 6223; Treas. Reg. §§ 301.6223-1(a), 301.6223-2(a).

[22] Treas. Reg. § 301.6223-2(d).

[23] I.R.C. § 6225(a)(1).

[24] I.R.C. § 6226(a); Treas. Reg. § 301.6226-2.

[25] I.R.C. § 6225(c)(2)(B).

[26] I.R.S. News Release IR-2023-166 (Sept. 8, 2023).

[27] *Id*.