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Passthrough Entities

IRS Aims to Audit C Corporations, Large Partnerships at Similar Rates

By Laura Davison

Feb. 26 — The Internal Revenue Service is shifting its focus from auditing C corporations to auditing large partnerships at a higher rate, agency officials said.

"Historically, we've spent a lot of time in large corporations," Rosemary Sereti, acting assistant deputy commissioner for services and enforcement, said Feb. 26 at a forum hosted by the District of Columbia Bar Taxation Section. "We're allowing for more flexibility to deploy resources. But just because we have an explosion in partnerships, doesn't mean we should directly audit more. We are focused on the right returns."

The IRS audits large partnerships at about the same rate as individual tax returns. Less than 1 percent of large partnerships' 2012 returns were audited, according to a 2014 report from the Government Accountability Office. C corporations with more than $100 million in assets were audited at a 27.1 percent rate.

William Heard III, senior counsel in the Office of Associate Chief Counsel (Procedure & Administration), said the IRS is seeking to make the audit process for large partnerships more streamlined by collecting from a fewer number of partners at the top of the structure.

BNA Snapshot

Development: IRS seeking to audit more large partnerships amid limited funding.

Potential Impact: Higher audit rates of partnerships would cripple the capabilities of IRS under TEFRA requirements.

No More Tiers

"One way to do is to have no tiers," Heard said. "We assess the first passthrough to the partner and they have to figure out how to handle it with indirect partners. They figure out how to share the liability or become a C corp."

Heard said the IRS is seeking to get the audit rate closer to that of C corporations.

We need to "make it easy to audit and process at the tail end," Heard said. "You might have a $10 million dollar adjustment, but you're never going to collect it if it's spread out over thousands of partners."

Size and Complexity

The number of large partnerships has increased in size and complexity in recent decades as companies seek to avoid the corporate tax code and pass tax liability onto their partners. From 2002 to 2011, large partnerships tripled to more than 10,000 and hold trillions of dollars of assets, the GAO report said.

The Tax Equity and Fiscal Responsibility Act of 1982, or TEFRA, introduced mandates for auditing large partnerships and also created many new administrative and reporting requirements, which can be complicated for practitioners and examination agents.

Sereti said the IRS can't handle additional partnership campus audits under the current TEFRA requirements. These audits link the entity with the tax returns of direct and indirect partners.

"The world of partnership taxation has become more complicated," Charles Ruchelman, a member in Caplin & Drysdale's Washington office, told Bloomberg BNA in a Feb. 26 e-mail. "Partnership examinations and reporting requirements, governed by TEFRA, seem to be mired in uncertainty since many of the ground rules remain undefined and full of traps for the non-specialists."

The IRS is in need of a more efficient and less costly process. Its budget has been reduced by about $1.2 billion, or 10 percent, since 2010. Staffing levels have been reduced by 11 percent and the agency expects the individual examination rate for 2015 to be about 20 percent lower than the 2014 target levels.

"For large partnerships, we don't want to assess 1,000, 10,000 partners," Heard said. "The Service no longer has resources to process all partner returns."

Future Guidance

Despite budget cuts and understaffing, the IRS is working on new guidance that aims to make processes for partnerships more efficient, Heard said. The IRS is in the process of writing a revenue procedure that would expedite administrative adjustment requests, which amend the treatment of items flowing through partnerships.

"We are also making attempts to redraft a regulation that would pull people out of TEFRA where it interferes or just doesn't work," Heard said. "We're struggling to come up with something that practitioners will agree with."

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