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Tax Enforcement: A Spotlight on Complex Partnership Structures

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Key Points

- A 10-year, $80 billion increase in funding for IRS enforcement will bolster and expand the agency's existing programs examining large, complex partnerships.
- Some of the new funding is expected to go toward improving data analytics technology, to make it easier for the service to identify taxpayers for audits based on the likelihood of noncompliance.
- These additional resources will supplement existing enforcement programs focused on issues such as partnership transactions, partners' tax bases and limited partners' self-employment tax exceptions.

The boost in funding for the Internal Revenue Service (IRS) provided in the Inflation Reduction Act of 2022 (IRA) comes just as it has started rolling out in earnest programs focusing on auditing complex partnership structures. While specific plans over the next 10 years for the $80 billion of increased funding are not yet known, at least $45 billion will be used to increase enforcement efforts, and auditing complex partnerships remains a priority.

Focus on Partnership Compliance

Increasing enforcement efforts against large, complex partnerships has been in the works for nearly a decade. Beginning with 2018 tax returns, the IRS has had the ability to collect tax directly from a partnership, unless the partnership and its partners take certain steps to ensure the tax is otherwise paid by the partners themselves (thereby shifting the burden of collection from the IRS to the taxpayers).

The IRA funding for tax enforcement enhances the IRS' efforts to train and organize examination teams with specialized knowledge to audit complex partnership structures. The IRS' Global High Wealth Industry Group (GHW) audits high-net-worth individuals who often invest through partnerships, which has led to increased enforcement relating to conservation easements, self-employment tax and nonfiling of foreign entities. The GHW frequently opens simultaneous audits of both high-net-worth individuals and the entities through which they invest.

The IRS has also launched the Large Partnership Compliance Program (LPCP), based on a similar program for large corporations. The LPCP is intended to audit some of the largest partnerships in a comprehensive fashion, not focused on a single issue or topic. Large partnerships are selected based on data analytics identifying those with the highest risk of noncompliance.

Data Gathering: Updates to Filing Requirements and Improved Technology

While the IRS has a sense of the types of issues it wants to audit, it needs a method to identify entities and specific returns for audits. Selection can be hampered by lack of data from partnership tax returns as well as limited IRS capabilities to analyze big data using analytics and machine learning.

The IRS has taken significant steps in recent years to address the first of these issues, particularly in the context of partnerships with cross-border activities. In 2021, the IRS introduced Forms K-2 and K-3, which require partnerships to report myriad data regarding their foreign activities (as might relate to U.S. taxpayers) and their U.S. activities (as might relate to foreign taxpayers). The IRS recently announced that it would not require partnerships without foreign activities or partners to prepare and submit these two forms.

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The extensive information the forms collect follows other IRS efforts to increase the amount of data partnerships must provide to the IRS and their partners, including:

- the required calculation of a partner's tax basis by the partnership;
- disclosure of partners' share of "hot assets" generating ordinary income on sale; and
- other targeted improvements to partnership informational tax returns.

But increased data only helps if the IRS can evaluate that information to target entities that are potentially not in compliance. The IRS' new funding provides over $25 billion for increased operational support, including improved technology. One expected area of spending is improved data analytics technology, to allow the IRS to better identify taxpayers for issue-specific audits.

Compliance Campaigns and Priority Plans

Many of the IRS' strategies surrounding partnership compliance and its GHW initiatives over the last decade, as well as issues developed from audits of large corporations, have been formalized and centralized into compliance campaigns of the Large Business & International Division. Many of these impact partnership businesses and investment structures more broadly.

Ongoing campaigns include:

Transactions in partnership interests: A trio of campaigns focusing on transactions relating to partners' bases in their partnership interests, including specifically on deductions of partnership losses in excess of partner basis, distributions in excess of partner basis and sales of partnership interests. All three campaigns focus on partnership loss limitation rules and the application of partnership basis rules to calculation of gain. In addition, the IRS is seeking to identify taxpayers who fail to report partnership gain and/or misreport the character of gain.

Self-employment tax exception for limited partner interests: A campaign evaluating the extent and application of the exemption from self-employment tax for limited partners' distributive shares of partnership income. The attention is on partnerships engaging in businesses that the IRS considers service based, including investment advisory firms.

Financial service entities and U.S. trades or businesses from lending activities: Audits evaluating whether financial service entities with lending activities are engaged in a U.S. trade or business. This impacts credit-focused investment funds in particular and often is an audit of those entities' withholding tax information reporting forms.

FATCA filing accuracy: A focus on whether foreign financial institutions and certain other foreign entities satisfy their Foreign Account Tax Compliance Act (FATCA) reporting and withholding obligations. This can impact foreign partnerships qualifying as foreign financial institutions.

Inbound investment compliance: A series of campaigns focused on inbound investment, which is often made via pass-through entities. These include:

- the adequacy of Foreign Investment in Real Property Tax Act (FIRPTA) reporting for gain and certain other income from U.S. real estate investments;
- compliance with Forms 1042 and 1042-S filing requirements (often involving documentation of exemptions and rate reductions);
- Form 1120-F filing and general compliance (often an issue for non-U.S. "feeder" funds into U.S. partnerships); and
- satisfaction of documentation and substantiation rules for applying nonresident alien treaty exemptions.

In Sum

The IRS continues to develop formal campaigns and evaluate issues that will likely feed into large partnership audits and drive targeted audits of pass-through entities. In fact, the 2022-23 IRS Priority Guidance Plan lists developing "guidance on abusive use of partnerships for inappropriate basis adjustments." One official informally described this effort as taking a closer look at related partners' use of nontaxable transfers of partnership interests as well as an election under Section 754 to increase and shift basis between related parties. Taxpayers can expect that ongoing audit efforts will result in new coordinated approaches to enforcement.

(See also "New Corporate Minimum Tax and Stock Repurchase Tax Will Take Effect in 2023, but Questions Remain.")