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TAX ENFORCEMENT

IRS Audit Processes Can Be Strengthened to Address a Growing Number of Large, Complex Partnerships

GAO Highlights

Highlights of GAO-23-106020, a report to the Chairman, Committee on Finance, U.S. Senate

Why GAO Did This Study

Business activity has increasingly shifted toward legal structures known as partnerships and away from C corporations subject to the corporate income tax. A partnership is generally an unincorporated organization with two or more members that conducts a business and divides profits. Partnerships usually do not pay income taxes as entities but pass the net income or losses to partners, such as individuals or corporations, who then report the income and pay any applicable taxes.

GAO was asked to examine trends in large partnerships and IRS auditing of them. This report (1) summarizes the number and characteristics of large partnerships; (2) describes the resources used and results of audits of large partnerships; and (3) assesses IRS's efforts to identify potential noncompliance risks in large partnerships. For purposes of this report, large partnerships are defined as having $100 million or more in assets and 100 or more total partners.

GAO analyzed IRS data pertaining to business and audit activity for tax years 2002 through 2019, the most recent year for which complete data were available; compared IRS statistical models to relevant statistical modeling standards; interviewed agency officials; and held discussion groups with IRS staff.

What GAO Recommends

GAO is making four recommendations to IRS, including improving the design of its models as well as developing guidance to define and measures to track large and complex partnership audits. IRS agreed with GAO's recommendations.

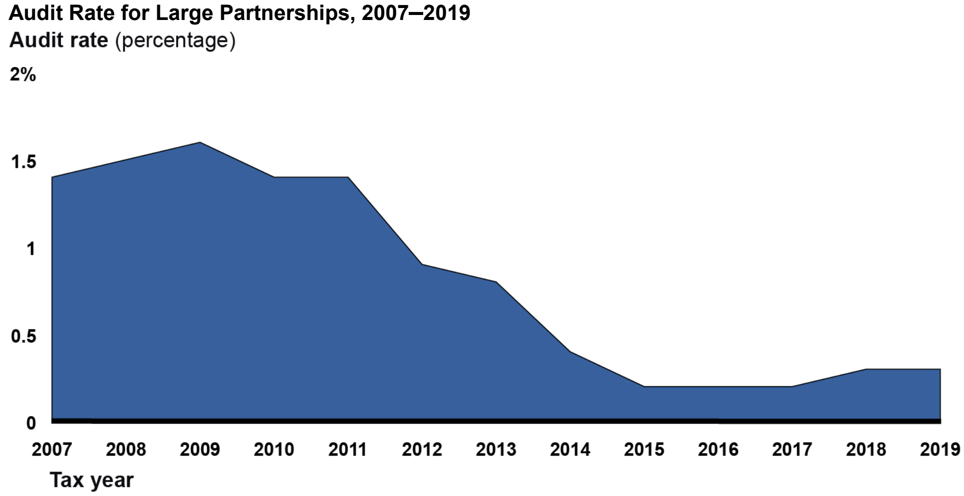
View GAO-23-106020. For more information, contact James R. McTigue, Jr. at (202) 512-6806 or mctiguej@gao.gov.

What GAO Found

In tax year 2019, there were 20,052 large partnerships, increasing nearly 600 percent since tax year 2002. Eighty-four percent of large partnerships reported providing finance and insurance services or real estate and rental leasing. Large partnerships can be complex with income or business expenses passing through multiple levels such that a partnership could be a partner in another partnership.

The Internal Revenue Service (IRS) audits few large partnerships—54 in tax year 2019—and the audit rate has declined since 2007. More than 80 percent of the audits resulted in no change to the return on average from tax years 2010 to 2018, double the rate of large corporate audits. For those that did change, the average adjustment was negative $264,000. IRS officials attributed the declining audit rate to resource constraints. The Inflation Reduction Act of 2022 (IRA) provided IRS with $45.6 billion for enforcement activities through the end of fiscal year 2031, and in response IRS identified large partnerships as an enforcement priority. About $1.4 billion of this funding was rescinded in 2023 with a White House briefing reporting an agreement to reduce future funding by $20 billion.

Audit Rate for Large Partnerships, 2007–2019



Source: GAO analysis of Internal Revenue Service data. | GAO-23-106020

As part of its audit selection process, IRS uses statistical models to help review partnership returns for potential noncompliance, but the models were developed without using representative samples of returns and with untested assumptions. Additionally, IRS has not developed a plan to incorporate feedback from audit results into the models. Addressing these modeling issues could improve IRS's ability to better identify and audit noncompliant partnerships.

IRS planning documents state that it will expand enforcement efforts related to large, complex partnerships using IRA funding. However, IRS has not defined complexity or size in terms specific enough to guide enforcement efforts. IRS also has not developed measures to ensure that additional audits focus on these entities. Developing such a definition and specific outcome measures would help IRS develop plans, track resources used, and assess the results of these new investments in large partnership audits.