GAO Highlights

Highlights of GAO-14-746T, a testimony before the Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs, U.S. Senate.

Why GAO Did This Study

Businesses organized as partnerships have increased in number in recent years while the number of C corporations (i.e. those subject to the corporate income tax) has decreased. The partnership population includes large partnerships (those GAO defined as having $100 million or more in assets and 100 or more direct and indirect partners). Their structure varies. Some large partnerships have direct partners that are partnerships and may bring many of their own partners into the structure. By tiering partnerships in this manner, very complex structures can be created with hundreds of thousands of direct and indirect partners. Tiered large partnerships are challenging for the Internal Revenue Service (IRS) to audit because of the difficulty of tracing income from its source through the tiers to the ultimate partners.

GAO was asked to study the challenges large partnerships pose for IRS. GAO describes the number of large partnerships and their assets, IRS's large partnership audit results and the challenges IRS faces in auditing these entities, and options for addressing these challenges. GAO analyzed IRS data on partnerships, reviewed IRS documentation, interviewed IRS officials, met with IRS auditors in six focus groups, and interviewed private sector lawyers knowledgeable about partnerships.

What GAO Recommends

GAO makes no recommendations but will issue a report later in 2014 assessing IRS's large partnership audit challenges. IRS provided technical comments, which were incorporated.

View GAO-14-746T. For more information, contact James R White at (202) 512-9110 or whitej@gao.gov.

July 22, 2014

LARGE PARTNERSHIPS

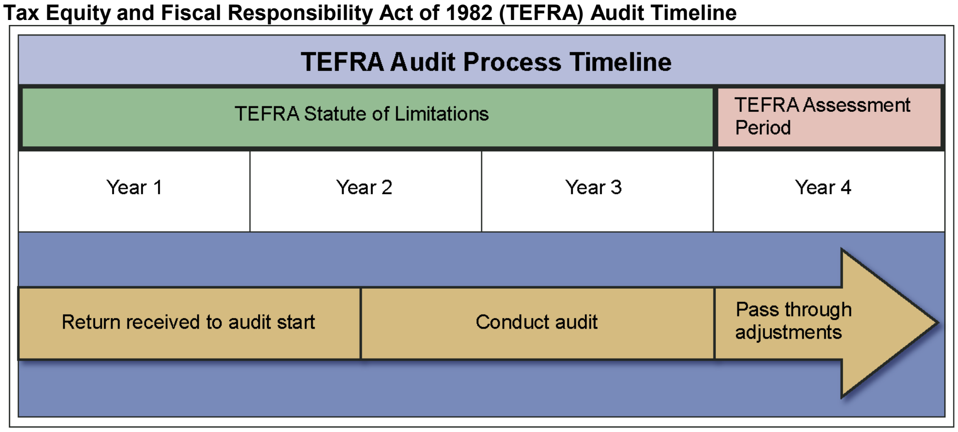
Growing Population and Complexity Hinder Effective IRS Audits

What GAO Found

Internal Revenue Service (IRS) data show, from tax years 2002 to 2011, the number of large partnerships more than tripled. According to IRS officials, many large partnerships are hedge funds or other investment funds where the investors are legally considered partners. Many others are large because they are tiered and include investment funds as indirect partners somewhere in a tiered structure. According to IRS data, there were more than 10,000 large partnerships in 2011. A majority had more than 1,000 direct and indirect partners although hundreds had more than 100,000. A majority also had six or more tiers.

IRS audits few large partnerships—0.8 percent in fiscal year 2012 compared to 27.1 percent for large corporations. Of the audits that were done, about two-thirds resulted in no change to the partnership's reported net income. The remaining one-third resulted in an average audit adjustment to net income of $1.9 million. These minimal audit results may be due to challenges hindering IRS's ability to effectively audit large partnerships. Challenges included administrative tasks required by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) and the complexity of large partnership structures due to tiering and the large number of partners. For example, IRS auditors said that it can sometimes take months to identify the person who represents the partnership in the audit, as required by TEFRA, reducing the time available to conduct the audit. Complex large partnerships also make it difficult to pass through audit adjustments across tiers to the taxable partners.

Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) Audit Timeline



Source: GAO analysis of IRS data and documentation. | GAO-14-746T

Note: A 3-year statute of limitations governs the time IRS has to complete partnership audits, according to the audit procedures enacted in TEFRA. The first stage is the period from when a return is received until IRS begins the audit. The second stage is the period in which IRS conducts the audit. The third stage is when IRS assesses the partners their portion of the audit adjustment.

IRS cannot resolve some of the challenges because they are rooted in tax law, such as those required by TEFRA. Congress and the Administration have proposed statutory changes to the audit procedures for partnerships, such as requiring partnerships to pay taxes on net audit adjustments rather than passing them through to the taxable partners. In addition, IRS has implemented some changes to its large partnership audit process, such as understanding the complexity of large partnerships and selecting returns for audits.