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IRS Launches New Large Partnership Audits, Relying on AI and Increased Funding

Enhanced budgets and innovative technologies such as artificial intelligence are driving stepped-up IRS guidance and enforcement actions aimed at complex partnerships.

Key Points:

- The IRS has historically faced challenges auditing complex, multi-tiered, and publicly traded partnerships. The partnership audit rules were overhauled in the Bipartisan Budget Act of 2015 (BBA),[1] but the IRS has lacked sufficient resources to test their effectiveness.
- Leveraging funding from the Inflation Reduction Act of 2022 (IRA),[2] the IRS recently initiated a significant number of new audits of the biggest partnerships, using artificial intelligence (AI) for return selection.
- Taxpayers should proactively prepare for enhanced scrutiny from IRS examiners in light of this renewed focus on perceived partnership abuses and on reversing historically low audit rates for large partnerships.

The IRS is making good on its promise to step up enforcement on large partnerships that issue more than 100 annual K-1s and have more than $100 million in assets. As noted in this Latham Client Alert, the IRS's renewed focus on large partnerships is a response to the explosive growth in the number, size, and complexity of these entities.

For more than a decade, the IRS audited less than 1% of large partnerships each year. But armed with AI tools and new funding from the IRA, it has launched at least 76 new audits targeting some of the largest partnerships in the country (assets exceeding $10 billion). These audits target entities in diverse industries, and include hedge funds, real estate investment partnerships, publicly traded partnerships, and large law firms.

A key aspect of the IRS's initiative to increase partnership audit rates is the use of AI to assist in the selection of audit targets. In particular, the IRS is concerned with certain partnership transactions, such as basis-shifting transactions between related parties, that are very difficult to identify — even with the help of AI. The IRS has said the AI is not making these decisions alone, because the selection process is carefully supervised by human tax experts who provide oversight and judgment. The IRS is therefore establishing a new team in the Office of Chief Counsel to further develop partnership guidance, including by adding new types of "reportable transactions."[3] The IRS is also planning to expand and deepen its

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technical training programs for revenue agents and economists that review large partnership and other complex returns, to improve personnel effectiveness.

Partnerships newly targeted for audit should be aware that, even under the BBA audit rules, audits can take years to complete, given modern partnerships' size and complexity. Also, while the BBA audit rules were intended to be more streamlined than the system they replaced, both the IRS and taxpayers are grappling with uncertainties and unexpected complications in these rules. With new funding giving the IRS a long-awaited chance to hone and accelerate partnership audits, all large partnerships should prepare for potential enforcement by familiarizing themselves with the BBA audit rules and readying their teams to manage the audit process proactively.

This Latham Client Alert described key action items for partnerships to minimize BBA risks and headaches. One such action item is to update partnership agreements to include explicit provisions regarding the conduct and control of an audit, such as requirements for providing audit correspondence to partners, requirements for securing partner approval before certain actions are taken, and requirements for partners to provide information and documents upon request and to cooperate to facilitate certain elections. Critically, the BBA audit rules include a default requirement that the partnership itself pay any assessed underpayment (imputed underpayment) — unless the partnership explicitly elects and rigorously follows an alternative process to "push out" the adjustments of partnership items to the partners for the year under audit. Potential complexities abound for both the "default" and "push out" scenarios, and partnerships should agree in advance on how to determine who will pay any imputed underpayment, and by what method.

The IRS has demonstrated that it has the desire and resources to follow through on both its planned selection of high-risk and high-value returns for audit and its expansion of partnership audits more generally. Addressing perceived non-compliance by large partnerships is one area in which the IRS aims to significantly improve enforcement. In the past, the IRS faced technical and financial impediments to its enforcement priorities. New funding, technologies, personnel, and training are enabling the agency to enhance the scope and effectiveness of its large partnership audit program. The time has come for large taxpayers to prepare proactively for an audit process — or risk being caught flatfooted.

If you have questions about this Client Alert, please contact one of the authors listed below or the Latham lawyer with whom you normally consult:

Miriam L. Fisher
miriam.fisher@lw.com
+1.202.637.2178
Washington, D.C.

C. Timothy Fenn
tim.fenn@lw.com
+1.713.546.7432
Houston

Brian C. McManus
brian.mcmanus@lw.com
+1.617.948.6016
Washington, D.C.

Jason B. Grover
jason.grover@lw.com
+1.312.876.7699
Chicago

Amy Feinberg
amy.feinberg@lw.com
+1.202.637.2221
Washington, D.C.

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

[3] A "reportable transaction" is one that must be separately disclosed on a tax return because it is of a type that the Treasury Secretary has determined has a potential for tax avoidance or evasion.