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**TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION**



***Despite Some Favorable Partnership  
Audit Trends, the Number of  
No-Change Audits Is a Concern***

**June 20, 2012**

**Reference Number: 2012-30-060**

This report has cleared the Treasury Inspector General for Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.

Redaction Legend:

1 = Tax Return/Return Information

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**Phone Number** | **202-622-6500**

**E-mail Address** | **[TIGTACommunications@tigta.treas.gov](mailto:TIGTACommunications@tigta.treas.gov)**

**Website** | **<http://www.tigta.gov>**



## HIGHLIGHTS

**DESPITE SOME FAVORABLE PARTNERSHIP AUDIT TRENDS, THE NUMBER OF NO-CHANGE AUDITS IS A CONCERN**

## Highlights

**Final Report issued on June 20, 2012**

Highlights of Reference Number: 2012-30-060 to the Internal Revenue Service Commissioner for the Small Business/Self-Employed Division.

### IMPACT ON TAXPAYERS

In deciding which returns to audit, the IRS strives to select those returns for which its examiners are likely to find areas of noncompliance and recommend changes to one or more items reported on the return. However, the number of audits closed with no recommended adjustments (no-change) is high among the returns selected by the Discriminant Index Function system, which uses mathematical formulas to calculate and assign a score to returns based on their audit potential. According to the IRS, a high no-change rate means compliant taxpayers are unnecessarily burdened by audits.

### WHY TIGTA DID THE AUDIT

This audit was initiated to determine whether Small Business/Self-Employed (SB/SE) Division examiners are conducting audits of partnership tax returns in accordance with IRS policy and procedures. The review was part of our Fiscal Year 2011 audit coverage and addresses the major management challenge of Tax Compliance Initiatives.

### WHAT TIGTA FOUND

The IRS closed nearly 25 percent more partnership audits in Fiscal Year 2011 than in Fiscal Year 2007. While the number of partnership audits has increased, the time examiners spend on partnership audits has decreased. The average number of calendar days for audits decreased almost 11 percent, and the number of examiner hours decreased more than 15 percent.

However, Fiscal Year 2011 statistics from the SB/SE Division showed that 50 percent of the partnership returns audited after selection by or related to the Discriminant Index Function were closed as a no-change. Except for a few instances, TIGTA did not find any significant quality problems during our review that would suggest how the items selected and audited on partnership returns could substantially improve the no-change rates. Examiners generally followed procedures in selecting and verifying the accuracy of items they audited on partnership returns.

SB/SE Division researchers should consider exploring partnership data files to determine whether the most productive returns are selected for audit. With skills in such specialized areas as statistics, operations research, economics, and computers, SB/SE Division researchers are uniquely qualified to suggest alternative audit selection methods and explore details such as evaluating whether examiners should audit more partnership returns with international features or assessing the revenue impact from partnership audits.

### WHAT TIGTA RECOMMENDED

TIGTA recommended that, as resources become available, the Director, Research, SB/SE Division, analyze partnership data files to help identify additional productive returns for audit, including returns with international features.

In their response to the report, IRS officials agreed with the recommendation and stated that the Director, Research, SB/SE Division, plans to work in collaboration with the SB/SE Division's Examination function to analyze partnership data files in order to better identify productive partnership returns for audit, including those returns with international features. As part of the return analysis, the SB/SE Division's Research function plans to consult with other IRS research units.



TREASURY INSPECTOR GENERAL  
FOR TAX ADMINISTRATION

**DEPARTMENT OF THE TREASURY**  
**WASHINGTON, D.C. 20220**

June 20, 2012

**MEMORANDUM FOR** COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED  
DIVISION

**FROM:** Michael E. McKenney  
Acting Deputy Inspector General for Audit

**SUBJECT:** Final Audit Report – Despite Some Favorable Partnership Audit  
Trends, the Number of No-Change Audits Is a Concern  
(Audit # 201030027)

This report presents the results of our review to determine whether Small Business/  
Self-Employed Division examiners are conducting audits of partnership tax returns in  
accordance with Internal Revenue Service policy and procedures. The review was part of our  
Fiscal Year 2011 Annual Audit Plan and addresses the major management challenge of Tax  
Compliance Initiatives.

Management's complete response to the draft report is included as Appendix V.

Copies of this report are also being sent the Internal Revenue Service managers affected by the  
report recommendation. Please contact me at (202) 622-6510 if you have questions or  
Frank J. Dunleavy, Acting Assistant Inspector General for Audit (Compliance and Enforcement  
Operations), at (213) 894-4470 (ext. 128).



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***Despite Some Favorable Partnership Audit Trends,  
the Number of No-Change Audits Is a Concern***

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## ***Abbreviations***

AIMS	Audit Information Management System
BRTF	Business Return Transaction File
DIF	Discriminant Index Function
FY	Fiscal Year
IRS	Internal Revenue Service
SB/SE	Small Business/Self-Employed
TEFRA	Tax Equity and Fiscal Responsibility Act of 1982
TIGTA	Treasury Inspector General for Tax Administration



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## ***Despite Some Favorable Partnership Audit Trends, the Number of No-Change Audits Is a Concern***

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### ***Background***

Partnerships are associations of two or more persons or entities, such as corporations or other partnerships that join to carry on a trade or business. Each partner generally contributes money, property, labor, or specialized skills in exchange for a share of the profits and losses from the partnership. Although partnerships are required to annually file Form 1065, *U.S. Return of Partnership Income*, no taxes are paid with these tax returns. The partners are responsible for reporting and paying any applicable taxes on their respective income tax returns for their share of the partnership's income. Because the partnership distributes untaxed income, losses, credits, and other tax items to the respective partners, partnerships are commonly referred to as flow-through entities.

Partnerships have provided a very popular way to shelter income from taxation because they have minimal legal startup formalities and costs, as well as the legal capacity to pass on to their partners losses that can be used to offset wages and other income sources of the partners. Changes in the legal and regulatory environment in the 1990s contributed to making partnerships one of the fastest growing segments of all tax returns filed. These changes include the creation of Limited Liability Companies<sup>1</sup> and the issuance of Check-the-Box Regulations<sup>2</sup> by the Department of the Treasury. Currently, the Internal Revenue Service (IRS) Small Business/Self-Employed (SB/SE) Division is responsible for managing most of the programs and activities related to partnerships, although the Large Business and International Division serves partnerships with more than \$10 million in assets.

Because partnership losses can offset other income sources of the partners, in the 1970s and early 1980s, some taxpayers began using partnerships as a vehicle to take advantage of unintended loopholes in the tax laws. Enactment of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA)<sup>3</sup> by Congress was intended, in part, to close these loopholes by including in the Internal Revenue Code statutory procedures that affected how the IRS conducts examinations of partnerships and certain other entities that meet the criteria under the TEFRA. The IRS developed a set of administrative procedures and updated the Internal Revenue Manual<sup>4</sup> to guide and assist its examiners and other personnel in complying with TEFRA statutory procedures.

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<sup>1</sup> This is a business entity that offers its owners the advantage of limited liability (like corporations) and partnership-like taxation, in which profits are passed through to the owners and taxed on their personal income tax returns.

<sup>2</sup> U.S. Treasury Regulations allow most unincorporated businesses to elect, by checking a box, whether they will be taxed as a corporation or a flow-through entity, such as a partnership, for Federal income tax purposes.

<sup>3</sup> Pub. L. No. 97-248, 96 Stat. 324 (codified in scattered sections of 26 U.S.C.).

<sup>4</sup> For example, many of the procedures for examining returns subject to the TEFRA are contained in Internal Revenue Manual 4.31 (Oct. 1, 2010).



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For partnerships subject to the TEFRA, the treatment of partnership items is determined at the entity level in one unified examination. Among other things, the TEFRA provides that: 1) every partnership has a tax matters partner<sup>5</sup> to serve as a liaison with the IRS, 2) tax adjustments to the partnership are made in one examination and are binding to all partners, and 3) special notices are issued and procedures followed by the IRS at the beginning and end of examinations. Current TEFRA procedures apply to partnerships that have more than 10 partners or have partners that are S Corporations, other partnerships, or Limited Liability Companies that filed partnership returns.

For partnerships not subject to the TEFRA, partnership audits are in many ways like an audit of the individual partners. Each partner's return is audited separately, and the determination and treatment of partnership items for one partner is not binding on any other partner. Additionally, the statute of limitations for assessment of taxes is tied to the individual partners' returns. Therefore, for the IRS to extend the statute of limitations to facilitate completing the audit of a partnership return, each partner must sign a consent form. This process can result in logistical problems for the IRS, especially if the partners are geographically dispersed and returns are filed at different IRS processing centers.

This review was performed at the IRS's SB/SE Division Headquarters in New Carrollton, Maryland, and the SB/SE Division field offices in Laguna Niguel, California; Denver, Colorado; Cincinnati, Ohio; and Oklahoma City, Oklahoma, during the period August 2010 through November 2011. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

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<sup>5</sup> See Appendix IV for a glossary of terms.



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## ***Despite Some Favorable Partnership Audit Trends, the Number of No-Change Audits Is a Concern***

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### ***Results of Review***

The IRS developed a variety of sources to select tax returns for audit. The IRS strives to select those returns for which its examiners are likely to find areas of noncompliance and recommend changes to one or more items reported on the return. One audit source is the Discriminant Index Function (DIF) system, which the IRS has relied on to help decide how to best allocate its audit resources. The system uses mathematical formulas to calculate and assign a score to returns based on their audit potential. The higher the score, the greater the chance an audit will result in recommended changes to the return.

While IRS audit sources have led to a substantial amount of recommended adjustments to items reported on partnership returns, the number of audits closed with no recommended adjustments<sup>6</sup> (no-change) is high for DIF-selected returns and returns related to the DIF-selected returns, such as the prior or subsequent year returns of the selected taxpayers. For example, SB/SE Division statistics show that 50 percent of the partnership returns audited after being selected by the DIF, or related to a DIF-selected return, were closed as a no-change in Fiscal Year (FY) 2011. According to the IRS, a high no-change rate means the IRS is spending a significant amount of resources on unproductive audits and compliant taxpayers are unnecessarily burdened by audits.

### ***Examiners Spend Less Time on Partnership Audits While Recommending a Considerable Amount of Adjustments to the Returns***

Although the IRS has historically emphasized auditing taxable business entities, such as sole proprietorships, in recent years, it has focused on maintaining audit coverage across all filing segments and on areas presenting the highest compliance risk. The number of partnership audits has increased as the IRS strives to maintain coverage over the growing number of partnership returns filed while addressing the compliance risk they pose. In terms of their compliance risk, partnerships can provide its partners with opportunities to structure transactions improperly so that they can reduce the income taxes the partners would otherwise owe. For example, in Calendar Year 2000, the IRS published guidance on 10 transactions that would likely trigger an audit because they purportedly abuse the tax law, represent a significant loss of tax revenue, and undermine the public's confidence in the tax system. Reflecting the increased compliance risk, there are 34 such transactions as of January 2012, several of which involve partnerships.

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<sup>6</sup> For this report, we considered audits closed with Disposal Code 02 as no-changes. For a flow-through entity, this means that no adjustments were made to the reported income, loss, deductions, or credits of the entity.



***Despite Some Favorable Partnership Audit Trends,  
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The IRS closed 24.94 percent more partnership audits in FY 2011 than in FY 2007 and, as Figure 1 shows, except for partnerships with \$10 million or more in assets, the increases occurred for nearly every size of partnership.

***Figure 1: SB/SE Division Partnership Audit Closures  
for FYs 2007 Through 2011***

Dollar Value of Reported Assets	Number of Partnership Returns Audited					Percentage Change: FY 2007 – FY 2011
	FY 2007	FY 2008	FY 2009	FY 2010	FY 2011	
Under \$250,000	2,313	2,500	2,811	2,232	2,714	17.34%
\$250,000 to Under \$1 Million	665	722	759	800	892	34.14%
\$1 Million to Under \$5 Million	816	865	931	1,109	1,218	49.26%
\$5 Million to Under \$10 Million	289	273	266	321	345	19.38%
\$10 Million and Over	167	151	121	113	141	-15.57%
<b>Totals</b>	4,250	4,511	4,888	4,575	5,310	24.94%

*Source: Treasury Inspector General for Tax Administration (TIGTA) analysis of Audit Information Management System (AIMS) data for partnership audits completed in FYs 2007 through 2011.*

While the number of partnership audits has increased, the time examiners spend on partnership audits has decreased. This is noteworthy because, in response to surveys showing business taxpayers wanted the audit process to consume less time, the IRS invested considerable effort in work process changes focused on reducing the length of audits. As Figure 2 shows, both the number of examiner hours and the number of calendar days spent on partnership audits decreased between FYs 2007 and 2011. The average number of calendar days for all partnership audits decreased 10.47 percent and the average number of examiner hours decreased 15.56 percent.



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**Figure 2: Average Calendar Days and Examiner Hours  
for SB/SE Division Partnership Audits in FYs 2007 and 2011**

Dollar Value of Total Assets	Average Number of Calendar Days			Average Number of Examiner Hours		
	FY 2007	FY 2011	Percentage Change	FY 2007	FY 2011	Percentage Change
Under \$250,000	893	827	-7.39%	34	31	-8.82%
\$250,000 to Under \$1 Million	904	850	-5.97%	46	39	-15.22%
\$1 Million to Under \$5 Million	948	806	-14.98%	56	45	-19.64%
\$5 Million to Under \$10 Million	1,065	856	-19.62%	69	49	-28.99%
\$10 Million and Over	1,384	1,195	-13.66%	90	68	-24.44%
Average for All Partnership Audits	936	838	-10.47%	45	38	-15.56%

Source: TIGTA analysis of AIMS data for partnership audits completed in FYs 2007 and 2011.

In addition to reducing the time spent on partnership audits, examiners are recommending a considerable amount of adjustments to items reported on the returns. For example, in FY 2011, examiners closed 5,310 audits of partnership returns and recommended approximately \$728 million in adjustments to items reported on the returns. This indicates that examiners recommended an average of \$137,000 in adjustments for each return audited. When analyzing the recommended audit adjustments, it is important to recognize what they represent. In general, the recommended adjustments measure only the items or portion of items the examiner believes were not properly reported on the partnership return when it was filed. The recommended adjustments do not measure the amount of taxes that will ultimately be assessed. Generally, the taxes assessed are significantly lower than the recommended adjustments to items on the tax returns.

At the close of a partnership audit, if an examiner recommends an adjustment to the partnership's tax liability, the partners or the tax matters partner may agree or disagree with the examiner's determination. If the partners or tax matters partner agree with the examiner's determination, the audit adjustments pass through to their individual tax returns, where the tax is computed based on each partner's income tax bracket and percentage of ownership in the partnership. For example, if adjustments of \$4,000 were made to the tax return of a partnership that has two equal partners in the 35 percent tax bracket, each partner would be assessed \$700 on his or her individual return (50 percent of \$4,000 multiplied by the 35 percent tax rate). If the partners or tax matters partner disagree with the examiner's determination, the dispute is settled through the



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IRS appeals process or the court system, both of which can significantly reduce or even eliminate the proposed adjustments.

**The Number of Unproductive Audits Is High for Partnerships That Are Not Involved in Abusive Transactions**

One important measure of audit productivity the IRS tracks is the percentage of audited returns that result in recommended adjustments to the return. The IRS associates a high percentage of audited returns that result in recommended adjustments with greater audit productivity, while audits that result in no change are considered unproductive. In FYs 2009 through 2011, the SB/SE Division no-changed 5,247 partnership return audits of the 14,773 partnership returns it selected for audit from all sources. This indicates that about one out of every three (36 percent) partnership returns audited was closed as a no-change. However, the no-change rate was considerably higher for the partnership returns selected by the DIF or related to a DIF-selected return.

The average DIF no-change rate was about 49 percent for FYs 2009 through 2011. In comparison, the average no-change rate for partnership returns selected for audit because of an abusive transaction was around 17 percent for FYs 2009 through 2011. As Figure 3 shows, partnership returns selected from audit sources other than the DIF also had a lower no-change rate than DIF-selected returns. These other sources include IRS projects and studies such as the ones designed to focus on specific suspected areas of noncompliance, other than known abusive transactions.

**Figure 3: SB/SE Division Closures of Audits of Partnership Returns in FYs 2009 Through 2011 by Audit Source**

Selected Statistical Categories	Abusive Transactions			DIF and DIF-Related			All Other Audit Sources		
	FY 2009	FY 2010	FY 2011	FY 2009	FY 2010	FY 2011	FY 2009	FY 2010	FY 2011
<b>Total Partnership Returns Audited (a)</b>	1,414	971	1,439	1,535	1,957	2,129	1,939	1,647	1,742
<b>Audits With Adjustments (b)</b>	1,199	750	1,207	878	928	1,069	1,381	1,072	1,042
<b>No-Change Audits (a) – (b)</b>	215	221	232	657	1,029	1,060	558	575	700
<b>No-Change Rate</b>	15.21%	22.76%	16.12%	42.80%	52.58%	49.79%	28.78%	34.91%	40.18%

Source: TIGTA analysis of AIMS data for partnership audits completed in FYs 2009 through 2011.

The difference between the DIF no-change rate and the no-change rate of returns audited because of an abusive transaction or as part of an IRS project can be attributed to how returns are selected



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for audit and how well examiners audit the returns. For example, once the IRS identifies an abusive transaction and its participants, the participants' returns are assigned to examiners who disallow the abusive transaction and compute the additional taxes and penalties that may be owed. In contrast, partnership returns selected by DIF mathematical formulas do not identify the specific items to audit. Instead, examiners use their experience and judgment to screen the return manually to identify the items that are questionable and should be included in the audit. Consequently, outdated compliance data in the formulas, unintentional errors that are inherent in any manual process, and audits that do not meet quality standards are all factors that contribute to high no-change rates.

Except for a few instances, we did not find any significant quality problems during our review of closed audits that indicated how examiners might select and audit the items on partnership returns to substantially change the no-change rates. However, we believe SB/SE Division researchers should consider exploring the use of partnership data files to determine if the most productive returns are selected for audit.

### **Examiners generally followed procedures in verifying the accuracy of items on partnership returns**

We evaluated a judgmental sample<sup>7</sup> of 60 partnership audits closed by the SB/SE Division in FY 2009 and found that examiners generally documented the steps taken to plan the audits, used a variety of fact-finding techniques to determine the accuracy of the partnership returns, and cited applicable sections of the tax law to support any recommended adjustments. However, we found that examiners did not properly consider issues between the partnership and related returns (e.g., the individual returns of the partners, information returns, and employment tax returns) in 22 of the 60 audits.

While the related return issues would not have changed the recommended adjustments for the partnership return or affected the partnership no-change rate, they might have resulted in changes to one or more of the partner's returns. Such changes could make the overall audit effort more productive than official IRS statistics indicate. This is because the IRS reports a partnership audit as a no-change when the adjustments do not change the partnership return, even if the adjustments result in changes to one or more of the partner's returns.

For example, we found instances where one or more partner's estimated personal living expenses far exceeded (more than \$10,000) the income reported on their individual returns. The differences noted between expenditures and income raise serious questions about whether the partnership audit should have been expanded to include the partner's individual returns to determine if there were additional sources of income that should have been reported on the returns.

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<sup>7</sup> A judgmental sample is a nonstatistical sample, the results of which cannot be used to project to the population.



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We recently made recommendations in other reports to address the quality concerns with issues on related returns during audits.<sup>8</sup> The SB/SE Division responded with plans for improvement efforts that include taking advantage of the IRS's automated information systems and its performance management processes to ensure examiners properly consider and address issues on related returns during audits. Therefore, we are not making any additional recommendations for related return issues at this time.

### ***SB/SE Division researchers should consider using IRS data files to identify more productive returns for audit***

The IRS last studied and measured how well partnerships comply with tax laws by using the returns filed for Tax Year 1981. Since then, economic changes, time, and major legislative and regulatory changes, such as TEFRA and Check-the-Box regulations, have rendered the formulas less effective in minimizing no-change audits. IRS Data Books show that after introducing new formulas shortly after the last study, the no-change rate for partnership audits dropped from a high of 49 percent in 1983 to a low of 18 percent in 1989, but has climbed to above 30 percent in the 1990s and has remained over 40 percent since the 2000s. According to IRS officials, because of budget constraints, there are no plans to collect and study the compliance data needed to update the scoring system for selecting partnership returns for audit. Therefore, the SB/SE Division should pursue alternative audit selection techniques by using existing databases containing partnership data to help identify additional productive returns for audit.

To illustrate, we compared the Business Return Transaction File (BRTF) database to the audit results for DIF-selected and DIF-related returns in the FY 2011 AIMS database. We found that audits of real estate or construction industry partnerships with two partners and a reported loss were highly productive in terms of recommended adjustments. The 321 audited returns meeting these criteria accounted for approximately \$215.5 million in recommended adjustments, or about \$671,000 for each return audited.<sup>9</sup> In comparison, the 3,181 non-DIF-selected or DIF-related audited returns closed in FY 2011 generated recommended adjustments of approximately \$283 million, or about \$89,000 per return. Although this analysis may have limitations, it suggests that directing resources to partnerships with two partners reporting a loss in the real estate or construction industries might result in audits that are more productive.

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<sup>8</sup> See, for example, TIGTA, Ref. No. 2011-30-084, *Additional Steps Are Needed to Better Ensure Audits Are Expanded to Prior and/or Subsequent Year Returns When Substantial Taxes May Be Owed*, p. 11 (Sep. 2011) and TIGTA, Ref. No. 2011-30-113, *Steps Can Be Taken to Enhance the Quality of Audits Involving Small Corporate Returns*, p. 10 (Sep. 2011).

<sup>9</sup> This and other calculations in the report are affected by rounding. All initial calculations were performed using the actual numbers rather than the rounded numbers that appear in the report.



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***The SB/SE Division should explore partnership returns with international features***

According to the IRS, the compliance risk associated with international tax transactions involves significant tax revenues and presents tax administration challenges as businesses continue to expand operations across international borders and engage in international transactions. To evaluate and address the compliance risks posed by returns with international features, the IRS relies largely on its staff of international examiners (specialists). Geographically dispersed throughout the country, the estimated 568 specialists are selected from the ranks of experienced IRS examiners and then trained to take on the complexities of the international tax laws. In FY 2011, the specialists spent over 235,000 hours on audits and recommended that business entities pay almost \$2.1 billion in additional taxes. This indicates that for each hour a specialist spent auditing a business entity, they generated about \$8,800 in recommended additional taxes.

Considering the large amount of adjustments generated by specialists, it is not surprising that IRS procedures require their involvement for returns containing certain international features, both in selecting returns for audit and after initiating an audit. To make requests for assistance faster and less cumbersome, in 2002, the IRS replaced a paper process with the Specialist Referral System, which allows examiners to request a specialist's assistance online. The Specialist Referral System also provides management with a tool for monitoring the timeliness of service requests.

To assess the SB/SE Division's audit coverage of partnership returns with international features,<sup>10</sup> we analyzed BRTF and AIMS data for Processing Years 2007 through 2011 and matched the data to closed AIMS data for FYs 2009 through 2011. We found that of the 16,192,563 partnership returns reporting less than \$10 million in assets filed during this period, 32,090 returns contained international features. The SB/SE Division audited only 10 of those partnership returns \*\*\*\*\* ] \*\*\*\*\*.

There are various limitations to the above analysis and the previous analysis involving BRTF and AIMS data. Therefore, we do not expect the IRS to change how it selects partnership returns based on our limited analysis. For example, we did not evaluate the closed audit files to determine why the returns were selected for audit or the basis for the recommended adjustments to the returns. In addition, we did not attempt to assess the tax impact at the partner level from the adjustments. Without assessing the tax impact at the partner level, the productivity from the audits might be higher because significant adjustments might have been made to the partners' individual returns even though the audit of the partnership returns might have resulted in a no-change.

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<sup>10</sup> Due to data limitation, the analysis is limited to partnership returns filed with the SB/SE Division that included Form 8858, *Information Return of U.S. Persons With Respect to Foreign Disregarded Entities*; Form 8865, *Return of U.S. Persons With Respect to Certain Foreign Partnerships*; or reporting foreign taxes greater than \$25,000.



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## ***Despite Some Favorable Partnership Audit Trends, the Number of No-Change Audits Is a Concern***

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However, our analysis shows how the IRS could use data files to identify productive returns for audit and could prove useful to SB/SE Division researchers who are responsible for providing information, guidance, and advice on methodologies and strategies for optimizing available resources to address areas of noncompliance. With skills in such specialized areas as statistics, operations research, economics, and computers, SB/SE Division researchers are uniquely qualified to suggest alternative audit selection methods and explore details that we did not, such as assessing the revenue impact from partnership audits by determining the taxes assessed or refunded at the partner level.

### ***Recommendation***

**Recommendation 1:** As resources become available, the Director, Research, SB/SE Division, should analyze partnership data files to help identify additional productive returns for audit, including those returns with international features.

**Management's Response:** IRS management agreed with this recommendation. The Director, Research, SB/SE Division, plans to work in collaboration with the SB/SE Division's Examination function to analyze partnership data files in order to better identify productive partnership returns for audit, including those returns with international features. As part of the return analysis, the SB/SE Division's Research function will consult with the Large Business and International Division and other Headquarters Research units.



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### **Appendix I**

#### ***Detailed Objective, Scope, and Methodology***

The overall objective was to determine whether SB/SE Division examiners are conducting audits of partnership tax returns in accordance with IRS policy and procedures. To accomplish this objective, we:

- I. Evaluated the adequacy of controls for ensuring that partnership audits in the SB/SE Division are conducted in accordance with IRS policy and procedures. This included documenting the applicable Internal Revenue Code sections, Treasury Regulations, Internal Revenue Manual (policy and procedural) sections,<sup>1</sup> examiner training materials, and IRS public announcements.
- II. Determined how closely examiners are following IRS procedures and guidelines during partnership audits.
  - A. Obtained FY 2007 through FY 2009 closed AIMS<sup>2</sup> data for Form 1065, *U.S. Return of Partnership Income*, partnership cases worked by SB/SE Division examiners. We conducted the following analyses:
    1. Analyzed the number of audit closures by asset class.
    2. Analyzed the overall no-change rate to determine which types of cases contributed the highest no-change rate to the overall percentage.
    3. Analyzed the adjustment amounts.
    4. Randomly selected 20 closed accounts from the AIMS data for validation against the Integrated Data Retrieval System. We found no discrepancies and determined the data were reliable for report purposes.
  - B. Selected a judgmental sample<sup>3</sup> of 60 closed FY 2009 partnership audits for evaluation. We determined whether examiners followed proper procedures during these audits, to include:

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<sup>1</sup> For example, the policy statements for the examining process are contained in Internal Revenue Manual 1.2.13 (Aug. 31, 2007), and many of the procedures for examining returns are contained in Internal Revenue Manual 4.10.1 (Jul. 13, 2001).

<sup>2</sup> See Appendix IV for a glossary of terms.

<sup>3</sup> A judgmental sample is a nonstatistical sample, the results of which cannot be used to project to the population. Judgmental samples were used in all instances because we did not intend to project the results of the samples to the entire population.



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1. Conducting required filing checks.
  2. Adequately addressing any issues identified by classifiers.
  3. Identifying and addressing any other significant issues on the face of the partnership tax return.
- III. Analyzed FY 2011 closed AIMS data for DIF-selected cases with above-average adjustments and matched them to the BRTF to obtain their return characteristics. We computed the recommended and average adjustments. We also computed the recommended and average adjustments for non-DIF-selected cases.
- IV. Evaluated SB/SE Division and Large Business and International Division partnership returns with international features.
- A. Obtained data from the BRTF for Processing Years 2007 through 2011 for returns filed with Form 8858 or Form 8865,<sup>4</sup> or reporting foreign taxes greater than \$25,000, and matched that data to the closed AIMS data for FYs 2009 to 2011.
  - B. Determined whether the SB/SE Division refers partnership audits with international features to Large Business and International Division specialists for assistance.
  - C. Randomly selected 10 accounts from the BRTF data for validation against the Integrated Data Retrieval System. We found no discrepancies and determined the data were reliable for report purposes.

**Internal controls methodology**

Internal controls relate to management's plans, methods, and procedures used to meet their mission, goals, and objectives. Internal controls include the processes and procedures for planning, organizing, directing, and controlling program operations. They include the systems for measuring, reporting, and monitoring program performance. We determined the following internal controls were relevant to our audit objective: IRS policies, procedures, and practices for examining partnership returns. We evaluated these controls by reviewing source materials, interviewing management, reviewing examination case files, and researching taxpayer accounts.

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<sup>4</sup> Form 8858, *Information Return of U.S. Persons With Respect to Foreign Disregarded Entities*, and Form 8865, *Return of U.S. Persons With Respect to Certain Foreign Partnerships*.



***Despite Some Favorable Partnership Audit Trends,  
the Number of No-Change Audits Is a Concern***

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**Appendix II**

***Major Contributors to This Report***

Margaret E. Begg, Assistant Inspector General for Audit (Compliance and Enforcement Operations)  
Frank Dunleavy, Director  
Robert Jenness, Audit Manager  
Aaron Foote, Acting Audit Manager  
William Tran, Lead Auditor  
Kristi Larson, Senior Auditor  
Stanley Pinkston, Senior Auditor



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***Despite Some Favorable Partnership Audit Trends,  
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**Appendix III**

***Report Distribution List***

Commissioner C  
Office of the Commissioner – Attn: Chief of Staff C  
Deputy Commissioner for Services and Enforcement SE  
Commissioner, Large Business and International Division SE:LB  
Deputy Commissioner, Large Business and International Division SE:LB  
Deputy Commissioner, Small Business/Self-Employed Division SE:S  
Director, Communications, Liaison and Disclosure, Small Business/Self-Employed Division  
SE:S:CLD  
Director, Examination, Small Business/Self-Employed Division SE:S:E  
Director, Exam Planning and Delivery, Small Business/Self-Employed Division SE:S:E:EPD  
Director, Exam Policy, Small Business/Self-Employed Division SE:S:E:EP  
Chief Counsel CC  
National Taxpayer Advocate TA  
Director, Office of Legislative Affairs CL:LA  
Director, Office of Program Evaluation and Risk Analysis RAS:O  
Office of Internal Control OS:CFO:CPIC:IC  
Audit Liaisons: Commissioner, Small Business/Self-Employed Division SE:S  
Commissioner, Large Business and International Division SE:LB



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***Despite Some Favorable Partnership Audit Trends,  
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**Appendix IV**

***Glossary of Terms***

**Asset Class** – A method used by the IRS to classify business returns for examination purposes based on the amount of assets held by the taxpaying entity.

**Audit Information Management System** – A computer system used by the SB/SE Division and others to control returns, input assessments/adjustments to the Master File, and provide management reports.

**Business Return Transaction File** – A computer file of the transcribed line items on all business returns and their accompanying schedules or forms.

**Discriminant Index Function** – Mathematical formulas used by the IRS to calculate and assign a score for all partnership and other types of returns based on their examination potential.

**Fiscal Year** – A 12-consecutive-month period ending on the last day of any month, except December. The Federal Government’s fiscal year begins on October 1 and ends on September 30.

**Integrated Data Retrieval System** – An IRS computer system capable of retrieving or updating stored information; it works in conjunction with a taxpayer’s account records.

**IRS Data Book** – Provides information on returns filed and taxes collected, enforcement, taxpayer assistance, the IRS budget and workforce, and other selected activities.

**Master File** – The IRS database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations accounts.

**Processing Year** – The year in which the IRS processes tax returns and other tax data.

**Tax Matters Partner** – The designated general partner who serves as a liaison with the IRS.



***Despite Some Favorable Partnership Audit Trends,  
the Number of No-Change Audits Is a Concern***

Appendix V

***Management's Response to the Draft Report***



COMMISSIONER  
SMALL BUSINESS/SELF-EMPLOYED DIVISION

DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

MAY 21 2012



MEMORANDUM FOR MICHAEL R. PHILLIPS  
DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Faris R. Fink *Faris R. Fink*  
Commissioner, Small Business/Self-Employed Division

SUBJECT: Draft Audit Report – Despite Some Favorable  
Partnership Audit Trends, the Number of No-  
Change Audits Is a Concern (Audit # 201030027)

Thank you for the opportunity to review your draft report titled: "Despite Some Favorable Partnership Audit Trends, the Number of No-Change Audits Is a Concern." Partnership filings continue to grow and it is important to select returns with the greatest audit potential. We appreciate your acknowledgement of the improvements we have made to increase audit coverage of partnership returns and in areas posing the highest compliance risk. We also appreciate your acknowledging the improvements we have made to work processes which have reduced the time our examiners spend on audits. Taxpayer feedback identified this as an area of significant interest.

Reducing the number of no-change audits will minimize taxpayer burden and enhance overall compliance. With this goal, we agree to initiate research of partnership return data to help identify more productive returns for audit, including returns with international features.

Attached is a detailed response outlining our corrective actions.

If you have any questions, please contact me, or a member of your staff may contact, Shenita Hicks, Director, Examination, Small Business/Self-Employed Division at 859-669-5526.

Attachment



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***Despite Some Favorable Partnership Audit Trends,  
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Attachment

**RECOMMENDATION 1:**

As resources become available, the Director, Research, SB/SE Division should analyze partnership data files to help identify additional productive returns for audit, including those returns with international features.

**CORRECTIVE ACTION:**

The Director, SB/SE Research, will work in collaboration with SB/SE Examination to analyze partnership data files in order to better identify productive partnership returns for audit, including those returns with international features. As part of the return analysis, SB/SE Research will consult with LB&I and other Headquarters Research Units.

**IMPLEMENTATION DATE:**

November 15, 2014

**RESPONSIBLE OFFICIAL(S):**

Director, SB/SE Research

**CORRECTIVE ACTION MONITORING PLAN:**

The IRS will monitor this corrective action as part of our internal management system of control.