

# ***IRS Hot Topics***

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## *IRS emphasis on partnership audits - What you need to know*

Information published by the IRS shows a major change in the types of tax returns companies are filing due to changes in their business structures. Many companies are now choosing to operate with flow-through entities, including S Corporations and limited-liability companies, instead of corporate form. In 2009, partnerships and Subchapter S corporations represented 175,316 of all tax returns filed within the jurisdiction of Large Business and International (LB&I), compared to 80,643 Forms 1120 and 1120F filed. Thus, partnerships represent 68% of all the tax returns in LB&I inventory of available work. This trend of filing flow-through returns is expected to continue to increase over the next five years, and we estimate the percentage of such returns will approach 75% of LB&I inventory by 2014.

As a result of the major shift in the types of returns companies are filing, the IRS has been establishing flow-through examination groups throughout the United States. Consequently, many more partnerships are being examined. In addition, the IRS is increasing its staff to conduct examinations of high wealth individuals. As part of the high wealth audits, the IRS will be taking an "enterprise approach" to these examinations; they will look at all entities owned or controlled by an individual. Many of these entities operate in the form of partnerships, which will increase the number of partnership examinations as well.

### ***Background***

A partnership examination is classified by the IRS as either TEFRA or non-TEFRA. If the partnership



meets the criteria to be classified as TEFRA, then certain procedures must be followed during the examination. In general, a TEFRA partnership is any partnership that has more than 10 partners or has any partner that is a flow-through entity itself (including a partnership, S Corporation, or disregarded entity). Every TEFRA partnership must designate a tax matters partner to be the main contact point between the IRS, the partnership and the partners. Once a TEFRA partnership is selected by the IRS for examination, the IRS agent will be working primarily with the tax matters partner. It may be the responsibility of the tax matters partner to notify certain partners of the administrative proceedings concerning the tax examination.

### *How to keep the partners informed*

Once the IRS decides to review a TEFRA partnership return, a Notice of Beginning of Administrative Proceedings (NBAP) letter will be mailed to the partnership and to the tax matters partner. Within 45 days of issuing the NBAP letter to the tax matters partner, the IRS will decide whether to commence a full examination of the partnership return. If it decides to examine the partnership return, the IRS will send a NBAP to all "notice partners" as well as any five-percent notice group representatives (as those terms are defined in the TEFRA rules). The tax matters partner must concurrently forward the NBAP to all non-notice partners. Direct partners who are so notified, and are themselves flow-through entities, must notify their partners, and so forth, so all persons who might be affected by the result of

the partnership examination are notified.

In this way, all direct and indirect partners will learn about the examination. Every partner is issued a NBAP letter from either the IRS Service Center, from the tax matters partner, or from a flow-through partner. However, depending on the partnership's relations with its members, it may be preferable for all partners to learn of the partnership examination from the tax matters partner before receiving notice from the IRS.

### *PwC Observations*

Historically, the IRS has always preferred conducting examinations of corporate tax returns over partnership returns for several reasons, including the fact that TEFRA procedures are complicated and time-consuming. Regardless of preference, however, business trends are now such that more partnerships will be examined. Therefore, businesses need to be familiar with basic TEFRA rules. Even routine things associated with corporate examinations are very different for TEFRA partnerships than for corporations. These include who can sign tax returns, how powers of attorney and extensions are prepared and signed, what the tax director's responsibilities are to keep the investors/partners informed of the examination, and many other issues.

Further, nearly all IRS internal processing of TEFRA examinations and their results occurs at the Ogden Service Center. It has come to our attention that the partnership clerical units there are considerably understaffed. In some situations, the IRS has taken more than a year to process and send notices to investors

based on the results of the partnership return examination. The administrative process is also even more complicated if the audit is not agreed to and the case is sent to Appeals, where the process could take several more years to resolve.

Businesses need to be aware of the IRS' increasing focus on examinations of Form 1065 and must also be familiar with the responsibilities and

practices relevant to tax matters partners. Further, they need to understand how partnership processing differs from other income tax examinations and when it might be advisable to take action to stop any potential interest that the service center may not yet have assessed to the individual returns.

The PwC Tax Controversy and Dispute Resolution team has members in offices around the country who understand the partnership rules and procedural issues and can advise businesses appropriately.

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