IRS Audits of Partnerships – are they likely to increase in frequency?

Partnerships have long been the entity of choice in the commercial real estate arena, with about ½ of all partnership returns filed in 2012 as real estate or rental related. Of course, partnerships have increased in popularity significantly largely due to the widespread acceptance of LLCs (the number of LLC filings has increased from 2003 through 2012 by 150%, with LLC filings representing 65% of the total filings in 2012, while limited partnership and general partnership filings have stayed generally flat). Largely partnership filings have increased (along with S corporation filings) at the expense of "regular" C corporation filings.

Despite the growth in this area and my specialization in it as a tax professional, I have experienced few, if any, IRS audits of partnerships attributable to my clients. To be sure, I have worked on a number of audits of partnerships, but as an expert to deal with a sticky technical issue that is real estate or partnership specific. Even in those cases, the incidence of a significant change that resulted from the audit was low, with the audit typically ending with a "no change" letter. I did not know whether to attribute this to luck or skill, but I certainly did not observe the same experience with individual or corporate clients.

Recent studies by an alphabet soup of different government agencies has shed light on the issue. As it turns out, not only are partnerships in general audited at a much lower rate than other business entities, but when they are audited they result in an adjustment at much lower rates as well. In fact, the IRS currently audits C corporations at over three times the rate of partnerships. Therefore you are much less likely to be audited if operating as a partnership and, even if you are audited, it is much less likely that a change will result.

It requires some guess work to answer why this is the case, but suffice it to say that partnership audits are messy and difficult to administer relative to the audit of a taxpaying entity. Originally, auditing a partnership meant the IRS had to deal with all the partners as well. That was (mostly) changed years ago, but the administration is still a pain and it is clear the IRS struggles with the process --- sometimes (it is rumored) deciding just to bail and issue a no change letter rather than deal with all the administrative trouble to comply with the rules. The audit of the partnership itself is not the issue, but rather the requirement to then assess and collect from all the partners, particularly given the common use of tiered partnership arrangements.

So before you conclude that you will simply move all your business filings to the partnership format, note that all of the aforementioned studies were intended to not only verify the problem, but also to offer a solution to get the IRS to "right size" their audit work in the partnership area. More to it than this, but it seems the Obama administration, members of Congress and the government agencies all think a big part of the solution is to allow the IRS to bill the partnership directly for any audit changes, allowing them to sidestep having to deal with all the partners. That "solution" presents many practical issues, but it does seem to be the direction they are headed and is intended to be effective beginning in 2017.

The result of all this could be that the incidence of and the bill for IRS audits of partnerships may begin to rise dramatically beginning on or around the 2017 tax year. Of course, if this can't be handled as an administrative rule change (legislation is required), it could be delayed. Further, the IRS continues to plead poverty and claims it just can't afford to implement anything new. However, I think we should all expect in a relatively near term time frame that audits of partnerships will rise and that more adjustments will result, relative to past history.

The information in this newsletter was gleaned from a number of sources. If you have a particular question, or would like a citation to the source, please contact Zane Dennis at zane@richeymay.com or 303-721-6131.