TREASURY INSPECTOR GENERAL FOR TAX ADMINISTRATION

Examinations of Partnerships Often Do Not Follow All Procedures Required by the Tax Equity and Fiscal Responsibility Act of 1982

July 31, 2006

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TREASURY INSPECTOR GENERAL
FOR TAX ADMINISTRATION

DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

July 31, 2006

MEMORANDUM FOR COMMISSIONER, LARGE AND MID-SIZE BUSINESS DIVISION
COMMISSIONER, SMALL BUSINESS/SELF-EMPLOYED DIVISION

Michael R. Phillips

FROM: Michael R. Phillips
Deputy Inspector General for Audit

SUBJECT: Final Audit Report – Examinations of Partnerships Often Do Not Follow All Procedures Required by the Tax Equity and Fiscal Responsibility Act of 1982 (Audit # 200530021)

This report presents the results of our review of the Internal Revenue Service's (IRS) examination of partnerships that require the use of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA)[1] procedures. The overall objective of this review was to determine whether examinations initiated under the TEFRA were conducted in accordance with statutory and administrative procedures. In general, the term TEFRA is used to describe a set of rules (both statutory and administrative) that affect how the IRS conducts examinations of tax returns from partnerships and certain other entities. There are important reasons for the IRS to ensure these rules are followed during examinations. Most importantly, perhaps, is that procedural errors can affect the validity of assessments, infringe on taxpayer rights, and result in improper disclosures of tax information.

Synopsis

Prior to enactment of the TEFRA, partnership examinations were in many ways examinations of the individual partners. Each partner's return was examined separately, and the determination and treatment of partnership items for one partner was not binding on any other partner. For those 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 requires that (1) every partnership have a tax matters partner who serves as a liaison with the IRS, (2) tax adjustments to

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[1] Pub. L. No. 97-248, Title IV, Section 402(a), 96 Stat. 648.

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.

Despite IRS controls and emphasis on case file documentation, additional steps must be taken to ensure procedures are properly followed when partnership examinations are initiated. We evaluated case files from 60 partnership return examinations closed between October 1, 2003, and June 30, 2005, by examiners located in IRS offices from across the country. One or more required procedures were not followed in 55 percent (33 out of 60) of these examinations. For example, in two cases, examiners should have used TEFRA statutory and administrative procedures to initiate and conduct the examinations, but information in case files indicated non-TEFRA procedures were used. Consequently, the case files did not contain any documentation showing the partnerships and their partners received the notices they were entitled to under the Internal Revenue Code, and, had there been any assessments, such assessments may not have been valid.[2] We also identified other problems, including issuance of a Notice of Beginning of Administrative Proceeding (Letter 1787) well after examinations had started and partnership records had been examined.[3]

A combination of factors contributed to the concerns identified in our case reviews. First, examiners need to take better advantage of IRS resources when conducting partnership examinations. We used four IRS job aids to review the cases in our sample. While the Internal Revenue Manual[4] does not specifically require examiners to use the job aids, the aids are readily accessible for examiners online through the IRS Intranet. We saw limited documentation in case files that these resources were used, even though they can provide a reliable and consistent method for directing and guiding examiners through all phases of the partnership examination process.

Second, quality controls could be strengthened. IRS guidelines require both the Small Business/Self-Employed (SB/SE) Division[5] and Large and Mid-Size Business (LMSB) Division[6] to review a sufficient sample of closed examinations through their respective quality measurement systems. Although the LMSB Division quality measurement system evaluates how well examiners follow TEFRA procedures, the SB/SE Division quality measurement system does not include such evaluations. Consequently, management may not be aware of the procedural problems.

[2] In both instances, the examinations resulted in no change to the partnership and the partners' tax liabilities.
[3] A Letter 1787 is required to be issued under the Internal Revenue Code and serves as the official notification from the IRS that it is beginning a TEFRA examination.
[4] This is an official compilation of procedures, instructions, and guidelines that govern the operational features of the IRS; it includes guidance that examiners are to use in conducting both TEFRA and non-TEFRA examinations.
[5] The taxpayers served by the SB/SE Division include small businesses and self-employed individuals.
[6] The taxpayers served by the LMSB Division include corporations and partnerships with assets of more than $10 million.

Third, examiners and managers should be held accountable for following TEFRA procedures. Prior to our review, the LMSB Division recognized the need to better hold its examiners and managers accountable for properly documenting work and introduced an Administrative Procedures Standard (APS) to its quality measurement system in March 2003. While the APS does not specifically address TEFRA procedures, it does require examiners and managers to provide documentation that many non-TEFRA statutory and administrative procedures are followed in planning, initiating, conducting, and closing examinations. Documentation supporting that non-TEFRA procedures are followed is captured on the Administrative Procedures Standard Input Document (Form 13327).[7] Modifying the APS to cover TEFRA procedures, and incorporating it in the SB/SE Division quality measurement system, would provide a mechanism for enhancing accountability and increasing assurances that TEFRA procedures are followed in all partnership examinations.

Recommendations

We recommended the Director, Quality Assurance and Performance Management, LMSB Division, modify the APS and related Form 13327 to cover TEFRA examination procedures. We recommended the Commissioners, LMSB and SB/SE Divisions, initiate actions to revise the Internal Revenue Manual so examiners are required to complete, and include in partnership examination case files, appropriate TEFRA job aids. Additionally, the Director, Examination, SB/SE Division, should evaluate how well examiners are complying with TEFRA examination procedures in reviews conducted under the SB/SE Division quality measurement system and implement a process that will better hold examiners and their managers accountable for following TEFRA procedures.

Response

IRS management agreed with our recommendations and will be taking appropriate corrective actions to better ensure examiners and managers are accountable for following TEFRA procedures. In the LMSB Division, the Form 13327 will be changed to cover TEFRA examination procedures and an interim guidance memorandum will be jointly issued with the SB/SE Division instructing examiners to complete and include an updated TEFRA Procedures Check List in case files. In the SB/SE Division, quality controls will be strengthened by evaluating how well examiners are adhering to TEFRA examination procedures and developing guidelines to assist TEFRA reviewers in conducting their evaluations. Additionally, SB/SE Division management will supplement TEFRA lead sheets used by examiners with a revised

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[7] Form 13327 is required to be completed during the course of every examination, self-certified by examiners and managers that listed procedures were followed, and included in case files so it can be used in subsequent managerial reviews. Form 13327 is reproduced, in part, in Appendix IV.

TEFRA Procedures Check List that will require managers and examiners to provide documentation showing TEFRA procedures were followed. Management's complete response to the draft report is included as Appendix V.

Copies of this report are also being sent to IRS managers affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Daniel R. Devlin, Assistant Inspector General for Audit (Small Business and Corporate Programs), at (202) 622-8500.

Table of Contents

Background

Partnerships are associations of two or more persons or entities, such as corporations or other partnerships, that join together 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 file a U.S. Return of Partnership Income (Form 1065) annually, no taxes are generally 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 partnership income, losses, credits, and other tax items are generally distributed untaxed to the respective partners, partnerships are commonly referred to as flowthrough entities.

From a practical standpoint, partnerships have long provided a very popular way to shelter income from taxation because they have minimum 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 partners. Moreover, changes in the legal and regulatory environment in the 1990s contributed to making partnerships one of the fastest growing segments of all tax return filers. Specifically, these changes included the creation of Limited Liability Companies[1] and the issuance of so-called Check-the-Box Regulations[2] 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 devoted to partnerships, although the Large and Mid-Size Business (LMSB) Division[3] serves partnerships reporting more than $10 million in assets.

Because partnership losses can offset income sources of 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)[4] by Congress was intended, in part, to close these loopholes by including in the Internal Revenue Code (I.R.C.) statutory procedures that affected how the IRS conducts examinations of partnerships and certain other entities that meet the criteria under the TEFRA. To guide and assist its examiners and other personnel in complying with the TEFRA statutory procedures, the

[1] 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.
[2] United States Treasury Regulations allow most unincorporated businesses to elect, by checking a box, whether they will be taxed as a corporation or a flowthrough entity, such as a partnership, for Federal income tax purposes.
[3] The taxpayers served by the SB/SE Division include small businesses and self-employed individuals, while taxpayers served by the LMSB Division include corporations and partnerships with assets of more than $10 million.
[4] Pub. L. No. 97-248, Title IV, Section 402(a), 96 Stat. 648.

IRS developed a set of administrative procedures that are reflected in the Internal Revenue Manual (IRM).[5]

Prior to enactment of the TEFRA, partnership examinations were in many ways examinations of the individual partners. Each partner's return was examined separately, and the determination and treatment of partnership items for one partner was not binding on any other partner. Additionally, the statute of limitations for assessment of taxes was tied to the individual partners' returns; so, for the IRS to extend the statute of limitations to facilitate completing the examination of a partnership return, each partner had to sign a consent form. This process resulted in logistical problems for the IRS and created significant burdens on examiners and the private sector, especially if the partnership had numerous partners who were geographically dispersed across the country and filed returns at different IRS processing centers.

For those 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 have a tax matters partner (TMP) who serves 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. Although some TEFRA statutory and administrative procedures have been modified over the years,[6] current TEFRA procedures generally 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.

This review was performed in the IRS LMSB and SB/SE Divisions, which are respectively headquartered in Washington, D.C., and New Carrollton, Maryland, during the period September 2005 through March 2006. The audit was conducted in accordance with *Government Auditing Standards*. 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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[5] The IRM is an official compilation of procedures, instructions, and guidelines that govern the operational features of the IRS; it includes guidance that examiners are to use in conducting both TEFRA and non-TEFRA examinations.

[6] For example, Congress enacted legislation in 1996 that eliminated the need to treat S corporations as TEFRA entities for tax periods ending after December 31, 1996. An S corporation, also known as a Subchapter S corporation, is a popular form of business entity for a small business that provides limited liability for its shareholders and partnership-like taxation.

Results of Review

Examiners Have a Critical Role in Initiating Examinations in Accordance With Administrative and Statutory Procedures

Many of the administrative and statutory procedures required to initiate a TEFRA examination are the same as those required to initiate a non-TEFRA examination. In both types of examinations, IRS examiners review tax return information to identify questionable items and indications of unreported income. If questionable items are identified or there are indications of unreported income, the examiner will schedule an appointment with the taxpayer, or his or her designated representative, and request information needed to resolve the questionable items. In addition to these administrative procedures, examiners are required by the I.R.C. to inform taxpayers of their rights at the start of the examination. The statutory procedures under the I.R.C. state, among other things, that taxpayers have the rights to know why the IRS is asking for information about their tax returns and to authorize another person, such as an accountant or attorney, to work with the examiner during the examination.

The initiation process for TEFRA examinations requires examiners to complete additional steps to comply with administrative and statutory procedures

Although there are similarities in the processes used to initiate TEFRA and non-TEFRA examinations, there are steps required to initiate TEFRA examinations that are not required for non-TEFRA examinations. These steps include:

- Determining for each tax year that will be examined whether the partnership is in fact subject to the TEFRA. This step is required because a partnership can be subject to the TEFRA in 1 tax year and not in another. This determination can involve multiple steps and is emphasized in IRS procedures as being critically important for ensuring additional tax assessments, if any, resulting from an examination are valid under the tax law.

- Identifying a qualified TMP. This step can involve considering as many as 65 separate items. As the designated representative of the TEFRA partnership, the TMP performs several important duties that may include entering into formal agreements with the IRS, which will bind all partners in the partnership to additional tax assessments resulting from the examination. Consequently, if a TMP is not properly identified, agreements entered into on behalf of the partnership may not be valid under the tax law. Just as many taxpayers whose tax returns are selected for examination execute a Power of

Attorney[7] and Declaration of Representative (Form 2848) to have an accountant or attorney work with the IRS examiner through the examination process, a TMP may similarly take advantage of this right extended under the tax law. Although the same Form is used to designate a power of attorney in all examinations, IRS procedures require examiners to add special statements to the Form 2848 when it involves a TEFRA partnership.

- Providing the partnership with official notification by mail that the IRS is beginning a TEFRA examination. To meet this statutory requirement, the IRS instructs its examiners to both hand-deliver and forward by certified mail a Notice of Beginning of Administrative Proceeding (Letter 1787) to the TMP. The Letter 1787 is required to be issued under the I.R.C. and serves as the official notification from the IRS that it is beginning a TEFRA examination. In addition, examiners are instructed by IRS procedures to complete control documents needed for establishing the TEFRA partnership examination on the IRS Partnership Control System 60 calendar days after issuing the Letter 1787 to the TMP. The IRS uses the Partnership Control System to, among other things, generate and issue TEFRA notices, such as the Letter 1787, to other partners.

These three different processes make initiating a TEFRA examination more detailed and can place greater burden on examiners because they require completion of additional administrative and statutory procedures.

Management controls have been developed to help examiners properly initiate partnership examinations

Ultimately, the IRS relies on its examiners to ensure partnership examinations are properly initiated. To assist examiners in meeting this responsibility, the IRS has developed a system of controls that are in line with the Government Accountability Office *Standards for Internal Control in the Federal Government.*[8] At the top of the agency, broad policy statements provide guidance nationwide to IRS personnel that are involved in IRS programs and activities. Of the 189 IRS Policy Statements, 34 cover examination issues, such as taxpayer rights and examiner responsibilities.

At the divisional level, the quality measurement staff in the LMSB Division review samples of examination cases to assess the degree to which LMSB Division examiners complied with TEFRA procedures when initiating partnership examinations. In addition to reviews by the LMSB Division quality measurement staff, mid-level managers in both the LMSB and SB/SE Divisions may evaluate ongoing work in open TEFRA examinations during their operational

[7] A power of attorney is a legal instrument that gives legal authority to another person (called an agent or attorney-in-fact) to make property, financial, and other legal decisions for the principal.
[8] GAO/AIMD-00-21.3.1, dated November 1999.

reviews. Operational reviews are required to be performed at least annually to ensure work is being done in conformance with procedures. These processes serve as a quality control by identifying managerial, technical, and procedural problems and providing a basis for corrective actions.

First-line managers are an important control component because they are responsible for the quality of work performed by the examiners they supervise. They use a variety of techniques to ensure examiners' work is meeting acceptable standards and procedures are followed in planning, initiating, and conducting TEFRA examinations. These techniques, as we have previously reported,[9] include observations and discussions with examiners and reviews of work during examinations and after they are closed. Through these observations, discussions, and reviews, first-line managers attempt to identify problems so examiners can take prompt corrective actions.

The IRM is another important control component because it contains the official compilation of detailed instructions and explanations of the statutory and administrative procedures for examiners to follow in conducting both TEFRA and non-TEFRA examinations. Throughout the IRM, examiners are instructed to properly document in examination case files all aspects of their work during the planning, initiating, conducting, and closing phases of examinations. This documentation is important because it provides the principal evidence that procedures were followed, as well as the foundation for other control processes such as managerial reviews and the quality measurement systems. The importance of examiner documentation is further emphasized in management directives, examiner training materials, and the quality measurement standards.

Additional Steps Are Needed to Ensure Statutory and Administrative Procedures Are Followed When Partnership Examinations Are Initiated

Despite the IRS' controls and its emphasis on case file documentation, additional steps must be taken to ensure procedures are properly followed when partnership examinations are initiated. We evaluated case files from 60 partnership return examinations closed between October 1, 2003, and June 30, 2005, by examiners located in IRS offices from across the country and found that 1 or more required procedures were not followed in 55 percent (33 out of 60) of these examinations. There are important reasons for the IRS to ensure procedural errors such as the ones we identified are avoided in the future. Most importantly, perhaps, is that procedural errors can affect the validity of assessments, result in improper disclosures of tax information, and infringe on taxpayers' rights. Although we did not use statistically valid sampling

[9] *Consistent and Effective Manager Involvement Is Needed in Examinations of Large Businesses* (Reference Number 2004-30-054, dated February 2004).

techniques, we believe our results indicate a concern nationwide because the examinations were conducted from geographically dispersed IRS offices. Moreover, the IRS officials who evaluated our case reviews agreed with the problems identified.

We found, for example, two cases for which examiners should have used TEFRA statutory and administrative procedures to initiate and conduct the examinations, but the information in the case files indicated non-TEFRA examination procedures were used. Consequently, there was no documentation in the case files that the partnerships and their partners received the notices they were entitled to under the tax law, and, had there been any assessments, such assessments may not have been valid. In both instances, the examinations resulted in no change to the partnership and the partners' tax liabilities. In another 25 cases, the Form 2848 did not contain required information that allows examiners to disclose tax return information to individuals or organizations designated by the partnership. The IRM instructs examiners that it is imperative to complete the Form 2848 correctly or risk making improper disclosures of tax information. As summarized in Figure 1, we also identified other problems in our case reviews, including issuance of the Letter 1787 well after examinations had started and partnership records had been examined.

Figure 1: Description of Problems in 60 Partnership Examinations Reviewed and the Potential Risk to the IRS

Problem Description	Potential Risks	Number of Cases (✓)
1. Minimum tests were not documented to determine if non-TEFRA statutory and administrative procedures should be used to examine the partnership.	➢ Invalid tax assessments ➢ Taxpayer rights violation	**33**
2. Necessary checks were not documented in case files to ensure the TMP was qualified to represent the partnership for tax matters arising from the examination.	➢ Invalid tax assessments ➢ Barred assessment statutes ➢ Improper disclosure of tax information	**23**
3. Form 2848 did not contain required information that allows disclosure of tax return information to designated individuals or organizations.	➢ Barred assessment statutes ➢ Improper disclosure of tax information	**25**
4. Letters 1787 were not correctly issued. Case files did not contain evidence that notices were mailed to the TMP, and some were issued after partnership records were examined.	➢ Invalid tax assessments ➢ Taxpayer rights violation	**31**

(✓) The total number of cases will add to more than 60 because some cases contained multiple problems.
Source: Analysis of 60 closed partnership return examinations.

The *Standards for Internal Control in the Federal Government* specify that control activities are the policies, procedures, techniques, and mechanisms that enforce management's directives. In short, controls ensure actions are taken to minimize risks. We applied these standards in evaluating the problems in the partnership examinations and determined a combination of factors contributed to the concerns identified in our case reviews. Steps can be taken at both the examiner and quality control levels to provide better assurance that required procedures are followed, thereby minimizing the risks outlined in Figure 1.

Examiners need to take better advantage of IRS resources when conducting partnership examinations

As previously discussed, many of the examination case files we reviewed were not documented to show that statutory and administrative procedures were properly followed when the examinations were initiated. Although managers were involved in 92 percent of the cases we reviewed, their involvement was not effective in identifying and correcting inadequately documented files or cases for which required procedures were not followed.

We used the 4 IRS job aids outlined in Figure 2 to review the 60 cases in our sample. While the IRM does not specifically require that examiners use the job aids, the aids are readily accessible to examiners online through the IRS Intranet. We saw limited documentation in case files that these resources were used by either examiners or their managers.

Figure 2: IRS Job Aids for Initiating Partnership Examinations in Accordance With Statutory and Administrative Procedures
1. ***TEFRA Partnership Criteria Checklist and Flowchart.*** The list and chart solicit answers from examiners to questions that, if followed, will correctly determine whether the partnership examination should be conducted under TEFRA or non-TEFRA statutory procedures.
2. ***TMP Checklist.*** The seven-page checklist is designed to be completed concurrently with interviewing the identified TMP for each tax year under examination. The checklist can be a valuable tool for ensuring specific requirements of the statute are met with respect to the TMP's designation and qualifications.
3. ***TEFRA Procedures Checklist and Flowchart.*** The list and chart provide a summary of the sequential steps to complete in properly initiating a TEFRA examination. They also provide important references to applicable sections of the IRM where more detailed instructions can be located.
4. ***TEFRA Form 2848 Instructional Guide.*** The document illustrates how to properly prepare a Form 2848 for completion when working with a TMP in a TEFRA examination. The document additionally cautions examiners that improperly completed Forms 2848 can lead to disclosures issues and barred assessments.

Source: The IRM and the IRS TEFRA Intranet site.

Requiring the use of IRS job aids can provide a reliable and consistent method for directing and guiding examiners and their managers through all phases of the partnership examination process.

At the same time, using these job aids can significantly minimize the risks associated with not following TEFRA statutory and administrative procedures.

Quality controls could be strengthened

IRS guidelines require both the LMSB and SB/SE Divisions to review a sufficient sample of closed examinations through their respective quality measurement systems. From October 1, 2003, through December 31, 2005, the LMSB Division quality measurement staff evaluated whether examiners followed TEFRA procedures in 88 applicable examinations and identified concerns similar to those we identified in our case reviews. However, reviews performed by the SB/SE Division quality measurement staff do not include evaluating how well examiners are adhering to TEFRA procedures, even though the SB/SE Division conducts the majority of partnership examinations for the IRS. Consequently, management may not be aware of the procedural problems in TEFRA examinations.

The errors identified in our case reviews and the reviews conducted by the LMSB Division quality measurement staff raise questions about how well examiners and first-line managers are being held accountable for following required procedures. Prior to our review, the LMSB Division recognized the need to better hold its examiners and managers accountable for properly documenting work and introduced an Administrative Procedures Standard (APS) to its quality measurement system in March 2003. While the APS does not specifically address TEFRA procedures, it does require examiners and managers to provide documentation that the many non-TEFRA statutory and administrative procedures were followed in planning, initiating, conducting, and closing examinations.

Documentation supporting that the non-TEFRA procedures were followed is captured on the Administrative Procedures Standard Input Document (Form 13327), which is evaluated by the LMSB Division quality measurement staff and is reproduced, in part, in Appendix IV. The Form 13327 is required to be completed during the course of every examination, self-certified by examiners and managers that listed procedures were followed, and included in case files so it can be used in subsequent managerial reviews.

Modifying the APS to cover TEFRA procedures and requiring first-line manager involvement in the self-certification process could provide a mechanism for enhancing accountability and better ensuring case files are documented to show TEFRA procedures were followed. At the same time, incorporating the APS in the SB/SE Division quality measurement system could increase assurances that TEFRA procedures are followed in all partnership examinations.

Recommendations

Recommendation 1: The Director, Quality Assurance and Performance Management, LMSB Division, should add TEFRA examination procedures to the LMSB Division APS and related Form 13327.

> **Management's Response:** The IRS agreed with this recommendation. The LMSB Division will revise Form 13327 to cover TEFRA examination procedures by adding the question "Was the TEFRA checksheet included in the case file?" to the Form.

Recommendation 2: The Commissioners, LMSB and SB/SE Divisions, should initiate actions needed to revise the IRM so examiners are required to complete, and include in partnership examination case files, appropriate TEFRA job aids.

> **Management's Response:** The IRS agreed with this recommendation. The SB/SE and LMSB Divisions will issue a joint interim guidance memorandum instructing examiners to complete and include an updated TEFRA Procedures Check List in the partnership examination case files. If necessary, the Divisions will begin the process to revise the IRM procedures to include such procedures.

Recommendation 3: The Director, Examination, SB/SE Division, should incorporate an evaluation of how well examiners are complying with TEFRA examination procedures in reviews conducted under the SB/SE Division quality measurement system.

> **Management's Response:** The IRS agreed with this recommendation. The SB/SE Division will strengthen quality controls by evaluating how well examiners are adhering to TEFRA examination procedures and developing guidelines to assist TEFRA reviewers in conducting their evaluations.

Recommendation 4: The Director, Examination, SB/SE Division, should implement a process, such as required use of the APS and Form 13327, that will better hold examiners and their managers accountable for following TEFRA procedures and that can be monitored through the SB/SE Division quality measurement system.

> **Management's Response:** The IRS agreed with this recommendation. The SB/SE Division will supplement TEFRA lead sheets used by examiners with a revised TEFRA Procedures Check List that will require managers and examiners to provide documentation showing TEFRA procedures were followed. Additionally, evaluations conducted by TEFRA reviewers will be provided to upper-level management.

Appendix I

Detailed Objective, Scope, and Methodology

The overall objective of this review was to determine whether examinations initiated under the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA)[1] were conducted in accordance with statutory and administrative procedures. Except as noted otherwise, we used judgmental sampling techniques due to time and resource constraints. To accomplish the objective, we:

I. Reviewed a significant amount of source material to gain an understanding of the statutory and administrative procedures involved with partnership examinations. These sources included the Internal Revenue Code; the United States Treasury Regulations; court cases; and the Internal Revenue Service (IRS) Internal Revenue Manual, job aids, memoranda, Audit Technique Guides, and training materials.

II. Used the Government Accountability Office *Standards for Internal Control in the Federal Government*[2] to identify and assess the management controls that the IRS established to help examiners meet their responsibility for complying with the statutory and administrative procedures when initiating partnership examinations.

III. Used the IRS Audit Information Management System[3] to select a judgmental sample of 60 partnership return examinations out of the 2,441 partnership return examinations that were closed between October 1, 2003, and June 30, 2005, and determined if the examinations were initiated in accordance with statutory and administrative procedures. In selecting our sample cases, we excluded Coordinated Industry[4] partnership examinations because different techniques are used in these examinations.

IV. Reconciled the judgmental sample of 60 partnership return examinations to the IRS Audit Information Management System and verified that the examinations were in fact closed between October 1, 2003, and June 30, 2005.

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[1] Pub. L. No. 97-248, Title IV, Section 402(a), 96 Stat. 648.
[2] GAO/AIMD-00-21.3.1, dated November 1999.
[3] The Audit Information Management System stores and maintains data on tax return examinations.
[4] A Coordinated Industry examination warrants the application of team examination procedures and techniques.

V. Evaluated documentation from the quality measurement systems of the Large and Mid-Size Division and Small Business/Self-Employed Division to determine if evaluations were made that assessed how well examiners complied with the statutory and administrative procedures when initiating partnership examinations.

VI. Reviewed IRS Data Books, which annually provide information on a broad base of tax administration subjects, to identify trends in partnership return filings.

VII. Reviewed the IRS Table 37, Examination Program Monitoring, reports for Fiscal Years 2003 through 2005 to identify the number of TEFRA examinations of partnerships with 11 more partners that were closed each year.

Appendix II

Major Contributors to This Report

Dan Devlin, Assistant Inspector General for Audit (Small Business and Corporate Programs)
Kyle Andersen, Director
Preston Benoit, Acting Director
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William Tran, Lead Auditor
Stanley Pinkston, Senior Auditor
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Appendix III

Report Distribution List

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Deputy Commissioner for Services and Enforcement SE
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Commissioner, Large and Mid-Size Business Division SE:LM
Commissioner, Small Business/Self-Employed Division SE:S

Appendix IV

Administrative Procedures Standard Input Document

LMSB Quality Measurement System
Administrative Procedures Standard

Case Procedures and Processes *Managers complete Part IA. Examiners complete Part IB and Part II.*

Taxpayer's Name ______ Tax Year(s) ______ Workpaper # SAIN 003

Part IA ***(Manager's Self-Certification)***

1. Were financial conflicts of interest considered and appropriate documents completed in accordance with 5 CFR Part 2635? Yes ☐ No ☐
2. Was approval obtained for personnel involved in more than three cycles, in accordance with P-4-5? Yes ☐ No ☐ N/A ☐

Manager's Signature ______ Date ______

Part IB ***(Examiner's Self-Certification)***

1. Was an advance payment solicited and payment options explained? Yes ☐ No ☐ N/A ☐
2. Were Rules of Engagement discussed? Yes ☐ No ☐ N/A ☐
3. Utilization of Issue Management Strategies:
   A. Were issue management strategies discussed with the taxpayer? Yes ☐ No ☐
   *If **yes**, check which strategy was discussed.*
   - ☐ Pre-Filing Agreements *(PFA)*
   - ☐ Fast Track Settlement (FTS)
   - ☐ Advance Pricing Agreements *(APA)*
   - ☐ Accelerated Issue Resolution *(AIR)*
   - ☐ Early Referral to Appeals
   - ☐ Team Manager Settlement Authority (DO 236/4-25)
   - ☐ Other *(Please specify.)* ______

   B. Were issue management strategies applied to this case? Yes ☐ No ☐ Not Yet Determinable ☐
   *If **yes**, check which strategy was used.*
   - ☐ Pre-Filing Agreements *(PFA)*
   - ☐ Fast Track Settlement (FTS)
   - ☐ Advance Pricing Agreements *(APA)*
   - ☐ Accelerated Issue Resolution *(AIR)*
   - ☐ Early Referral to Appeals
   - ☐ Team Manager Settlement Authority (DO 236/4-25)
   - ☐ Other *(Please specify.)* ______

   *If **no**, check reason.*
   - ☐ Taxpayer declined
   - ☐ Inappropriate issues
   - ☐ Insufficient IRS resources
   - ☐ Negative impact on cycle time or case closure
   - ☐ Other *(Explain.)* ______

4. Planning of the Examination -
   Were you able to plan this examination in a way that reduced the resources, burden and/or time spent by the taxpayer and the IRS? Yes ☐ No ☐
   *If **yes**, how was this accomplished? (Check all that apply.)*
   - ☐ Risk analysis
   - ☐ Materiality assessment
   - ☐ Planning with the taxpayer/taxpayer cooperation
   - ☐ Limited scope/limited issues
   - ☐ LIFE
   - ☐ Compliance checks waived
   - ☐ Other *(Please specify.)* ______

Examiner's Signature ______ Date ______

Visit our Quality Assurance website at http://lmsb.irs.gov/hq/pqa/Quality_Assurance/default.asp to e-mail inquiries and obtain more information.

Form **13327** (Rev. 12-2005) Cat. No. 34849P (Page 1) publish.no.irs.gov Department of the Treasury-**Internal Revenue Service**

Part II ***(Completed by Examiner)***

1.	Were mandatory specialist referrals made during the planning process?	Yes ☐	No ☐	N/A ☐	WP# ______
2.	Was a copy of the final examination plan provided to the taxpayer?	Yes ☐	No ☐	N/A ☐	WP# ______
3.	Was the Taxpayer/Representative provided a copy of Pub. 1, ***Your Rights as a Taxpayer*** and Pub. 5, ***Your Appeal Rights,*** or Pub. 3498, ***The Examination Process***, in accordance with IRM 4.10.1.6.3 and IRM 4.11.55.2.1.1?	Yes ☐	No ☐		WP# ______
4.	Was proper authorization obtained to discuss tax matters?	Yes ☐	No ☐	N/A ☐	WP# ______
5.	Were Third Party contact procedures observed in accordance with RRA '98?	Yes ☐	No ☐	N/A ☐	WP# ______
6.	Was the examiner's name and badge number provided in communications to Taxpayer as required by RRA '98 Section 3705?	Yes ☐	No ☐	N/A ☐	WP# ______
7.	Was an EOAD *(UIL code)* printout for all examined issues included in the case file?	Yes ☐	No ☐	N/A ☐	WP# ______
8.	Was CEMIS accurately and timely updated? **(CIC ONLY)**	Yes ☐	No ☐	N/A ☐	WP# ______
9.	Were Statute of Limitations procedures followed, including types of extensions and timely solicitation? *(e.g. Notification Statement in Part I of Examination Plan per IRM 4.45.12.3 & IRM 4.60.2.1. TEFRA, Succesor in Interest, Transferee, Notification of Rights to Restrict Consent)*	Yes ☐	No ☐	N/A ☐	WP# ______
10.	Was the Taxpayer/Representative provided a copy of Pub. 1976, ***Independent Contractor or Employee?***, in accordance with IRM 4.23.5? **(E/T ONLY)**	Yes ☐	No ☐	N/A ☐	W/P# ______

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Form **13327** (Rev. 12-2005) Cat. No. 34849P (Page 2) publish.no.irs.gov Department of the Treasury-**Internal Revenue Service**

Appendix V

Management's Response to the Draft Report

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

COMMISSIONER
SMALL BUSINESS/SELF-EMPLOYED DIVISION

RECEIVED
JUL 03 2006

July 3, 2006

MEMORANDUM FOR DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Kevin M. Brown
Commissioner, Small Business/Self-Employed Division

SUBJECT: Draft Audit Report – Examinations of Partnerships Often Do Not Follow All Procedures Required by the Tax Equity and Fiscal Responsibility Act of 1982 (Audit 200530021)

We have reviewed your draft report and agree with your audit recommendations. We concur that additional steps can be taken to better ensure examiners and managers are accountable for following Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) procedures.

As noted in your report, the Internal Revenue Service has a number of management controls in place to help examiners comply with statutory and administrative TEFRA procedures. In addition to the control components highlighted in your report, TEFRA cases are subject to mandatory review by the Technical Services staff in the SB/SE Division. Errors and problems identified during the case review process by Technical Services are reflected on a Form 3990, Reviewers Report, and returned to the examiner and manager. This process serves as a quality control by identifying managerial, technical, and procedural problems and provides a basis for corrective actions.

To increase focus, ensure consistency, and enhance the specialized technical expertise of TEFRA reviewers, the SB/SE Division centralized the TEFRA case review process in FY 2006. We created three specialized TEFRA review groups within Technical Services under one Territory Manager. These groups provide specialized technical TEFRA support to examiners and managers. They will also expand their current review responsibilities to include evaluations of how well examiners are adhering to TEFRA procedures. The results from these evaluations will be shared with upper management on a quarterly basis.

The recommendations and corrective actions are included. If you have any questions, please call me at (202) 622-0600 or Steve Burgess, Director, Examination, Small Business/Self-Employed at (202) 283-2220.

Our comments on your recommendations are as follows:

RECOMMENTATION 1
The Director, Performance, Quality, and Audit Assistance, LMSB Division, should add TEFRA examination procedures to the LMSB Division APS and related Form 13327.

CORRECTIVE ACTION
Part II of Form 13327, Administrative Procedures Standard Input Document, will be revised to add the following question regarding TEFRA examination procedures: "Was the TEFRA checksheet included in the case file?"

IMPLEMENTATION DATE
October 1, 2006

RESPONSIBLE OFFICIAL(S)
Director, Performance, Quality, and Audit Assistance, LMSB Division

CORRECTIVE ACTION MONITORING PLAN
The Director, Performance, Quality, and Audit Assistance, LMSB Division will advise the Commissioner, LMSB Division of any delays in implementing this corrective action.

RECOMMENDATION 2
The Commissioners, LMSB and SB/SE Divisions, should initiate actions needed to revise the IRM so examiners are required to complete, and include in partnership examination case files, appropriate TEFRA job aids.

CORRECTIVE ACTION
The SB/SE and LMSB Divisions will issue a joint interim guidance memorandum instructing examiners to complete and include an updated TEFRA Procedures Check List in partnership examination case files. If necessary, we will begin the process necessary to revise the IRM procedures to include such procedures.

IMPLEMENTATION DATE
December 1, 2006

RESPONSIBLE OFFICIAL(S)
Director, Exam Policy SB/SE Division
Director, Technical Services SB/SE Division
Director, Pre-Filing and Technical Guidance, LMSB Division
Director, Performance, Quality, and Audit Assistance, LMSB Division

CORRECTIVE ACTION MONITORING PLAN
The responsible officials above will advise their respective Division Commissioners of any delays in implementing the corrective actions.

RECOMMENDATION 3
The Director, Examination, SB/SE Division, should incorporate an evaluation of how well examiners are complying with TEFRA examination procedures in reviews conducted under the SB/SE Division quality measurement system.

CORRECTIVE ACTION
The SB/SE Division's Examination Quality Measurement System (EQMS), a unit within Technical Services, currently considers the TEFRA procedures in their reviews. If an examiner fails to follow TEFRA procedures or fails to issue a Notice of Beginning of Administrative Proceeding (NBAP), the quality attribute "protection of taxpayer rights" would be marked as failed. If there is an error involving an invalid Form 2848, Power of Attorney and Declaration of Representative or improper designation of the tax matters partner (TMP), the quality attribute "protection of taxpayer confidentiality" would be marked as failed. While the failure of these attributes is included in the reports prepared by EQMS, your report correctly notes that EQMS reports do not specifically evaluate how well examiners follow TEFRA procedures.

To strengthen quality controls, the Director, Technical Services, SB/SE Division will establish procedures to expand the current review responsibilities. The three specialized TEFRA review groups within Technical Services will include an evaluation of how well examiners are adhering to TEFRA examination procedures. Using the TEFRA Procedures Check List, we will develop guidelines to assist the TEFRA reviewers in conducting their reviews.

IMPLEMENTATION DATE
October 1, 2006

RESPONSIBLE OFFICIAL(S)
Director, Technical Services SB/SE Division

CORRECTIVE ACTION MONITORING PLAN
The Director, Technical Services SB/SE will advise the Director, Examination SB/SE if there are any delays in the implementation of this corrective action.

RECOMMENTATION 4
The Director, Examination SB/SE Division, should implement a process, such as required use of the APS and Form 13327 that will better hold examiners and their managers accountable for following TEFRA procedures and that can be monitored through the SB/SE Division quality measurement system.

CORRECTIVE ACTION
We will supplement TEFRA lead sheets used by SB/SE examiners with a revised TEFRA Procedures Check List that will also require examiners and managers to provide documentation that TEFRA procedures are followed.

The Director, Technical Services SB/SE will also establish procedures to expand the current review responsibilities of the three specialized TEFRA review groups within Technical Services. This will include evaluations of how well examiners are adhering to TEFRA examination procedures and documenting their TEFRA work. These evaluations will be provided to the Director, Examination on a quarterly basis.

IMPLEMENTATION DATE
October 1, 2006

RESPONSIBLE OFFICIAL(S)
Director, Exam Policy SB/SE Division
Director, Technical Services SB/SE Division

CORRECTIVE ACTION MONITORING PLAN
The Directors, Technical Services and Exam Policy, SB/SE Division will advise the Director, Examination, SB/SE Division if there are any delays in the implementation of this corrective action.