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Repeal of Tax Equity and Fiscal Responsibility Act (TEFRA)

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Introduction

The enactment of the Bipartisan Budget Act of 2015 (H.R. 1315) on November 2, 2015 (the Act) quietly repealed the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) and the electing large partnership (ELP) rules that have governed partnership audits for decades. For partnership tax years beginning on or after January 1, 2018, TEFRA and the ELP rules will be replaced by the Act s new audit regime (the New Regime), which will be codified at 26 U.S.C. §§ 6221 6241.

As suggested by its name, the Act is designed to raise revenue. The New Regime will accomplish that goal by expanding the reach of the entity-level audit and adjustment procedures, i.e., by making it harder for businesses to opt out of the entity-level tax regime. The Act likely marks the first step in the government s attempt to tax partnership income at the entity level.

TEFRA Regime

Congress enacted TEFRA to shift the procedure for auditing partnership income from the partner level to the partnership level. 26 U.S.C. §§ 6621 6234. TEFRA s tax refund procedure was binding on every partner who had not resolved his individual tax liability with the IRS. The system proved cumbersome and inefficient for partnerships with hundreds or thousands of partners. As a result, Congress created a new audit regime for ELPs as part of the Taxpayer Relief Act of 1997. 26 U.S.C. §§ 771 777 and §§ 6240 6255.

TEFRA divided partnerships into three categories (collectively, the TEFRA Regime). The category into which a partnership falls determines how it is audited:

1. Partnerships with more than 10 partners are considered TEFRA partnerships. TEFRA partnerships are audited at the partner level, and the procedure is binding on the individual partners.
2. Partnerships with 100 or more partners may elect ELP treatment. ELPs are audited at the partnership level, but adjustments are reported by individual partners. Instead of filing amended prior year returns, the partners report any adjustments in the year that the adjustment not the audit actually occurs.
3. Partnerships with fewer than 10 partners are not audited at the partnership level but on the individual level of each partner.

New Regime

The Act creates a streamlined procedure for auditing both partnerships and partners at the partnership level by

eliminating the partnership categories that existed under the TEFRA Regime and subjecting all partnerships, regardless of size, to the New Regime.

Unlike the TEFRA Regime, adjustments to partnership items will be reflected on the returns of the partnership itself rather than the individual partnerships. However, adjustments will still be reported in the year that the audit is completed rather than the year to which the audit relates. The New Regime also differs from TEFRA inasmuch as it eliminates joint and several liability of individual partners for partnership level adjustments or liabilities.

In short, the adjustment is based on information about the partnership rather than the individual partners. However, if the partnership can show that a determination based on information about the individual partners would have resulted in a lower adjustment, the IRS will use that information instead.

Certain types of partnerships have the ability to opt out of the New Regime. A partnership that opts out of the New Regime will be audited in accordance with the same rules that apply to individual taxpayers.

Eligibility to opt out of the New Regime is limited to partnerships with 100 or fewer qualifying partners. Qualifying partners include individuals, C corporations, S corporations, foreign entities that would be treated as C corporations under the laws of the United States, and estates of deceased partners. Pass-through entities, such as other partnerships, LLCs, and trusts, are not considered qualifying partners.

Conclusion and Recommendations

In anticipation of the New Regime, business entities that are taxed as partnerships should start reviewing their governing documents now. Many businesses will find that amendments are necessary to preserve the option of opting-out. For example, some entities may want to impose transfer restrictions on partnership or membership interests to ensure that such interests are not transferred to a non-qualifying member. Some entities may need to alter the existing composition of their partnership or membership. For family partnerships and entities where interests are often transferred by inheritance, more comprehensive changes may be necessary.

The IRS was charged with issuing regulations to implement the New Regime. To date, however, no such regulations have been issued. Without guidance from the IRS, business entities are left to speculate on many of the details.