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Section 385 update: Treasury's regulatory guidance process

Debt-equity regulations under section 385 were sent to the Office of Information and Regulatory Affairs (OIRA) within the Office of Management and Budget (OMB) for final review at the end of last week. A recent report from the U.S. Government Accountability Office (GAO) may be instructive in understanding the regulatory review process in general, and the role of OIRA in reviewing the section 385 regulations in particular.

GAO report

The GAO last month published a report—"Regulatory Guidance Processes: Treasury and OMB Need to Reevaluate Long-Standing Exemptions of Tax Regulations and Guidance," [GAO-16-720](#).

The GAO report was requested by several Republican and Democrat members of the House and the Senate, including Senator Hatch (R-UT), the Chairman of the Senate Finance Committee.

The GAO report discusses authorities relevant to IRS guidance, including: (1) the Administrative Procedure Act; (2) the Paperwork Reduction Act; (3) the Regulatory Flexibility Act; and (4) the Congressional Review Act. The GAO report also discusses executive orders that are relevant to the regulatory process, including E.O. 12866.

E.O. 12866 (issued under President Bill Clinton) requires OIRA to review all "significant" regulations before they take effect, and defines significant regulatory actions as those that:

- Have an annual effect on the economy of \$100 million or more or adversely affect in a material way the economy, a sector of the economy, productivity, competition,

jobs, the environment, public health or safety, or state, local, or tribal governments or communities (i.e., the regulatory actions are “economically significant”)

- Create a serious inconsistency or otherwise interfere with an action taken or planned by another agency
- Materially alter the budgetary impact of entitlements, grants, user fees, or loan programs or the rights and obligations of recipients thereof, or
- Raise novel legal or policy issues arising out of legal mandates, the president’s priorities, or the principles set forth in the executive order

In the case of “economically significant” regulations, E.O. 12866 requires administrative agencies to provide a detailed cost-benefit analysis, with quantification of effects as well as a similar analysis of “potentially effective and reasonably feasible” alternatives.

Other executive orders also are relevant to the rule-making process—including E.O. 13563 (issued under President Obama). E.O. 13563 reaffirms, incorporates, and builds on the principles of E.O. 12866.

Congressional Review Act

The GAO report explains that the Congressional Review Act (CRA) requires administrative agencies to submit rules to Congress before they take effect. In the case of “major” rules, the CRA generally requires the Comptroller General to provide a report assessing the agency’s compliance with procedural steps in the CRA to the relevant congressional committees within 15 days of submission or publication.

A major rule relating to such a report generally cannot take effect for 60 calendar days after submission to Congress or publication in the Federal Register (whichever is later)—subject to special effective date rules if Congress passes a joint resolution of disapproval that is vetoed. Nonetheless, section 808 of the CRA allows a rule to take effect at such time as the issuing agency determines if the agency “for good cause finds (and incorporates the finding and a brief statement of reasons therefor in the rule issued) that notice and public procedure thereon are impracticable, unnecessary, or contrary to the public interest.”

Read the Congressional Research Service (CRS) [report](#) [PDF 847 KB] on *The Congressional Review Act: Frequently Asked Questions* for more information on the CRA.

OIRA

The GAO report explains OIRA’s role in the regulatory process. As suggested above, OIRA is responsible for coordinating the Executive Branch’s review of significant regulatory actions before publication.

According to “frequently asked questions” on the [OIRA website](#), OIRA is responsible for ensuring agency compliance with the principles of E.O. 12866, “which include

incorporating public comment, considering alternative to the rulemaking, and analyzing both costs and benefits.” The OIRA website further explains that OIRA places emphasis on regulatory analysis because:

“Regulatory analysis is a tool that regulatory agencies use to anticipate and evaluate the likely consequences of rules (including both costs and benefits). It provides a formal means of organizing the evidence on the key effects—both good and bad—of the various alternatives that should be considered in developing regulations. Among the purposes are (1) to learn if the quantitative and qualitative benefits of an action are likely to justify the costs, (2) to promote accountability to the public, and (3) to discover which of various possible alternatives would produce the highest net-benefits. Sometimes careful analysis can show that a less stringent alternative is best; sometimes more stringency will be shown to be justified; sometimes a creative option will emerge.”

Executive agencies provide OIRA with lists of planned regulatory actions, including information about whether rules are significant within the meaning of E.O. 12866. OIRA is responsible for determining whether rules are economically significant for that purpose. OIRA also can determine if regulatory rules are “major” for purposes of the CRA; however, as explained in the CRS report, the CRA does not specifically require agencies to submit their rules to OIRA so that this designation can be made. (CRS report at pages 9-10.) According to the CRS report, the definitions of “economically significant” and “major” are similar but not identical and, in most cases, a rule that is “economically significant” also will be “major,” and vice versa. (CRS report at page 10.)

E.O. 12866 limits the period for OIRA review for most regulatory actions to 90 calendar days. However, the review period may be extended indefinitely by the head of the rulemaking agency. Further, the OMB director may extend the review period on a one-time basis by no more than 30 days. There is no minimum period for review. The OIRA website includes information regarding how outside groups can submit comments or request meetings with OIRA’s “Administrator” during the review period.

Long-standing agreement between Treasury and OMB

According to the GAO report, few tax regulations are deemed “significant” by OIRA such that they are subject to the additional requirements of E.O. 12866. Likewise, the report indicates that OIRA deems few tax regulations to be “major” under CRA. The GAO report cites one tax regulation that was deemed to be both economically significant under E.O. 12866 and major under the CRA—a regulation issued in 2011 regarding paid preparers.

Moreover, the GAO report states that some tax regulations are exempt from OIRA review that otherwise would be required under E.O. 12866 based on a long-standing agreement between Treasury and OMB dating back to 1983. According to the GAO report, the effect of this agreement has been that few tax regulations are subject to OMB review.

Nonetheless, the GAO report also indicates that, under the long-standing agreement, Treasury is still required to notify OMB of any major rules for which review has been waived and any non-major regulation that reasonably could be expected to have a significant economic impact—and OMB reserves the right to review the economic impact. The GAO report states: “...Treasury and IRS officials told us that they comply with this requirement by providing a memorandum to OMB for every regulatory action,” with that memorandum providing a plain-language description of the regulation and its significance to OMB.

GAO recommendations

The GAO report makes several recommendations, including that the Director of the OMB and the Secretary of the Treasury take the following two actions:

- Examine the relevance of the long-standing agreement that exempts certain tax regulations from executive order requirements and OIRA oversight; and if relevant, make publicly available any reaffirmation of the agreement and the reasons for it.
- Develop a process to ensure that OIRA has the information necessary to determine whether tax rules are major under CRA and significant under E.O. 12866. Consideration should be given to ways to solicit public comments on the potential effects of proposed regulations and non-regulatory guidance, including measures of economic impacts, and on how to document internally the consideration of significant comments by both Treasury/IRS and OIRA.

Written comments from Treasury

The GAO report includes written comments from the IRS and the Treasury in appendices. In the Treasury letter, Mark Mazur, the Assistant Secretary (Tax Policy), indicates that “...Treasury and OMB are examining the relevance of the long-standing agreement discussed in the draft report” and that:

“We will consider additional ways to improve the quality and efficacy of our notification process. In addition, we will consider seeking public comment on the economic or other impact of certain proposed rules during our standard notice-and-comment process, in cases where the impact of the proposed rule may be significant. Treasury and IRS will continue to take into account any public comments on a proposed rule’s impact in the same way that we carefully consider and respond to all public comments.”

KPMG observation - Section 385 regulation review

OIRA’s “Reginfo” [website](#) currently lists the section 385 regulations as a final rule pending regulatory review under E.O. 12866. The website further indicates that the regulations were received by OIRA on September 30, 2016. Thus, the 90-day review period described in E.O. 12866 would expire on December 29, 2016—unless it were extended. However, as noted, there is no minimum review period required.

OIRA's website also indicates that the section 385 regulations are economically significant. Thus, it would appear that OIRA's review would consider whether the regulations comply with the principles of E.O. 12866, which include incorporating public comment, considering alternatives to the rulemaking, and assessing the costs and benefits. OIRA's "cost-benefit" assessment could be particularly interesting in light of the comments received on the costs and benefits associated with the proposed regulations. OIRA, at least in theory, could direct Treasury to consider (for example) other alternatives; however, tax professionals are aware of little historical evidence regarding OIRA providing feedback on tax regulations, given that those regulations generally have not been subjected to OIRA review.

The [description](#) of the section 385 regulations in OIRA's "Unified Agenda" for spring of 2016 suggests that the proposed version of the regulations may have been considered "major" for purposes of the CRA. If the final version of the regulations is considered major, the provisions of the CRA regarding effective dates seemingly would apply—that is, the rules that generally provide for prospective application unless Treasury (the issuing agency) finds that "notice and public procedure thereon are impracticable, unnecessary, or contrary to the public interest."

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