

Client Alert

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GAO's Report on Treasury and the IRS's Regulatory Guidance Process

The United States Government Accountability Office ("GAO") recently completed a study of the tax guidance and rulemaking process. The report analyzed Treasury and the IRS's compliance with the authorities that govern the rulemaking process. The GAO concluded that Treasury and the IRS routinely do not comply with fundamental rulemaking requirements. As a result, this report may help taxpayers challenge the validity of regulations in future proceedings.

The GAO received a bipartisan request to undertake the study from the chairmen and ranking members of several committees, including Senate Committee on Finance Chairman Orrin Hatch. Chairman Hatch has focused on the guidance process and previously asked Treasury to produce the 1983 agreement regarding rulemaking between Treasury and the Office of Management and Budget ("OMB").

Five legal authorities govern the issuance of tax regulations.

1. The Administrative Procedure Act ("APA") generally requires agencies, including Treasury and the IRS, to publish a notice of proposed rulemaking in the Federal Register and to provide the public with the opportunity to comment on proposed regulations.
2. The Paperwork Reduction Act ("PRA") requires agencies to obtain approval from the OMB if they want to collect information from the public.
3. The Regulatory Flexibility Act ("RFA") generally requires federal agencies to consider and analyze the impact of regulations on small entities and to make the analyses available for public comment.
4. The Congressional Review Act ("CRA") requires agencies to submit each rule to Congress and the Comptroller General before it can take effect and to signify if it is "major"—*i.e.*, that it will substantially affect the economy. If deemed major under the CRA, Congress has an additional 60 days to review the rule before it takes effect, and the GAO must describe the procedural steps the agency took in promulgating the rule. All rules, whether or not deemed "major," are subject to the 60-day review period during the last 60 days of a Congressional session.

5. The Internal Revenue Code requires the IRS to (among other things) publish regulations and submit proposed regulations for comment to the Chief Counsel for Advocacy of Small Business Administration (SBA). If the SBA provides comments, the IRS must summarize them and respond to them in the preamble of the final regulations.

Current IRS Procedures

The IRS classifies a guidance project based on definitions in the Chief Counsel Directives Manual (“CCDM”), which is the primary collection of IRS policy and procedure guidelines. The GAO observed that written procedures are a basic component for effective internal controls. The IRS, however, does not have documented procedures for selecting the type of guidance project to issue. Treasury and the IRS contend that clear-cut procedures may not be practical or feasible because classifying guidance is not always a straightforward process. In response to the GAO audit, the IRS conceded that the CCDM could be revised to include a list of factors to consider when selecting guidance type.

OMB’s Oversight of Rulemaking Process

The Office of Information and Regulatory Affairs (“OIRA”)—an organization within the OMB—is responsible for the coordinated review of regulatory actions by executive agencies. When drafting rules, executive agencies provide the OIRA with planned regulatory actions to determine if further review is needed. If the OIRA concludes that a rule is “significant,” then the OIRA reviews a draft of the regulation and may request changes or additional analyses. The OIRA also has the responsibility under the CRA for determining when rules are “major.” The OIRA is also responsible for reviewing certain non-regulatory guidance issued by executive branch agencies.

The IRS Routinely Exempts its Guidance from External Scrutiny

The CRA and Executive Order (“E.O.”) 12866

IRS guidance is often not subject to the analysis and oversight requirements of the CRA and E.O. 12866. (Executive Order 12866 was supplemented by President Obama in E.O. 13563, but the relevant requirements applicable to IRS guidance did not change.) When asked by the GAO, OIRA identified only one of more than 200 tax regulations issued between 2013 and 2015 as “significant” and subject to the additional rulemaking requirements and analysis under E.O. 12866. By contrast, from 2011 to 2013, the OIRA determined that more than 350 agency rules were significant; about 20 percent of those were also economically significant under E.O. 12866. Similarly, between 2013 and 2015, the OIRA did not identify any tax regulations that Treasury and the IRS identified as major under the CRA. (“Major” regulations require additional review by Congress and a written report by the GAO.)

APA Notice and Comment

Between 2013 and 2015, Treasury and the IRS contended that the APA's notice-and-comment rulemaking requirements did not apply to nearly 90 percent of tax regulations. Treasury and the IRS follow the guidelines in the CCDM to determine if a regulation is legislative or interpretative. Those guidelines contend that a rule is legislative if Congress provides an end result without guidance as to how to achieve the desired goal or if the statute does not provide adequate authority for the regulatory action. The CCDM states that a rule is interpretive if Congress made a specific rule and left gaps for the Secretary to fill. Treasury and the IRS allege that the notice-and-comment procedures of the APA do not apply to tax regulations because they are almost always interpretive (as defined in the CCDM).

RFA

OMB concluded that "Treasury and IRS rarely perform a regulatory flexibility analysis assessing a regulation's impact on small businesses and other small entities." The GAO reviewed 200 tax regulations from 2013 to 2015. Of those, only two included a regulatory flexibility analysis. For about half of the regulations that lacked any small-business-impact analysis, Treasury and the IRS contended that the RFA did not apply because the regulation did not impose a collection-of-information requirement on small entities. In the other half, Treasury and the IRS posited that the regulation would not have a significant economic impact on a substantial number of small entities.

Non-regulatory Guidance

In its review of IRS non-regulatory guidance—such as revenue rulings, revenue procedures, and notices—issued between 2013 and 2015, the GAO did not find a single instance in which the IRS determined that such guidance constituted a rule—let alone a "major" rule—under the CRA. The GAO also reviewed examples in its database covering the period from 1996 through June 2016 and again found no instances of the IRS reporting such guidance as a rule under the CRA.

FAQs

The Internal Revenue Bulletin ("IRB") includes regulations, revenue rulings, revenue procedures, notices, and announcements and is binding on the IRS. These types of guidance go through a multi-step clearance process at both the IRS and Treasury, requiring review and approval by a wide variety of officials at both offices. However, the IRS also publishes substantive guidance outside of the IRB. The GAO determined that the IRS has recently issued substantive information in the form of FAQs. These FAQs do not fall under the IRS's definition of official guidance and therefore cannot be relied upon as binding authority. In addition, FAQs are generally not reviewed by Treasury and are not necessarily subject to a multi-step clearance process within the IRS. But the IRS does not always clearly communicate these limitations to taxpayers. The GAO found some examples of guidance in the IRB in the form of FAQs, but also found FAQs published outside of the IRB containing substantive guidance.

Treasury and OMB's Review-Exempt Agreement

Treasury contends that many tax regulations are exempt from OIRA review due to an agreement between Treasury and OMB that purportedly exempts tax regulations from independent analysis and review unless the regulations are both legislative and major. Because the IRS unilaterally concludes that tax rules are neither legislative nor significant, few tax regulations—and none of the other types of tax guidance—are subject to OMB review.

The GAO stated that the original intent of the agreement, and whether it remains valid, is unknown.

The GAO observed that the agreement warrants reconsideration due to changes in the nature of tax regulations since 1983. The most notable change is the shift in using the tax code to accomplish social and economic objectives through special tax credits, deductions, and exemptions.

In response to the GAO report, Treasury contended that “no change in circumstances has occurred that would warrant changes or a reaffirmation of the agreement.” But Treasury also agreed to review the continuing relevance of the agreement.

The GAO's Findings

The GAO found it difficult to determine whether Treasury and the IRS followed policies and procedures outlined in the CCDM. The GAO sampled eight IRS guidance projects and found that the IRS did not fully document key phases of the guidance process in four of the eight case files.

Four of the case files were missing a Background Information Note (“BIN”), which provides a record of clearance at each stage, important background information, the identification of risks, and any significant issues raised during coordination and circulation. Only one of the eight case files had a complete BIN. Due to incomplete BINs, the GAO was unable to verify from the case files that all required steps in the CCDM were followed in seven of the eight case files.

Based on its review of the eight case files, the GAO found that the IRS did not consistently document discussions of whether final guidance should be reported to Congress or considered major under the CRA. One of the two revenue procedures reviewed by the GAO was not submitted for review under the CRA, even though the CCDM states that all revenue procedures and revenue rulings will be treated as rules and must be reported to the GAO and Congress. The IRS told the GAO that it was not submitted because the personnel managing the revenue procedure were not familiar with the usual requirements.

Of the eight case files reviewed, three contained evidence that the IRS obtained public comments. One contained public comments estimating sizeable economic impacts from potential guidance being drafted. In response, the IRS simply stated that the statute caused the economic impact. As such, the IRS did not further consider the comments or the economic impacts of its guidance.

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Observations

1. The IRS routinely insulates its guidance from independent review. The IRS unilaterally concludes that further review is not needed by failing to classify its rules as major under the CRA or significant under E.O. 12866. Although OMB has the ability to dispute the IRS's characterization of a rule as exempt from review, in our experience, OMB rarely disagrees with the IRS's initial characterization. The GAO specifically recommended that Treasury and OMB develop a process to ensure that the OIRA has the information necessary to determine whether tax regulations are major under the CRA and significant under E.O. 12866. The GAO also recommended that Treasury and OMB consider ways to solicit public comments on the potential effects of proposed regulations and non-regulatory guidance, particularly economic impacts, and how to internally document the consideration of significant comments by both the IRS and OIRA.
2. The IRS bases its conclusions about whether its regulations are "legislative" based on its own interpretation in the CCDM and not on the way that the APA and the courts define that term. Regulations are legislative if they "create rights, impose obligations, or effect a change in existing law." *Altera Corp. v. Commissioner*, 145 T.C. 91, 111 (2015) (internal citation omitted). Legislative regulations have the force of law. *Perez v. Mortg. Bankers Ass'n*, 575 US ___, 135 S. Ct. 1199, 1200 (2015); see also 5 U.S.C. § 553(b),(c). The IRS has not updated the CCDM to reflect the standard administrative-law distinction between legislative and interpretive regulations.
3. Sometimes the IRS's substantive rules are cloaked in other forms of guidance. For example, the IRS issues rules in the form of FAQs. These FAQs are not subject to fundamental notice-and-comment requirements and are not independently reviewed. OMB's findings dovetail with those of the National Taxpayer Advocate, who, in her June 2016 report to Congress, criticized the IRS for placing substantive rules in FAQs on its web site. Similarly, the IRS sometimes issues notices that contain legislative rules under the APA. In 2012, a federal district court concluded that Notice 2006-50 was a legislative rule that should have been—but was not—provided to the public for comment. *In re Long-Distance Tel. Serv. Fed. Excise Tax Refund Litig.*, 853 F. Supp. 2d. 138 (D.D.C. 2012). This secret rulemaking process makes it difficult for taxpayers and practitioners to track the changes in the rules, and it largely disenfranchises them from having a voice in rules that directly affect them. Moreover, the IRS's common practice of removing "old" FAQs from its website when it issues updated versions makes it difficult for taxpayers to locate the rules that applied to their prior conduct.

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4. The 1983 agreement between Treasury and OMB determined—without explanation—that tax regulations are not subject to independent scrutiny. This agreement is suspect. In particular, it is not clear how Treasury and OMB can override a Congressional mandate and Executive Orders that contemplate independent review of tax regulations. Indeed, the GAO specifically recommended that Treasury and OMB examine that agreement to determine if it is still relevant and, if so, to make any reaffirmation of the agreement and reasons for it public. Treasury recently released the 1983 agreement pursuant to a FOIA request, and Tax Notes and BNA published the document.
5. The IRS's guidance-issuance process is inconsistent and incomplete. The GAO's audit was hampered by the lack of routine information—such as the Background Information Note—in the IRS's guidance files. Accordingly, the GAO recommended that the IRS ensure that required steps are consistently documented during key phases of the non-regulatory guidance process. Because of internal confusion as to the proper type of guidance to issue, the GAO recommended that the IRS amend its policies and procedures for drafting guidance to include factors to consider in deciding the type of guidance to issue. The GAO also recommended that the IRS modify its procedures for internally documenting those decisions.
6. Congress may use the report and the recently released 1983 agreement to conduct one or more hearings on the guidance process. Members of Congress could introduce legislation to address some of the deficiencies cited in this report, an issue that may play out over the course of the lame duck session and the next Congress. The incoming Administration may also have different views on the appropriateness of the 1983 agreement.

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