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BY THE U.S. GENERAL ACCOUNTING OFFICE

Report To The Secretary Of The Treasury

Further Improvements Needed In Processing Tax Regulations

IRS and the Treasury have experienced a backlog of tax regulations for over 15 years and the backlog is increasing. These agencies have responded to the problem by (1) revising the regulatory review process, (2) increasing the number of review positions in Treasury, and (3) developing a computerized management information system to monitor the agencies' performance. GAO believes that IRS and Treasury can further improve the process by publishing some regulations with limited review and developing the additional management information needed to highlight long-delayed projects and determine whether additional review staff is needed.



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UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

GENERAL GOVERNMENT
DIVISION

B-209685

The Honorable Donald T. Regan
Secretary of the Treasury

Dear Mr. Secretary:

At the request of the Chairman, Subcommittee on Select Revenue Measures, House Committee on Ways and Means, we have studied the growing backlog of tax regulations. The Chairman made the request because of his concern that Internal Revenue Service (IRS) budget constraints might be contributing to growth in the backlog.

The primary cause of growth in the backlog was an inadequate number of attorneys in the Office of the Assistant Secretary (Tax Policy). Given current procedures in IRS and the Department of the Treasury, the prospects for eliminating the backlog are not good in spite of several recent improvements, including the assignment of additional attorneys to work on tax regulations. Additionally, we believe that IRS and Treasury need to collect data on the amount of attorney staff time dedicated to issuing regulations. With such data--not now available--officials will be better able to determine whether staffing levels are adequate to deal with the existing workload and with the backlog.

Also, we believe that, as IRS and Treasury continue to develop and refine their management information systems, a routine highlighting of long-delayed projects would help make managers more aware of processing problems needing attention. Finally, as a short term measure, we believe that IRS and Treasury should experiment with reduced review before the initial publication of some regulations currently in the inventory. A detailed discussion of the results of our review, conclusions, and recommendations are presented in appendix I.

In comments sent to us on a draft of this report, IRS and Treasury generally agreed with our recommendations to improve the available management information systems for tracking projects but believed that the reduced review of some projects that we suggested would not save much time. The Office of Management and Budget (OMB) in its comments thought some of the management information we suggested gathering was needed but other data related to the time charges by attorneys was not. OMB also felt that our suggestion for changes in review procedures was "an interesting alternative."

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As you know, 31 U.S.C. §720 requires the head of a Federal agency to submit a written statement on actions taken on our recommendations to the House Committee on Government Operations and the Senate Committee on Governmental Affairs within 60 days of the date of the report and to the House and Senate Committees on Appropriations with the agency's first request for appropriations made more than 60 days after the date of the report. Our recommendations to you appear on page 15 of appendix I.

We are sending copies of this report to the Director, Office of Management and Budget; the Commissioner of Internal Revenue; appropriate Senate and House Committees, including the Subcommittee on Select Revenue Measures, House Committee on Ways and Means; and other interested parties.

Sincerely yours,

W. J. Anderson

William J. Anderson
Director

RESULTS OF GAO'S REVIEW OF THE
PROCESS USED TO DEVELOP TAX REGULATIONS

Development and issuance of regulations to clarify tax law are the joint responsibility of the Department of the Treasury's Office of Tax Policy (Treasury) and the Internal Revenue Service (IRS). By December 31, 1982, the end-of-year inventory of unpublished regulations had reached 468--a record high. In our review of the regulations process we found that IRS and Treasury were falling behind in handling this growing inventory. We concluded that a bottleneck has existed primarily because the number of attorneys in the Office of the Assistant Secretary (Tax Policy) has not been adequate to deal with the workload.

Since we began our review, IRS and Treasury have taken several actions intended to reduce the regulations backlog. In January 1982, IRS and Treasury began developing a new review process designed to reduce the regulations backlog and, in January 1983, announced refinements to that process. In addition, they have developed a new management information system which provides for better monitoring of the existing workload. Most recently, in May 1983, Treasury announced an increase in the number of attorneys reviewing drafts of regulations.

OBJECTIVES, SCOPE,
AND METHODOLOGY

Our review was undertaken at the request of Congressman Fortney H. Stark, Chairman, Subcommittee on Select Revenue Measures, House Committee on Ways and Means. The objective was to determine what could be done to eliminate or reduce the backlog in developing tax regulations.

In the course of our work we reviewed relevant case files and management reports to gain an understanding of how regulations are developed. We discussed selected individual projects, as well as the regulations process as a whole, with appropriate IRS officials, and particularly with the Office of Chief Counsel's Legislation and Regulations Division (L&R) and Employee Plans and Exempt Organizations Division attorneys who have initial responsibility for drafting regulations projects. In the Department of the Treasury, we discussed the growing regulations inventory with top officials in the Office of Assistant Secretary (Tax Policy), and the reviewing attorneys in Tax Legislative Counsel (TLC) and General Counsel's Office. We also had discussions with staff of the Office of Management and Budget and with interested nongovernmental organizations, such as the American Bar Association and the American Institute of Certified Public Accountants.

In addition, we analyzed all regulations projects closed in 1980 and 1981 and about 85 percent of the pending projects which were over 2 years old in March 1982. We have continued to monitor changes in the regulations process and have revised our data

as appropriate. We conducted our review in accordance with generally accepted government auditing standards.

REGULATIONS ARE IMPORTANT
FOR ORDERLY TAX ADMINISTRATION

A tax regulation is a more specific and/or technical explanation of a particular section of the tax code. Regulations provide guidance to both taxpayers and IRS staff in clarifying and fulfilling the full intent of a particular section of the tax code. Among other things, tax regulations (1) specify filing dates and required filing information, (2) provide needed definitions, (3) give computational examples, (4) provide general explanations, and (5) establish administrative procedures.

The first step in development of regulations is the opening of a "project." IRS and Treasury term each tax code section which requires regulations a project. A project is opened when IRS identifies the need for regulations under a new section of the Internal Revenue Code or when an existing regulation needs to be changed. IRS attorneys in either the Legislation and Regulations or Employee Plans and Exempt Organization Division first develop a draft regulation. After the draft passes through the IRS review process, it is sent to Treasury attorneys in the Tax Legislative Counsel for their review. The TLC-approved draft is then forwarded to the Office of General Counsel and the department's Executive Secretary for departmental clearance. The Treasury-approved draft is returned to IRS and published for public comment. After the comment period IRS revises the draft, which is again reviewed by Treasury. The approved draft then is issued by Treasury as a regulation, published in the Federal Register, and the project is closed. Projects which produce temporary regulations are closed after the first publication.

Regulations are needed in various situations and with different degrees of urgency. For example, IRS and Treasury believed there was an immediate need for regulations following the enactment of the Windfall Profit Tax Act of 1980. To avoid large tax revenue losses, IRS and Treasury issued temporary regulations on the day the act became law. A more common example of a need for a regulation involved a tax credit for increasing research activities. This regulations project, opened as a result of a provision of the Economic Recovery Tax Act of 1981 (ERTA), was needed to define "qualified research expenses" and to determine what research qualified for the tax credit. Without this clarification, for example, insurance companies and accounting firms could not readily determine whether expenditures for actuarial studies or for the development of new accounting procedures qualified.

REGULATIONS PROCESS IS BACKLOGGED
AND THE INVENTORY IS GROWING

As of December 31, 1982, the backlog of regulations projects was 468, as compared to 140 in January 1967. Appendix II illustrates how the backlog of tax regulations has grown in the past 15 years and how, historically, the passage of new tax legislation has caused the number of projects to increase. We estimate that, at average annual rates of production, IRS and Treasury would need about 5 years to eliminate the current backlog. However, additional projects resulting from new tax legislation will in all likelihood add to the current number of projects.

Regulations projects are mainly created by: (1) the enactment of new legislation and (2) the need to revise or clarify existing regulations for a particular section of the tax code. The primary reason for the dramatic increase in the number of regulations projects over the past few years has been the enactment of major tax legislation by the Congress. For example, in the 4 months following the enactment of the Tax Reform Act of 1969, 128 projects were created. Similarly, within 4 months following the enactment of the Tax Reform Act of 1976, 190 regulations projects were created. The Economic Recovery Tax Act of 1981 and the recently passed Tax Equity and Fiscal Responsibility Act of 1982 will require at least 90 and 77 new projects, respectively. Moreover, in addition to creating more regulations projects, passage of new legislation often diverts resources from ongoing projects to new regulations projects where guidance is considered critical to implement the law.

Since 1967, IRS has opened an average of 101 regulations projects each year. To date, the number of newly opened projects has ranged from a low of 27 in 1969 to a high of 224 in 1976. Regulations projects are closed when a draft becomes a temporary or final regulation or when a project is considered unnecessary and dropped from the current inventory. Between 1967 and 1982 an average of about 84 projects per year was closed, with closings ranging from 32 in 1969 to 176 in 1977. In 1977, IRS made a special effort to close regulations projects which it considered unnecessary--thus the large number of projects closed that year. In a recent effort, IRS and Treasury closed 46 projects without regulations between November 1982 and January 1983. Appendix III summarizes the opening and closing of projects between 1967 and 1982.

Time to Issue Regulations
Varies Widely

The large backlog of regulations and the way they are handled have resulted in (1) many projects which have been pending for several years and (2) a wide variance in the amount

of time it took to complete those projects that were issued as regulations. At the end of 1982, IRS still had at least one regulations project pending that was opened in 1964.

Because of the wide variance in complexity, sensitivity, length of regulations, and in the number of taxpayers affected, it is difficult to determine how long it should take to produce a regulation. We discussed the time required to issue regulations with many people who had been involved in tax regulations development including a former IRS Commissioner, a former Assistant Secretary of the Treasury (Tax Policy), three former Directors of L&R, and attorneys involved in the regulations process at IRS and Treasury. The general consensus of the discussions was that, while regulations development time could vary for many reasons, a regulation of ordinary complexity and importance should take about 2 years to develop and issue. One IRS official stated that 2 1/2 years was more reasonable.

There were 83 temporary and final regulations issued in 1980 and 52 in 1981. The average time for completion was 28.8 months for those issued in 1980, and 27.4 months for 1981. In 1980, 41 percent of completed projects took longer than 2 years (34 of 83 total); in 1981, 48 percent of completed projects were similarly time consuming (25 of 52 total). Further comparison is presented in the following table:

<u>Completion Timeframes</u>	<u>Number of regulations projects completed</u>	
	<u>1980</u>	<u>1981</u>
Within 6 months	18	21
6 months to 1 year	10	2
1 year to 2 years	21	4
2 years to 3 years	5	11
3 years to 4 years	13	2
4 years to 5 years	5	5
over 5 years	11	7
	<u>83</u>	<u>52</u>

<u>Range</u> (in days)	7 to 3,361	2 to 3,541
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Several Reasons Contributed to the Delay of Projects

In addition to analyzing the time it takes to issue regulations, we reviewed the backlog to determine why there were so many old projects. After analyzing completed 1980 and 1981

regulations and discussing them with various officials, we looked at all pending L&R projects which were more than 2 years old.¹

To gain insight into why these projects had not been completed, in March 1982 we interviewed each of the six branch chiefs in L&R regarding their older projects. The branch chiefs cited many reasons why these regulations projects had not been completed. According to the six branch chiefs, the main reasons for the backlog are:

- (1) Inadequate staffing at TLC has been a continual problem. TLC's inability to respond in a timely way to the large volume of work coming in from IRS was believed to be due primarily to heavy legislative demands, such as drafting proposed legislation and congressional testimony, which take priority over regulations activity.
- (2) Staff turnover both in L&R and in TLC has been a major factor. Most L&R attorneys remain with IRS for about 4 years, and the TLC attorneys stay about 2 years. Each time an attorney leaves and the projects are reassigned, the new attorney must learn the entire project.
- (3) Pending congressional action or a related court case which would have an impact on a pending regulation has caused some projects to be informally suspended awaiting the outcome.
- (4) Fundamental policy decisions which must be made before the regulation is issued are delayed. For example, at the time of our review in March 1982 a group of projects dealing with the arbitrage restrictions on tax-exempt bonds was awaiting a basic Treasury policy decision on the proper scope of the arbitrage rules.

CHANGES IN REGULATIONS PROCESS
HAVE NOT REDUCED THE BACKLOG

Because the inventory of unissued regulations was growing significantly, IRS and Treasury made substantial changes to the procedures at the beginning of 1982 and announced further refinements of those procedures in January 1983. Even with the

¹There were 208 open regulations projects on February 28, 1982, which were begun prior to 1980. Of these 208 projects, 176 were in L&R and 32 in the other IRS division that originates some projects, the Employee Plans and Exempt Organizations Division. Since L&R had most of the inventory, we concentrated on those 176 projects.

changes, the regulations process remains complicated, with numerous levels of review and comment involving several different organizations. The changes to the process have not yet reduced the large backlog.

The Old Process Resulted in Large Inventories at Treasury for Review

Prior to January 1982, the regulations process between IRS and Treasury provided for no routine monitoring of specific regulations projects by either IRS or Treasury and no formal means for resolving policy problems in a timely manner.

When a new regulation was required, the appropriate branch in either L&R or the Employee Plans and Exempt Organization Division,² depending upon the subject matter, "opened" a project and assigned it to one of its docket attorneys. The docket attorney prepared a preliminary draft of the regulation. After the draft was approved by a reviewer, copies were forwarded to at least one of IRS' Technical Divisions and to TLC for concurrent review.

IRS standards required Technical to provide its comments within 30 days after receiving the draft. Within this 30-day period, other IRS functions such as Examination, Returns Processing, or Collection would also be asked to provide comments if the project affected their programs. The IRS review standards emphasized that comments should address feasibility, completeness, technical accuracy, and consistency with previously advocated positions.

Within Treasury's TLC, the draft was assigned to a staff attorney for review. Each of the 12 to 14 staff attorneys at TLC was assigned responsibility for particular sections of the tax code. No time frames were established for TLC reviews. Once the attorney completed his review of the draft regulation, it was reviewed by higher level TLC officials.

If neither Technical nor TLC believed significant changes were needed, they could meet with the L&R staff to resolve any

²Since most regulations relate to areas under the jurisdiction of L&R and TLC, we describe the process in terms of their actions. We do not discuss the actions of Employee Plans and Exempt Organization Division, which originates regulations projects in the pension plans and tax exempt organization areas, or International Tax Counsel, which reviews projects related to international issues. However, these organizations use procedures similar to those of L&R and TLC.

minor problems. After agreement had been reached, L&R prepared the "Notice of Proposed Rulemaking" which was circulated for formal approval. The Notice was sent sequentially for approval to several points within IRS: the L&R Division Director, the Assistant Commissioner (Technical), the Chief Counsel and, finally, the Commissioner. Upon the Commissioner's approval, the Notice was forwarded to TLC for approval and then sent to the Assistant Secretary (Tax Policy) for final approval and publication in the Federal Register. One of the purposes of the Notice was to solicit public comments. After evaluating any comments and holding a public hearing if necessary, L&R prepared a draft final regulation, known as a "Treasury Decision." This decision followed exactly the same process as the draft Notice. This entire process, as it existed prior to January 1982, is illustrated in appendix V.

We found that under this regulations process, IRS divisions generally commented on preliminary drafts within their 30-day time frame but that review periods at TLC were frequently protracted. For example, as of December 31, 1981, 68 regulations projects had preliminary drafts of Notices approved by the Technical Division and other IRS divisions but had not been reviewed and commented on by TLC attorneys. The number of months these 68 projects had been with TLC awaiting action was as follows:

<u>Months</u>	<u>Number of Projects</u>
1-6	11
7-12	19
13-24	17
25-36	13
37-48	4
49-60	2
Over 60	2
	<u>68</u>

IRS and Treasury officials pointed out that the higher priority work that TLC attorneys must do resulted in their devoting only a portion of their time to reviewing drafts. Because TLC attorneys do not account for their time by work activity, we requested that they provide us with an estimate of the amount of time they devoted to reviewing regulations projects. The 13 TLC attorneys responding estimated that they spent about 40 percent of their time on this activity. This is equivalent to about 5 full-time attorneys (13 x 40% = 5.2). From 1967 to 1982 this level of effort has yielded an average of 95 projects published each year. This is an overall output of 19 published projects per staff year (95 total published projects/5 staff years = 19 projects per staff year).

TLC attorneys do have other major duties in addition to reviewing regulations for accuracy and policy positions. TLC prepares testimony in the tax area for Treasury officials and prepares and monitors the progress of tax legislation proposed by the Administration. Treasury officials told us that since 1969 there has been a marked increase in the number of appearances by Treasury officials to testify before congressional committees on tax matters. Yet, during the same period, there has been only a small increase in TLC's staff. This contrast is illustrated in the following table which compares the staff attorney positions available in TLC and the number of testimonies prepared by TLC for selected years:

	<u>1969</u>	<u>1970</u>	<u>1981</u>	<u>1982</u>
TLC Attorney Positions ³	14	14	19	19
Congressional Testimonies	9	7	42	41

This increase, coupled with the 5 major tax laws enacted since 1969, has placed a heavy burden on the TLC staff.

In addition to the increase in testimony and tax legislation that occurred during this time, the regulations process was slowed by a lack of management control over review of drafts which hindered prompt review and resolution of disputes in promulgating regulations. IRS and Treasury officials had recognized this problem prior to our review and, in January 1982, changed the process in an effort to increase the total output of regulations.

The New Process Is Intended
To Speed Up the Regulations
Process and Reduce the Backlog

In January 1982, IRS and Treasury adopted a new process designed to get regulations issued sooner as well as reduce the backlog. The new process (1) provides for IRS to divide regulations projects into categories--from the simple or routine to the complex--and sets time frames for review by TLC of each project category, (2) limits the number of projects that IRS can forward monthly to Treasury for review, (3) sets a goal of publishing 130 projects per year, and (4) establishes an improved

³Includes the Tax Legislative Counsel and his Deputy as well as two Associate Tax Legislative Counsels. In 1981 and 1982 the staff also included one correspondence attorney who was not responsible for working on either tax regulations or tax legislation.

tracking system to monitor the performance of the respective units in Treasury and IRS. In addition, the new procedures provide for a more thorough review within IRS before a draft is sent to TLC. This review is expected to provide the TLC staff with a higher quality draft that should require less review than in the past. Staffing levels in L&R and Employee Plans and Exempt Organization Division are not affected by the agreement.

The following four categories of regulations provide the basic framework of the process:

- Category 1 projects are routine in nature, contain no policy issues and, therefore, require no substantial policy review by Treasury. Because they are neither controversial nor complex, TLC is given 2 weeks in which to review them and offer comments before the draft notice is forwarded to General Counsel and the Executive Secretary for final review prior to publication and solicitation of public comments. If 2 weeks expire and TLC has not responded to a Category 1 project, IRS may forward the draft to General Counsel and the Executive Secretary for final review.
- Category 2A projects contain some policy issues but IRS believes the issues do not require extensive Treasury review. TLC, upon receipt of these projects, is given 30 days to review them.
- Category 2B projects contain policy issues requiring more time for Treasury review. Forty-five days are allowed. TLC may, if needed, use additional time; however, all issues are to be resolved within 135 days from the date IRS first forwards the project to Treasury.
- Category 3 projects are complex and/or contain highly sensitive policy issues. To focus attention on these projects early, the docket attorney in L&R prepares an issue memorandum within 90 days after the date the project is opened. This memorandum is circulated in IRS and Treasury and updated periodically. Upon receipt of a draft of the regulation from IRS, the process requires TLC to review and comment within 60 days and to resolve all outstanding issues within 180 days. However, because of the complexity and/or sensitivity of some projects, an extension of time for TLC review is permitted if IRS and Treasury agree to such an extension.

As of January 31, 1983, IRS estimated that there were 124 projects identified as Category 1's, 263 projects listed as either Category 2A or 2B, and 55 projects classified as Category 3's.

In addition to categorizing the regulations projects and establishing review times for each category, IRS and Treasury under the new process also set 16 as the maximum number of projects per month that IRS could send to Treasury for review. The total was to consist of no more than 6 Category 1 projects, 8 Category 2 projects, and 2 Category 3 projects. Then, in January 1983, IRS and Treasury agreed to change the process by (1) reducing the total number of projects that could be sent to TLC to between 10 and 12 each month (and up to 3 to International Tax Counsel each month) and (2) eliminating the quotas by category. This change was made because the original quota of 16 projects per month proved to be too many for TLC to handle. In addition, the quotas by category did not match TLC's ability to review the projects.

The new process also included another aspect designed to expedite the issuance of regulations--more thorough review within IRS before each project is forwarded to TLC for review. Under the new process, L&R no longer automatically forwards preliminary drafts to TLC; instead, they are forwarded for comment only to selected IRS components. Each IRS division is still given 30 days to comment on the preliminary draft. A revised preliminary draft incorporating their comments is then forwarded to these same divisions. This time the divisions have only 14 days to comment. Once all issues have been resolved within IRS, the revised preliminary draft is approved by the L&R division director and forwarded to the Chief Counsel Review Staff. Upon approval of the Review Staff, the draft is presented at a briefing before top IRS officials. Upon their concurrence, the draft is forwarded to TLC. IRS and Treasury believe that this approach will reduce TLC review time because Treasury will be receiving higher quality drafts than in the past. Appendix VI illustrates this entire process.

OMB's Role in the Regulations Process

An additional requirement that could affect the timeliness with which some tax regulations are issued is the Office of Management and Budget (OMB) review of selected major proposed regulations. Executive Order 12291, signed by the President on February 17, 1981, was intended to reduce the burden associated with future Government regulations issued by all executive branch agencies. It gave OMB the responsibility to minimize the burden of new regulations. While tax regulations are covered under the order, there is an agreement between Treasury and OMB partially exempting them. Under the procedures agreed to by