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Report to the Chairman, Subcommittee on Private Retirement Plans and Oversight of the Internal Revenue Service, Committee on Finance, U.S. Senate

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TAX ADMINISTRATION

IRS Should Expand Financial Disclosure Requirements

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August 17, 1992

The Honorable David Pryor
Chairman, Subcommittee on Private
Retirement Plans and Oversight
of the Internal Revenue Service
Committee on Finance
United States Senate

Dear Mr. Chairman:

You asked us to evaluate the adequacy of Internal Revenue Service (IRS) procedures and practices to detect and prevent employee conflicts of interest. The review of annual employee financial statements is one way IRS can identify potential employee conflicts of interest. Early in our evaluation, we noted that thousands of IRS employees who are vulnerable to conflicts of interest, such as revenue agents, revenue officers, and criminal investigators, were not filing annual confidential financial statements. After discussions with your office, you asked us to determine the adequacy of IRS' employee financial disclosure process.

In assessing the adequacy of financial disclosure, we compared IRS employee financial disclosure practices with legal and regulatory requirements and disclosure policies, procedures, and practices followed by other federal agencies. We also obtained and relied heavily on the views of the Office of Government Ethics (OGE), as this agency is responsible for establishing financial disclosure standards for all federal executive agencies. A detailed objective, scope, and methodology section is contained in appendix I.

Results in Brief

Because of their access to tax return information and their ability to make or influence tax decisions affecting corporate and private entities, about 64,000 of IRS' 120,000 employees may be vulnerable to financial conflicts of interest. Employee conflicts could erode public confidence in the integrity of the tax system. IRS is not likely to detect such conflicts unless employees are required to disclose their financial interests. Yet IRS required only 662 employees to file annual financial disclosure statements in 1991.

IRS did not comply with Treasury regulations that required disclosure by over 12,000 employees in grades 13 through 15. Furthermore, IRS has identified about 52,000 other employees, grades 12 and below, in positions it identified as vulnerable to conflicts. This includes about 19,000 revenue agents, revenue officers, and criminal investigators, who OGE concluded in 1986 were vulnerable to conflicts and should be required to file annual financial disclosure statements.

Even when financial disclosure documents were filed, some statements did not provide enough information, and IRS managers did not effectively use them to detect potential conflicts of interest. We reviewed the 34 confidential statements reviewed and maintained by officials in the Southeast Region. Five of the six employees who reported having investments did not provide enough information for managers to identify potential conflicts. More importantly, the managers who reviewed the statements did not have information on specific employee assignments. Although we cannot project our findings to the remainder of IRS, we are concerned that IRS managers do not have sufficient information to determine whether employees' investments conflict with their assigned duties.

IRS takes various steps to prevent conflicts of interest, including employee ethics training, background investigations, and assignment rotation. Nevertheless, conflicts may go undetected, as disclosed recently by IRS Internal Audit. Internal Audit recently found that 23 of 1,200 employees who audit the tax returns of large corporations owned stock in the companies they audited. Sixteen of them had stock valued at more than $1,000—the Treasury regulation threshold above which such holdings are considered to pose the potential for conflict. One of them had stock valued at $34,000. Another 143 employees had investments in corporations that were examined by others in the same work group—a practice allowed by IRS regulations, but which might lead to real or perceived conflicts. One of them had stock valued at more than $800,000. Since none of these employees filed financial disclosure statements, Internal Audit identified the stock holdings and estimated stock values by reviewing employee tax returns and related information.

As a result of our audit, IRS has taken actions to lessen the vulnerability of its workforce to potential conflicts of interest. Comments from both IRS and Treasury indicate that IRS has begun to comply with existing Treasury regulations, requiring more than 5,000 additional employees to file confidential disclosure statements in 1992. It is also reevaluating whether coverage should be extended to other IRS employees and who should review the disclosure statements to ensure adequate oversight of work assignments and potential conflicts.

However, IRS said it is "not ready" to implement our recommendation to require confidential financial disclosure statements from all revenue agents, revenue officers, and criminal investigators. In its comments to us, IRS cited a number of concerns it has regarding the implementation of this recommendation. For 1992, it obtained filing exemptions for many of these employees, arguing successfully to Treasury that the degree of supervision and review over these employees is a sufficient safeguard against conflicts of interest. Treasury emphasized in its comments that the 1992 exemptions were for 1 year only, and that they would be reevaluated in the future as Treasury implemented OGE's new regulations on confidential financial disclosure.

We believe it is important that the new OGE regulations be interpreted to allow the widest possible coverage among the listed employee types. It is our view, as it was of OGE in its 1986 opinion, that these employees are inherently vulnerable to conflicts of interest because they have access to information they can use for personal gain and they influence or make decisions that have an economic impact on taxpayers and nonfederal enterprises.

Background

To preserve public trust in the integrity of federal officials and the fairness of government agency operations, U.S. ethics laws and regulations prohibit federal employees from engaging in activities or having financial interests that conflict or appear to conflict with their duties and responsibilities. Annually, all senior executives and certain employees whose positions are vulnerable to conflicts of interest are required to file public or confidential financial disclosure reports.

Treasury regulations define conflict of interest as a situation in which an employee's private interest, usually of a financial or economic nature, conflicts or raises a question of conflict with the employees's public duties and responsibilities. Concerning financial interests, Treasury regulations state that investments in mutual funds and investments in stocks and bonds of publicly traded corporations with a value of $1,000[1] or less are too remote and inconsequential to affect the integrity of an employee's service. Notwithstanding this general waiver, employees should refrain from participating in any matters that may appear improper.

[1]Section 232.22 (4)(b) of the Internal Revenue Manual establishes the amount for asset reporting at $5,000. Even though it is inconsistent with Treasury's regulations, the Treasury's General Counsel assented to this provision in 1989.

Title I of the Ethics in Government Act of 1978, as amended, prescribes requirements for public financial disclosure by certain higher level individuals in all three branches of the government. Individuals who must file public disclosure reports include (1) those who are paid, other than under the General Schedule, at a rate equal to or greater than 120 percent of the rate of pay for GS-15, step 1, including special government employees who work in the federal government more than 60 days in a calendar year; (2) members of the Senior Executive Service; and (3) presidential appointees.

OGE was created by title IV of the 1978 act and developed regulations to implement the public disclosure requirements for the executive branch (5 C.F.R. Part 2634).[2] OGE issued a standard form (SF-278) and instructions for use in filing disclosure reports. The form and instructions specify that information required by the act is to be reported by employees in seven categories: assets and income sources; transactions; gifts, reimbursements, and travel expenses; liabilities; agreements and arrangements; positions held outside the federal government; and compensation in excess of $5,000 paid by one source. Within these categories, information is required, such as the nature of the assets and transactions, the asset and income category of value, type of debt owed, and type of outside position held. The act requires that certain financial interests of spouses and dependent children also be disclosed in the employees' reports.

The Ethics in Government Act does not contain mandatory financial disclosure provisions for lower level employees. However, under the act, supervising ethics offices, including OGE, may require officers and employees to file confidential disclosure reports in such form as the supervising ethics office prescribes.

OGE presently administers 5 C.F.R. Part 735, a regulation issued by its predecessor agency, OPM. This regulation requires executive agencies to issue regulations on employee responsibilities and conduct. The agency regulations are to establish systems for reviewing confidential financial disclosure reports and resolving potential conflicts of interest. Confidential reports must include information on financial interests of

[2]OGE was under the Office of Personnel Management (OPM) until October 1, 1989. On that date, OGE became an independent executive agency as a result of the Office of Government Ethics Reauthorization Act of 1988 (Public Law 100-598, Nov. 3, 1988). In this report, we refer to regulations on confidential disclosure issued in September 1968 as OPM regulations and to other regulations, which were developed after OGE was created, as OGE regulations.

spouses, children, and blood relatives who are members of the employees' households.

In December 1986, OGE proposed new confidential disclosure regulations in the Federal Register. OGE told us that its new interim regulations, issued in April and to be effective in October 1992, took a long time to issue due to the complicated review process and delays in getting Justice and OPM approval. The new regulations will require annual confidential financial disclosure by all employees who are considered vulnerable to conflicts of interest, regardless of grade.

Currently, Treasury regulations require confidential financial disclosure by only those employees in grades 13 and above in vulnerable positions, such as contracting and auditing. The Treasury regulations allow IRS to obtain annual financial statements from lower graded employees in similar positions when specifically approved by OGE.

Failure to Require Financial Disclosure Allows Potential Conflicts of Interest to Go Undetected

IRS takes various steps to prevent conflicts of interest, but it does not require financial disclosure statements from thousands of employees who are in positions that could be vulnerable to conflicts of interest. Our review showed that about 64,000 of IRS' 120,000 employees may be vulnerable to financial conflicts of interest because of their duties and access to nonpublic information. Yet, IRS required only 662 of its employees to file financial disclosure statements in 1991. Consequently, a recent internal audit revealed that some IRS managers failed to detect employee financial conflicts.

IRS Measures to Prevent Conflicts of Interest

Recognizing the sensitivity of its mission and the need to preserve public confidence in the integrity and fairness of tax administration, IRS has taken steps to help prevent employee conflicts of interest. When recruiting new employees, IRS requires that all applicants provide a net worth statement and examines applicants' tax returns for 3 prior consecutive years. For sensitive positions, such as criminal investigators and revenue agents, IRS performs background investigations on the applicants.

For employees who are already on board, IRS has a comprehensive ethics program designed to make employees aware of their ethical responsibilities. As part of its ethics program, IRS provides training that covers a variety of ethics and integrity topics, including conflicts of interest. IRS also publishes Rules of Conduct, which provide guidance on

IRS' expectations about various ethics and integrity issues and include discussions of the rules and laws pertaining to financial conflicts of interest. The Rules of Conduct cover such things as employee purchases of government property, restrictions on business or financial transactions with taxpayers and their representatives, prohibitions in regard to outside employment and business activities, and limitations on gifts and gratuities.

IRS' Rules of Conduct also require that employees inform their supervisors whenever they suspect that their personal circumstances may conflict with their assigned duties. While IRS distributes its Rules of Conduct to all employees and expects employees and supervisors to discuss the Rules each year, IRS has no way of knowing whether employees have potential conflicts. When potential conflicts are reported, IRS may reassign employees or require them to divest their conflicting financial interests.

IRS also takes steps to avoid the appearance of conflicts of interest. For instance, IRS requires reassignment every 6 years of revenue agents who audit large corporations. Further, although IRS does not have a mandatory rotation policy for managers such as District Directors, it encourages managers to rotate on a periodic basis.

IRS Did Not Comply With Treasury Regulations Regarding Confidential Financial Disclosure Statements

The Department of the Treasury has adopted the position that financial disclosure is a viable means for detecting potential financial conflicts of interest, particularly among employees in certain positions at grades 13 and above.

Both the law and Treasury regulations require all political appointees and senior executives to annually disclose their financial interests on statements that are available to the public. Treasury regulations also require annual, confidential[3] financial disclosure by employees, grades 13 through 15, who are responsible for "making a Government decision" or "taking a Government action" in regard to

- contracting or procurement,
- administering grants or subsidies,
- regulating or auditing private enterprise, and
- other activities where the decision or action has an economic impact on the interests of any nonfederal enterprise.

[3]Confidential statements are not available to the public.

With OGE approval, IRS can obtain annual financial statements from employees below grade 13 who serve in similar positions if IRS believes it is essential to protect the integrity of the government and avoid employee conflicts of interest. IRS has not sought approval to require financial disclosure by any employee below grade 13.

In 1991, the IRS Commissioner and 211 senior executives filed public disclosure statements, and 450 employees (primarily grade 15 managers and contracting and procurement personnel down to the grade 13 level) filed confidential disclosure statements. However, as shown in table 1, IRS did not require confidential financial disclosure statements from 12,260 employees in grades 13 through 15, including more than 9,000 revenue agents, revenue officers, and criminal investigators who have frequent, unsupervised contact with taxpayers, make decisions about taxpayer accounts and liabilities, and have access to nonpublic information.

Table 1: Number of IRS Employees, by Position, in Grades 13 and Above Who Were and Were Not Required to File Financial Disclosure Statements During 1991

Position	Number of employees	Required to file	Not required to file
Revenue Agents	6,169	0	6,169
Criminal Investigators	1,943	0	1,943
Attorneys	1,734	0	1,734
Appeals Officers	1,167	0	1,167
Revenue Officers	909	0	909
Selected GM-15 Managers	346	346	0
Tax Law Specialists	333	0	333
Senior Executives	211	211	0
Contracting Personnel	104	104	0
Tax Auditors	3	0	3
Tax Examiners	2	0	2
Commissioner	1	1	0
Total	**12,922**	**662**	**12,260**

IRS ethics officials told us that on the basis of their interpretation of Treasury regulations, they believed the employees who did not file were exempt from disclosing their financial interests because they were closely supervised, they were considered not likely to have a conflict of interest, and the decisions they made had an inconsequential effect on the integrity of IRS.

While Treasury regulations allow certain exemptions, such exemptions must be approved by Treasury's Designated Agency Ethics Official (DAEO). IRS decided which employees did not have to report without seeking Treasury's approval. As a result, the appropriateness of such exemptions was never determined through established procedures. Further, as early as 1965, the Civil Service Commission (the predecessor of OPM) advised IRS that such exemptions would not be approved. Additionally, both the U.S. Customs Service and the Bureau of Alcohol, Tobacco and Firearms—sister agencies to IRS within the Treasury Department—required confidential financial disclosure in accordance with the regulations.

After we brought our findings to the attention of Treasury and IRS ethics officials in October 1991, they agreed to take immediate steps to comply with Treasury regulations. Commenting on a draft of this report, the Treasury DAEO informed us that 5,782 of these employees will be required to file annual confidential financial disclosure statements during the reporting period that ends July 31, 1992. IRS obtained formal approval from Treasury's DAEO to waive disclosure requirements for the other 7,000 or so employees.

As reflected in IRS' comments on a draft of this report, IRS believed these employees should be exempted from confidential disclosure requirements because of the technical nature of their jobs and because they are closely supervised. The DAEO emphasized in his comments that the 1992 exemptions were for 1 year only, and that they would be reevaluated in the future. We believe the Treasury DAEO should be cautious when granting exemptions and should not exempt any employee who influences or makes decisions that have an economic impact on taxpayers and nonfederal enterprises.

Thousands More IRS Employees Are Vulnerable to Financial Conflicts of Interest but Are Not Required to File Annual Confidential Statements

As of May 1991, IRS had thousands of employees in grades 12 and below who were vulnerable to conflicts of interest, including about 19,000 revenue agents, revenue officers, and criminal investigators. IRS did not require any of them to file disclosure statements in 1991. Unlike IRS, some other agencies require all of their employees who have similar responsibilities to file annual statements, regardless of grade.

In 1986, OGE reviewed Treasury's ethics program and concluded that IRS' confidential disclosure practices were "grossly inadequate," primarily because they were based on employee grade level rather than position vulnerability. OGE concluded that all IRS revenue agents, revenue officers, and criminal investigators, regardless of grade, were vulnerable to conflicts of interest and should be required to disclose their financial interests. Had IRS implemented OGE's recommendation in 1991, IRS would have obtained confidential financial statements from about 19,000 revenue agents, revenue officers, and criminal investigators in grades 12 and below.

Revenue agents are vulnerable to conflicts of interest because they have access to tax return information and review taxpayer records to determine their tax liability. Similarly, revenue officers and criminal investigators often work independently when collecting taxes or gathering evidence. Also, they make decisions about the amount of taxes owed and collected and offer opinions about pursuing taxpayers for criminal violations.

After its 1986 review, OGE also recommended that IRS identify other vulnerable positions. While Treasury did not disagree with OGE, Treasury did not require IRS to comply with OGE's recommendation at that time, believing that new OGE regulations would be issued within the next several weeks. As noted above, interim regulations were recently issued and will be effective October 5, 1992.

IRS reviewed and commented on OGE's 1986 draft regulations, which would have required financial disclosure based on position vulnerability rather than position and grade. Rather than leaving it to IRS'—or other agencies'—discretion for employees in grades 12 and below, the proposed regulations would have required all employees who are in certain positions to file annual financial disclosure statements, regardless of grade. In its comments on the draft regulations, IRS identified over 50,000 employees who would have been required to file confidential financial disclosure statements under the draft regulations. At that time, IRS commented that the cost of collecting and reviewing such a large number of statements would outweigh any benefits. As of May 1991, staffing levels for the same positions had increased to 64,000, about 52,000 of which were for grades 12 and below.

OGE officials told us that the time required to complete and review confidential financial disclosure statements would vary depending on the extent of reported financial interests. Statements from employees who have little or no financial interests would require little time to complete and review. OGE's opinion was confirmed by IRS reviewers in the Southeast Region. They told us that most disclosure statements can be reviewed in 5 to 10 minutes. While disclosure statements from employees who have extensive financial holdings would take longer to prepare and review, OGE believes this time is warranted as these employees are more likely to have potential conflicts of interest.

We have taken the position in the past that the cost of completing and reviewing the forms is not a legal basis for failure to collect and review employee financial disclosure statements.[4] For example, the Farmers Home Administration (FmHA) believed that the cost of requiring financial disclosure by approximately 2,000 county supervisors would outweigh the benefits. We concluded that the cost effectiveness of obtaining disclosure reports and reviewing them is not a factor to be considered under either the act or implementing regulations. Subsequently, FmHA agreed with our recommendation to collect and review confidential financial disclosure statements from county supervisors.

In October 1991, Treasury ethics officials agreed that many of the 52,000 lower graded IRS employees may be vulnerable to conflicts of interest. They told us that IRS would be required to comply with OGE's new regulations when they become effective in October 1992.

Unlike IRS, some agencies whose employees have similar responsibilities and access to nonpublic information base their employee financial disclosure requirements more on position vulnerability than on employee grade. For example, Treasury regulations require financial disclosure by grades 13 through 15 auditors and investigators, while other agencies require annual financial disclosure by all auditors and investigators, as shown in table 2.

Table 2: Confidential Financial Disclosure Requirements for IRS and Selected Agency Auditors and Investigators

Agency	Employees required to file
Internal Revenue Service	Grade 13 and above
Federal Deposit Insurance Corporation	All
Resolution Trust Corporation	All
Department of the Interior	All
Commodity Futures Trading Commission	All

Consistent with these agencies' practices and OGE's 1986 recommendation, we believe IRS should act to require confidential financial disclosure by all revenue agents, revenue officers, and criminal investigators. Also, as OGE

[4]Financial Disclosure: USDA's Systems Limited by Insufficient Top Management Support (GAO/GGD-90-100, July 13, 1990).

recommended, IRS and the Treasury DAEO should identify any other employees who are vulnerable to conflicts and decide whether they should file annual disclosure statements. These measures are consistent with both OGE's earlier recommendations and IRS' current efforts to make employees more aware of their ethical responsibilities. Requiring employees in vulnerable positions to periodically review their financial holdings in relation to their work assignments should aid in making them more aware of potential conflicts of interest.

Internal Audit Identified Financial Conflicts of Interest

During 1991, IRS' Internal Audit Division reviewed the tax returns of 1,200 IRS employees who examine the tax returns of large corporations. Large corporation audits typically take 2 to 3 years to complete. IRS revenue agents who do this work generally complete two consecutive audits and are then rotated to audit another corporation. In its report, Internal Audit disclosed that it had identified 23 managers and examiners who had investments in the corporations they examined. The value of the investments ranged from less than $1,000 up to $34,000.

Another 143 examiners had investments in corporations that were examined by the same work group or post-of-duty. The value of these investments ranged from less than $1,000 to as high as $800,000. Consistent with IRS regulations, the possession of stock in a company by one employee in a section or post-of-duty does not preclude any other employee in that group from working on an audit of the company. However, requiring these individuals to file annual disclosure statements would provide IRS managers the information they need to prevent conflicts when the employees are reassigned to audit other corporate taxpayers.

As shown in table 3, most of the investments were valued at more than $1,000, the amount Treasury views as the threshold for a potential conflict of interest.

Table 3: Extent of Investments in Large Corporations That Were Being Audited by IRS Examiners and Their Peers in the Same Group or Post-of-Duty

Investment value	By assigned examiners	By other examiners in same group or post-of-duty
Less than $1,000	7	8
$1,001 to $5,000	8	44
$5,001 to $100,000	8	63
Over $100,000	0	4
Undetermined	0	24
Total	**23**	**143**

IRS expects its employees to inform their supervisors whenever they suspect that their personal interests may conflict with their assigned duties. However, only 1 of the 23 employees who had stock in the companies they examined properly notified his supervisor as required by IRS rules of conduct. This employee received a properly approved determination that the investment was not a conflict of interest, according to Internal Audit. Managers acknowledged that they were aware of four other employees' investments. They did not, however, require the employees to document their financial interests and obtain waivers in accordance with established procedures.

None of the 23 employees had been required to file confidential financial disclosure statements. Internal Audit identified the stock holdings and estimated stock values by reviewing employee tax returns and related information.

Internal Audit reported that many of the employees who did not disclose their potential conflicts were unaware of, or did not understand, the reporting procedures. In response to Internal Audit's report on this issue, IRS management commented that ". . . case managers will be required to ascertain from each team member that all financial interests which are potential conflicts of interest are properly disclosed." Management also commented that case managers will ensure all team members are aware of and understand the statute requiring disclosure of any financial interest that conflicts, or that might create a real or apparent conflict of interest.

IRS Managers Need Better Information on Employee Financial Holdings and Work Assignments

As mentioned earlier, IRS plans to take immediate steps to require financial disclosure statements from about 5,000 employees. In our view, IRS also needs to broaden its coverage to include thousands of other employees who are vulnerable to conflicts of interest. Regardless of the number of IRS employees who are ultimately required to file financial disclosure statements, IRS needs to ensure that its managers can appropriately use financial disclosure statements to identify and act upon potential conflicts of interest. Accordingly, IRS managers must have sufficient information to match employee holdings against work assignments. Without this information, IRS managers are less able to protect IRS and its employees from potentially embarrassing conflicts that could erode taxpayers' confidence in the tax system.

We examined the 34 confidential financial disclosure statements that were filed by employees in the Southeast Region during 1991. Our review showed that managers in that region did not always have sufficient information to identify potential financial conflicts of interest. This was because some statements did not provide enough information, and the managers who reviewed the statements did not have information on the employees' specific work assignments.

Our review in the Southeast Region showed that 24 regional appeals officials filed disclosure statements in 1991. One filer did not answer certain questions, leaving doubt as to whether the filer overlooked the questions or had no investments. Also, five of the six who reported having stock did not identify the value of their stock holdings or the names or locations of the companies. The Treasury regulations do not call for the filer to provide the precise value of an investment. However, managers need to know the value of an employee's investment when determining whether recusals or waivers should be granted. The Regional Director of Appeals, who reviewed the statements, said he did not request additional information. Further, he stated that he was not familiar with the specific appeals reviewed by these officials. He told us that he did not request additional information on the reported investments or work assignments because he relies on his employees to inform him whenever they believe their financial interests conflict with their duties.

Similarly, the Regional Commissioner told us that his review of 10 other confidential statements was based on his general knowledge of the filer's position, rather than on a detailed comparison of the filer's financial investments and specific work assignments. Like the Regional Director of Appeals, he relies on these employees to identify any potential conflicts.

According to the Regional Director of Appeals, further delegation of disclosure statement review would be one way of assuring that reviewers are familiar with assignments. For example, Chiefs of Appeals could be delegated the responsibility for reviewing statements submitted by Associate Chiefs. However, the Regional Director of Appeals told us appeals officials in the Southeast Region are generally opposed to disclosing their personal financial interests to their immediate supervisors.

Using Employee Financial and Assignment Information to Prevent Conflicts of Interest

When IRS expands its financial disclosure requirements to cover all vulnerable employees, a sizable number of revenue agents (17,000 nationwide) will be required to file confidential financial disclosure statements. Accordingly, we met with Examination officials in the Atlanta District Office to discuss how the financial disclosure statements of revenue agents and employee assignment information could be used by reviewers in IRS' Office of Examination. A senior official in the District Office told us that Examination's group managers could be the assigned reviewers because they make or approve assignments. He said that a typical Examination group manager makes or approves case assignments for about 12 revenue agents. He added that each agent normally works on 10 or fewer tax returns at a time and normally closes about 50 or fewer cases each year. The senior official said that delegating the review to group managers would be one way of assuring that the reviewer has knowledge of the employees' specific work assignments.

Unlike IRS, some other federal agencies, as well as some CPA firms, use investment information when making employee assignments. For example, according to officials representing two Federal Deposit Insurance Corporation regions, disclosure statements submitted by field office employees are reviewed by regional officials who also have information on the banks and thrifts in the employee's area of responsibility. The reviewing officials send letters to all examiners and managers who have loans with or own stock in banks in their area, notifying them that they should not examine the related institutions. Letters are also sent to each employee's supervisor, who is expected to prohibit the employee from examining these institutions.

CPA firms such as Arthur Andersen and Ernst and Young take other steps to assure that their employees do not have conflicting financial interests in the firms they audit. According to their ethics officials, both firms use computers to track the financial interests reported by their partners and managers because they are prohibited from having any financial interests in the firms' clients. Senior and staff level auditors are required to report annually their financial interests in the firms' clients. They are then prohibited from auditing those clients.

After our discussions with IRS ethics officials, they agreed to evaluate our concern that the individuals who review the statements do not have sufficient information to determine if the reported financial holdings conflict with employee duties.

Conclusions

IRS has not complied with Treasury's regulations concerning financial disclosure requirements. As a result, thousands of employees who are vulnerable to conflicts of interest are not filing annual financial disclosure statements. In 1991, IRS required financial disclosure statements from about 650 employees. On the basis of our work, IRS agreed to comply with Treasury regulations for the 1992 filing year, requiring over 5,000 more employees to file confidential statements and seeking formal approval from the Treasury DAEO to exempt another 7,000 or so employees. We believe that compliance with Treasury regulations will enhance IRS' ability to detect and prevent financial conflicts by vulnerable employees in grades 13 and above.

However, we believe IRS has thousands of employees below grade 13 who are vulnerable to conflicts of interest and should be required to file annual financial disclosure statements. These employees are vulnerable to conflicts of interest because they have direct access to taxpayers and taxpayer information and determine the amount of taxes owed and collected. Real or apparent employee financial conflicts of interest could erode public confidence in the integrity of the tax system.

IRS should act to implement OGE's 1986 recommendation to require confidential financial disclosure by all revenue agents, revenue officers, and criminal investigators. Also, as OGE recommended, IRS and the Treasury DAEO should identify any other employees who are vulnerable to conflicts and decide whether they should file annual disclosure statements. Not only are these measures consistent with OGE's earlier recommendations, they are also consistent with IRS' current efforts to make employees more aware of their ethical responsibilities.

Our review of financial disclosure statements in the Southeast Region indicated that even when statements are filed, IRS managers may not have sufficient information about employee holdings and work assignments. As

IRS expands its universe of employees who are required to file confidential financial disclosure forms, it needs to ensure that managers can appropriately use the statements to identify and act upon potential conflicts of interest. In doing so, IRS would be better able to protect the agency and its employees from conflicts that could embarrass the agency.

Recommendations

We recommend that the Secretary of the Treasury direct the Commissioner of Internal Revenue to take the following actions:

- Require annual confidential financial disclosure statements from all revenue agents, revenue officers, and criminal investigators.
- Determine, with Treasury DAEO assistance, whether other employees are vulnerable to conflicts because of their duties and responsibilities, and decide whether they should file annual disclosure statements.
- Ensure that IRS reviewing officials have adequate information on employee investments and specific work assignments to enable them to determine whether reported financial interests conflict with employee duties and responsibilities.

Agency Comments and Our Evaluation

Treasury and IRS provided written comments on a draft of this report in letters dated May 7, 1992, and June 11, 1992, respectively (see apps. II and III). In their comments both agencies noted that IRS has begun to take actions recommended in our draft report. For 1992, IRS has sought to comply with existing Treasury regulations, requiring over 5,000 more employees to file confidential disclosure statements. IRS is also reevaluating whether coverage should be extended to more of its employees and who should review the disclosure statements to ensure that the reviewers have adequate information to assess work assignments and potential conflicts. In addition, IRS mentioned that it has taken other steps in the past year, urging management emphasis on conflict of interest issues and publishing a newsletter on employee ethics.

While IRS has required over 5,000 more employees (management employees in grades 13 through 15) to file confidential disclosure statements, it requested and obtained Treasury approval to exempt 7,318 nonsupervisory employees in grades 13 through 15 from the filing requirement for the reporting year ending July 31, 1992. IRS justified this exemption by arguing, as it has since 1965, that the work of these employees is subject to continuous supervisory review and guidance. In its letter to us, Treasury emphasized that the exemption for these positions was for 1 year only. We agree with Treasury's requirement that IRS provide detailed descriptions of the guidance and supervision received by these individuals before deciding on further exemptions. In addition, Treasury said it shared our view "that exemptions should be weighed carefully in light of the need to ensure that potential conflicts are brought to light quickly and eliminated."

In its comments, IRS said that it is "not ready" to agree with our recommendation that all revenue agents, revenue officers, and criminal investigators be required to provide annual disclosure statements. IRS argued that this requirement would effectively remove the responsibility for identifying potential conflicts of interest from the employees and place it on the managers.

We do not believe that implementing our recommendation would entail an inappropriate shift of ethical responsibility from the individual employee to his or her manager, although it would more actively engage managers in a process in which they now largely play an inactive role. Indeed, we believe that annual disclosure would increase employee accountability because the employee would be required to certify each year to his or her financial holdings. Moreover, this disclosure statement would provide the managers with additional information, better equipping them to assist employees in avoiding conflicts of interest.

IRS raised other concerns about this recommendation. IRS mentioned that requiring financial disclosure by employees below grade 13 would require OPM approval and the need to notify, and possibly negotiate with, the National Treasury Employees Union. The new OGE regulations, effective in October 1992, do not distinguish among covered employees based on grade or pay and allow IRS to decide which employees are vulnerable to conflicts. Thus, obtaining approval from OGE (not OPM) is not an obstacle to implementing our recommendation. And, because the OGE regulations apply governmentwide, their applicability to IRS employees is not negotiable, although the specifics of their implementation may be.

Finally, IRS questions the usefulness of the statements and points to the difficulty in matching employee holdings against work assignments. With appropriate delegation of review authority to individuals who are familiar with employee work assignments, we believe that the statements will be much more useful and administration of the system far less unwieldy.

IRS' comments indicate that it may perceive annual employee financial disclosure as a substitute for the other steps IRS now takes to avoid conflicts of interest, such as requiring employees to inform their supervisors if they are concerned about a potential conflict of interest. We see no reason why this should be the case. To the contrary, an annual financial disclosure requirement for employees in vulnerable positions should be viewed as only one part of an effective and comprehensive ethics program.

As agreed with the Subcommittee, we plan no further distribution of this report until 30 days after the date of this letter, unless you publicly announce its contents earlier. At that time, we will send copies of this report to the Secretary of the Treasury, the Commissioner of Internal Revenue, and other interested parties. We will also make copies available to others upon request.

The major contributors to this report are listed in appendix IV. If you have any questions on this report, please call me on (202) 275-6407.

Sincerely yours,

Jennie S. Stathis

Jennie S. Stathis
Director, Tax Policy and
Administration Issues

Contents

Abbreviations

IRS	Internal Revenue Service
DAEO	Designated Agency Ethics Official
FmHA	Farmers Home Administration
OGE	Office of Government Ethics
OPM	Office of Personnel Management

Objective, Scope, and Methodology

Our objective was to determine the adequacy of IRS' employee financial disclosure process. In doing so, we compared IRS' financial disclosure policies, procedures, and practices with legal and regulatory requirements and with disclosure practices in other federal agencies. We also obtained and relied heavily on the views of OGE, the agency currently responsible for establishing financial disclosure standards for all federal executive agencies.

We reviewed and discussed with OGE, Treasury, and IRS officials (1) ethics laws, executive orders, and regulations; (2) IRS' policies, procedures, and practices on financial disclosure; (3) OGE's 1986 evaluation of Treasury's ethics program; and (4) IRS' comments on OGE's 1986 proposed confidential disclosure regulations. We also examined the 34 confidential statements reviewed by Southeast Region officials.

We compared IRS confidential financial disclosure requirements with those of the Federal Deposit Insurance Corporation, the Resolution Trust Corporation, the Department of the Interior, and the Commodity Futures Trading Commission. We chose these agencies because they have employees with responsibilities and access to nonpublic information similar to IRS employees.

We also obtained information about the employee financial disclosure policies and practices of two public accounting firms—Arthur Andersen and Ernst and Young.

We performed our work primarily at OGE and IRS headquarters in Washington, D.C., and IRS' Southeast Regional Office and Atlanta District Office in Atlanta, Georgia. Our work was done between December 1990 and October 1991 in accordance with generally accepted government auditing standards. Treasury and IRS provided written comments on a draft of this report; these comments are incorporated where appropriate and are included in appendixes II and III.

Comments From the Internal Revenue Service

COMMISSIONER

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

JUN 11 1992

Mr. Richard L. Fogel
Assistant Comptroller General
United States General Accounting Office
Washington, DC 20548

Dear Mr. Fogel:

We have reviewed your draft report entitled, "Tax Administration: IRS Should Require Financial Disclosure by Employees Vulnerable to Conflicts of Interest". The following comments respond to the report's recommendations regarding financial disclosure statements as well as other issues raised in the report.

We agree with GAO that it is important for government officials to avoid the appearance of conflicts of interest as well as actual conflicts. As part of our efforts to ensure that our own employees are meeting these standards, our Internal Audit Division recently conducted a review of employees assigned to the Coordinated Examination Program for compliance with existing rules prohibiting conflicts of interest. The GAO drew extensively on the Internal Audit Report in their findings. Internal Audit found that IRS employees generally complied with the statute prohibiting conflicts of interest and did not identify individual situations that appeared to be egregious conflicts. Both Internal Audit and GAO made recommendations to strengthen rules covering disclosure of financial interests that potentially conflict with work assignments.

We have already taken steps to require all appropriate managers and management officials in grades 13-15 to file disclosure statements. This will increase the number of filers to approximately 6,000. As suggested by GAO, we are also reevaluating the issue of who should review these statements. For the reasons listed below, we are not ready to agree to GAO's recommendations that all revenue agents, revenue officers and criminal investigators be required to provide annual confidential disclosure statements. However, extended coverage and review issues will be reevaluated in connection with the issuance of the Office of Government Ethics (OGE) confidential financial disclosure regulations which will be effective in October 1992.

Prior to 1992, in accordance with OGE rules in effect since 1965, IRS had made a decision that non-supervisory employees below grade 15 were exempt from the confidential financial disclosure requirements because the degree of supervision and review was a sufficient safeguard against conflicts of interest. For 1992 IRS was granted an exemption from the filing

Now on pp. 1-2.

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requirements for certain categories of non-supervisory grade 13-15 employees based on the nature of the duties performed and by noting in each instance that all aspects of their work is subject to continuous supervisory review and guidance. Treasury has informed us that under the newly issued OGE interim financial disclosure regulations, this exclusion will be reconsidered for 1993.

The report generalizes on page two that IRS identified thousands of employees who are significantly vulnerable to conflicts of interest. Recognizing the potential vulnerability, IRS has had in place long-standing Rules of Conduct which require employees to inform their supervisors of financial investments related to their work assignments and for supervisors to make determinations of whether or not an assignment was appropriate in light of this information. Both GAO and Internal Audit found that these rules were not always followed. Based on these findings Internal Audit recommended that IRS strengthen existing procedures to ensure general understanding of these Rules by both managers and employees. In line with these recommendations, over the past year managers have been urged to emphasize potential conflict of interest issues during mandatory Rules of Conduct discussions. Also, we have published an all-employee ethics newsletter, "Practicing Ethics," that teaches employees how to recognize and report potential conflicts of interest.

As to GAO's recommendation to require all revenue agents, revenue officers and criminal investigators to provide annual financial disclosure statements, regardless of grade level, we have grave concerns. Our current rules affix responsibility on each individual to determine actual or potential conflicts of interest with assigned work. Such conflicts can arise for a variety of reasons, only one of which includes financial investments. We believe that reliance on a system where each employee is responsible is much more effective than a system where this responsibility is transferred to management, who must rely on a matching process which, at best, can only do a marginal job of identifying potential or actual conflicts. The difficulty of maintaining and matching employee statements against work assignments, as well as the limited information available from such statements, makes their usefulness questionable. For example, new investments during the year are not revealed and there are many kinds of financial investments, even if reported, that do not readily identify potential conflicts of interest, such as mutual funds. This proposed procedure removes the responsibility for identifying potential conflicts of interest from the employees and places it on the managers.

We have other, practical, concerns which would preclude immediate implementation of any changes that affect bargaining level employees. The regulations state that OPM must approve any filing by employees below the grade 13 level. Another issue

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involves notification and probable negotiation with the National Treasury Employees Union if IRS were to impose a filing requirement on bargaining unit employees. Finally, there is the issue of the practical usefulness of confidential financial disclosure statements in large agencies with significant turnover, and workloads that involve millions of cases. We believe the report underemphasizes these issues, particularly with respect to matching employee holdings against work assignments, as is suggested by GAO on pages 21, 22, and 27.

Now on pp. 13, 13-14, and 15-16.

In conclusion, the IRS has been and continues to be in substantial compliance with existing regulations on financial disclosure. We believe there is a sound basis for our decision not to compel thousands of additional employees to file financial disclosure forms in the absence of any indication that there are significant conflict of interest problems. We are improving our supervisory oversight of potential conflict situations and increasing our efforts to make employees aware of potential conflicts. Finally, the IRS intends to fully comply with the new OGE regulations concerning financial disclosure by employees and we will be reevaluating the number of confidential filers in light of these new regulations, in making our recommendations to the Department's Designed Agency Ethics Official.

Best regards.

Sincerely,

Shirley D. Peterson

Shirley D. Peterson

Comments From the Department of the Treasury

DEPARTMENT OF THE TREASURY
WASHINGTON

May 7, 1992

Mr. Richard L. Fogel
Assistant Comptroller General
General Government Division
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Fogel:

This is in response to your invitation to comment on the draft report prepared by your office entitled, Tax Administration: IRS Should Require Financial Disclosure By Employees Vulnerable to Conflicts of Interest. The draft report discusses the adequacy of the employee confidential financial disclosure process within the IRS and recommends that we direct that agency to take several actions to improve that process.

I have reviewed the contents of the draft and first wish to make several brief comments concerning specific sections, as follows:

Now on p. 4.

-- On page 5, paragraph 2, the first definition of those who must file public disclosure reports should be modified to read:

> ...those who are paid, other than under the General Schedule, at a rate equal to or greater than 120% of the rate of pay for GS-15, Step 1...

Now on p. 3.

-- Regarding page 5, footnote 1, it should reflect the fact that in 1989 the General Counsel assented to the continuing existence of a provision in the Internal Revenue Manual which set the threshold amount for asset reporting on the confidential statements at $5000. We understand that your auditors were provided with a copy of the memorandum communicating this decision.

Now on pp. 9-10.

-- On page 16, paragraph 2, it is not clear to us who concluded that "most" disclosure statements could be reviewed in 5 to 10 minutes or that the amount of time needed to complete such a review can be determined solely with reference to the extent of a filer's financial holdings. It has been our experience that a filer's job description, and other information concerning his or her duty assignments, must also be examined in light of any financial interests disclosed before the review process may be completed. This

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frequently requires more than 5 or 10 minutes when an IRS filer has disclosed financial interests in corporations or other business enterprises or associations.

As an immediate result of your audit, IRS officials have advised me that they have now identified some 5,782 employees who will be required to file confidential statements during the reporting year which ends July 31, 1992. This figure represents a significant increase in the number of filers from previous years.

The IRS has formally sought exclusions from the filing requirements from me for nine categories of non-supervisory employees. I currently have authority to make determinations of this nature under section 0.735-92 of the Treasury's Minimum Standards of Conduct (31 C.F.R. 0.735-92). These categories of non-supervisory employees include those of Internal Revenue Agent, Internal Revenue Officer, Appeals Officer, Mining Engineer, General Engineer, Valuation Engineer, Forester, Valuation Geologist, and Special Agent. The total number of the employees in these nine categories is 7,318, with the largest number (4,343) in the category of "Internal Revenue Agent". The IRS has sought to justify the exclusions of these non-supervisory employees from the filing requirements by describing the nature of the duties performed and noting in each instance that all aspects of their work are subject to continuous supervisory review and guidance.

Given IRS's justification and the practical problems inherent in such a large expansion of the current filing program, I have approved the exclusion of these employees from the filing requirements for this year only. I have informed the IRS that, under the newly issued OGE interim regulations concerning the filing of confidential statements, 5 C.F.R. Part 2634, much more detailed information regarding supervisory oversight will be required should IRS seek similar exclusions in the future. For example, I would anticipate, at a minimum, receiving representative job descriptions of positions occupied by the employees in these categories as well as much more detailed descriptions of the guidance and supervision received by these individuals.

As you can see, IRS has made substantial strides toward expanding its program for confidential financial disclosure. As we implement OGE's new regulations over the next year, we will be particularly mindful of your concern, which we share, that

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exemptions should be weighed carefully in light of the need to ensure that potential conflicts are brought to light quickly and eliminated.

Thank you for the opportunity to comment on your proposed report.

Sincerely,

Dennis I. Foreman

Dennis I. Foreman
Deputy General Counsel

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