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Report to the Honorable
Herbert H. Kohl, U.S. Senate

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TAX ADMINISTRATION

Process Used to Revise the Federal Employment Tax Deposit Regulations

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The Honorable Herbert H. Kohl
United States Senate

Dear Senator Kohl:

This report responds to your request that we review the development of the revised federal employment tax deposit regulations issued by the Department of the Treasury and the Internal Revenue Service (IRS) on September 24, 1992. Specifically, we considered (1) whether the Treasury and IRS developed the regulations by applying principles from IRS' Compliance 2000 approach, which is designed to improve voluntary taxpayer compliance, reduce taxpayer burden, and increase IRS attention to the needs of those parties affected by its actions; (2) whether, and, if so, how the process used by Treasury and IRS to develop and revise regulations could be improved; and (3) how Treasury and IRS officials know when their efforts to develop and revise regulations result in regulations that are sufficiently simple and easy to follow.

Background

We previously identified problems with the federal employment tax deposit system.[1] In fiscal year 1988, IRS collected employment tax deposits totaling $627 billion from approximately 5 million employers. About one-third of these employers were penalized a total of $2.6 billion for not making timely deposits. In addition, IRS found employment tax deposit regulations difficult to administer and enforce because employers could be subject to more than one deposit rule during a tax period and because exceptions to the rules could be confusing. The regulations required employers to monitor and accumulate withheld income and Social Security taxes from payday to payday until one of four separate deposit rules (quarterly, monthly, eighth-monthly,[2] or daily) was triggered.

IRS developed the revised employment tax deposit regulations after it adopted Compliance 2000, which it began to develop in 1988. Compliance 2000 is an approach IRS uses to improve voluntary taxpayer compliance with the tax law. It is designed to change the behavior of noncompliant taxpayers and to reduce taxpayer burden. Under Compliance 2000, IRS seeks to identify and address the causes of taxpayer noncompliance and taxpayer burden by analyzing its own systems and by obtaining feedback from those who must comply with a tax, i.e, "stakeholders."

[1]Federal Tax Deposit Requirements Should Be Simplified (GAO/GGD-90-102, July 31, 1990).

[2]The eighth-monthly rule divided the month into eight parts of varying lengths.

IRS began revising the regulations in May 1990, when it first asked the public for suggestions on how to simplify the employment tax deposit regulations. In 1991, Congress considered two bills that were intended to simplify the regulations, and hearings were held on the bills in the House and Senate. A tax bill incorporating employment tax simplification was vetoed in March 1992 for reasons unrelated to its employment tax deposit provisions. Treasury and IRS then tried to simplify the employment tax rules by proposing regulatory changes that were based on the vetoed legislation. Proposed regulations were published in May 1992, IRS convened a hearing in August of that year, and final regulations were issued that September. In appendix I, we discuss in further detail the events surrounding the issuance of the final regulations.

Results in Brief

The final employment tax deposit regulations launched a new process that was widely considered to be significantly simpler and easier for stakeholders to understand and comply with than the earlier one. The regulations simplified the employment tax deposit rules largely by providing most employers with a fixed deposit rule that they can follow for an entire calendar year—except for the largest employers, employers pay employment taxes either by the fifteenth day of the following month or by specific semiweekly dates following their payday.

In keeping with Compliance 2000, IRS obtained stakeholders' input, either oral or written, throughout the process. For example, according to most witnesses at IRS' August 3, 1992, hearing on the proposed regulations, the proposed regulations were not simple enough and therefore did not adequately fix the complexity that was an underlying cause of noncompliance. Treasury and IRS then modified the proposed regulations and significantly improved them, according to stakeholders we interviewed.

Although stakeholders were satisfied with the final employment tax deposit regulations, stakeholders differed in their satisfaction with the process used in developing them. Representatives from two small business organizations considered their access to IRS officials during the process followed in developing the revisions to be exemplary. On the other hand, eight stakeholder representatives expressed their dissatisfaction in a letter to the Assistant Secretary (Tax Policy) and the IRS Commissioner on August 25, 1992. The letter expressed their desire for a two-way dialogue with policymakers on business matters of concern to the stakeholders.

When developing regulations, Treasury and IRS officials may not always be able to interact with all stakeholders to the extent the stakeholders desire. However, Treasury and IRS officials may be able to improve their future communications with stakeholders by structuring the regulation development process to direct regulation drafters' attention to stakeholders' concerns.

To determine whether new or revised regulations are simple to understand and follow, IRS officials largely rely on the professional, yet subjective, judgment of those officials who draft the proposed regulations. As they revised the employment tax deposit regulations, officials say they used some measures to gauge whether simplicity was being achieved and to balance simplicity with other regulatory objectives. Treasury and IRS guidance does not, however, require that such measures be used.

Consideration of Stakeholders' Views Resulted in Simpler and Easier to Follow Regulations

Treasury and IRS officials reached out to stakeholders between May 1990 and August 1992 to obtain input on how to simplify the employment tax deposit regulations. The officials used a legislatively developed proposal that was reviewed in congressional hearings as the basis of the revised regulations that were proposed in May 1992. Officials published their proposed regulations, obtained significant suggestions for improvements, and rapidly made changes that resulted in final regulations that were considered by most stakeholders to be much simpler than the regulations they replaced.

As early as May 1990, IRS recognized that the complexity of its employment tax deposit regulations resulted in noncompliance. It attempted to simplify these complex regulations at the same time it was also undertaking Compliance 2000. IRS began developing the Compliance 2000 approach to tax administration in 1988 to reduce taxpayer noncompliance. Compliance 2000 aims to reduce unintentional noncompliance by increasing education and outreach. Compliance 2000 also entails IRS' factually determining the causes of noncompliance and correcting them. According to IRS, correcting causes of unintentional noncompliance, such as complex regulations and insufficient explanations, may be more effective than addressing them through traditional means, i.e., enforcement sanctions. In concert with the Compliance 2000 approach, IRS is increasing its role as an advocate for simpler tax laws and regulations. IRS intends to provide taxpayers with an opportunity to participate in the design and evaluation of regulations.

In discussions with us, 5 of the 10 stakeholders we interviewed said that IRS operated in the spirit of Compliance 2000 during its efforts to revise the employment tax deposit regulations. Small business stakeholders in particular said that IRS actively sought their views.

IRS' efforts to obtain stakeholder input began in May 1990 when IRS asked for public suggestions on how the employment tax deposit regulations might be simplified.[3] Its efforts also included sending IRS officials to an August 1990 meeting of the American Institute of Certified Public Accountants (AICPA) on the deposit regulations and having IRS officials meet with stakeholders in March 1991. In May 1992, Treasury and IRS published proposed revisions to the employment tax deposit regulations to provide stakeholders an opportunity to provide written comments. In addition, IRS convened an August 3, 1992, hearing on the proposed regulations. Most witnesses questioned whether the regulations were simple enough to help employers achieve a high compliance rate.

Considering the process overall, the National Federation of Independent Business and the Small Business Legislative Council considered their access to IRS officials during the regulation development process to be exemplary. The Small Business Legislative Council representative considered the process followed in revising the employment tax deposit regulations to be a model for future regulation projects. Some other stakeholder representatives, notably eight who sent a letter to the Treasury and IRS executives, were less pleased with their communications with Treasury and IRS officials. Nevertheless, virtually all of the stakeholders we interviewed said that with the final regulations, IRS had responded well to their concerns and significantly simplified the employment tax deposit rules.

Employment Deposit Experience Holds Lessons to Improve Future Interactions With Stakeholders

Although the final employment tax deposit regulations were well received, certain stakeholders were dissatisfied with various aspects of the process used as Treasury and IRS developed the revisions. Two concerns of these stakeholders were that an adequate dialogue did not occur between Treasury and IRS officials and the stakeholders and that Treasury and IRS officials did not follow statutory or executive branch guidance that either appeared to be applicable or that the stakeholders thought would have been appropriate to follow. The experience gained in developing these

[3]IRS asked for comments in Internal Revenue Bulletin Notice 90-37, which provided guidance to taxpayers regarding a related tax matter.

revised regulations may help Treasury and IRS officials improve future efforts to communicate meaningfully with stakeholders.

Dialogue Between Stakeholders and Regulatory Policymakers

After IRS' August 3, 1992, hearing on the proposed employment tax deposit regulations, eight stakeholder representatives signed letters to the Assistant Secretary (Tax Policy) and the IRS Commissioner on August 25, 1992. The letters stressed the stakeholders' belief that a two-way dialogue had not occurred between the stakeholders and policymakers on business issues of concern to the stakeholders. The representatives' belief was based, in part, on a question from the hearing panel during the August hearing. At least two stakeholders interpreted the question to imply that the stakeholders' motive for participating in the regulation development process was solely profit-driven. Also, in the letter the representatives noted the short deadline set by IRS and Treasury for finalizing the regulations. The representatives took the short deadline, along with the close working relationship that Treasury and IRS officials had with two other stakeholder organizations that strongly supported the proposed approach, to imply that few changes would be made to respond to their concerns.

Regulatory Flexibility Act and Executive Order 12291

Certain stakeholders also believed that Treasury and IRS should have followed provisions of the Regulatory Flexibility Act of 1988 (RFA) and/or Executive Order 12291 (EO)[4]. RFA requires federal agencies to assess the effects of their proposed rules on small entities. As defined in RFA, small entities include small businesses, small governmental units, and small not-for-profit organizations. As a result of their assessments, agencies must either (1) perform a regulatory flexibility analysis describing the impact of the proposed rules on small entities or (2) certify that their rules will not have a "significant economic impact on a substantial number of small entities." Where applicable, an agency must include an initial regulatory flexibility analysis, or a summary, in the Federal Register notice of proposed rulemaking. A final analysis must be made available to the public, with information on how to obtain copies included in the Federal Register with the issuance of final regulations. The regulatory flexibility analysis is intended to focus attention on the effect of regulations on small entities and to minimize that effect. However, RFA requires such analyses

[4]EO 12291 was repealed and replaced by EO 12866 on September 30, 1993. The new order makes some revisions to executive branch procedures for developing regulations. However, it is consistent with EO 12291 in emphasizing that regulations be developed taking into consideration their benefits and costs as well as those of alternative approaches. EO 12866 is also consistent with EO 12291 in emphasizing that the views of potentially affected parties be sought and considered.

for regulations only when agencies must publish the regulations for notice and comment under the provisions of the Administrative Procedure Act (APA). Because they had classified the employment tax deposit regulations as interpretative and interpretative regulations do not have to be published for notice and comment,[5] Treasury and IRS officials did not prepare a regulatory flexibility analysis.[6]

EO 12291 required that drafters of major regulations (1) develop a regulatory impact analysis that considered the costs and benefits of proposed regulations and (2) determine whether the least burdensome approach was selected. EO 12291 was intended, among other things, to reduce the burdens of regulations, increase agency accountability for regulatory actions, and ensure well-reasoned regulations. EO 12291 considered a regulation major if it met certain criteria. For example, a regulation was considered major if it was likely to result in an annual effect on the economy of $100 million or more or if it would cause significant adverse effects on competition, employment, investment, productivity, innovation, or the ability of United States-based enterprises to compete with foreign-based enterprises in domestic or export markets.

Treasury and IRS officials determined that the proposed employment tax deposit regulations were not major. Although the agencies stated in the notice of proposed rulemaking that the proposed regulations were not major, they were not required to explain why. A memorandum submitted to the Office of Management and Budget (OMB) in compliance with Treasury's procedures for implementing the EO also did not explain the basis for the officials' determination that the regulations were not major.

However, even if the proposed regulations had been classified as major by Treasury and IRS officials, they would not have been subject to a regulatory impact analysis. Treasury and OMB have a memorandum of agreement that exempts Treasury from following the EO's processes for IRS' interpretative regulations.[7]

The belief that IRS did not follow RFA or EO 12291 was a source of dissatisfaction among some stakeholders. Several stakeholders told us

[5]Section 553(b)(A) of the APA excepts interpretative rules from the general requirement that proposed rules be published in the Federal Register. Therefore, IRS' publication of the proposed revisions to the employment tax deposit rules was voluntary.

[6]IRS submitted the proposed regulations to the Small Business Administration to obtain its comments on the regulation's impact on small businesses as required by section 7805(f) of the Internal Revenue Code, which was added in 1988.

[7]Treasury officials said that this memorandum also applies to the new EO 12866.

that even if Treasury and IRS officials did not have to develop a regulatory flexibility analysis under RFA, they nevertheless should have. As the revised regulations were being developed, IRS officials noted that a primary focus of their efforts to simplify the employment tax deposit regulations was to address problems that small employers were having in complying with the existing regulations. These stakeholders said that if small employers were the focus of the Treasury and IRS effort to revise the regulations, they did not understand the rationale for IRS' not following a process specifically intended to help ensure that small employers' needs were addressed in the rulemaking process.

Similarly, several stakeholders believed that the proposed regulations were major regulations subject to the regulatory impact requirements of EO 12291. As interpretative regulations, the employment tax deposit regulations were exempt from the EO's requirements under a memorandum of agreement between Treasury and OMB. The notice of proposed rulemaking did not explain that this exemption existed because the memorandum of agreement did not require such an explanation.

Ultimately, on the basis of satisfaction with the final regulations expressed by virtually all parties involved, we believe that meaningful communication did occur before the employment tax deposit regulations were finalized. However, the dissatisfaction of some stakeholders with their ability to engage Treasury and IRS officials in a dialogue during the process used in developing the regulations suggests that opportunities may exist to improve future communications, which would be consistent with IRS' Compliance 2000 initiative and would enhance the probability that sound regulations will be adopted.

Regulatory Flexibility and Impact Analyses May Have Been Beneficial

Although Treasury and IRS officials judged that they were not required to do either the regulatory flexibility or regulatory impact analyses, such analyses may have been beneficial. Regulatory flexibility and regulatory impact analyses direct regulation drafters' attention to the effect of regulations on stakeholders, increasing the likelihood that effective communications will occur between regulation drafters and stakeholders.

In general, RFA and EO 12291 reflected policymakers' judgments that the process used in developing regulations could be improved. Accordingly, RFA and EO 12291 have provided structures that focus regulation drafters' attention on minimizing the burden of regulations on affected parties in general and on small entities in particular. RFA and EO 12291 established

criteria for regulation drafters to apply in judging whether burden reduction goals were being achieved. They also established processes requiring the regulation drafters to document their consideration of how burdens were minimized and make their analyses available to the public when proposed and final regulations are published.

More specifically, if RFA applies to a regulation and the agency cannot certify that the regulation will not have a significant economic impact on a substantial number of small entities, RFA requires an initial regulatory flexibility analysis that focuses on small entities and is to contain the following reporting items:

- a description of the reasons why action by the agency is being considered;
- a statement of the objectives of, and legal basis for, the proposed regulation;
- a description of and, where feasible, an estimate of the number of small entities to which the proposed regulation will apply;
- a description of the projected reporting, recordkeeping, and other compliance requirements of the proposed regulation, including an estimate of the classes of small entities that will be subject to the requirement and the type of professional skills necessary for preparation of the report or record; and
- an identification, to the extent practicable, of all relevant federal regulations that may duplicate, overlap, or conflict with the proposed regulation.

The analysis must also describe any significant alternatives to the proposed regulation that accomplish the stated objectives and that minimize any significant economic impact on small entities.

EO 12291 required a regulatory impact analysis for major rules that was to include, but not be limited to, the following:

- a description of the potential benefits of the regulation, including any beneficial effects that cannot be quantified in monetary terms, and the identification of those likely to receive the benefits;
- a description of the potential costs of the regulation, including any adverse effects that cannot be quantified in monetary terms, and the identification of those likely to bear the costs;
- a determination of the potential net benefits of the regulation, including an evaluation of effects that cannot be quantified in monetary terms; and

- a description of alternative approaches that could substantially achieve the same regulatory goal at lower cost, together with an analysis of this potential benefit and costs and a brief explanation of the legal reasons why such alternatives, if proposed, could not be adopted.

In our opinion, the processes required by RFA and EO 12291 reflected principles similar to those of IRS' Compliance 2000 approach, e.g., that regulations are better when they are based on an analysis of their effect on stakeholders and designed to avoid unwarranted burdens.[8]

Treasury officials believe that the efforts of Treasury and IRS officials to reach out and obtain stakeholders' input during the time they were revising the employment tax deposit regulations effectively satisfied RFA's and the EO's requirements. To the extent that they were unsuccessful in obtaining stakeholders' input or adequately reflecting that input in the proposed regulation, Treasury and IRS officials point out that the notice and comment process they voluntarily followed is intended to permit anyone who has concerns about proposed regulations to raise those concerns. The officials further noted that they did respond to the concerns that were raised during the notice and comment period and did so in a manner that led to widespread satisfaction with the final regulations.

Treasury officials also said that even though RFA did not apply, a copy of the notice of proposed rulemaking was provided to the Chief Counsel for Advocacy of the Small Business Administration for comments, as required by section 7805(f) of the Internal Revenue Code.[9] Furthermore, Treasury and IRS officials sought the views of small businesses by contacting small business associations.

Given the considerable stakeholder satisfaction with the final employment tax deposit regulations, it may well be that had Treasury and IRS officials followed RFA and EO 12291 requirements, the final regulations would not have been significantly different. The principal advantage that may have been gained by following RFA and EO processes in this case could have been less contentious communications with some stakeholders. If IRS and

[8]EO 12866 reflects similar principles.

[9]The Small Business Administration's (SBA) Chief Counsel for Advocacy provided extensive comments on the proposed revisions to the employment tax deposit rules. Overall, SBA agreed with the changes made in the final employment deposit regulations. However, SBA annual reports on RFA have taken the position that many of IRS' interpretative rules have the same impact on small entities as rules requiring notice and comment, and therefore they should have been considered subject to RFA's provisions. For more on SBA's position on RFA see Regulatory Flexibility Act: Status of Agencies' Compliance (GAO/GGD-94-105, Apr. 27, 1994).

Treasury follow these processes in the future, this might better ensure sound communications with all stakeholders. One stakeholder's view was that Treasury and IRS officials chose to obtain stakeholder input as they worked on revising the employment tax deposit regulations, but obtaining input should be a requirement rather than a choice to be made by regulators.

Although following RFA procedures or those of EO 12291 when Treasury and IRS officials are not required to do so may promote sound communications with stakeholders, doing so also could subject the government to future litigation. That is, following the procedures would set a precedent that could provide the basis for future suits seeking to compel Treasury and IRS to adhere to the procedures even though RFA or the EO did not require adherence. To the extent that such litigation was successful, Treasury and IRS could be required to follow RFA and the EO for interpretative regulations. Our work was not intended to determine whether such a result would be desirable.

Treasury and IRS could avoid such litigation and yet better ensure that regulation drafters consider the principles of RFA and the EO by incorporating RFA- and EO-like requirements into the Treasury regulations handbook. This handbook provides guidance to regulation drafters as they develop or revise regulations. Treasury could require regulation drafters to document their consideration of the factors specified in RFA and the EO. Although this would be internal documentation that would not be available for stakeholders to review, a documentation requirement could provide greater assurance that regulation drafters obtain and consider information analogous to that required by RFA and the EO.

Benefits of Discussing Draft Regulations With Stakeholders

Whether or not Treasury and IRS incorporate RFA and EO requirements into the internal procedures for developing regulations, once regulation drafters basically have fixed on a regulatory scheme, that scheme may provide a valuable focus for obtaining stakeholder reactions. Working through the implementation consequences of a draft regulatory proposal with stakeholders could help promote communications with stakeholders and develop regulation drafters' knowledge of businesses affected by their regulations.

As they began considering how to revise the employment tax deposit regulations, IRS officials invited stakeholders to provide suggestions for how the regulations might be improved. Treasury and IRS officials also met

with various stakeholders to discuss ideas for revising the regulations. In addition, congressional hearings, at which many stakeholders testified, were held on two legislative proposals to replace the employment tax deposit regulations. Despite these opportunities to provide their views, most of the stakeholders commenting on the proposed regulations during IRS' August 1992 hearing raised concerns about whether the proposed regulations would simplify the process and whether they met the needs of small businesses.

It is not clear why some of these concerns surfaced so late in the process. For example, some of those who expressed concerns in their written comments on the proposed regulations had opportunities as early as May 1990 to provide input to IRS. In part, the stakeholders may not have raised their concerns because they did not have a specific proposal to react to during the earliest opportunities they had to meet with or otherwise provide input to IRS or Treasury officials.[10]

However, when hearings were held in 1991 on the House and Senate bills[11] addressing how the employment tax deposit regulations should be simplified, stakeholders did have specific proposals to react to. Stakeholders from several organizations testified on the House and Senate bills. In general, they concluded that the proposed legislation, particularly in the Senate bill, would improve existing deposit rules significantly. Given the overall support for the congressional bills and the relatively few suggested modifications—especially to the Senate bill—Treasury and IRS officials adopted the Senate bill's approach to simplifying the employment tax deposit regulations.

On the basis of our discussions with stakeholders and our review of the comments offered on the proposed regulations, it appears that stakeholders did not thoroughly analyze some of the implementation issues associated with the legislative bills until after hearings had been held. For example, the Tuesday/Friday deposit dates specified in the congressional proposals were not raised as a problem by witnesses in the congressional hearings. However, witnesses at the IRS hearing did have concerns, and Treasury and IRS responded by changing the deposit dates to Wednesdays and Fridays. Similarly, witnesses at the congressional

[10]A stakeholder has suggested that concerns may not have been raised earlier for other reasons, such as that the legislatively considered proposals were so much better than the existing eighth-monthly system that stakeholders did not sufficiently scrutinize the proposals or that stakeholders' attention turned to other matters when prospects for tax legislation dimmed in late 1991 and early 1992.

[11]H.R. 2775 and S. 1610.

hearings did not raise concerns about having the data necessary to implement the "look back" rule, but data availability issues were raised at the IRS hearings. In contrast, some witnesses in both the congressional and IRS hearings pressed for higher thresholds for businesses to qualify for monthly depositor status and for retaining the 5 percent safe harbor rule which enabled employers to avoid penalties for underpayment of taxes if their shortfall was no more than 5 percent of taxes due and the shortfall was deposited by a specified make-up date.

Thus, regardless of why stakeholders did not raise concerns about the legislative proposal, the emergence of implementation concerns from stakeholders' analyses of Treasury's proposed revisions to the regulations suggests the importance of a specific proposal to obtaining the most useful input from stakeholders. The notice and comment process Treasury and IRS followed by publishing the proposed regulations did provide an opportunity for stakeholders to analyze the implementation consequences associated with the regulatory approach. However, the notice and comment process did not provide the forum for dialogue desired by a significant portion of stakeholders.

Important, although somewhat intangible, additional benefits could result if such analyses were done as part of Treasury and IRS officials' efforts to develop the proposed regulations themselves. Meeting with stakeholders to work through the implementation issues associated with draft regulations before the regulations are published for notice and comment would be a step toward providing the level of dialogue with regulatory policymakers that certain stakeholders perceived was lacking in the development of the employment tax deposit regulations. To the extent that such meetings facilitated a two-way dialogue, communications between regulatory officials and stakeholders could be more productive and the officials' understanding of the businesses their regulations affect could be increased. Doing such analyses before regulations are proposed for comment would complement the purposes of RFA and the EO and would be in concert with IRS' Compliance 2000 approach.

Treasury and IRS officials suggested that working through the implementation consequences of draft regulations with stakeholders could present problems. Many tax-related regulations affect a broad spectrum of taxpayers and professions that provide tax services to them. Officials were concerned that they could not meet with representatives of all potentially affected parties and that parties not included likely would object.

Deciding which stakeholders to include in meetings is a practical problem. However, regulation drafters informally seek input from various stakeholders now. One of the concerns of the stakeholders who were dissatisfied with the process used to develop the revised employment tax deposit regulations was that this informal communication appeared to favor certain stakeholders over others. Thus, ensuring balanced and fair inclusion of stakeholders would not appear to be a deciding factor in determining how to obtain comments since it would apply to both how officials currently interact with stakeholders and to any future meetings that might be held with stakeholders to work through the implementation consequences of draft regulations.

Measures of Simplicity Could Result in Better Informed Judgments

According to Treasury and IRS officials, to determine whether a regulation has been simplified, they must consider multiple objectives. Thus, they must judge such things as whether the revised regulations treat stakeholders fairly and whether the burden imposed on the affected parties is minimized without sacrificing acceptable compliance levels. In the specific case of the employment tax deposit regulations, a Treasury official noted that officials also were concerned that the revised regulations neither gain nor lose significant amounts of revenue. Balancing these sometimes conflicting objectives—e.g., fairness may require exceptions for specific unusual cases but such exceptions can add complexity and burden—restricts the ability of regulators to achieve fully any one objective like simplification. However, certain information could be useful for officials to reach an informed judgment about whether a regulation has been simplified and is successful over time.

In general, the officials involved in the process of developing and approving a regulation make a judgment as to whether it has been simplified. According to IRS officials, to judge whether a regulation has been simplified, officials consider how closely the final regulation corresponds to the comments of those stakeholders who would be affected by any change. According to this criterion, Treasury and IRS officials and virtually everyone we interviewed agreed that the final employment tax deposit regulations had been simplified, especially given the revenue and compliance constraints that also had to be met.

In our opinion, Treasury and IRS officials could make more informed judgments about whether simplification has been achieved if they had information that indicated whether simplification was likely. For example, will fewer steps be required of taxpayers to comply with a regulation? Will

the time it takes to comply be reduced? Will the number of records or amount of information that taxpayers must assemble and maintain be reduced?[12]

For the employment tax deposit regulations, the answers to such questions indicate that simplification was achieved. Fewer steps are now involved in determining when deposits are due. In appendix II, we show the steps involved before and after the simplification effort. For many employers, the time required to comply should decrease since they no longer must continuously monitor their employment tax liabilities to determine when they should make deposits. Employers may need to retain somewhat more information on their past employment tax liabilities to determine under the look back rule what their filing frequency will be for the forthcoming year. However, they can avoid retaining information if they rely on the notification of filing status that IRS will send to employers before each calendar year.

Treasury officials said that at least some simplicity measures were considered as the employment tax deposit regulations were being revised. For instance, officials analyzed information to determine how many small employers would move from semiweekly depositor status to monthly depositor status at different thresholds for determining that status. Officials worked to establish a threshold that moved the greatest number of small employers to the monthly depositor status while maintaining revenue neutrality in the regulatory change.

On the other hand, officials cautioned against placing emphasis on developing and using measures of simplicity. Their reservations included that (1) developing and using such measures would require more resources or would divert resources from regulatory efforts; (2) it would be very difficult to develop meaningful measures; and (3) simplicity must be balanced with other objectives, such as equity and administrability of regulations.

While measuring simplicity is difficult, and balancing it against other regulatory objectives requires judgment, in our opinion judgments can be made on a more informed basis if measures of simplicity are used as reference points. To control the number of such measures developed and the associated resources required to collect and maintain the measures, officials may wish to agree on a set of key simplicity measures for any

[12]AICPA has developed some indicators that are presented in Blueprint for Tax Simplification, Tax Simplification Working Group, Robert M. Brown, Chairman, April 1992.

particular regulation. In the case of the employment tax deposit regulations, the number of small businesses qualifying for monthly depositor status was one such measure. Another measure at least implicitly used in determining that the employment tax deposit regulations were too complex was the number of taxpayers subject to penalties each year. Having used such measures in revising the employment tax deposit regulations, officials also have a means for determining the success of the revisions over time. By checking whether the number of penalties assessed falls and remains lower over time, and whether the number of monthly depositors rises to expected levels and remains there, officials would be able to judge on a more informed basis whether the revised regulations should be revisited in the future.

In addition, identifying and using simplicity measures would complement IRS' objective of reducing taxpayer burden, which is one of three IRS' objectives in its fiscal year 1994 strategic business plan. To assess burden, IRS is developing a system to measure the burden of complying with tax law.

Conclusions

The final employment tax deposit regulations published in September 1992 are widely considered to be significantly simpler and easier to apply than earlier versions of the regulations. Treasury and IRS officials developed the regulations by soliciting input from stakeholders—those who would be affected by changes to the regulations. Involving stakeholders in the process is a basic strategy employed under IRS' Compliance 2000 approach. Stakeholders we interviewed agreed that their concerns were considered and acted upon by Treasury and IRS officials in the development of the final regulations. One stakeholder even considered the development of this regulation to be a model for how Treasury and IRS officials generally should develop new or revised regulations.

Despite the widespread satisfaction with the final employment tax deposit regulations, certain stakeholders were dissatisfied with the process followed by Treasury and IRS officials as they revised the regulations. Concerned stakeholders did not believe that an adequate dialogue had been established with Treasury or IRS officials or, in some cases, believed that officials should have followed the procedures specified in RFA or the EO 12291.

Given such things as the diversity of interests among the stakeholders who may be affected by tax regulations, the time constraints under which

Treasury and IRS officials often must operate, and the sometimes conflicting goals that must be reconciled when tax regulations are written, complete stakeholder satisfaction is unlikely. Nevertheless, the employment tax deposit regulation experience suggests that Treasury and IRS officials could modify their practices to improve communications with stakeholders and provide greater assurance that stakeholders' views will be obtained and considered.

Communications clearly would be impeded when information is not made available. The confusion and frustration that some stakeholders experienced because the regulatory impact analysis requirements of EO 12291 were not followed might have been avoided. Several stakeholders believed that the regulations were major and thus subject to the EO. But the notice publishing the proposed regulations did not explain that even if the regulations were major under the EO's criteria (which officials did not believe was the case), the EO did not apply pursuant to the existing memorandum of understanding between Treasury and OMB. The new EO 12866 contains criteria similar to those in the revoked EO 12291 to be used in identifying regulations subject to the new EO's requirements. However, according to Treasury officials, IRS' interpretative regulations continue to be exempt from EO 12866's requirements. Treasury and IRS could help forestall stakeholder confusion by providing this explanation in notices of proposed rulemaking, when applicable.

In addition, although Treasury and IRS officials judged that the regulatory flexibility and regulatory impact analyses of RFA or EO 12291 did not have to be done for the employment tax deposit regulations, the principles underlying such analyses were complementary to the intent of officials to simplify employment tax deposit regulations for small businesses. The RFA and EO principles also are similar to those stated in IRS' corporate objective to reduce the burden on taxpayers and, under Compliance 2000, to make regulations and procedures as simple and fair as possible. If Treasury and IRS adopted internal policies that require drafters of regulations to document, when time constraints permit, their consideration of the factors that are included in RFA and the new EO, these policies could help ensure that the principles will be applied consistently by officials who develop regulations.

IRS officials say that they informally communicate with stakeholders while regulations are being developed. This communication should help the regulation drafters understand the effects that differing regulatory schemes could have on stakeholders and whether the regulatory

approaches can be effective in achieving their purposes. The fact that stakeholders had concerns once they had analyzed the proposed employment tax deposit regulations suggests that the value of communicating with stakeholders may be related to how complete the regulatory proposal is when informal communications occur. It is true that the notice and comment process can, as it did with the employment tax deposit regulations, trigger stakeholder analyses that help identify improvements needed in proposed regulatory approaches. Earlier recognition of those concerns could improve communications between regulators and stakeholders. In the case of the employment tax deposit regulations, such focused informal communications could have lessened the need to rework the proposed regulations and could have forestalled the impression among some stakeholders that Treasury and IRS officials were not giving balanced consideration to the concerns of all parties.

A major current IRS objective is to simplify tax laws and regulations because complexity is considered a contributing factor to noncompliance. Whether simplification is achieved in any particular circumstance or overall in the tax system is a somewhat subjective judgment. According to Treasury and IRS officials, although regulatory guidance did not require officials to do so, they used some measures of simplicity as the employment tax deposit regulations were revised to make judgments concerning the balance between achieving simplicity and obtaining other regulatory objectives. By explicitly identifying key simplicity measures, using them while developing regulations, and continuing to use them to gauge whether the final regulations are successful, Treasury and IRS would better ensure that informed judgments are made and that these judgments would be consistent with IRS objectives.

Recommendations to the Secretary of the Treasury

To help forestall stakeholder confusion and frustration regarding the applicability of statutory and executive guidance to tax-related regulations, we recommend that the Secretary of the Treasury direct that when such guidance is not applicable the text accompanying the publication of proposed and final regulations should contain a complete explanation why this is so. We also recommend that the Secretary require that regulation drafters document internally, when time constraints permit, their consideration of the factors provided in such statutory and executive guidance to better ensure that tax regulations reflect stakeholders' needs. To maximize the value of informal communications with stakeholders, we recommend that the Secretary encourage regulation drafters to meet with selected stakeholders to work through

implementation issues associated with draft tax regulations before publishing the regulations for notice and comment.

To better ensure that a well-informed basis exists for Treasury and IRS officials to make judgments concerning whether simple, yet effective, regulations have been designed, we recommend that the Secretary of the Treasury require regulation drafters to develop key measures of simplicity for tax regulations. Officials should use these measures to help judge whether existing regulations are too complex and whether regulations under development are sufficiently simple.

Agency Comments

In commenting on a draft of this report, Treasury's Commissioner, Office of Tax Policy, and the IRS Chief Counsel said they were generally very pleased with the conclusions set forth and generally agreed with the recommendations. However, the officials disagreed with certain statements in the report dealing with the issue of how the flexibility analysis of RFA and the regulatory impact analysis of EO 12291 apply to IRS regulations in general. The officials considered some of these statements to be inaccurate. We made appropriate changes to ensure that the report accurately portrays the RFA and EO requirements.

In addition, the officials interpreted other statements in the report as strongly suggesting that all IRS regulations should be subject to the analytical requirements of RFA and the EO. The officials believed that it would be inappropriate to draw such a conclusion from an analysis of, and some stakeholders' statements concerning, the development of one regulation. On the other hand, the officials did not object to the specific recommendation made in the draft.

We revised some of the text in the report to remove any implication that all IRS regulations should be subject to the analytical requirements of RFA and the EO. The pertinent recommendation in the draft report recognized, for example, that time constraints would not always permit regulation drafters to adhere to the analytical requirements of RFA and the EO.

We also modified our recommendation to clarify that regulation drafters' documentation of their consideration of the factors contained in RFA and applicable executive branch guidance would be for internal purposes. In our opinion, by requiring that drafters of regulations internally document their consideration of the factors in the RFA and executive guidance, Treasury and IRS would increase assurance that these factors, which

complement IRS goals in developing regulations, will be weighed consistently by officials as they develop regulations. Such internal documentation, however, would not go beyond what Congress or the president may have intended when they designed the procedures applicable to developing regulations.

Objectives, Scope, and Methodology

Our objectives were to determine (1) whether Treasury and IRS developed the employment tax deposit regulations by applying principles from IRS' Compliance 2000 approach, which is designed to improve voluntary taxpayer compliance, reduce taxpayer burden, and increase IRS' attention to the needs of those affected by its actions; (2) whether, and, if so, how the process used by Treasury and IRS to develop and revise the regulations could be improved; and (3) how Treasury and IRS officials know when their efforts to develop and revise regulations result in regulations that are sufficiently simple and easy to follow.

We discussed all three objectives with IRS officials and obtained written information from IRS. In addition, to determine if IRS followed Compliance 2000 to revise the federal employment tax deposit regulations, we reviewed IRS documents describing Compliance 2000 to obtain an understanding of its principles and requirements. We discussed IRS' adherence to Compliance 2000 with IRS officials and various stakeholders who participated in the process of developing the revised regulations. We also interviewed IRS officials and stakeholders who commented on the proposed regulations to understand the history of the development of the revised regulations and to determine how the views of all parties were considered. From those who had been involved in the development of the revised regulations, we selected a judgmental sample of 10 stakeholders who represented those in federal and state governments, Congress, and private industry who would be affected by the revised regulations or who were knowledgeable about the process of developing tax-related regulations.

To determine whether Treasury and IRS followed required procedures and whether the process used could be improved, we obtained from the appropriate IRS officials a description of the statutory, regulatory, and internal processes that must be followed when Treasury and IRS develop a regulation. We analyzed requirements that IRS must adhere to when it develops regulations to determine if IRS complied with the requirements in its interpretative ruling of the regulations. Further, to determine how well

these requirements were followed, we also obtained the opinions of various stakeholders and Treasury and IRS officials.

To determine how Treasury and IRS officials knew whether the proposed regulations had been simplified, we interviewed appropriate Treasury and IRS officials. We also asked various stakeholders how Treasury and IRS officials could determine whether regulations were sufficiently simple.

We obtained written comments on a draft of this report from Treasury and IRS and incorporated their comments where appropriate. (See app. III for the full text of Treasury's and IRS' comments.) We did our work from August 1992 to July 1993 in accordance with generally accepted government auditing standards.

We are sending copies of this report to various interested congressional committees, the Secretary of the Treasury, the Commissioner of Internal Revenue, the Director of the Office of Management and Budget, and other interested parties. We will also make copies available to others on request.

The major contributors to this report are listed in appendix IV. Please contact me on (202) 512-5407 if you or your staff have any questions concerning this report.

Sincerely yours,

Jennie S. Stathis

Jennie S. Stathis
Director, Tax Policy and
Administration Issues

Contents

Abbreviations

AICPA	American Institute of Certified Public Accountants
APA	Administrative Procedure Act
EO	Executive Order
IRS	Internal Revenue Service
OMB	Office of Management and Budget
SBA	Small Business Administration
RFA	Regulatory Flexibility Act

Background

Employers who withhold income and Social Security taxes are required to deposit these employment taxes under the federal employment tax deposit system. Under section 6302(c) of the Internal Revenue Code, the Secretary of the Treasury has the authority to set the requirements for when employers must deposit employment taxes. The frequency of deposits and when the deposits are due are determined by the amount of taxes withheld and when paydays occur.

In July 1990, we reported that the rules for depositing employment taxes were complex and resulted in nearly one-third of all employers being penalized in 1988 for failing to make timely deposits.[1] We recommended that IRS simplify the employment tax deposit rules by making the deposit date more certain and by exempting significant numbers of small employers from frequent deposit requirements.

Having earlier reviewed our July 1990 report, IRS solicited suggestions from the public for ways to improve the employment tax deposit rules. It did so as part of a notice (Notice 90-37, May 21, 1990) that provided information for the public on changes Congress had made to a related penalty. IRS received about 30 responses. Later that year, IRS and Treasury officials attended a roundtable discussion sponsored by the American Institute of Certified Public Accountants (AICPA) that focused on changes needed in the employment tax deposit system. IRS developed an internal draft of revised regulations by December 1990, and a meeting was held in March 1991 to consider the input of the payroll community. Approximately 30 outside organizations were represented.

However, at about this time, the House Committee on Ways and Means began to consider legislative changes to address the employment tax deposit problems. Therefore, Treasury and IRS officials suspended their efforts to revise the regulations. The Senate Committee on Finance also considered a bill to address the problems. Both Committees held hearings that covered the employment tax issue, and a simplified employment tax deposit rule was incorporated in H.R. 4210, which was subsequently vetoed for reasons unrelated to the employment tax deposit regulations. During the fall of 1991, IRS drafted regulations to implement the House and Senate bills.

After the veto, Treasury and IRS began to revise the draft regulations. On May 18, 1992, IRS published in the Federal Register (57 FR 21045) a notice of proposed changes to the employment tax deposit regulations. The

[1]GAO/GGD-90-102.

proposed regulations were similar to the provisions contained in the vetoed bill.

The existing employment tax deposit process required employers to monitor and accumulate employment taxes from payday to payday until one of four separate deposit rules (quarterly, monthly, eighth-monthly,[2] or daily)[3] was triggered (see app. II for a depiction of the decisionmaking process required under these rules). Under the deposit rules, deposit requirements could change from month to month. Employers had difficulty determining when deposits were due and could inadvertently switch from one rule to another and be penalized for failure to make timely deposits. The eighth-monthly deposit rule was particularly complicated since it divided the month into eight parts of varying lengths.

IRS' proposed changes sought to simplify the employment tax deposit regulations in part by classifying a greater portion of employers as small employers and letting such small employers deposit employment taxes less frequently, generally monthly. The proposed regulations increased the number of employers classified as small employers by raising the threshold for those qualified to make monthly deposits. Previously, anyone with a tax liability of less than $3,000 in a calendar month would have deposited on a monthly basis for that month. The proposed regulations specified that a taxpayer with a quarterly liability of $12,000 or less during the reference period would deposit on a monthly basis for a calendar quarter. For those above the small employer threshold, the proposed regulations simplified the deposit schedule by designating specific days of the week, i.e., Tuesdays and Fridays, that deposits would be due. The proposed regulations also enabled an employer to look back on a quarterly basis, examine its deposit history for a 1-year period, and determine whether it would be a monthly or semiweekly depositor for the next quarter.

[2]The eighth-monthly rule established eight dates within each month that employers used in determining when to make their employment tax deposits. For employers subject to the rule, payments were due within 3 banking days of the next eighth-monthly date following the employer's payroll date. The amount of time an employer would have after a payday to make a deposit varied from 3 to 8 days, depending upon the length of the deposit period as well as where in the eighth-monthly period the payday fell.

[3]Large employers, those that accumulate employment tax liabilities of $100,000 or more during any deposit period, are statutorily required to deposit those taxes on the first banking day after the $100,000 threshold is reached. Small employers, those with less than $500 of employment taxes during a calendar quarter, are allowed to remit the taxes with their quarterly tax returns. Neither of these rules was modified as IRS revised the employment tax deposit rules.

The proposed regulations also modified the IRS "safe harbor" rule, which allowed employers that did not deposit the full amount of taxes due to avoid penalties as long as the shortfall was no more than 5 percent and the shortfall was deposited by a specified make-up date. The proposed regulations decreased the allowable shortfall to 2 percent of the amount due or $100, whichever amount was greater.

IRS received written comments responding to the Federal Register notice, and a hearing was held on August 3, 1992. The comments suggested changes to the proposed employment tax regulations, which included modifying the semiweekly deposit rule, increasing the threshold for monthly deposits, changing the look back period (the period for which an employer would review its deposit history and determine its future deposit schedule), altering the safe harbor threshold, and reconsidering the implementation date.

On August 19, 1992, Treasury and IRS held a meeting with representatives of Members of Congress and small business. Treasury and IRS held a second meeting on August 20, 1992, with members of the payroll community. Each group was informed of IRS' most recent proposals and tentative decisions about the regulations.

After Treasury and IRS officials considered the written and oral comments on the proposed regulations, the final regulations were issued on September 24, 1992. These regulations replaced the existing employment tax deposit process with a new one that is considered to be significantly simpler and easier to understand and comply with. The new employment tax regulations basically treat an employer as either a monthly depositor or a semiweekly depositor. The semiweekly deposit rule changed so that deposits are made on Wednesdays or Fridays.[4] According to IRS, as long as an employer deposits employment taxes within 3 banking days after a payroll, it will always satisfy the semiweekly rule. In addition, the final regulations incorporate the statutory requirement that employers that accumulate employment taxes of $100,000 or more during any deposit period must deposit those taxes on the first banking day after the $100,000 is reached. This rule applies to both monthly and semiweekly depositors.

The final regulations also increased the dollar threshold for determining whether an employer is a monthly depositor or a semiweekly depositor. The threshold increased from $12,000 per quarter of employment taxes to

[4]Employers required to deposit employment taxes under the semiweekly rule and having paydays on Wednesday, Thursday, and/or Friday must deposit on or before the following Wednesday. Those with paydays on Saturday, Sunday, Monday, and/or Tuesday must deposit on or before the following Friday.

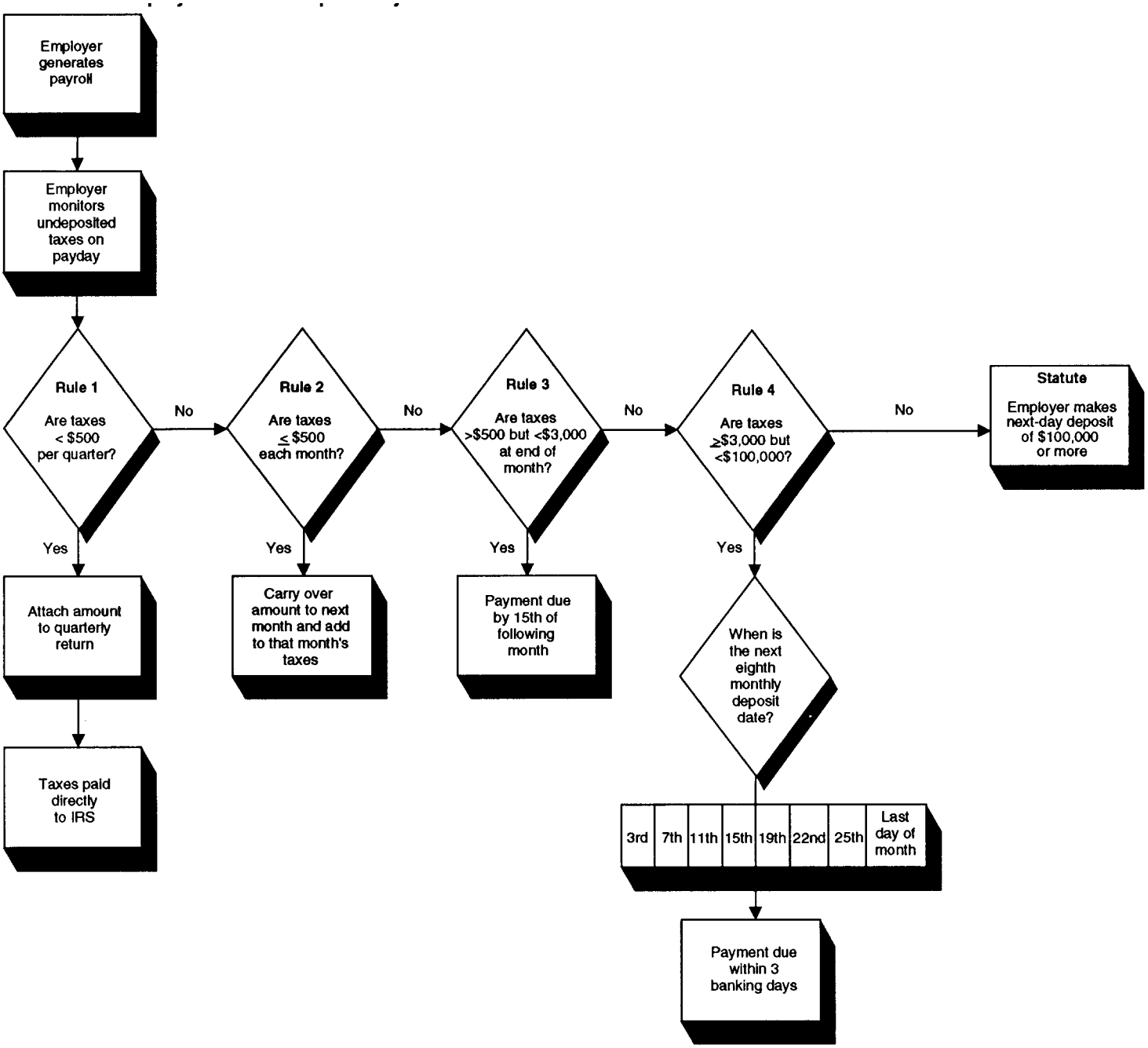
$50,000 per year. An employer that reported $50,000 or less in taxes during the look back period would deposit monthly. Conversely, an employer who reported more than $50,000 would be a semiweekly depositor. Further, under the final regulations, employers can determine their deposit status for an entire calendar year rather than for each quarter. The look back period for each calendar year is the 12-month period that ended the preceding June 30. In its Federal Register announcement issuing the new regulations, IRS also committed to determining an employer's deposit status and notifying the employer before the beginning of each calendar year.

In finalizing the regulations, IRS did not modify its proposed safe harbor; the shortfall amount remained at $100 or 2 percent of the amount of employment taxes required to be deposited, whichever was greater. IRS retained the January 1, 1993, date for implementing the new regulations, but it provided a 1 year transition period so that employers had until December 31, 1993, to change to the new process if they needed to take longer to adapt their systems to the new requirements.

Old and New Employment Tax Deposit Processes

The diagrams in figures II.1 and II.2 show the old and new employment tax deposit processes. Among other changes, the new process reduced the number of rules for determining how often employment taxes are due and substituted two fixed days of the week for the eighth-monthly periods previously used by relatively large employers to determine when their deposits had to be made.

Figure II.1: Old Employment Tax Deposit Process

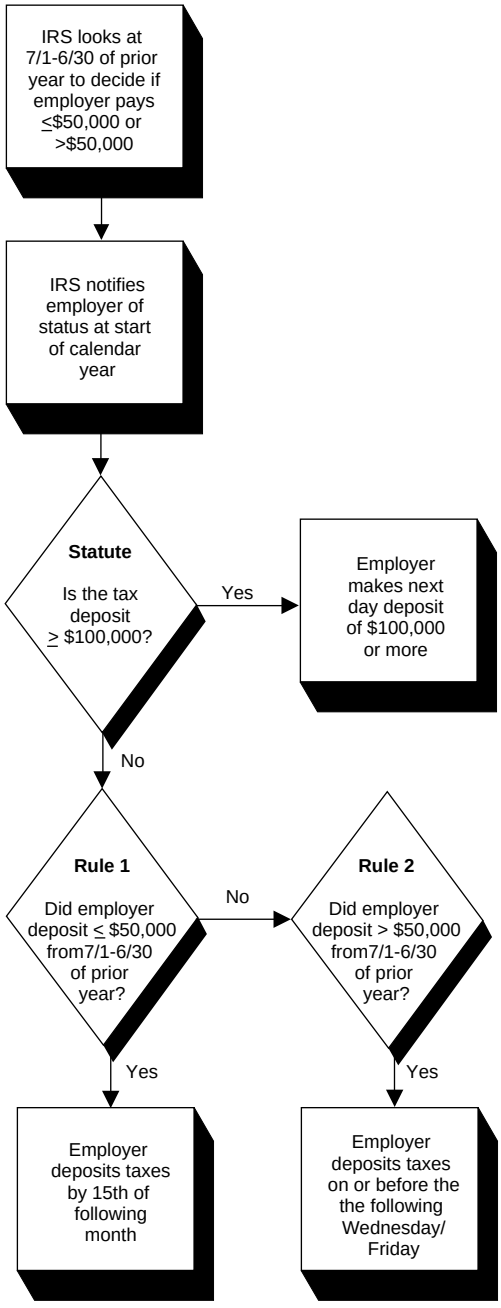


(Figure notes on next page)

Source: GAO/GGD-90-102.

Figure II.1 depicts the old process used by employers for determining when employment taxes were due. Under this process, employers were burdened with a series of rules from payday to payday. As in the figure, when employee wages were paid at the end of the pay period, employers accumulated their tax liabilities and then determined which of the four deposit rules applied for that pay period. Depending on the deposit requirement, different modes of payment were required. The use of the eighth-monthly deposit period added to the complexity of this process. The eight periods between the dates the deposits would be due varied in length from 3 to 6 days, depending on the specific period and the month involved. The amount of time an employer would have after a payday to make a deposit varied from 3 to 8 days, depending upon the length of the deposit period as well as where in the eighth-monthly period the payday fell. To comply with the changing deposit requirements, employers monitored undeposited employment taxes from payday to payday to determine when changes in employment tax amounts would trigger a different deposit rule that required an earlier deposit as well as when each eighth-monthly period ended. Otherwise, the employer could unintentionally make a late deposit and be penalized.

Figure II.2: New Employment Tax Deposit Process



Source: Department of the Treasury, Internal Revenue Service, 26 CFR Part 31, Deposits of Employment Taxes, T.D. 8436, 57 FR 44099, Sept. 24, 1992.

Figure II.2 illustrates the new employment tax deposit process. The process is streamlined, and the number of rules the employers were required to follow under the old process has been reduced. Under the new rules, an employer's status as either a monthly depositor or semiweekly depositor is determined annually. The look back period for each calendar year is the 12-month period that ended the preceding June 30. IRS will notify employers of their status before the beginning of each calendar year. This notification will provide employers with additional upfront certainty for determining their deposit obligations. For example, an employer that reported $50,000 or less in employment taxes for the period July 1, 1992, through June 30, 1993, generally would be a monthly depositor during calendar year 1994. An employer who reported more than $50,000 in employment taxes for that look back period would be a semiweekly depositor during 1994. The new rules enable employers to identify when their employment taxes will be due throughout a year, eliminating the need for the employer to continuously monitor employment tax liabilities and redetermine deposit due dates.

Comments From the Internal Revenue Service

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

CHIEF COUNSEL

September 14, 1994

Mr. Michael Brostek
United States General Accounting Office
1440 New York Avenue, N.W.
Washington, D.C. 20005

Re: GAO Draft Report

Dear Mr. Brostek:

Thank you for the opportunity to review the July 26, 1994 GAO Draft Report entitled "Tax Administration: IRS Simplifies the Federal Employment Tax Deposit Regulations."

The Commissioner, Office of Tax Policy and Chief Counsel are generally very pleased with the conclusions set forth in the reports regarding the Internal Revenue Service's (IRS) efforts in connection with the regulations that are the subject of Senator Kohl's inquiry. We fully agree that these regulations "launched a new process that is widely considered to be significantly simpler and easier for stakeholders to understand and comply with than the earlier one." We think that the report does a very good job of describing the process and the comments received from the stakeholders that were interviewed. In particular, the report notes that the IRS obtained stakeholders' input, either oral or written, throughout the process. We also generally agree with the stated recommendations.

Nevertheless, we disagree with a few statements in the report, in particular those statements that attempt to address the much broader issue of how the flexibility analysis of the Regulatory Flexibility Act (RFA) and the regulatory impact analysis of Executive Order 12291 (EO) apply to IRS regulations in general. Some of these statements contain factual and legal inaccuracies. We have attached to this letter a copy of the relevant pages from the report showing appropriate corrections. In addition, other statements strongly suggest a recommendation that all IRS regulations be subject to analytical requirements of the RFA and EO. We believe that it is inappropriate to draw this conclusion based merely on the statements of some of the interviewed stakeholders and on an analysis of the process

undertaken in preparing one regulation, a process that, as the report indicates, was largely successful. The attached comments also attempt to address this concern.

Again, we would like to thank you for the opportunity to comment on this report and we hope that you find our comments helpful. We would be happy to continue to work with you. If you have any questions, please feel free to contact me at 622-3380.

Sincerely,

Paul C. Feinberg
Acting Special Counsel to
the Acting Chief Counsel

Attachment:
As stated

cc: Mr. Richard Carro
Mr. Alan Lehrman
Ms. Judith Dunn
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Mr. Norlyn Miller

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