

# FRAUD IN INCOME TAX RETURN PREPARATION

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HEARING  
SUBCOMMITTEE ON OVERSIGHT  
OF THE  
COMMITTEE ON WAYS AND MEANS  
U.S. HOUSE OF REPRESENTATIVES  
ONE HUNDRED NINTH CONGRESS  
FIRST SESSION

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JULY 20, 2005  
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**FRAUD IN INCOME TAX RETURN  
PREPARATION**

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**WEDNESDAY, JULY 20, 2005**

U.S. HOUSE OF REPRESENTATIVES,  
COMMITTEE ON WAYS AND MEANS,  
SUBCOMMITTEE ON OVERSIGHT,  
*Washington, DC.*

The Subcommittee met, pursuant to notice, at 3:02 p.m., in room 1100, Longworth House Office Building, Hon. Jim Ramstad (Chairman of the Subcommittee) presiding.

[The advisory announcing the hearing follows:]

# ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

## SUBCOMMITTEE ON OVERSIGHT

FOR IMMEDIATE RELEASE  
July 13, 2005  
No. OV-4

CONTACT: (202) 225-7601

### **Ramstad Announces Hearing on Fraud in Income Tax Return Preparation**

Congressman Jim Ramstad (R-MN), Chairman, Subcommittee on Oversight of the Committee on Ways and Means, today announced that the Subcommittee will hold a hearing on fraud in income tax return preparation. **The hearing will take place on Wednesday, July 20, 2005, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 3:00 p.m.**

In view of the limited time available to hear witnesses, oral testimony at this hearing will be from invited witnesses only. Invited witnesses will include representatives of the Internal Revenue Service (IRS), the National Taxpayer Advocate, and representatives of professional associations of tax preparers.

#### **BACKGROUND:**

According to the U.S. Government Accountability Office, more than 70 million of the 131 million tax returns filed last year were prepared by a tax professional. Because of the increasing complexity of the law, taxpayers place a high degree of reliance on tax professionals, and due to this increasing reliance, tax professionals have become the guardians and distributors of billions of dollars in tax refunds and refundable credits. The IRS paid more than \$227 billion in individual income tax refunds in fiscal year 2004, including \$33 billion in refundable Earned Income Credits (EIC).

The following are just several recent examples of malfeasance by preparers:

- A New Jersey tax preparer who prepared 13,000 returns in 2001 and 2002 was caught on tape advising an undercover agent to include phony expenses on his tax return in order to qualify for a tax refund.
- Thousands of low-income Somali immigrants in Minnesota were victimized by a group of tax preparers who created fictitious businesses and claimed improper fuel tax credits in order to qualify for refunds. In addition to prosecuting the preparers, the IRS has commenced scores of taxpayer audits and will eventually audit nearly all of the victims.
- In Long Beach, California, a tax preparer is being prosecuted for generating hundreds of false returns claiming improper EIC refunds for Cambodian immigrants. The preparer allegedly used the proceeds from his tax preparation service to fund an armed insurgency in Cambodia.

The IRS Criminal Investigation office and the Office of Professional Responsibility work together to hold tax professionals accountable, and the IRS has stepped up its enforcement efforts against corrupt professionals in recent years. Presently, the IRS has 343 active investigations of tax professionals, and it identified about \$79 million in suspect refunds last year.

In light of the amount of money at stake for the Federal Government and the severity of penalties faced by taxpayers for participating, however unwittingly, in an

illegal tax filing, the statutory and regulatory structure that sets the boundaries for Federal tax practice is of utmost importance to taxpayers.

In announcing the hearing, Chairman Ramstad stated, "Because of the complexity of our laws, taxpayers increasingly rely on a professional tax preparer. Most tax preparers are honest, but there is a troubling and persistent occurrence of tax fraud by unscrupulous preparers who take advantage of taxpayers. It is incumbent on us to review what the IRS is doing to address this problem and consider our legislative options."

#### **FOCUS OF THE HEARING:**

The hearing will focus on evidence of negligent and fraudulent return preparation practices by tax professionals and the statutory and regulatory structure that sets the boundaries for Federal tax practice.

#### **DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:**

**Please Note:** Any person(s) and/or organization(s) wishing to submit for the hearing record must follow the appropriate link on the hearing page of the Committee website and complete the informational forms. From the Committee homepage, <http://waysandmeans.house.gov>, select "109th Congress" from the menu entitled, "Hearing Archives" (<http://waysandmeans.house.gov/Hearings.asp?congress=17>). Select the hearing for which you would like to submit, and click on the link entitled, "Click here to provide a submission for the record." Once you have followed the on-line instructions, completing all informational forms and clicking "submit" on the final page, an email will be sent to the address which you supply confirming your interest in providing a submission for the record. You **MUST REPLY** to the email and **ATTACH** your submission as a Word or WordPerfect document, in compliance with the formatting requirements listed below, by close of business Wednesday, August 3, 2005. **Finally**, please note that due to the change in House mail policy, the U.S. Capitol Police will refuse sealed-package deliveries to all House Office Buildings. For questions, or if you encounter technical problems, please call (202) 225-1721.

#### **FORMATTING REQUIREMENTS:**

The Committee relies on electronic submissions for printing the official hearing record. As always, submissions will be included in the record according to the discretion of the Committee. The Committee will not alter the content of your submission, but we reserve the right to format it according to our guidelines. Any submission provided to the Committee by a witness, any supplementary materials submitted for the printed record, and any written comments in response to a request for written comments must conform to the guidelines listed below. Any submission or supplementary item not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All submissions and supplementary materials must be provided in Word or WordPerfect format and **MUST NOT** exceed a total of 10 pages, including attachments. Witnesses and submitters are advised that the Committee relies on electronic submissions for printing the official hearing record.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. All submissions must include a list of all clients, persons, and/or organizations on whose behalf the witness appears. A supplemental sheet must accompany each submission listing the name, company, address, telephone and fax numbers of each witness.

Note: All Committee advisories and news releases are available on the World Wide Web at <http://waysandmeans.house.gov>.

The Committee seeks to make its facilities accessible to persons with disabilities. If you are in need of special accommodations, please call 202-225-1721 or 202-226-3411 TTD/TTY in advance of the event (four business days notice is requested). Questions with regard to special accommodation needs in general (including availability of Committee materials in alternative formats) may be directed to the Committee as noted above.

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Chairman RAMSTAD. The hearing will please come to order. I would like to welcome our witnesses as well as our audience here to this important hearing today. Like most Americans, Lusanga Ngiele and his wife do not consider themselves expert enough to prepare their own tax return. Although Mr. Ngiele is highly educated, a former Member of the General National Assembly of Zaire, it was a natural decision for him and his wife to entrust the filing of their tax return to a fellow African emigre who held himself out as a paid tax preparer, but unhappily for Mr. Ngiele and his family, it was a bad decision. To generate an Earned Income Credit (EIC) to which Mr. Ngiele was not entitled, the preparer improperly disregarded his marital status. The Internal Revenue Service (IRS) audit, interest, and penalties that followed caused severe personal and financial hardship, and this is far from an isolated example.

The IRS will testify today that it is reviewing the tax returns of more than 33,000 victims of corrupt or incompetent tax preparers, and I am sorry to say that a number of these taxpayers are Somali immigrants from my home State of Minnesota. I have heard too many horror stories firsthand and from press accounts, that mention unscrupulous tax preparers preying on innocent Somali immigrants. Unfortunately, the Subcommittee budget does not allow for us to provide travel expenses for any of these victims to come here and tell their stories firsthand. Suffice it to say, hundreds of these hard-working taxpayers are now subject to an IRS audit because they had the misfortune to secure the services of a preparer who claimed wholly unjustified fuel tax and other credits on their behalf.

Each year, American taxpayers file over 130 million income tax returns and claim more than \$275 billion in tax refunds, including approximately \$33 billion in EICs. Increasingly, the individual most responsible for claiming these refunds is not the individual taxpayer but rather a professional tax preparer. There is nothing wrong with this. In fact, it is encouraging, I believe, that most taxpayers take their tax filing obligations so seriously that they pay a sizeable fee to get it right. The vast majority of preparers are honest, hard-working, virtuous people, but a few, an increasing few, are not. Unfortunately, taxpayers receive little or no guidance on how to avoid a bad or unscrupulous preparer. Tax preparers are not licensed by the IRS, as we all know, and although the IRS administers a detailed set of rules that governs tax practice, known as Circular 230, hundreds of thousands of income tax preparers are not covered by these rules. They are simply outside the parameters of the Circular. While States require a license for every profession,



from raising dogs to giving haircuts, only California and Oregon require a license for tax preparers. The result; taxpayers are at risk.

There are countless unfortunate examples of outright fraud by preparers, but fraud is not the only problem. Negligence is also a major problem. Negligence by a barely qualified preparer, such as your car dealer, could cause you to lose—that is right, your car dealer, and we are going to see shortly what I mean—but negligence by unqualified preparers could cause taxpayers and is causing taxpayers to lose refunds to which they are entitled. One return preparation business that raises such questions I just alluded to is called, “Tax Deals 4 Wheels.” I will let them explain how the process works. Please roll the film.

[A videotape was played, the transcript of which follows:]

“Has your car seen better days? Does Uncle Sam owe you money? You can use your tax refund to purchase terrific transportation! Because ‘Tax Deals 4 Wheels’ has your ticket to ride. Take your W-2, Drivers License and Social Security card to a participating ‘Tax Deals 4 Wheels’ dealer, and while you test drive that perfect car, ‘Tax Deals 4 Wheels’ will calculate your estimated refund. ‘Tax Deals 4 Wheels’ can then file your taxes and apply part or all of your Refund Anticipation Loan toward that perfect car!”

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Chairman RAMSTAD. We laugh, and the Chairman joins in laughter, but it is really not funny when you think that now some creative geniuses are offering tax preparation while you are test driving the car, and by God knows whom. The State of Oregon, which does license preparers, as I mentioned, has stopped Tax Deals 4 Wheels from signing a contract to prepare tax returns in Oregon.

Today, we will hear from two high-quality and highly qualified panels of witnesses, including Nancy Jardini, the Director of Criminal Investigation at the IRS—thank you for being here, Director Jardini—and Nina Olson of the National Taxpayer Advocate. Thank you, Ms. Olson, for being here again. Also on our first panel is Elizabeth Atkinson, the President of the Board of Trustees of the Community Tax Law Project of Richmond, Virginia. We thank you, Ms. Atkinson, for being here, as well. By the way, this organization, incidentally, as I understand it, was founded by Ms. Olson. Congratulations to you both. On our second panel today, we are privileged to have five individuals representing the major tax practitioner groups. I look forward to the testimony of all the witnesses as they help the Subcommittee understand the scope of this problem. I am now pleased to yield to my very good friend, the distinguished Ranking Member from Georgia, Mr. Lewis.

Mr. LEWIS. Thank you very much, Mr. Chairman. I want to thank you for holding this hearing today. Today’s hearing will focus on whether tax return preparers should be subject to better oversight by the IRS or possible Federal regulation through the Tax Code. To begin looking at this question, the Subcommittee on Oversight will hear testimony from the IRS Taxpayer Advocate, the IRS Criminal Tax Division, and representatives of the professional tax preparer community. Tax fraud is unacceptable, whether done by individual taxpayers or with the help of tax return preparers. To-

day's hearing will be useful in understanding the extent of tax return fraud and the parties involved.

I should note that the vast majority of taxpayers nationwide fully comply with our tax laws. It is also true that with some rare exceptions, tax return preparers provide taxpayers with valuable help in preparing their annual tax return and do so in a professional manner. It is the few very bad apples that cause trouble for our voluntary tax system. The IRS has programs designed to identify and deter those intent on violating the law. I look forward, with the Chairman and the Members, to the testimony of the IRS National Taxpayer Advocate and Criminal Tax Division representatives on this matter. Also, I welcome the views of representatives of the tax return preparation community. Mr. Chairman, again, I want to thank you as Chair of the Subcommittee for scheduling this hearing in follow-up to our earlier hearing on tax fraud by prisoners. I hope we don't have anyone coming in today that we sort of have to mask. I think this will be a little more real.

Chairman RAMSTAD. That is right. To my knowledge, none of our witnesses today are handcuffed or manacled and none have to have a privacy shield.

Mr. LEWIS. Thank you, Mr. Chairman.

Chairman RAMSTAD. Thank you. I thank the distinguished Ranking Member. I now would call the first panel. I remind the distinguished panelists that we have a 5-minute rule. All of you are familiar with that. Also, your complete written testimony will be entered in the record. Please begin, Ms. Olson.

**STATEMENT OF NINA E. OLSON, NATIONAL TAXPAYER  
ADVOCATE, INTERNAL REVENUE SERVICE**

Ms. OLSON. Mr. Chairman and Members of the Subcommittee, thank you for inviting me to testify here today. First, let me say that I believe return preparers play a central role in our tax system by helping millions of taxpayers comply with their Federal tax obligations. In fact, I have firsthand experience with the preparer-taxpayer relationship because I, myself, was an unenrolled preparer for 16 years before I became an attorney. It is precisely because this relationship is so important to the proper functioning of the tax system that we, as stewards of the system, must protect the integrity of that relationship. We can do so by ensuring that return preparers have basic knowledge about how to prepare tax returns and by ensuring that the IRS has adequate tools to deal with tax preparers who fail to do their jobs with integrity.

While criminal cases obviously receive considerable press attention, the vast majority of problems involving unenrolled preparers stem from either preparer lack of knowledge or from preparer negligence that might constitute a civil offense, but not a criminal one. Lack of knowledge and lack of integrity, although related, are two separate problems that call for separate approaches, and they are, in turn, distinct from criminal acts. Lack of knowledge is the most pervasive problem. This year, more than 60 percent of individual filers use practitioners to prepare their returns and the majority of these returns were prepared by preparers who are not subject to any professional educational requirements at all. While IRS Criminal Investigation has the authority to address many of the egre-

gious cases of fraud that have been highlighted in this hearing, the IRS currently has no authority to license preparers or require basic knowledge about how to prepare returns.

Based on my experience, I believe the government needs to take steps to professionalize the tax preparation industry to protect both taxpayers and the tax system itself. It is remarkable to me that in the United States today, an insurance agent can't sell insurance without a license, a contractor can't build without a license, and a hair stylist can't touch a lock on a person's head without a license. Yet anyone can prepare a tax return for a fee with no training, no licensing, and no oversight required. In my 2002 Annual Report to Congress, I proposed a plan for the IRS to register, test, and certify unenrolled preparers. My proposal was generally well received and it was passed by the U.S. Senate last year as part of the Tax Administration Good government Act. This proposal was introduced again in the Senate this year as part of S. 832, and I am pleased that the Chairman and Ranking Member of the Senate Committee on Finance are again cosponsors. I encourage this Committee to pass similar legislation.

The IRS originally expressed some misgivings that my proposal could place a strain on its enforcement resources, but as I describe in my written statement, I have designed the proposal carefully to avoid that result. California, for example, has adopted a registration system that is funded entirely by modest fees that preparers in that State pay. In addition, I note that the IRS itself has already designed a modest, but effective version of a testing and certification program and it did so within a one-year timeframe. "Link and Learn Taxes" is an online training program that allows Volunteer Income Tax Assistance volunteers to receive the training and certification necessary to prepare tax returns at VITA sites. The IRS estimates that about 10,000 volunteers received certification through this program for the 2005 filing season. So, this is imminently doable.

Apart from education, I also believe that more needs to be done to address the problems of preparers who lack integrity. The civil penalty regime currently in law is not adequate, and in particular, penalty amounts are too low for the IRS to treat enforcement of preparer penalties as priority work. Therefore, in my 2003 Annual Report, I identified gaps and inadequacies of the current compliance regime for preparers and Electronic Return Originators (ERO) and I recommended that Congress strengthen oversight of all preparers by enhancing due diligence and signature requirements, increasing the dollar amount of preparer penalties, and assessing and collecting those penalties as appropriate.

In conclusion, I believe a compelling case exists for regulating unenrolled return preparers at the Federal level. Federal regulation will protect all taxpayers and protect the tax system. We have a Federal tax system, and in my view, we owe our taxpayers Federal minimum standards of competency and Federal oversight. Thank you.

[The prepared statement of Ms. Olson follows:]

**Statement of Nina Olson, National Taxpayer Advocate, Internal Revenue Service**

Mr. Chairman and distinguished Members of the Subcommittee:

Thank you for inviting me here today to speak about the regulation of federal tax return preparers. For several years now, I have advocated for a two-pronged approach to this issue. First, as I outlined in my 2002 Annual Report to Congress,<sup>1</sup> we must establish minimum levels of competency for return preparation by requiring the registration, examination, and certification of unenrolled return preparers. Second, as I described in my 2003 Annual Report to Congress,<sup>2</sup> we must strengthen our oversight of all preparers by enhancing due diligence and signature requirements, increasing the dollar amount of preparer penalties, and assessing and collecting those penalties, as appropriate.

**The Case for Regulation**

As recently as fifteen years ago, before the push for electronic filing and the expansion of the Earned Income Tax Credit (EITC), most tax return preparers were Certified Public Accountants (CPAs), attorneys, enrolled agents, or persons who were in the business of preparing tax returns. Attorneys and CPAs are licensed by the states and must complete a course of study in addition to passing a test. All states require these professionals to register, and most states require some amount of continuing professional education. Enrolled agents, who are authorized to practice before the IRS, must pass a rigorous IRS-administered examination and complete 16 hours of continuing professional education every year.<sup>3</sup>

Unenrolled preparers, however, are an extremely diverse group. Some are public accountants who are tested and licensed by the states. Others are employees of major commercial tax preparation firms and, as such, are required to complete a series of courses and are subject to corporate quality control and due diligence standards. Still others are independent preparers who are members of various professional associations and annually complete professional training programs about tax law and tax preparation.

However, with the advent of electronic filing and electronic commerce and the increase in the maximum EITC dollars available to taxpayers, a new class of preparers has emerged—one which is not engaged primarily in the business of preparing taxes. Rather, these preparers use tax preparation as a means to attract customers for some other product or service they offer that is unrelated to return preparation or even financial or tax planning. These products include check cashing, automobile sales, pawned items, furniture rentals, and even—through the use of payday-type loans issued on debit cards that are honored at only a few locations—general household necessities that are sold at grossly inflated prices during the filing season.

Unlike fifteen years ago, when we could at least count on some minimum level of competency for “unenrolled” preparers because that was their primary business, we have no such comfort with the new businesses that are now preparing returns, because tax preparation is only an ancillary product of their business. Indeed, with the excellent commercial tax preparation software now available, a return preparer need not have any actual knowledge of tax law or tax administration in order to begin preparing taxes.

While this arrangement may seem to be an exercise in the free market, I believe it imposes unacceptable costs and risks on taxpayers and tax administration. We know, for example, that over 32 percent of EITC returns are prepared by unenrolled paid preparers and that the overclaim rate on those returns is over 34 percent.<sup>4</sup> The IRS’s criminal investigation division undertakes more than 200 preparer refund scheme investigations each year.<sup>5</sup> Preparer collusion with taxpayers is called “brokered” noncompliance—the preparer facilitates and enables the noncompliance.<sup>6</sup> At the other end of the spectrum, a preparer’s lack of training can lead to costly mis-

<sup>1</sup>National Taxpayer Advocate 2002 Annual Report to Congress 216.

<sup>2</sup>National Taxpayer Advocate 2003 Annual Report to Congress 270.

<sup>3</sup>Treas. Circ. 230 § 10.6(e) (Rev. 6–2005).

<sup>4</sup>Internal Revenue Service, Compliance Estimates for Earned Income Tax Credit Claimed on 1999 Returns (2/28/02). This data was derived from taxpayer answers to the examiner’s question about how the return was prepared.

<sup>5</sup>Response provided by Criminal Investigation Division to Taxpayer Advocate Service Information Request, 1 (Nov. 2, 2004).

<sup>6</sup>For a detailed discussion of the types of noncompliance, see Leslie Book, *The Poor and Tax Compliance: One Size Does Not Fit All*, 51 Kan. L. Rev. 1145 (2003) (discussing types of non-compliance); see also National Taxpayer Advocate 2004 Annual Report to Congress 211.

takes from the taxpayer's perspective—either failing to claim available credits or deductions, or overstating deductions or basis, leading to multi-year liabilities.

These circumstances may lead to disaffected taxpayers and decreased compliance—and lots of avoidable work for the IRS. The current situation allows serious and competent unenrolled preparers to be tarred with the misdeeds of unscrupulous or incompetent unenrolled preparers, and it leads to taxpayer confusion about who one should turn to for help. Is “buyer beware” really an appropriate or sensible standard for the federal tax return preparation market?

### **What's the Solution?**

In my 2002 Annual Report to Congress, I proposed a scheme for the IRS to register, test, and certify unenrolled preparers. Since that time, my office has continued to study and meet with existing state and international regulators. In the summer of 2004, TAS conducted six discussion groups with all types of preparers at the Tax Forums<sup>7</sup> on the question of regulation of return preparers. I or my staff met with representatives of almost all tax professional groups, including some large franchises. Moreover, we have worked with both this subcommittee and the Senate Finance Committee to address concerns of both tax professionals and the IRS about preparer regulation.

The components of my original proposal include:

- *Registration.* Each person who prepares more than five federal tax returns for a fee in a calendar year and is not an attorney, CPA, or enrolled agent would be required to register with the IRS and pay a fee.
- *Testing.* As originally described, each applicant would be required to complete a test that demonstrates competency in certain returns. The proposal recommends two tiers of testing, based on the complexity of returns. Tier 1 would include the 1040 series, including simple sole proprietorship schedules (Schedule C); Tier 2 would include business and employment tax returns. The original proposal also recommended that each preparer be required to pass an annual refresher examination, reflecting tax law changes and the most common preparer return errors for the preceding year.
- *Certification.* The IRS would issue to successful applicants a certificate containing a certification number and expiration date. The preparer would enter the certification number on every return he or she prepares for a fee.
- *Maintenance of Public List.* The IRS would be authorized to maintain a public list (in print and electronic media) of return preparers who are registered and certified, who are registered but not certified, and whose registration has been revoked. This list should also be available on the Internet and be searchable.
- *Consumer Information Campaign.* The IRS should be authorized to conduct an extensive public awareness campaign that informs taxpayers of the need to look for a preparer's registration certificate before paying the preparer to prepare a tax return.
- *Oversight and Penalties.* Return preparers who fail to register would be subject to a scale of progressive deterrents ranging from educational notices and warnings to monetary penalties. The IRS would be authorized to notify the taxpayer if the taxpayer's return preparer was not registered with the IRS within the required time frame.

I have since modified this proposal to permit the annual competency requirement to be met either by testing or completion of continuing professional education.<sup>8</sup> We also think it may make sense to register all return preparers, including those licensed as attorneys and CPAs.<sup>9</sup> In response to the IRS's concern that it cannot commit resources to administering a registration program, we have clarified our intent that some of these duties can be administered by professional groups and that the

<sup>7</sup>The IRS Nationwide Tax Forums offer the latest word from the IRS on tax law, compliance and tax practice and procedure. The tax professional community is offered a one-stop shop with opportunities to attend seminar presentations and workshops, as well as focus groups with subjects from ethics and professional conduct to how to enroll and participate in e-file and the new e-services.

<sup>8</sup>Although many preparers can easily keep up their skill levels and the currency of their knowledge by attending seminars sponsored by associations of tax professionals, I continue to believe that some preparers—particularly those in remote areas or who have physical disabilities—will benefit from the availability of a self-study and web-based test option.

<sup>9</sup>These state-licensed professionals could submit proof of current good-standing status in lieu of completing the examination or continuing education requirements.

IRS can contract out much of the program's administration on a self-funding basis. Indeed, one such entity has already drawn up a proposal.<sup>10</sup>

### IRS "Link and Learn Taxes"

The IRS itself has already designed a modest but effective version of a testing and certification program—and did so within a one-year timeframe. "Link and Learn Taxes" is an online training program that allows Volunteer Income Tax Assistance (VITA) volunteers to receive the training and certification necessary to prepare tax returns at VITA sites. The IRS estimates that about 10,000 volunteers received certification through this program for the 2005 filing season.

The program consists of six modules:

- Course Introduction
- Basic Module
- Wage Earner Module
- Pension Earner Module
- Military Module
- What's New This Year (for returning volunteers only)

When a volunteer passes an individual module, he or she is certified to prepare returns involving issues addressed in that module. Thus, volunteers can tailor their certification toward the type of returns they anticipate preparing.

Each module starts with a pretest. If the volunteer scores 70 percent or higher on the pretest, the volunteer passes and is certified. If the volunteer fails the pretest, he or she must take individual lessons within each module. Each such lesson contains a number of sections, including:

- Comprehensive exercises that test individuals' knowledge of various issues;
- Additional references that provide links to forms, publications, and websites containing additional information on the topic;
- "Check Your Knowledge" questions located throughout each module; and
- Topic activities at the end of each topic allowing for practical application of the topics covered in the lesson.

Each lesson concludes with a post-test. The volunteer must receive a score of 70 percent or higher to pass and receive certification.<sup>11</sup>

### Improving the Oversight of All Preparers

Regulation of preparers will go a long way toward increasing the accuracy of tax returns and providing taxpayers with some confidence that they are receiving assistance from a preparer who meets a minimum level of competence. However, there will always be preparers who are negligent or even unscrupulous. Since 1976, Congress has recognized that an appropriate system of penalties must exist to deter negligent or more serious preparer misconduct.<sup>12</sup> In my 2003 Annual Report to Congress, I identified the gaps and inadequacies of the current compliance regime for preparers and Electronic Return Originators (EROs). Given that the IRS is virtually a nonexistent presence in the unenrolled preparer community—levying only \$2.4 million in preparer penalties in calendar years 2001 and 2002, and collecting only 12 percent (or \$291,000) of those assessments<sup>13</sup>—and given that preparers can easily absorb these low-dollar penalties into the cost of doing business, I made the following recommendations:

- Increase the IRC § 6694(a) preparer penalty for understatements due to unrealistic positions from \$250 to \$1,000 and the IRC § 6694(b) penalty for intentional disregard of the rules and regulations from \$1,000 to \$5,000.
- Increase the preparer penalties under IRC § 6695(a) through (e) with respect to certain requirements for preparation of income tax returns for other persons

<sup>10</sup>A consortium of administrators recently approached the IRS to administer a program similar to that proposed in the Taxpayer Protection and Assistance Act of 2005 (S. 832). Under this proposal, there would be no initial cost to the IRS, and the proposed program is expected to be fully funded by preparer registration fees of approximately \$35, imposed every three years. This proposal is in sharp contrast to the \$25 million initial cost estimated by the Congressional Budget Office for the program included in S. 882, the Tax Administration Good Government Act of 2004. See Congressional Budget Office Cost Estimate, S. 882; Tax Administration Good Government Act of 2004 (May 24, 2004).

<sup>11</sup>If a volunteer fails the post-test, he or she must take an additional post-test and pass with a score of 70 percent or higher.

<sup>12</sup>See, e.g., Tax Reform Act of 1976, Pub. L. No. 94-455, § 1203(b)(1).

<sup>13</sup>General Accounting Office, *Tax Administration: Most Taxpayers Believe They Benefit from Paid Tax Preparers, but Oversight for IRS is a Challenge*, GAO-04-70 (October 2003) 16.

(including signing the return and providing the taxpayer with a copy of the tax return), from \$50 per occurrence to \$100 per occurrence.

- Increase the preparer penalty under IRC § 6695(f) for negotiation of a refund check from \$500 per check to \$1,000 per check.

We know that preparers play a role in EITC noncompliance. Currently, EITC preparers are required to meet certain due diligence requirements<sup>14</sup> and are subject to a \$100 penalty for each failure to meet those requirements.<sup>15</sup> Where EITC overclaims result from either preparer incompetence or intentional disregard of the rules and regulations, the IRS often cannot recover any overpayments from the low income taxpayer. Moreover, many competent and scrupulous return preparers complain that they cannot compete with return preparers who are willing to turn a blind eye to taxpayers who are gaming the system. Thus, to ensure that preparers conduct the proper due diligence in preparing EITC returns and to increase the personal risk for preparers who are more than merely negligent in preparing such returns, we made the following legislative recommendations:

- Amend IRC § 6695(g) to impose a tiered penalty structure for violation of the EITC due diligence requirements. For the first year in which the IRS imposes a penalty against an EITC preparer, the penalty would be \$100 per occurrence; for the second year, \$500 per occurrence; and for the third year, \$1,000 per occurrence. The IRS should waive or abate the penalties, in whole or in part, where the preparer enrolls in EITC education courses and demonstrates an ability to comply with due diligence requirements.
- Amend IRC § 6695(g) to require the EITC due diligence certification to be signed, under penalties of perjury, by the return preparer and attached to the taxpayer's income tax return and expand the due diligence requirements to address the most common EITC preparer errors.
- Amend IRC § 6695 to authorize the Secretary to impose a civil penalty against a tax return preparer who, by reason of intentional misstatement, misrepresentation, fraud, deceit, or any unlawful act causes a taxpayer a tax liability attributable to the EITC in an amount equal to the tax attributable to the disallowed EITC.

Taxpayers suffer from and the IRS continually struggles with various submissions from persons who purportedly “assist” taxpayers with tax debts, for a fee, but who are not authorized to practice before the IRS. We see this most often in the realm of Offers-in-Compromise (OICs) and, to a lesser extent, in Collection Due Process hearings. In the OIC arena, businesses review recent IRS public filings of Notices of Federal Tax Liens and then notify the taxpayers that they can help the taxpayers settle for “pennies on the dollar.” These preparers merely transmit taxpayer-prepared OIC forms and financial statements, without review for accuracy, to the IRS. Because the preparers are not required to sign these forms, the IRS does not know who has prepared them and thus cannot assess any negligence penalties against the preparers. To help remedy this situation, we proposed the following:

- Amend IRC § 6695 to impose a penalty of \$100 per occurrence on persons who fail to sign or include certain information on specified IRS forms prepared by them for a fee, including applications for Offers-in-Compromise and financial information statements of individuals and businesses.
- Amend the Internal Revenue Code to authorize the Secretary to impose a \$1,000 penalty, per occurrence, against any person who willfully and intentionally misrepresents his or her professional status on a power of attorney authorizing him or her to represent a taxpayer before the IRS or who willfully and intentionally practices before the IRS without proper authorization.

<sup>14</sup>To meet the due diligence requirements, EITC preparers must complete an eligibility checklist (using either IRS Form 8867 or a comparable form), complete the EITC worksheet(s) in the Form 1040, 1040A or 1040EZ instructions or in Publication 596 (or a comparable form), have no knowledge that any of the information used to determine if a taxpayer is eligible for the EITC is incorrect, and retain this information for three years following the date of filing (the three-year period begins on the June 30<sup>th</sup> following the date the taxpayer was given the return to sign. Treas. Reg. § 1.6695-2(b)(1)-(4).

<sup>15</sup>Treasury regulations require preparers of EITC returns or refund claims to record how and when information used to complete the required EITC checklist and worksheet was obtained by the preparer, including the identity of any person furnishing the information. Treas. Reg. § 1.6695-2(b)(4)(i)(C). IRS Form 8867, Paid Preparer's Earned Income Credit Checklist, is not required to be filed with the taxpayer's return, so the IRS has no systematic way of verifying due diligence compliance.

Electronic Return Originators (EROs) are persons or entities that originate electronically filed returns. EROs are subject to three levels of sanctions by the IRS for failing to comply with e-file Program requirements. These sanctions include a warning or written reprimand; the loss of e-file privileges for one year; and the suspension from the e-file program for the balance of the year and two additional years for fraud or other known criminal activity. *The IRS has no statutory authority to impose monetary penalties against egregious or repeat offenders of ERO program requirements.*

Prior to becoming an ERO, applicants are subject to a suitability investigation, which may include the following:

- A criminal background check;
- A credit history check;
- A tax compliance check to ensure that all requisite returns are filed and paid, and to identify fraud and preparer penalties; and
- A check for prior non-compliance with IRS e-file requirements.

IRS monitors EROs through visits based on mandatory or random referrals. During FY 2005, the IRS has a goal of visiting 1 percent of the over 200,000 active e-file participants. During fiscal year 2004, the IRS made 1,294 visits,<sup>16</sup> which resulted in 224 warnings, 154 written reprimands, 88 recommended suspensions, 31 immediate suspensions and 16 Criminal Investigation referrals.<sup>17</sup> According to the IRS Criminal Investigation Division, 70 percent of 58,774 electronically filed returns identified in fiscal year 2004 through its Questionable Return Program (QRP) were filed through EROs, and at present, 85 percent of fraudulent returns have a loan product such as a Refund Anticipation Loan associated with them.

We recommend that Congress amend the Internal Revenue Code to authorize the Secretary to impose a \$1,000 penalty, per infraction, in addition to other available sanctions, on EROs who repeatedly or egregiously fail to comply with ERO Program requirements. Where preparers, including EROs, commit violations by charging a fee for services that is a percentage of the taxpayer's refund or is based on a return item, or by failing to advise the taxpayer of the fact that a Refund Anticipation Loan product is a loan and the terms of that loan, the IRS should be authorized to assess a penalty equal to the greater of \$100 per occurrence or 50 percent of the fee for such service.<sup>18</sup>

In addition, S. 832, a bill pending before the Senate Finance Committee, would attempt to address some of the problems associated with RALs by requiring RAL providers to disclose more information to potential customers. Among other things, the bill would require RAL facilitators to register annually with the IRS and to disclose to taxpayers, both orally and in writing, that they may file an electronic tax return without applying for a RAL, the cost of a RAL, the cost of other types of consumer credit, and the expected time within which tax refunds are typically paid by the IRS. I think taxpayers deciding whether to purchase a RAL would benefit considerably from complete and clear disclosure of this information.

### Conclusion

I believe a compelling case exists for regulating unenrolled return preparers. The fact that about 60 percent of individual taxpayers use paid preparers<sup>19</sup> makes it unacceptable to expect 50 states and one district to enact 51 different regulatory schemes. We have a *federal* tax system and we owe our taxpayers *federal* minimum standards of competency and *federal* oversight.

Regulation of return preparers and enhanced tools for oversight of those preparers will increase taxpayer compliance and decrease IRS work resulting from errors. It will recognize the ever-increasing role that return preparers play in the fairness and accuracy of the tax system. More importantly, it will recognize that the IRS has an obligation to that part of the taxpayer population that is responsible for our 85 percent compliance rate—to ensure that if they need assistance preparing returns and the IRS isn't stepping up to the plate to help, then the least we can do is ensure that *paid* preparers are nominally competent, just as we are ensuring that *voluntary* VITA preparers are. I believe this obligation is a fundamental aspect of taxpayer service and a cornerstone for achieving more voluntary compliance.

<sup>16</sup>There were substantially fewer than 200,000 EROs in FY 2003, when IRS set the work plan for ERO visits during FY 2004.

<sup>17</sup>IRS, 2004 *e-file* provider Monitoring Report.

<sup>18</sup>National Taxpayer Advocate 2003 Annual Report to Congress 273.

<sup>19</sup>Taxpayer Usage Study (TPUS) Weekly Report 14, based on a sample of all individual income tax returns for Tax Year (TY) 2004 filed through May 6, 2005.



Thank you for the opportunity to testify today. I look forward to working with your subcommittee on this important matter.

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Chairman RAMSTAD. The Chair thanks you, Ms. Olson. Ms. Jardini, please.

**STATEMENT OF NANCY J. JARDINI, CHIEF, CRIMINAL INVESTIGATION DIVISION, INTERNAL REVENUE SERVICE**

Ms. JARDINI. Thank you, Chairman Ramstad, Ranking Member Lewis, and Members of this distinguished Subcommittee, for the opportunity to discuss the IRS' efforts to ensure that tax professionals comply with the law and adhere to professional standards. I also wish to commend the Subcommittee staff, who were extremely helpful as we worked together to prepare today's hearing. During the 2005 filing season, almost 123 million individual income tax returns were filed with the IRS, of which more than 74 million, or 60 percent, were signed by a professional tax preparer. It is in the best interest of the American people, as well as tax administration, to ensure that tax practitioners comply with the law, and therefore, this is one of our four overarching IRS enforcement priorities in our IRS strategic plan.

Unfortunately, not all tax return preparers are above board. For nearly 30 years, Criminal Investigation's Return Preparer Fraud Program has focused on identifying unscrupulous return preparers and referring those cases either to our field offices for criminal investigation and prosecution or to our civil partners within the IRS for injunctive action, examination, and application of penalties. Our criminal enforcement efforts during the past 5 years have identified over 200,000 questionable returns prepared by return preparers on behalf of clients. These returns claimed over \$700 million in refunds.

During that same time period, Criminal Investigation initiated over 1,000 investigations of return preparers. Cases referred to the Department of Justice recommending prosecution have increased by over 125 percent over just the last 4 years. The number of individuals sentenced increased more than 60 percent, with an average sentence in these cases 19 months of imprisonment. To further deter this fraudulent activity, Criminal Investigation aggressively publicizes enforcement results to send a clear message that unscrupulous return preparers will be prosecuted and sent to jail.

In the civil arena, since August of 2002, more than 98,000 audits have been completed and over \$200 million in additional tax has been assessed on returns related to these ongoing investigations. Similarly, we have worked closely with the Department of Justice and have seen a dramatic increase in the number of civil injunctions used to terminate this conduct. Professionalism and responsibility in the preparer and practitioner community is a cornerstone of a successful voluntary compliance system. As Commissioner Everson has repeatedly stressed, it is service plus enforcement that equals compliance. Registration and education may strengthen honest preparers, which we applaud, but we are concerned that this not dilute our important enforcement efforts designed to ad-

dress fraudulent practices that steal money from the revenue and from honest taxpayers.

Many fraudulent preparers rely on extensive knowledge of the tax law and IRS procedures to devise methods to circumvent the system. Unscrupulous preparers who are intent on ripping off the system will continue to commit fraud regardless of any educational or registration structure. Some will merely abide by the regulations, become certified preparers, and continue to prepare fraudulent returns with the imprimatur of the Federal government. Others will be driven underground and continue their fraudulent conduct, but will be harder for us to detect as this will serve only to deter them from signing fraudulent tax returns, but not from, in fact, preparing fraudulent returns. The IRS strategic plan which targets professionalism and accountability in the preparer and practitioner community is in the first year of a 5-year deployment. Our message today is that we seek to continue our productive partnership with the preparer and practitioner community, including the Taxpayer Advocate Service, but we stress the important role that enforcement efforts must play in leveling the playingfield for all law-abiding practitioners in protecting the revenue for all citizens.

To that end, the IRS currently has numerous tools available to address return preparer fraud and to educate the public. Effective application of these tools requires strong support of the IRS enforcement mission during this critical building stage. Some of the key tools include the Criminal Investigation Fraud Detection Centers, which deploy expert intelligence analysts who look at sophisticated data mining and data analysis tools and identify unscrupulous return preparers as well as defining the scope of their schemes. Numerous civil and criminal penalties can be deployed once return preparer schemes are identified and examined. The parallel investigative process permits a civil injunction to be issued, which allows us to stop fraudulent conduct in its tracks. Finally, we have no aggressive education and outreach program geared specifically to this problem which targets both law-abiding taxpayers and the preparer community.

In conclusion, the IRS recognizes the need to focus intensively on professionalism in the preparer community and unscrupulous return preparers, as reflected in our strategic plan. While we have made progress, continued support of the IRS enforcement and outreach efforts will go a long way in identifying and stopping this type of fraud and educating well-intentioned taxpayers. Thank you, and I look forward to taking your questions.

[The prepared statement of Ms. Jardini follows:]

**Statement of Nancy J. Jardini, Chief, Criminal Investigation Division,  
Internal Revenue Service**

Thank you for the opportunity to discuss how the unique skills of the Internal Revenue Service Criminal Investigation Division, or CI, are being utilized to detect and investigate allegations of tax return preparer fraud. In support of the overall IRS Mission, CI serves the American public by investigating potential criminal violations of the Internal Revenue Code and related financial crimes in a manner that fosters confidence in the tax system and compliance with the law. CI plays a critical role in the IRS's efforts to address fraud in the area of tax return preparers.

One of the enforcement goals of the IRS Strategic Plan for 2005 through 2009 is to enhance enforcement of the tax laws by ensuring that attorneys, accountants and

other tax practitioners comply with the law and adhere to professional standards. CI has aligned its strategic plan to meet this goal by focusing additional resources on legal source tax investigations and maximizing the impact of criminal enforcement through education and outreach. Legal source tax investigations are CI's primary resource commitment which includes investigating unscrupulous tax return preparers involved in abusive tax promotions and other tax evasion schemes.

Through the skill and effort of our dedicated employees and the use of effective investigative tools, CI, along with our partners in the IRS civil divisions, is able to identify, deter, and when warranted, criminally investigate the individuals who knowingly and willfully violate the law by preparing false returns. Many of those investigations are ultimately referred to the Department of Justice for prosecution and result in prison sentences, fines and other sanctions. Those not resulting in criminal prosecution are referred for civil examination.

Return preparer fraud has been one of CI's key investigative priorities for many years and this year is no exception, as evidenced by our current inventory of return preparer investigations which is at a five year high. Cases referred to the Department of Justice recommending prosecution have increased by 125% over the past 4 years, going from 73 in 2001 to 167 in 2004. The number of individuals sentenced during that same time period increased more than 60%, from 56 in 2001 to 90 in 2004. The average sentence was 19 months. Additionally, to further deter this type of fraudulent activity, CI continues to publicize enforcement results to send a clear message to the public that unscrupulous return preparers will be prosecuted.

#### **Tax Return Preparers**

Millions of Americans rely on tax practitioners for advice on the preparation of their personal and business-related returns each year. Although the taxpayer ultimately bears the responsibility for filing timely, complete and accurate tax returns, return preparers provide an important service. During the 2005 filing season, over 122.9 million individual income tax returns were filed with the IRS of which more than 74.2 million tax returns, about 60%, were signed by a professional tax preparer. These numbers do not reflect the returns that are prepared by someone who does not sign the return. There is no question that unscrupulous preparers prepare returns without signing them but we have no way of determining the scope of the problem.

Tax return preparers vary significantly in their level of education, expertise and experience. They also vary significantly in the types of services they provide and the clientele they serve. They may be employed by large accounting firms, partnerships or they may be sole proprietors. They may be attorneys, CPAs, Enrolled Agents or tax return preparers who have no formal education and little, if any, training or experience in accounting, tax law or tax return preparation. Their clients might include large corporations, businesses and individuals and they could offer general bookkeeping and accounting services in addition to preparing and filing tax returns. Some tax practitioners are also Electronic Return Originators (ERO) which enables them to electronically file a client's tax return with the IRS.

Most return preparers are assiduous in performing their duties and play an important role in our tax system by preparing accurate returns for their clients. Unscrupulous return preparers adversely affect compliance and contribute to the tax gap. To address this concern, the IRS Strategic Plan for 2005 through 2009 states, "We will encourage ethical behavior and deter non compliance by making the consequences of practitioner misbehavior more widely known within the boundaries of law and regulation. Those practitioners who choose not to comply with established standards of conduct will be subject to a broad range of coordinated actions that will effectively address their misconduct, e.g., the assessment of preparer penalties, disciplinary sanctions imposed under the authority of Treasury Circular 230, suspension of electronic filing privileges, the pursuit of injunctive action and, where warranted, criminal prosecution initiated by the Department of Justice."

Another long term strategic goal of the IRS is to detect and deter domestic and off-shore abusive tax schemes. The promoters of these schemes often use layers of complex offshore financial transactions, illegal trusts and other sophisticated means of concealing assets to avoid detection thereby giving their illegal activities the appearance of legitimacy. Unscrupulous tax return preparers play an integral role in many of these abusive tax schemes by facilitating the preparation and filing of false tax returns and related documents.

A return preparer is any person who prepares tax returns (or claims for refund) for compensation. Return preparers are broadly categorized by the IRS as either enrolled preparers or unenrolled preparers. Circular 230 is the IRS publication that contains regulations governing the practice of Attorneys, CPAs, enrolled agents and actuaries, and appraisers representing clients before the IRS. The IRS Office of Pro-

Professional Responsibility administers the provisions of Circular 230 and can impose sanctions including censure, suspension or disbarment on enrolled agents, attorneys and CPAs who act irresponsibly, unprofessionally, or illegally.

Not all tax preparers are practitioners subject to Circular 230. IRS Publication 470, which contains Revenue Procedure 81-38, prescribes the standards of conduct for unenrolled tax preparers. It limits these preparers to representation of taxpayers before the IRS solely for the years in which they prepared the returns. Unenrolled preparers must conform to the standards of conduct which are prescribed in the procedure and can be prohibited from representing clients before IRS for unprofessional or illegal conduct.

#### **Civil Penalties**

Return preparers can be subject to civil penalties if they act in negligent or intentional disregard of Treasury or IRS rules and regulations. Internal Revenue Code § 6694 imposes penalties on income tax return preparers who understate a taxpayer's tax liability. Where a preparer has taken a position on a return or refund claim for which he or she knew or should have known that there was "not a realistic possibility of being sustained on its merits," that preparer shall be subject to a \$250 penalty, absent a showing of reasonable cause for the understatement. A preparer will be subject to a \$1,000 penalty if the understatement is attributable to the preparer's willful attempt to understate the tax liability or is due to the preparer's reckless or intentional disregard of rules or regulations. In addition, Internal Revenue Code § 6695 imposes penalties on preparers for such activities as the preparer's failure to furnish a copy of their clients' prepared return to the client, failure of the preparer to sign the prepared return, failure of the preparer to furnish the preparer's identifying number on the prepared return and the preparer's negotiation of a client's refund check. Penalties under Internal Revenue Code § 6695 range from \$50 to \$500 per occurrence and are subject to an annual maximum penalty of \$25,000.

Preparers of returns or refund claims involving the Earned Income Tax Credit (EITC) must satisfy certain due diligence requirements for determining the taxpayer's eligibility for or amount of the credit. Failure to do so could result in a penalty of \$100 for each failure to meet such due diligence requirement under Internal Revenue Code § 6695(g).

The provisions of Circular 230 and Revenue Procedure 81-38 only apply to those who want to represent clients before the IRS. Notwithstanding these provisions, anyone can prepare a return for someone else. Therefore, fraudulent conduct occurs in both the enrolled and unenrolled preparer population.

#### **Criminal Provisions**

Tax return preparers can also be subject to possible criminal sanctions arising from their preparation of fraudulent returns or other documents. Criminal penalties can be imposed for the willful attempt to evade or defeat tax (Title 26, USC § 7201—up to 5 years imprisonment and not more than \$250,000 fine), the willful making of false statements under penalties of perjury (Title 26 USC § 7206(1)—up to 3 years imprisonment and \$250,000 fine), and the willful aiding, assisting, counseling, or advising in the preparation of any document in connection with the Internal Revenue laws that is false or fraudulent with respect to a material matter (Title 26 USC § 7206(2)—up to 3 years imprisonment and not more than \$250,000 fine).

#### **Unscrupulous Tax Return Preparers and Abusive Tax Schemes**

Unscrupulous return preparers, whether covered by Circular 230 or not, willingly and knowingly engage in fraudulent return schemes and assist in preparing returns to facilitate abusive tax schemes for profit. Unscrupulous return preparers frequently prepare returns for many clients. These clients/taxpayers are not only ultimately responsible for additional taxes and interest owed, but could be subject, depending on culpability, to severe civil and criminal sanctions. Many times, taxpayers are not just mere unwitting prey of an unscrupulous preparer but instead, knowledgeable and willing participants of the scheme. Some of the most common tax preparation schemes are committed by claiming false dependents; inflating deductions on schedule A (Itemized Deductions) including charitable contributions, medical or dental expenses; claiming tax credits through falsifying material matters such as business expenses; and creating a false Schedule C business in order to offset the taxpayer's income.

Unscrupulous return preparers play a pivotal role in abusive tax schemes. These schemes are aggressively promoted to affluent taxpayers and are characterized by the use of multiple flow-through entities such as trusts, Limited Liability Corporations (LLCs), Limited Liability Partnerships (LLPs) International Business Companies (IBCs), foreign accounts, offshore credit/debit cards and similar instruments.

These complex multi-layer transactions conceal the real nature of the transactions and ownership of the taxable income or assets. Promoters of these abusive tax schemes could not succeed without the active participation of unscrupulous return preparers who charge hefty fees in exchange for their involvement. In one of the most significant abusive tax schemes ever prosecuted, six people including an accountant from Los Osos, California, were convicted for their roles in promoting a fraudulent tax shelter to more than 1,500 clients. The defendants earned tens of millions of dollars in fees as they assisted clients in taking \$120 million in false deductions. The deductions were generated through a series of complex transactions involving foreign bank accounts.

Fraudulent behavior on the part of some practitioners does not generally have its foundation in a lack of understanding of the Internal Revenue Code and associated filing requirements. Rather, return preparers engaging in fraudulent activity frequently rely on extensive knowledge of the tax law and IRS procedures to devise sophisticated ways to circumvent the system.

#### **CI's Return Preparer Program**

Criminal Investigation's Return Preparer Program (RPP) was established in 1977 and was enhanced in 1996 with the addition of the IRS Revenue Protection Strategy. During the past five years, through the RPP CI has identified over 200,000 questionable returns prepared by practitioners on behalf of their clients. These returns claimed over \$700 million in refunds. Additionally, during that same time period, CI initiated over 1,000 investigations on return preparers. Since August 2002, more than 98,000 audits have been completed and over \$200 million in additional tax has been assessed on returns related to on-going return preparer investigations.

#### **Electronic Filing and Refund Anticipation Loans**

Tax returns can be prepared, filed electronically and accepted by the IRS one day and the taxpayer or unscrupulous preparer can obtain a Refund Anticipation Loan (RAL) the next. During the 2005 filing season, taxpayers filed over 66 million returns electronically. Approximately 16%, or 11 million, of those returns had a RAL indicator. While the majority of RALs are associated with legitimate returns, seventy-five per cent of the identified questionable and/or fraudulent returns have an associated RAL.

#### **Return Preparer Fraud Detection Tools**

##### **Fraud Detection Centers**

Since 1977, CI has been screening suspected fraudulent tax returns. This is done by the Criminal Investigation Fraud Detection Centers (FDC) at each of the IRS campuses where tax returns are filed. One of the functions of the FDC is to detect and develop return preparer schemes for criminal investigation or for referral to an IRS civil division for examination. There are approximately 600 analysts and staff members employed at these FDCs nationwide. The FDC investigative analysts evaluate data identified by data mining algorithms, conduct critical investigative analysis, and work with our partners in the civil divisions of the IRS in the preparation of the RPP scheme packages. For processing year 2005 to date, over 33,000 questionable returns have been identified claiming almost \$100 million in refunds associated with unscrupulous tax return preparers.

##### **Identification of Schemes Using Technology**

CI, in conjunction with the IRS's Information Technology Services (ITS) has developed the Electronic Fraud Detection System (EFDS) which is used by CI analysts at the FDCs. The EFDS houses large quantities of taxpayer data and has the capability to combine refund returns with other IRS files into one centralized system. In fact, EFDS is the second largest database maintained by the IRS. All refund returns are scrutinized by EFDS, which results in the identification of a substantial proportion of false returns. While this system has greatly enhanced the way the IRS identifies false returns, IRS is still unable to detect all false returns. As new schemes are identified, we program our computer systems to identify them to maximize the efficiencies of the automated systems.

In conjunction with EFDS, CI also utilizes a specific analysis tool for identifying potentially unscrupulous return preparers. The development of this tool is still in its infancy. It is comprised of electronically captured tax return information which can be filtered and sorted according to specified criteria. This has proven to be effective in identifying potentially unscrupulous return preparers for civil examination and/or criminal investigation.

### **Special Investigative Techniques**

Another effective investigative tool used by CI is our undercover program. Criminal Investigation conducts undercover operations in significant financial investigations when it is not possible to obtain evidence through less intrusive means. Undercover operations are extremely sensitive and potentially dangerous. Careful planning and oversight is critical to the success of an undercover operation and to the safety and security of the undercover special agent. Criminal Investigation works closely with its partners in the civil operating divisions to identify preparers who have demonstrated the propensity to prepare false returns, thereby allowing for more judicious use of the undercover technique. Over the past four years, CI has conducted over 400 undercover operations relating to unscrupulous return preparers. During fiscal year 2004 over 71% of the returns prepared for an undercover agent contained false information.

### **Parallel Proceedings**

Stopping unscrupulous return preparers as quickly as possible is critically important to the integrity of the tax system. One of the most effective means of accomplishing this is through the use of parallel proceedings. Parallel proceedings are simultaneous but separate criminal and civil proceedings. Obtaining a civil injunction effectively stops the illegal activities of the promoter while the criminal investigation proceeds. This process does not adversely impact the criminal prosecution, but is a useful means of discouraging additional taxpayers from participating in the scheme.

### **Publicity, Education and Outreach**

#### **Publicity**

Criminal Investigation works with media outlets and trade organizations to publicize criminal convictions involving all aspects of tax and financial fraud. This is especially true in unscrupulous return preparer cases because publicity will both deter other preparers from fraudulent activities and will increase taxpayer awareness to the importance of selecting a competent return preparer. In addition to seeking publication in traditional news outlets and trade publications, CI also posts public information about convictions on the IRS.gov website.

#### **Education/Outreach**

The IRS and CI in particular, continue to make a concerted effort to educate and alert taxpayers about unscrupulous tax return preparers and their tactics because prevention is an integral part of our enforcement strategy. Listed on the IRS.gov web site are various links taxpayers may access to learn about unscrupulous tax return preparers, dishonest practices, statistical data, examples of tax return preparer investigations, tax fraud alerts, a tax return preparer fraud fact sheet and how to report suspected fraudulent activity. Through the web site, taxpayers can also access the IRS annual news release on significant tax scams known as the "Dirty Dozen." Return Preparer Fraud is designated as one of the IRS "Dirty Dozen."

In an effort to prevent return preparer fraud, CI has developed a close working relationship with the return preparer community and does extensive outreach in this area. For the past 11 years, CI has participated in fraud discussions with practitioners at the IRS Nationwide Tax Forums. These forums offer information on the most current changes in the tax law, as well as updated information involving compliance and tax practices and procedures. Criminal Investigation has presented Refund Fraud and Abusive Tax Scheme seminars to approximately 18,000 tax practitioners and enrolled agents in the last two years alone. Representatives of CI also meet with local tax practitioner groups to continue the dialogue about badges of fraud and to encourage tax practitioners to alert the IRS about potential fraudulent schemes through field office contacts and the Fraud Hotline.

### **Highlights of Investigative Efforts**

**Jackson Hewitt Franchise Owner and his Manager Sentenced for Conspiring to Defraud the IRS**—On May 23, 2005, in Detroit, MI, Preston Harris, manager of a Jackson Hewitt franchise, was sentenced to 18 months in prison to be followed by three years of supervised release. Harris was also ordered to pay \$231,053 in restitution. Previously, on May 6, 2005, William Thomas, co-owner and general manager of three Jackson Hewitt franchises, was sentenced to 30 months in prison to be followed by three years of supervised releases. Thomas was ordered to pay \$229,805 in restitution. On July 26, 2004, Thomas and Harris were convicted by a jury on one count of conspiracy to defraud the IRS by means of fraudulent claims and two counts of filing false claims for refunds.

According to court records, Thomas and Harris, along with others, prepared over 50 false tax returns containing false and fictitious information, enlarging income tax refunds due to their clients by over \$115,000. The false information included claiming false charitable contributions and un-reimbursed employment related expenses. Some false returns claimed fictitious dependants and head of household status, along with creating fictitious Schedule C businesses, in order to generate an Earned Income Tax Credit. At sentencing, the total tax loss was calculated to be approximately \$229,000.

**Van Nuys Tax Preparer Sentenced for Preparing False Income Tax Returns**—On April 18, 2005 in Los Angeles, CA, Luis Olguin was sentenced to 18 months in prison to be followed by six months of home detention and was ordered to pay \$140,067 in a fine to the Internal Revenue Service. He will also be required to pay a special assessment of \$200. In addition, Olguin is barred from the preparation of tax returns during the three year period of supervised release. Olguin, who operated L&L Professional Services, a tax preparation business, admitted in his plea agreement that he prepared 234 false tax returns for the tax years 2000 through 2002, which claimed false and fraudulent Schedule A deductions.

**Stone Mountain Tax Preparers Sentenced in Tax Fraud Scheme**—On March 3, 2005, in Atlanta, GA, Deborah L. Thrower and Shashona P. Payton were sentenced on charges of conspiracy to commit tax fraud. Thrower was sentenced to 21 months in prison, ordered to pay \$337,684 in restitution to the IRS, and was given a 3 year term of supervised release. Payton was sentenced to a two year term of probation, with a special condition that she serves six months of the probationary term in home confinement. She was also ordered to pay \$60,251 in restitution to the IRS. Thrower and Payton, who are mother and daughter, pled guilty in October, 2004 to conspiring with one another to file false tax returns with the IRS in order to generate fraudulent tax refunds for their clients. For a fee, Thrower and Payton prepared federal income tax returns for their clients that were electronically filed with the IRS. In pleading guilty, the defendants admitted that they knowingly falsified their clients' federal income tax returns in order to generate a fraudulent refund by, among other things, falsely inflating the taxpayers allowable expenses and deductions, and by falsely reporting the taxpayers filing status, eligibility for dependent exemptions, individual retirement account contributions, student loan deductions, child care credits and expenses, and eligibility for the Earned Income Tax Credit. The effect of these false entries was to negate the taxpayer's taxable income, which, when combined with the withholdings, generated a false refund payment by the IRS.

**Local Tax Preparer Sentenced to 3 years in Federal Prison**—On January 3, 2005, in Dallas, TX, Yolanda Lavell Kaiser was sentenced to 36 months imprisonment following her guilty plea in October to one count of aiding and assisting in the preparation of a false tax return. Kaiser was also ordered to pay \$104,195 in restitution. Kaiser admitted that in February 2002, she prepared a tax return for an individual knowing that it was false and fraudulent in that it overstated the amount of the taxpayer's income and withholding, and falsely represented that the taxpayer was entitled to claim an education credit. Kaiser's preparation of this and other fraudulent tax returns resulted in a tax loss of \$90,095. Kaiser also admitted that at the time she committed this offense, she was in the business of preparing and assisting in the preparation of tax returns and that this offense was a part of a pattern and scheme from which she derived a substantial portion of her income.

**Three CPAs Plead Guilty in Anderson's Ark and Associates International Tax Scheme**—On May 16, 2005, in Seattle, WA, Tara Lagrand of Naples, FL; Gary Kuzel of Downers Grove, IL; and Lynden Bridges of Wheat Ridge, CO, pleaded guilty to aiding and assisting in the filing of false income tax returns. The estimated tax loss that resulted from the defendants filing false income tax returns was between \$2.5 and \$5 million for each defendant. These three accountants were part of Anderson's Ark and Associates (AAA), an organization through which fraudulent tax shelters and investment scams were promoted and sold. In their plea agreements, each defendant admitted that they assisted AAA clients, from their respective states, by preparing and filing the partnership agreements, promissory notes, and income tax returns required to implement the "Look Back" program—one of the two fraudulent schemes promoted by the AAA organization.

**Grass Valley Woman Sentenced in Tax Fraud Scheme**—On May 9, 2005, in Sacramento, CA, Karen Louise Younce was sentenced to 37 months in prison followed by three years of supervised release and ordered to pay a special assessment of \$100 for her role in a large-scale abusive trust scheme. Younce previously admitted, as a part of her plea, that during 1992 through August 2002, she participated in a conspiracy to impair, impede and obstruct the IRS in the computation, assessment and collection of more than \$2 million in federal income tax liabilities. For a

fee, Younce advised and assisted her clients in transferring assets and income-generating entities into domestic and foreign trusts, which she created and marketed for the purpose of evading federal income taxes. Younce also advised and assisted her clients in cycling their U.S. income through off-shore bank accounts she controlled and then returned the income to the clients.

In conclusion, our achievements are the result of a collective effort of the men and women of IRS CI, as well as our partners in the civil divisions. These dedicated employees are some of the most skilled financial investigators, auditors and investigative analysts in the federal government, and we are proud of the role we play in protecting our nation's revenue.

Mr. Chairman, I thank you for this opportunity to appear before this distinguished committee and I will be happy to answer any questions you and the other committee members may have.

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Chairman RAMSTAD. Thank you, Ms. Jardini. Thanks for your help in preparing for this hearing today. Now your testimony, please, Ms. Atkinson.

**STATEMENT OF ELIZABETH ATKINSON, PRESIDENT, BOARD OF TRUSTEES, COMMUNITY TAX LAW PROJECT, RICHMOND, VIRGINIA**

Ms. ATKINSON. Thank you, Chairman Ramstad, Ranking Member Lewis and distinguished Members of the Subcommittee, for inviting me here today to speak about examples I have witnessed of taxpayers who have been victimized by bad preparers, both fraudulent and incompetent. In both my private practice and through my affiliation with the Community Tax Law Project, which does pro bono work for low-income taxpayers, I have dealt with many taxpayers who have been victimized by bad return preparers. Because of tax law complexity, taxpayers increasingly must rely on paid preparers to prepare their tax returns and comply with the law. Your support for ensuring appropriate regulation and safeguards for taxpayers is key to maintaining taxpayers' trust in the fairness of the tax system.

Many taxpayers choose a preparer based on the recommendations of their family, friends, and community. Often, they choose a preparer based on the convenience of location or the reputation of the national tax preparer franchise, such as H&R Block, Jackson Hewitt, and Liberty Tax. Most taxpayers, in my experience, believe that because the preparer is in business, he or she is competent. A good tax preparer is an important financial advisor and often does things beyond preparing the tax return, such as preparing student loan applications, Small Business Administration (SBA) loan applications, and providing some business planning advice. A bad preparer, however, can have a devastating effect on a family, and here are some examples that I have encountered in my experience. One was a schoolteacher who used a preparer who, without her knowledge, inflated her itemized deductions on her Schedule A to generate a bigger tax refund. The preparer was discovered by the IRS and prosecuted. As part of the case against the preparer, all of his clients were audited, including the schoolteacher, for 3 years. She was then assessed additional tax, interest, and a negligence penalty equal to 20 percent of the tax. She appealed the negligence penalty to the Appeals Division of the IRS. The IRS Ap-



peals Officer refused to remove the penalty because he said she had a college degree. She should have known better. She then offered to have the Appeals Officer, who likewise had a college degree, to come teach her high school Spanish class, since if having a college degree prepares you for all these things, she thought the same should apply to him. Still, the penalty was not removed, and she further pointed out that if she had known how to prepare her tax return, she would have done it herself rather than having to pay someone to do it. It took several years for this woman to repay the IRS the taxes that she owed, and her faith in the tax system has been badly shaken as a result of her experience.

Another taxpayer we recently encountered at the tax clinic, responded to a newspaper ad that suggested prior years' returns could be reviewed for mistakes and amended returns could be filed. She then contacted the preparer. He reviewed and amended her returns. He showed her wages on the returns, but then on Schedule A backed off the wage amounts, bringing the taxable income to zero under a claim of right doctrine. She didn't understand any of this and now has a large balance with the IRS and no real recourse against this preparer, who is out of State. The preparer, in addition to advertising in the newspaper, operates a website. Our staff attorney at the clinic contacted the IRS Office of Professional Responsibility and was told because the preparer is not a Circular 230 preparer, that that office had no jurisdiction. She then asked where she could refer this preparer for some appropriate action to be taken, and there was some discussion about what Criminal Investigation office might have jurisdiction, since the preparer was in one State but the taxpayer was in a different State. Basically, it ended up in a runaround situation.

Furthermore, we had a group of Sudanese immigrants who were victimized by a woman who advised them to file tax returns claiming dependency exemptions for people whose identities had been stolen. She then got them to a return preparer who prepared returns and got refund anticipation loans for the taxpayers. They then split these loans with this woman conducting the fraudulent scheme. The woman told them that this was a mechanism for reimbursing the people whose dependency exemptions were being used and that this was perfectly legal in the United States. Of course, this group had no familiarity with the U.S. tax system. We also had a Hispanic couple who went to the tax preparer together and explained that they are a married couple. However, the preparer advised the wife to file Head of Household and claim grandchildren who did not live in the household, but whom they occasionally babysat. This was done for the purpose of obtaining a larger EIC. I see that my time is up, Mr. Chairman. I thank you for the opportunity to share some of these examples.

[The prepared statement of Ms. Atkinson follows:]

**Statement of Elizabeth Atkinson, President, Board of Trustees, Community Tax Law Project, Richmond, Virginia**

Dear Chairman Ramstad and members of the Subcommittee. My name is Elizabeth Atkinson and I am a tax attorney practicing in Norfolk, Virginia. I am also the President of The Community Tax Law Project (CTLP), a low-income taxpayer clinic that represents low-income taxpayers in tax disputes. It is through my affiliation with CTLP that I present to you examples of the impact of incompetent and

unscrupulous tax preparers on the lives of trusting taxpayers. Because of tax law complexity, taxpayers increasingly must rely on paid preparers to prepare their tax returns. Your support for ensuring appropriate regulation and safeguards for taxpayers who must pay professional preparers to do their tax returns is key to maintaining taxpayers' trust in the fairness of the tax system.

There are many types of tax preparers, ranging from the housewife who earns a bit of income preparing tax returns for friends and neighbors, to CPAs and tax attorneys at firms large and small. The knowledge, competence and experience of these preparers vary widely. One set of tax preparers is highly regulated, the so-called Circular 230 preparers. This group consists of attorneys, CPAs, and Enrolled Agents who must meet certain educational standards, often hold a state license, and are subject to extensive state regulation and continuing education requirements. Members of this group face severe consequences for improper tax return preparation, including fines and possibly loss of a license and ineligibility to practice before the IRS.

Non-Circular 230 preparers have almost no regulation. Only two states, Oregon and California, regulate them. However, most taxpayers have never heard of Circular 230 and don't realize that the return preparer they have just paid is not accountable for his work under the law.

#### CHOOSING A PREPARER:

Many taxpayers choose a preparer based upon the recommendations of family, friends, colleagues and neighbors. Others choose a preparer based upon convenience of location or the reputation of one of the national tax return preparation franchises, such as H&R Block, Jackson-Hewitt and Liberty tax. Most taxpayers, in my experience, believe that because the preparer is in business, he or she is competent.

A good tax preparer is an important financial advisor. He or she may make suggestions on investments, such as recommending saving for retirement via an IRA, give business planning advice, make the taxpayer aware of various tax incentives such as the education credits or the Earned Income Tax Credit, and otherwise assist the taxpayer in achieving financial health. Tax returns are also used for making mortgage lending decisions, student loan applications and often other loans such as SBA loans. Often the tax preparer may assist with the preparation of these documents as well as the tax return itself.

A bad tax preparer, on the other hand, may have a devastating effect on a family. Witness the following examples experienced in private practice and the tax clinic.

A schoolteacher used a preparer who, without her knowledge, inflated the itemized deductions on Schedule A to produce a bigger tax refund. The preparer was discovered by the IRS and prosecuted. As part of the case against the preparer, the IRS audited all of the preparer's clients, including the schoolteacher's returns for three years, assessed additional tax and a negligence penalty. The schoolteacher appealed the negligence penalty. The IRS appeals officer refused to remove the penalty because he said that, since she had a college degree, she should have known better. She then offered to have him teach her high school Spanish class, on the reasoning that, he too had a college degree. She further pointed out that if she knew how to prepare tax returns, she would have done it herself rather than paying a preparer. It took several years for this woman to repay the IRS the taxes assessed against her and her faith in the tax system remains shaken.

Another taxpayer responded to a newspaper ad that suggested prior years' tax returns could be reviewed for mistakes and amended returns could be filed in order to get a refund. The taxpayer contacted the preparer who then reviewed and amended her returns to deduct all of her wage income on Schedule A under a claim of right doctrine. The taxpayer thought the preparer was a professional and trusted his expertise. She was later audited, now owes a large balance and has no real recourse against the preparer who lives in another state. This preparer operates a website as well as conducting newspaper advertising. When the staff attorney at the tax clinic contacted IRS Office of Professional Responsibility (OPR) about the preparer, she was told that OPR could not deal with an unenrolled preparer. She could not get specific information from OPR on where to refer the preparer so that it could get handled. One issue was the question of what office of IRS Criminal Investigation would have jurisdiction.

A group of Sudanese immigrants were victimized by a woman who advised them to file tax returns claiming dependency exemptions and the earned income tax credit for people unrelated to them (whose identities had been stolen). The woman assured the immigrants that this was legal and the way it was done in the United States. She then sent them to a preparer to get refund anticipation loans. She split the refund loans with the immigrants, claiming that she needed to compensate the people whose names and numbers were used.

A Hispanic couple went to a tax preparer together and told the preparer that they are married. The preparer advised the wife to file head of household and claim the grandchildren whom they occasionally babysit but who do not live in the household. This meant a larger refund, including EITC, to which the taxpayers were not entitled (over \$5000 more than they were due). The preparer encouraged the taxpayers to get a refund anticipation loan. This is a very common scheme that we see. The preparer is motivated to inflate the refund to sell a refund anticipation loan so that he receives a bigger commission.

An 18-year-old man went with his girlfriend to a nationally franchised tax return preparation chain. The preparer filed the return as married filing jointly, even though the couple was not married, and the tax return claimed children for whom he could not be the biological father as the children were teenagers. The preparer listed the birthdates on the tax return but did not question the taxpayer to determine whether the eligibility requirements for the dependency exemption, or earned income credit were met. Through the preparer, the "couple" obtained a Refund Anticipation Loan of \$4700. The IRS disallowed the refund when the return was filed. Now the taxpayers owe the bank \$5220 on the loan.

#### IDENTIFYING UNSCRUPULOUS PREPARERS

There are several ways to detect an unscrupulous preparer. Since the bad preparer generally uses a predictable pattern of creating larger tax refunds, such as the schemes described above, often IRS computer algorithms can detect the patterns and flag the returns. The IRS then will open a preparer project and select all the returns prepared by a certain preparer.

Also, experienced IRS field personnel often are aware of the bad preparers in the community. Unfortunately, as the IRS decreases its field presence, moving to centralized workgroups, these "eyes and ears" are not as prevalent. Also, many of the field personnel are discouraged when they make referrals that receive no follow-up. When I worked for the IRS from 1982 through 1997, it was widely known that referrals to the Director of Practice (predecessor to the Office of Professional Responsibility) went nowhere.

Last tax season, the IRS proposed using "undercover shoppers" at the VITA sites, where preparers are unpaid volunteers. Instead of focusing its limited resources on volunteers, the IRS should send "undercover shoppers" to follow-up on preparers who advertise their ability to get big refunds in the newspapers and on the internet.

Often state and local tax officials and community advocates are aware of bad preparers. The IRS should do more to partner with these groups to identify and stop bad return preparers.

#### RECOMMENDATIONS

I believe the IRS should strategically focus its limited resources with respect to this issue. One bad preparer can prepare in excess of 100 returns per year. Stopping one bad preparer can prevent 100 cases wasting audit resources and potentially also wasting collection resources downstream.

The first focus of the IRS should be educating taxpayers on selecting a return preparer, common "schemes" employed by unscrupulous preparers and the devastating consequences for the taxpayer of selecting a bad preparer. The IRS could partner with tax professional groups to conduct a media campaign and to reach high school students and immigrants who are filing returns for the first time. The IRS Website contains good information on these issues, but often lower to middle income taxpayers lack internet access, especially the elderly, those in rural areas, and those who speak English as a second language.

The IRS should establish a hotline number for reporting bad preparers. The IRS should also partner with state and local tax officials and community advocates to identify and take appropriate action against bad preparers.

The IRS should treat the victims of bad preparers as victims rather than co-conspirators. When working on preparer projects, the focus should be on assisting the taxpayer in understanding what is wrong with the tax return, taking corrective action, educating the taxpayer on selecting a good preparer and finding the least intrusive way of resolving tax deficiencies that exist due to the bad preparer.

The IRS should work pro-actively with the Low-Income Taxpayer Clinics to enable the clinics to provide pro bono representation to those victims who qualify for tax clinic assistance. The IRS should also work proactively with the Taxpayer Advocate Service to ensure that taxpayers understand the availability of TAS assistance in such cases. This would enable the IRS to work a preparer issue more efficiently and would lessen the taxpayer's hostility toward the IRS. My experience in these cases is that the victim of a bad preparer feels tremendous hostility toward the IRS because of the perception that the IRS could have prevented the situation through

proper oversight. The taxpayer also feels that the IRS treats him as a co-conspirator when in fact the taxpayer did not understand that the tax return was incorrect or fraudulent. Correcting these misperceptions will strengthen the relationship between the IRS and the taxpayer and encourage the taxpayer to stay in the system. Thank you.

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Chairman RAMSTAD. The Chair thanks all three of you expert witnesses for your testimony here today and shedding light on this problem and proposed reform. Before yielding to the distinguished Ranking Member, I have a question for each of our witnesses. First, for Ms. Jardini, obviously, not every case investigated by Criminal Investigation in IRS results in prosecution. I think we all recognize that some cases are best handled administratively. Would you compare the administrative sanctions available to the IRS with respect to practitioners regulated under Circular 230 with those not so regulated?

Ms. JARDINI. First, let me explain that those regulated under Circular 230 are not necessarily return preparers. What the Service seeks to do under Circular 230 is represent those professionals—attorneys, Enrolled Agents (EA), Certified Public Accountants (CPA), appraisers, and so forth—who wish to represent clients before the IRS. We have an interest, of course, a strong interest in ensuring that that professional community who is representing clients before the IRS adheres to a certain standard of professionalism. Tax return preparers are not deemed as individuals who represent individuals before the IRS, so there is a slightly different distinction there. Nonetheless, the Office of Professional Responsibility has the authority to impose sanctions of all sorts, including disbarring or essentially disallowing professionals under their jurisdiction from practicing before the IRS. That does not prevent those individuals from filing returns. At the same time, overall, the IRS in general, not just the Office of Professional Responsibility, but the civil exam functions, have the ability to impose a panoply of penalties against all preparers, Circular 230 or not, if they engage in fraudulent, unprofessional, or unethical conduct. So, we do have authority as it relates to a variety of individuals.

Chairman RAMSTAD. I thank the witness. Thank you, Ms. Jardini, for that response. The next question I would like to ask you, Ms. Olson. Some observers, practitioners, so-called experts in the field believe that registration of tax return preparers will do little or nothing to stop corrupt preparers from engaging in criminal activity. We have heard that argument with respect to other criminal activity as well, and that might be right, but can you discuss how licensing of preparers would benefit taxpayers looking for assistance?

Ms. OLSON. Licensing enables the taxpayer to seek help from someone that they know is minimally—has met some minimal competency standards. It gives a bright line between going to someone who you are not sure about but your neighbor has referred you to, to someone that the IRS has said—at least this person has passed a test, has taken continuing education, and more importantly, that this person has gone through the steps and is holding themselves out to be a true preparer. I think that it is important to note, as

Nancy Jardini said, for example—the Circular 230 preparers, in the regime that we have—you can be barred from practicing before the IRS, representing a taxpayer before the IRS, but then turn around and hang out a shingle the next day—after you have already been determined to have done some misconduct that brings around that sanction—and prepare returns. We are exposing our taxpayers, the vast majority of our taxpayers, to that kind of preparation without any real viable means for sanctions.

Chairman RAMSTAD. Thank you, Ms. Olson, for that response. Finally, Ms. Atkinson, you alluded in your testimony to fraudulent preparers failing to adhere to the EIC due diligence requirements. Have you seen many examples at the Community Tax Law Project, over which you preside, of this failure to adhere to the EIC's due diligence requirement?

Ms. ATKINSON. Yes, Mr. Chairman. We have seen very frequent examples of that, frequently in concert with refund anticipation loans. Most often, that is the context in which those occur. Frequently, the IRS will flag those returns and not issue the refund, but then the taxpayer is still saddled with this refund anticipation loan and must pay that back with really very little legal recourse in most cases.

Chairman RAMSTAD. So, in your experience, given the examples you have encountered, is it fair to say that it is infrequent that the IRS assesses penalties for failing to adhere?

Ms. ATKINSON. It is infrequent, and in my experience, while I believe the Criminal Investigation Division has done a good job with prosecuting some bad preparers, the civil regime is totally lacking with respect to even when penalties are imposed. Those do not seem to be operating as a deterrent, or at least a sufficient deterrent, obviously.

Chairman RAMSTAD. That seemed to be the modus operandi. Fraud of that nature seemed to be the modus operandi of the "Tax Deals 4 Wheels" schemes that are quite widespread, as I have been told. Do you have any comments, either of you, on that question, Ms. Jardini or Ms. Olson?

Ms. OLSON. One of the consequences of the automobile loans, which I saw when I was at the Community Tax Law Project and have certainly seen cases coming across my desk as National Taxpayer Advocate, is that the refund anticipation loan is used as a downpayment toward the vehicle. The taxpayer, because the loan is a means to buy a more expensive vehicle than the taxpayer could actually afford, can't afford the monthly payments on the financing that they have put forward with that large downpayment from the Refund Anticipation Loan (RAL). So, they end up repossessing the vehicle. So, the taxpayer ends up without the refund, with a refund anticipation loan debt, and then when the taxpayer can't pay it, they get cancellation of indebtedness income from the repossession of the vehicle and they end up with a tax liability for the following year. Because of that pyramiding complication for the taxpayer, the IRS is tarred with those kinds of transactions because it all happens through the tax system.

Ms. JARDINI. I would agree, Mr. Chairman, that these types of transactions we are talking about are appalling and that they take advantage of innocent taxpayers. The unfortunate fact is that some

of the registration and education requirements that we are talking about here today aren't going to solve that problem because all those car dealers or furniture dealers or whomever else is out there promoting those deals could equally get licensed and then they will have a license to say that the Federal government says that what they are doing is okay, because there is nothing inherently illegal about what they are doing. So, that is a concern that we have about that.

Separately, with respect to one of Ms. Atkinson's comments, we agree within the IRS that the enforcement structure has suffered to some degree in vigorousness, particularly between 1998 and 2002. I know this Subcommittee has heard the Commissioner speak about that, and you have seen the charts that show the dramatic decreases in enforcement revenue and audit coverage and criminal investigations, and that is all now starting to come back. It is important that we remember that we are on a track here to aggressively pursue this. It is a strategic initiative and we need an opportunity within the IRS to get on our feet with this and really be able to establish programs and vigorous penalties in the programs we have, before we talk about instituting additional administrative burdens.

Chairman RAMSTAD. The Chair would thank all three of you for being here today and for very clearly framing the issue. I think we have done that, in terms of possible reforms. I think nobody disputes the nature, the scope of the problem, and now the question is what do we do about it. At this time, the Chair would yield to the distinguished Ranking Member, the gentleman from Georgia, Mr. Lewis.

Mr. LEWIS. Thank you very much, Mr. Chairman. Let me join you in thanking Members of the panel for being here and for your wonderful testimony. Ms. Jardini, Commissioner Everson, told the Committee during a briefing that he opposed the addition of Federal regulation of paid tax return preparers. He said that the IRS should beef up its current program rather than have the Congress impose new responsibilities on the IRS. Your written testimony does not address this issue. Do you agree with the Commissioner? Would you please explain your position?

Ms. JARDINI. Mr. Lewis, I always agree with the Commissioner in his vast wisdom.

Mr. LEWIS. Oh, I didn't know that.

[Laughter.]

Ms. JARDINI. Let me say that it goes to the answer that I had just started to give, and that is to say to you that we are in the beginning of the first year of a 5-year strategic plan for the overall effectiveness of the service. For every issue in enforcement that we could address within the Service, we identified four important enforcement initiatives that we intend to pursue vigorously over the period of 2005 to 2009. One of those initiatives is fraud and professionalism in the preparer community, and we agree that we need to more adequately assess and deploy the tools we currently have available to us before we start talking about adding additional tools and additional burdens on. So, I would fully agree with that statement, sir.

Mr. LEWIS. Let me continue. For each criminal case discussed at the end of your statement, what was the original source of your fraud investigation? Do you have tips or undercover operations? The IRS computer system? The whole fraud program, how do you get to the bottom of this?

Ms. JARDINI. There are a number of ways that we do. Our partnership with the practitioner community is extremely important in this arena because we get very, very valuable tips and information from the practitioner community. On the ground where these 123 million returns came in between January 1 and April 15 of this year, our Fraud Detection Centers in the IRS campuses are applying our Electronic Fraud Detection System data mining tool as well as the Return Preparer Analysis tool to identify those schemes that are identified to be related with one particular preparer that have similar characteristics and that involve a dramatic number of returns. Obviously, we are looking for the most egregious conduct.

The less egregious ones are sent out for civil examination. The more egregious ones are sent out to our field offices for what we call undercover shopping. What that means is, we have identified a return preparer through our systems that is likely engaging in fraudulent activity. We send an undercover agent in to determine whether he or she can discover what exactly that practitioner is touting, and from there, we develop a criminal investigation on that particular preparer. Our undercover shopping program has been very, very successful and highlights the success of these programs. In the last 4 years, over 70 percent of the undercover investigations in the shopping expeditions we have done have resulted in the development of an active criminal prosecution.

Mr. LEWIS. In some neighborhoods, especially in the inner cities, during tax filing season, you see these what I call "fly by night" operations that put up the big signs or the billboards. Come in, bring your W-2 form or whatever.

Ms. JARDINI. Sure.

Mr. LEWIS. Some of them are in a storefront, some rundown building, maybe just with a computer, maybe a desk, maybe a telephone. It is almost like a fast food mentality.

Ms. JARDINI. Exactly.

Mr. LEWIS. Rush in and get your work done and file it. How do you track people like that? They are here today and they are gone tomorrow. Do any of you want to respond to that type of operation?

Ms. OLSON. The IRS doesn't track those people. The point of my proposal, sir, is to not put those people out of business, because, in fact, they are in the community that needs that preparation done, but to raise the level of competency for those folks. So, if you have a car dealer or a check cashing place, they have to, in order to hang out their shingle and receive a fee for tax preparation, they have to have learned the rules of tax preparation. If, to go to Nancy's concerns, they don't follow those rules and they continue to do inflated loans and they take inflated deductions and they take inflated EICs, then their license is revoked, and we have a public database that people can search to know whether or not their preparer is licensed by the IRS or has been revoked, and more importantly, we have a public information campaign that makes the taxpayer an educated consumer.

To go to the concerns about cost, the IRS doesn't need a lot of resources to implement this program because you use the taxpayer him or herself to find the right preparer. We give them the tools to select the right preparer. California today uses an outside contractor to administer their entire program at no cost to their government. The IRS can do that. I find it really interesting that the IRS has a schizophrenic approach to tax preparer oversight. They are interested in the professionals who promote tax shelters; they are interested in criminal preparers, who are very few compared to the 200,000 to 300,000 to 600,000 preparers; they are interested in regulating volunteer preparers; yet for the preparers for the vast majority of taxpayers, there is no oversight whatsoever.

Mr. LEWIS. Ms. Atkinson?

Ms. ATKINSON. I would like to say that the taxpayers cannot wait 5 years. For every tax preparer that is out there, generally speaking, you have got at least 100 bad returns that then get into the system. The taxpayer gets audited, and the IRS is spending a lot of resources on auditing, collection—on things that would not happen if you stopped the problem at the beginning. I know what you are saying. I have seen the same thing you have, and I think that regulation—the beauty or barber shop can function, why can't a tax system function with licensing? I don't understand why not.

Ms. JARDINI. If I might, Mr. Lewis, the example you are talking about, the fly-by-night, trunk-of-the-car, storefront tax preparer; they are not engaging in fraudulent conduct because they don't know better and education isn't going to help them. These are stone-cold criminals who are engaging in fraudulent conduct and are doing so in a fashion to evade the law. It is absolutely untrue that the IRS doesn't track those people. In Criminal Investigation, we can tell you, in our experience, they shut down somewhere this week and they pop up somewhere else next week. Generally speaking, we are able to track them. What we are hoping to avoid is to drive those individuals further underground.

Mr. LEWIS. Thank you very much. Thank you, Mr. Chairman.

Chairman RAMSTAD. Thank you. At this point, the Chair would recognize Mr. Beauprez.

Mr. BEAUPREZ. I thank the Chairman. Let us stay on that point for a minute, Ms. Jardini. Which is the bigger problem? If 60 percent of these 123 million tax returns are professionally prepared, is the bigger problem the faulty ones that, they just don't know any better, they are basically incompetent—lack some degree of competency—or is it that they are really gaming the system; they set out to be less than honest?

Ms. JARDINI. The people we are talking about today, the people Criminal Investigation is interested in, the examples set forth by Ms. Atkinson are people that are engaged in knowing and intentional fraudulent conduct. Those individuals represent less than one-half of 1 percent of all professionally-prepared returns in this country. So, while it is an important problem, and it is an important problem for taxpayers, and why we care deeply about it, and it is one of our strategic initiatives, we need to keep that particular point, and the scope of it, in mind.

Separately, these individuals are not going to be cured and the problems Ms. Atkinson referenced are not going to be solved by



education. These people are, in fact, overly educated in the tax system. I reference Prisoner John Doe. He is a return preparer, which is defined as an individual who is preparing returns for others for money, for compensation. It is not because he doesn't know any better.

Mr. BEAUPREZ. No, he obviously knew the Tax Code about as well as most anybody I have come across. He knew exactly how to use it to his end. Ms. Olson, you have talked, all of you have talked, and I know that our second panel is going to address the issue, as well, about certification, some kind of national certification. Maybe use California as the reference. What does this cost? What are we looking at?

Ms. OLSON. I don't have the estimates before me. They are in my written testimony. I will be glad to get you them. There is actually a proposal that a consortium of outside companies have presented and formulated for the IRS that shows that it will be self-funding, that it is self-funding.

Mr. BEAUPREZ. I accept that—

Ms. OLSON. I can get you the additional information.

[The information follows:]

A consortium of administrators recently approached the IRS to administer a program similar to that proposed in the Taxpayer Protection and Assistance Act of 2005 (S. 832). Under this proposal, there would be no initial cost to the IRS, and the proposed program is expected to be fully funded by preparer registration fees of approximately \$35, imposed every 3 years. This proposal is in sharp contrast to the \$25 million initial cost estimated by the Congressional Budget Office for the program included in S. 882, the Tax Administration Good government Act of 2004. See Congressional Budget Office Cost Estimate, S. 882; Tax Administration Good government Act of 2004 (May 24, 2004).

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Mr. BEAUPREZ. To be devil's advocate for just a little bit, there could be an outrageous cost and the program would still be self-funding.

Ms. OLSON. No, I think that the proposal was a \$35 fee for preparers.

Mr. BEAUPREZ. Annually?

Ms. OLSON. Yes.

Mr. BEAUPREZ. That would be the other question I would have, and maybe back to you, Ms. Jardini, again. The Tax Code, in spite of all of our talk about simplification, it seems to be growing in both size and complexity. I am assuming you are not talking—or when you talk about certification, you are talking about annually or at least fairly periodic, not some sort of lifetime certification, are we?

Ms. JARDINI. Well, I am not actually talking about certification, but let me say that there are certification programs out there, as Ms. Olson referenced, in California and in Oregon, but the fact of the matter is that we don't have any empirical data from those yet. There is one study out of Oregon which tells us that, in that structure, the returns prepared by professional certified preparers are more accurate than self-prepared returns. We don't have a datapoint or baseline on that to know what it was like before, what it is like nationally. Other than that, there is just no data, and

there is no real ability for us to point to those yet because they are so new, to take what is good from those programs and apply those nationally to the Federal government. So, I would suggest that we need more information.

Mr. BEAUPREZ. Yes. I would worry, as well, that we may push the problem underground. Let me give you a different reference point, one that I expect that the Chairman and the Members of the Committee are familiar with, as well. Before I came to Congress, I was a community banker. You can imagine that when you are making loans, you are relying on the accuracy of the analysis you do for any credit application, and principal in that analysis is the tax returns. The old garbage in, garbage out scenario happens way too frequently. Sometimes, I am convinced it is not accidental. Sometimes, it may “favor,” if I can put that in quotes, the credit applicant. It may also work to their disadvantage when all their income is not accurately stated. So, it is very much a large problem out there and one that I hope we can find a way to get our arms around, and maybe this hearing today, especially from all of our panelists, both panels included, we can come up with some legitimate, sound ideas that might push our work here in Congress forward. I thank the panelists and I thank the Chairman.

Chairman RAMSTAD. The Chair now recognizes the gentleman from North Dakota, Mr. Pomeroy.

Mr. POMEROY. I thank the Chair and enjoy once again seeing this panel. They do a tremendous job, I think, in their respective areas and it is good to see you again. Ms. Jardini, do some of the differences expressed between you and Ms. Olson basically come down to the distinction between overt fraud and sheer incompetence?

Ms. JARDINI. I think that is right. This is not the first time, nor will it be the last time, that Ms. Olson and I have had this conversation and the vigorous dialog about criminal—

Mr. POMEROY. We have even had some disagreements across the dais once in a while.

Ms. JARDINI. My point is that criminals—first of all, the victims are not always the victims. The victims in some of these instances are actually knowing co-conspirators in the fraud—

Mr. POMEROY. Sure.

Ms. JARDINI. When you talk about regulating individuals and you are walking down the street in a regulated world and you have the fly-by-night tax preparer that Mr. Lewis discussed with a sign in front that says, “Come to me; I will get you your largest refund,” and the guy next door who has his certifications framed in the window and a sign that says, “Honest tax preparation,” I would be afraid to see how many citizens walked into the one that said “Largest return” and ignored any certification whatsoever. So, the question here really is how much are people willing to—in some instances, how much are they willing to listen to and what can we do to educate them about the pitfalls of certified or uncertified.

Mr. POMEROY. Your part of the business is fraud—

Ms. JARDINI. Yes, it is.

Mr. POMEROY. Not competency?

Ms. JARDINI. No.

Mr. POMEROY. You don't have information coming across your desk regarding preparer errors.

Ms. JARDINI. Well, within my ambit are the Fraud Detection Centers in the campuses that look at all of these schemes that we develop and determine what the level of willfulness is here.

Mr. POMEROY. For example, just to illustrate the point, the EIC; for many years we heard about rampant fraud. Some say, well, it is just darn confusing and people are making mistakes. It seems like the initial government Accountability Office (GAO) research would tend to confirm that it is actually preparer error, not fraud. Have you reached a conclusion on that?

Ms. JARDINI. Well, actually, the Service currently is undergoing a test project on certification related to the EIC and those results should be available to this Subcommittee very soon. It is in the clearance process.

[The information is being retained in the Committee files.]

Mr. POMEROY. Now, last year, I believe, of about 25,000 returns that were examined, they found 67 involving fraud.

Ms. JARDINI. That is still ongoing. That pilot project—

Mr. POMEROY. That 67 may go higher?

Ms. JARDINI. I can't tell you that because that report is not public and I haven't viewed it. What I can tell you that we do know preliminarily from that study, and what you will know in full soon when you have the report, is that the purpose of it was to maximize enrollment, minimize errors, and minimize fraud. What the program found was with specific directive contact with those taxpayers, there was a change in the manner in which they filed their EIC claims. So, there is an impact, but the results of that will be to you shortly.

Mr. POMEROY. I think that shows the interplay between—even though you have differences of opinion on things, you are certainly serving the same ends. Advancing competency reduces fraud in certain direct ways. Ms. Olson, the proposal that you are talking about is a minimum competency. There are States that have done this for preparers?

Ms. OLSON. Yes. Oregon and California have, and they actually have been around for a number of years, and I think if you talk to Oregon or California, they would strenuously disagree with Ms. Jardini about whether they have good data or not. They think that they do. I think another thing to point out is, GAO itself has done several studies that show on the competency side that incompetent preparers harm taxpayers. They don't claim credits and deductions and things that they are entitled to. I think that that is the other side of this equation. We don't think about the things that—because a preparer isn't up on the Code, and hasn't had to take continuing education, so they don't know how the law has changed and what new benefits are there, that taxpayers don't avail themselves of everything that they are entitled to. I think that by the focusing on fraud so much—which I commend Criminal Investigation for all the work they are doing in that area—I don't see this as mutually exclusive. I see this as addressing another aspect of a problem.

Mr. POMEROY. Thank you. I yield back, Mr. Chairman.

Chairman RAMSTAD. The gentleman from Georgia, Mr. Linder.

Mr. LINDER. Thank you, Mr. Chairman. Ms. Olson, you said that there are 200,000 or 300,000 or 600,000 tax preparers in this country. How many are there? That is a pretty big—

Ms. OLSON. Well—

Mr. LINDER. Do you have any idea?

Ms. OLSON. I don't have an idea. We derived our number, from 300,000 to 600,000, from the IRS database of preparers who had signed returns and then we sort of extracted from that, entities that prepare returns how many are attorneys

Mr. LINDER. So, you don't know?

Ms. OLSON. I don't—

Mr. LINDER. I only have 5 minutes. Let me get to it.

Ms. OLSON. Yes. I am sorry.

Mr. LINDER. Can you name any professional or nonprofessional, any organization or group of organizations whose competency is certified at the Federal level?

Ms. OLSON. Securities dealers. We actually modeled our proposal under the securities dealer regulation scheme. I thought that maybe we could contract with some of the professional associations—

Mr. LINDER. Securities dealers? Is that contracted within terms of—

Ms. OLSON. They do contract out, yes.

Mr. LINDER. Okay. Ms. Jardini, tax preparers tell me that the only category of taxpayers who overstate their income are people seeking EITC refunds. They might get a W-2 for \$1,000 a month in income and then go to a tax preparer and say, "I want to be honest with you; I made another \$12,000 last year and I just want to make sure it is reported." They get themselves up to \$22,000 or \$23,000, and get the highest EITC return. How do you find that?

Ms. JARDINI. How do we find it in the system?

Mr. LINDER. How big is that?

Ms. JARDINI. How big is that problem? Well, I can tell you with respect to return preparers, we see fraudulent—in terms of fraudulent return preparers—

Mr. LINDER. These are honest return preparers who are taking the word of the taxpayer and overstating their income so they get a larger EIC.

Ms. JARDINI. Right. Right.

Mr. LINDER. Do you have a measurement of that?

Ms. JARDINI. I don't have an exact measurement for you, sir, on that, but what I can tell you is because of the regulations of the EIC program and because it is a refundable credit, there is opportunity there for both dishonest people who want to claim income they don't have as well as unscrupulous preparers to take advantage of that, and we do see fraud in that program. I can't give you the specific number right now.

Ms. OLSON. Sir, the IRS just completed its national research program and I think that its study will identify some of that. Its 1999 study, which is the most current one that we have, pending this new one, found some evidence, but said it was minimal. It does happen, but it was minimal dwarfed with the other types of overclaims that we saw.

Mr. LINDER. I happen to disagree with you, but—

Ms. OLSON. Okay.

Mr. LINDER. Ms. Atkinson, you said that the first focus area should be educating taxpayers on selecting a return preparer. We have 10,000 school districts in this country who can't educate people who their Senator is. How are we going to set them aside and teach them how to select a tax preparer?

Ms. ATKINSON. Well, school would be a good place to start. I just think that there are some things that the IRS could do, could partner with some of the professional organizations, because the professional organizations have—the ABA, for instance, I believe about a year ago, did do a media campaign on selecting a preparer and things like that which I think was a good model of the kind of thing that can be done.

Mr. LINDER. Do you agree with the idea of certification?

Ms. ATKINSON. I do.

Mr. LINDER. You say that a good preparer is an important financial advisor. He or she may make suggestions on investments, suggest recommended savings for retirement. Would that tax preparer also have a financial certification?

Ms. ATKINSON. Well, I think in some cases, that is the case. I know that—

Mr. LINDER. In general, a tax preparer who is certified is not going to be certified to make these kind of recommendations.

Ms. ATKINSON. No, that is correct, but I believe that the certified financial planners' professional organization increasingly is trying to build a base of getting people certified in financial planning because it is—

Mr. LINDER. That is not what you said. You said a good tax preparer is an important financial advisor.

Ms. ATKINSON. Well, a tax preparer ends up being a financial advisor indirectly when they prepare other sorts of documents for financial things, such as loan applications, and they don't recommend specific investments, but they say things like, if you were to put money in an IRA, it would be deductible to this extent in your income bracket. So, perhaps I crafted that inartfully, but certainly, tax preparers, part of their duty—and I think part of the problem is that they don't necessarily advise, if they are uneducated, on credits the taxpayer could take, or savings vehicles which would reduce the tax, but certainly not recommending a specific investment.

Mr. LINDER. Thank you, Mr. Chairman.

Chairman RAMSTAD. The Chair recognizes the distinguished Chairman of the Subcommittee on Trade, Mr. Shaw.

Mr. SHAW. Thank you, Mr. Chairman. I want to pursue a line of questioning that Mr. Linder started, because I think this is something that we should be taking a look at, and that is the question of how do we track reported income that was not income. If somebody puts down that they have received additional income and received it by cash, you would, first of all, think that was an honest person that was stepping up to the plate and doing it. Then when you look behind it and say, well, Social Security wasn't paid on that, but we are paying out the EIC based upon the information that we get, it would seem to me, Ms. Jardini, that this is something that would be almost impossible to be able to track down and

be able to pinpoint. I agree with John Linder and disagree with Ms. Olson; I think this is widespread. I used to Chair the Subcommittee on Human Resources when we set all this stuff up, and I have tracked it and know that it is a problem. How big a problem do you see it as, and what we should do to close that gap? It is an ever-growing problem and we have seen it a lot in south Florida.

Ms. JARDINI. Right, and this is also relevant to the prisoner problem we just discussed a few weeks ago here in this Subcommittee, and is also an important problem all across Florida. This is the problem of income verification and how we do that most effectively within the Service. I agree with both of you that it is a substantial problem and we do see significant fraud in this area. In our Fraud Detection Centers in the campuses, once these—every single refund return runs through the Electronic Fraud Detection System and we are looking for specific characteristics; cash income being one of them. For example, Schedule C or 1099 income that would be hard to verify is one of the characteristics we look to, as well as identifying the Head of Household filing status in some instances. These are characteristics that might, when taken together, indicate that this is a return that we would pull out of sequence and attempt to verify.

We have 600 analysts nationwide who attempt to verify those returns, literally hundreds of thousands of returns, 3-and-a-half month period that represents the filing season. In some instances, what those analysts are doing is literally picking up the phone and attempting to verify income through employers or employment listed, which frankly is not the most efficient way to go about it. In 2006, we hope to be funded to deploy the National New Hire Database from the Department of Health and Human Services, together with our Electronic Fraud Detection System, which will be an enormously valuable tool for us in verifying W-2 wage income. We would then—because they keep very, very good up-to-date statistics in that system, be able to turn more of our attention toward Schedule C and 1099 and other types of income that is more difficult to verify.

Mr. SHAW. Does the IRS in turn, then, try to collect the money that would be due to the Social Security Trust Fund out of those particular wages?

Ms. JARDINI. I don't know what the referral process would be to—what the civil examination process—

Mr. SHAW. My guess is that IRS is not talking to Social Security. That is my guess, but—

Ms. JARDINI. We do talk to them with frequency in relating to verifying income data, because they do have verification of Social Security numbers and other issues that we are trying to work together with them to try to make some progress. I am not aware of—

Mr. SHAW. I think it would be quite helpful if maybe you were to take a look at the Code and see exactly how we define income subject to the EITC and make it subject to only Federal Insurance Contributions Act (FICA) wages and that Social Security has been paid. That would cut down a lot of it, and it would almost take a conspiracy with the employer in order to play the system there,

which I think would cut down on quite a bit of it. In another area, and this is something I am not sure any of you are equipped to answer, but would the State—and I think I know the answer to this—I don't think the State can regulate who can file income tax returns. Is that a correct assumption?

Ms. OLSON. That the State cannot?

Mr. SHAW. Yes, the State. Now, the State can certify—I know they have who the CPAs are and how you set those things up, and those are State regulated even though it is subject to nationwide qualifications as to education, and the test is similar all over the country. I question whether the States—maybe I should say, do any of the States attempt to regulate who can file income tax returns?

Ms. JARDINI. Well, as was previously mentioned, California and Oregon both do, and as Ms. Olson pointed out, while they would tout successes potentially from that, there is no empirical data to establish that the educational and certification requirements that they have imposed result in a higher-quality return. What their success is, they would tout would be additional registration, which is not necessarily an outcome measure.

Mr. SHAW. I wonder if anybody has challenged that, as to whether a State can require qualifications as to who can and who cannot file a Federal return. It is an interesting question, but anyway, God bless them if they are trying to do it. I hope they would. Just maybe one further question very quickly, Mr. Chairman, and that is, are there certain preparers whose name appears as a preparer on the bottom of the return and it sends up a red flag that almost automatically calls for an audit? Or to state it another way, does the reputation of the preparer have anything—make it more or less likely that the individual will be audited?

Ms. JARDINI. Well, as I pointed out previously, our Fraud Detection System as well as our Return Preparer Analysis Tool look at a whole bunch of characteristics of returns. If we had evidence that a specific identified tax return preparer had, in the past, prepared fraudulent returns, that would be a characteristic that would flag it and cause us to look at all of the returns associated with that particular preparer.

Mr. SHAW. Thank you. Thank you, Mr. Chairman.

Chairman RAMSTAD. Thank you, Mr. Shaw. I want to thank again the three witnesses here today, truly expert witnesses. Thank you for your testimony and I look forward to working with you on this matter.

Chairman RAMSTAD. We have a series of votes, six, to be exact, starting about 4:45, so we have enough time for our second panel, if we could quickly make the transition. If the five distinguished witnesses would take their respective places, we would begin. We have just enough time for the testimony—the 5-minute rule applies, of course—of each witness, and then it should give us about 10 minutes for questions, so we will be able to get the second panel. Thank you, gentlemen, for your patience and thank you for coming here today to enlighten the Subcommittee on the problem that has been outlined and the possible reforms.

The second panel comprises Kenneth W. Gideon, Chair of the Section of Taxation of the American Bar Association; Francis X.

Degen, President of the National Association of Enrolled Agents (NAEA); Robert L. Cross, Chairman of the Right to Practice Committee of the National Society of Accountants; Tom Purcell, Chair of the Tax Executive Committee, American Institute of Certified Public Accountants(AICPA); and Larry Gray, government Liaison, National Association of Tax Professionals. Gentlemen, again, thank you all for being here today, for your patience and indulgence. Your testimony, please, Mr. Gideon.

**STATEMENT OF KENNETH W. GIDEON, CHAIR, SECTION OF  
TAXATION, AMERICAN BAR ASSOCIATION**

Mr. GIDEON. Thank you, Mr. Chairman and Members of the Committee. The section of Taxation appreciates the opportunity to appear today and discuss proposals for ensuring that tax return preparers are both ethical and competent. Because return preparers play an important role in the efficient and effective administration of the tax laws, these proposals complement efforts of the IRS to regulate tax professionals and to increase the level of taxpayer compliance. Today, more taxpayers than ever pay third-party preparers to prepare their individual returns, but most of these preparers, as you have heard today, are subject to no regulation by anyone or any registration or competence requirement of any kind. This is in contrast to the groups whose representatives are testifying on this panel, who are subject to regulation under Circular 230 as well as State certification programs and examinations with respect to their competence. Improving the quality of income tax return preparation, we think, will benefit all taxpayers. First, individuals who use paid preparers will be less likely to file erroneous returns.

Second, and perhaps equally important, taxpayers who are least able to understand complicated tax rules. Taxpayers with little education, taxpayers who speak English as their second language, should be able to consult a preparer who is competent. There are bills that have been introduced both in this body and in the Senate to address this. The National Taxpayer Advocate has proposed a registration system. The section of Taxation today supports a registration program for tax return preparers who are not already regulated professionals. To be effective, we think this program should have six components: Registration, examination, continuing education, public awareness, adequate administration, and funding.

We would limit registration to a preparer who prepares at least five returns a year and receives at least \$5,000 in fees for that preparation. This would target the program where it is most needed, on commercial preparers. It is also important that the program not interfere with volunteer tax assistance programs, such as VITA, or other non-commercial tax return preparation for low-income taxpayers, relatives, civic groups, and the like. Therefore, the scope of the registration requirement should be flexible enough to permit volunteer preparer expense reimbursement without triggering registration. In addition, we don't believe that there is any need to include professionals that are already subject to regulation under the other programs, such as Circular 230, in such a registration program. We think an examination is a very good idea for testing competence, but there may be other ways, particularly as a



transitional matter, for people who have demonstrated that they can competently prepare returns by partially preparing returns for years without having penalty problems. So, there may be some role for grandfathering.

Second, we think that another consideration that the Committee should keep in mind is that you do not want to inhibit the entry of new return preparers into the program. You may want to provide for their supervision on an interim basis by people who are already in the return preparation business. We support mandatory continuing education for preparers. We think this is likely to be both more cost effective and a better way to go than annual reexamination or something of that sort. We think that this program will only be successful if it is adequately and properly administered. We note that there is a concern about burdening the Service with this regard. We think that a good deal of this proposed program, particularly the largely clerical tasks of the mechanics of registration, recordkeeping, credentials verification, examination administration, for example, could be performed by outside contractors under Service supervision. A group like the Office of Professional Responsibility will have to, in our judgment, supervise discipline and supervise the actual contractors themselves administering the program, but we think that a lot of routine administration could be done through contractors, and that, through fees, this could probably be done without a burden on the Federal budget.

Nevertheless, as a final matter, if you are going to register progress, it is important that such a program be adequately funded and, therefore, Congress will need to assure that the Service has the funding for the supervisory resources that would be involved, and that there is an adequate system of private funding, if that is the way you go, to administer the exams and the like. Thank you, Mr. Chairman.

[The prepared statement of Mr. Gideon follows:]

**Statement of Kenneth W. Gideon, Chair, Section of Taxation, American Bar Association**

Good afternoon. My name is Kenneth Gideon. I appear before you today in my capacity as Chair of the American Bar Association Section of Taxation. This testimony is presented on behalf of the Section of Taxation. It has not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, it should not be construed as representing the policy of the Association.

The Section of Taxation appreciates the opportunity to appear before the Subcommittee on Oversight (the "Subcommittee") today to discuss proposals for ensuring that tax return preparers are both ethical and competent. Because tax return preparers play an important role in the efficient and effective administration of the tax laws, these proposals complement the efforts of the Internal Revenue Service (the "Service") to regulate tax professionals and increase the level of taxpayer compliance.

*American Bar Association Section of Taxation*

The Section of Taxation is comprised of more than 18,000 tax lawyers. Our members include attorneys who work in law firms, corporations and other business entities, government, non-profit organizations, academia, accounting firms and other multidisciplinary organizations. As the country's largest and broadest-based professional organization of tax lawyers, one of our primary goals is to make the tax system fairer, simpler and easier to administer.

Our members provide advice on virtually every substantive and procedural area of the tax laws, and interact regularly with the Internal Revenue Service and other

government agencies and offices responsible for administering and enforcing such laws. Many of our members have served in staff and executive-level positions at the Service, the Treasury Department, the Tax Division of the Department of Justice, and the Congressional tax-writing committees.

*The Need for Tax Return Preparer Registration*

Today, more taxpayers than ever pay a third party to prepare their individual income tax returns. Paid preparers advise taxpayers on issues for which guidance is unclear. They explain record-keeping and other requirements. Many taxpayers use them to navigate their way through overlapping or recently changed provisions. The complexity of many provisions, such as the credits for earned income, dependent care, and education, raises particular needs for preparer assistance.

Many paid preparers are subject to no regulation by the Service or by state licensing authorities. Their situation contrasts with that of attorneys, CPAs, and enrolled agents (“Regulated Professionals”), who are subject to oversight through Circular 230 rules and the Service’s Office of Professional Responsibility. Attorneys and CPAs must pass licensing examinations to practice their professions. Enrolled agents who do not have prior experience working for the Service pass a written examination that tests their knowledge of tax law and procedure. Regulated Professionals are subject to continuing professional education requirements and ethical obligations. By contrast, paid preparers are subject only to the Internal Revenue Code’s preparer penalties. Under current circumstances, it can be difficult for the Service to locate and review all returns prepared by a preparer when instances of willful or reckless conduct or intentional disregard of rules and regulations are detected.

In most states, individuals who are not Regulated Professionals can advise taxpayers and prepare tax returns. Neither the Internal Revenue Code nor the Treasury Regulations impose any skill, knowledge, training, or other qualifications on tax return preparers. Members of the public, who are unaware that no such requirements exist, have no means of determining which preparers are ethical and competent and which are not.

Improving the quality of tax return preparation will benefit all taxpayers. First, individuals who use paid preparers will be less likely to file erroneous tax returns. Because erroneous returns result in unexpected tax liability, imposition of interest on back taxes, and time spent resolving problems, even inadvertent errors cause hardship. In addition to individual hardships, correcting these returns diverts Service resources from other taxpayer education and enforcement activities. Second, taxpayers who are least able to understand complicated tax rules, *i.e.*, taxpayers with little education or who speak English as their second language, should be able to consult a preparer who is competent.

Bills addressing these problems have been introduced in both Houses of Congress, and the National Taxpayer Advocate has proposed a registration system. These proposals are thoughtful responses to a problem that affects the administration of tax laws and individual taxpayers. The Section of Taxation supports a registration program for tax return preparers who do not qualify as Regulated Professionals. To be effective, this program should have six components: registration; examination; continuing education; public awareness; administration; and funding. My testimony focuses on these components.

*Registration.* The program should establish criteria for determining which preparers are subject to the Registered Preparer program rules. Limiting the registration requirement to any preparer who both prepares at least five tax returns in a calendar year and who receives fees totaling at least \$5,000 per annum for such preparation would assure targeting of the program where it is most needed—on commercial preparers. Obviously, any initial registration thresholds can be revisited in light of information gathered in the program’s early years. What is important is that the program adopted not burden or interfere with volunteer tax assistance programs, such as VITA, or other non-commercial tax return preparation for low-income taxpayers, relatives, civic groups, etc. (even if the preparer receives a modest payment or expense reimbursement). In addition, we do not believe that there is any need to include Regulated Professionals in a registration program and would oppose such inclusion.

*Examination.* An examination can test technical knowledge, competency to prepare returns, and familiarity with the standards of tax practice required of preparers. But an examination may not be the only means for assessing competence. Congress might, for example, consider “grandfathering” individuals who have prepared returns for at least three years without being assessed preparer penalties (at

activity levels in each of those years that would have met the registration threshold had it been in effect).

The Registered Preparer program should not be structured in a manner that might adversely affect recruiting new tax preparers. Unless qualification examinations are offered on a frequent basis, entry-level preparers might be denied registration based on timing rather than on lack of knowledge. Perhaps an always available on-line examination with suitable security protections could be designed. Because being unregistered has potentially adverse consequences, Congress may wish to provide interim registration status for individuals who are relatively new tax preparers. Interim registrants might be subject to continuing education requirements and mandatory supervision by Registered Preparers or Regulated Professionals. A maximum time limit for interim status would be appropriate.

*Continuing Education.* The Section supports mandatory continuing education for retaining status as a Registered Preparer. This requirement mirrors requirements already imposed on most Regulated Professionals. Registered Preparers can focus their continuing education on those topics that are most relevant to their practices. We believe that continuing education is more likely to serve the public's needs than annual re-examination of preparers. It is also likely to involve fewer administrative costs. Mandatory re-examination and other appropriate sanctions might be imposed on Registered Preparers who fail to meet the continuing education requirement.

*Public Awareness.* Public lists of Registered Preparers should be available in both print and online formats in English and other languages. Public service announcements and similar publicity should acquaint preparers and the public with the new program.

*Administration.* A registration program will be successful only if it is effectively administered. However, the mechanics of registration, record-keeping, credentials verification, and examination administration could be performed by one or more private contractors under Service supervision. This approach would avoid burdening Service employees with tasks that are largely clerical and preserve Service resources for matters requiring judgment, such as examination content and discipline of preparers who violate the rules. The IRS Office of Professional Responsibility ("OPR") should receive authority to regulate Registered Preparers comparable to the authority it has for Regulated Professionals. The OPR should be charged with devising the qualifying examination or approving an examination prepared by others. Allowing routine program administration tasks to be performed by private contractors would be one way of assuring that the program does not adversely affect the Service's existing taxpayer service and enforcement functions.

*Funding.* Congress must adequately fund any Registered Preparer program. If private contractors administer registrations and examinations, they might directly collect fees sufficient to offset their costs. The OPR or any other Treasury or IRS offices given responsibility for publicity of the program, oversight of the registration and examination process, and Registered Preparer discipline must have adequate staffing and funding to perform those tasks.

#### *Summary*

A well-designed and administered Registered Preparer program would benefit taxpayers who use preparers and benefit tax administration generally. Such a program would support the Service's focus on enforcement and further its commitment to ensuring the integrity of the tax system. A registration program would recognize that tax return preparers are an integral part of effective tax administration and should reduce the likelihood that tax returns prepared by such preparers will include inadvertent and purposeful errors.

As always, Section members stand ready to work with you and your staff members on this important matter.

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Chairman RAMSTAD. Thank you, Mr. Gideon. Mr. Degen, your statement, please.

#### **STATEMENT OF FRANCIS X. DEGEN, PRESIDENT, NATIONAL ASSOCIATION OF ENROLLED AGENTS**

Mr. DEGEN. Thank you, Mr. Chairman, for this opportunity to testify. I suggest to you that the paid preparer problem we are ad-

ressing today has two components, intentionally noncompliant returns attributable to preparer fraud and other noncompliant returns attributable to preparer negligence and incompetency. Both are problematic. We share the concerns of the Congress regarding fraud and incompetency because they undermine the integrity of our voluntary tax system, contribute to the \$300 billion-plus gross tax gap, and perhaps most importantly, create resentment in those who file honest returns. A taxpayer or tax preparer who is doing the right thing should not feel that he or she is the dupe in the preparation of income tax returns.

To help remedy this disturbing situation, NAEA urges Members of this Subcommittee to take legislative action. As one of our Members commented in regard to this hearing, people drive in excess of the speed limit until they notice the cop. Then they all observe the speed limit for a while, but when the cop leaves the beat, speeds begin to creep back up. Mr. Chairman, it has been too long since the tax cop has been out circling the neighborhood in his black and white. While fraud is the focus of the hearing today, preparer error is a major cause of noncompliance. Unfortunately, too many preparers fail to attain adequate training and education or do not undergo the necessary annual investment in time and money to keep up with the constantly changing tax code.

Mr. Chairman, it is important to place negligence and incompetency on an equal footing with intentional fraud when attempting to understand the magnitude of the noncompliance problem among unregulated preparers. The NAEA strongly endorses the concept of regulating all paid return preparers. In the Senate, Senators Bingaman, Grassley, and Baucus have developed thoughtful legislation that addresses most of these elements. The NAEA has endorsed this legislation as the most comprehensive road map to address the problem of unregulated preparer noncompliance. While any legislation can be improved, we would urge the Subcommittee to use this legislation as your base for drafting a House bill. If, however, you choose to start from scratch, we would urge you to consider the following four principles in developing your legislation.

Number one, the legislation should contribute significantly to taxpayer access to competent and ethical preparation services. The legislation should require all non-Circular 230 paid preparers to pass an IRS-supervised initial competency examination. We urge you to avoid a scenario where preparers can fulfill this requirement by taking one of a multitude of different tests created by various outside groups. Further, paid preparers should be required to complete annual continuing education and should be subject to the ethical standards of Circular 230.

Number two, build on the existing regulatory framework and consolidate enforcement under one entity. The Office of Professional Responsibility would oversee one ethical code, one set of coordinated exams that would allow for professional advancement and standardized continuing education requirements.

Number three, ensure adequate resources for administration, promotion, and most importantly, for enforcement. Without enforcement and potential disciplinary action, the legislation would not be effective.

Number four, strike the correct balance for creating a new tax practice credential. Congress needs to be cognizant of the ramifications of creating a new credential in the world of tax administration. Currently, the general public is presented with three options for individuals that are authorized to practice before the IRS, EAs, lawyers and CPAs. Circular 230 is very specific as to how these individuals may advertise and generally present themselves to the public. A new credential that implies a higher level of authority and competency than merely preparing basic tax returns will cause confusion and undermine the general intent of the legislation.

In closing, Mr. Chairman, NAEA stands ready to work with you in developing legislation to regulate unenrolled preparers. As I have testified before this Subcommittee at a previous hearing, most people would be astounded to find out that while their barber or manicurist is licensed, their tax preparer may not be. Comparing the downside of a bad haircut to an incorrect tax return, it is time to establish Federal standards to ensure basic competency and, therefore, good behavior. It stands to reason that an ethical and competent tax preparer is a taxpayer's best and lowest-cost insurance against IRS problems and the Service's best and lowest cost assurance of return compliance. Thank you. I am sorry.

[The prepared statement of Mr. Degen follows:]

**Statement of Francis X. Degen, President, National Association of Enrolled Agents**

Thank you, Mr. Chairman, Ranking Member Lewis, and members of the Oversight Subcommittee for asking the National Association of Enrolled Agents (NAEA) to testify before you today. NAEA is the premier organization representing the interests of the 40,000 enrolled agents (EAs) across the country. EAs are the only practitioners for whom the IRS directly attests competency and ethical behavior. Over the years, NAEA has worked tirelessly to increase the professionalism of its members and the integrity of the tax administration system as a whole.

**Background**

Based on input from our membership, I suggest to you that the paid preparer problem we are addressing today has two components—intentionally non-compliant returns attributable to preparer fraud and other non-compliant returns attributable to preparer negligence and incompetency. Both are problematic.

Legislators care about return fraud and incompetency because they undermine the integrity of our voluntary tax system, create resentment in those who file honest tax returns, and contribute to the \$300 billion plus gross tax gap. We share those concerns. Further, as federally licensed enrolled practitioners, EAs find themselves at a disadvantage when competing in the marketplace against the unscrupulous and find that these bad actors sully the reputation of all licensed tax professionals.

In our testimony today, I would like to present a picture of the problems presented to the tax system by unlicensed return preparers, who in many instances we have found to be unscrupulous or incompetent, and unfortunately in far too many cases both unscrupulous and incompetent. To help remedy this disturbing situation, the NAEA urges members of this Subcommittee to take legislative action.

**The Problem**

While most of the focus for the IRS and policymakers over the last few years has been on large dollar compliance areas such as corporate tax shelters and executive compensation, generally involving licensed practitioners, NAEA members have observed equally disturbing trends in the world of return preparation for ordinary taxpayers, almost always involving unlicensed preparers.

The NAEA is not alone in acknowledging this problem. In her 2003 annual report, the National Taxpayer Advocate noted that over 55 percent of the 130 million individual taxpayers hired a return preparer. The majority of those preparers did not possess a legitimate license demonstrating competency or ethical standards. The result is startling; Ms. Olson noted that at least 57 percent of EITC earned income

overclaims were attributable to returns prepared by unlicensed paid preparers, resulting in billions of dollars in lost revenue to the government.

For our members and all preparers who abide by the highest levels of ethical and competency standards in order to live up to the requirements set by federal regulations, the competitive disadvantages of this situation are stark. Time and time again, when our members are surveyed, they relate instances of what we call “preparer shopping” during every tax season. Indeed some taxpayers gather up their tax documents and walk out of a practitioner’s office because someone right down the street has guaranteed them a minimum refund amount: \$1,000, \$3000 or even higher. Or, the taxpayer wants the preparer to help them create phony business or unreimbursed employee business expenses. Or, incorrectly report expenses or income from rental property. Or, not report “under-the-table” income. The list goes on and on.

Many of our members are aware of specific preparers in their neighborhoods that specialize year-in and year-out in ripping off the Treasury. Many have even complained to the IRS, but because of the lack of resources, the agency appears to focus on practitioners currently regulated under Circular 230. As one of our members commented in regard to this hearing, “People drive in excess of the speed limit until they notice the cop; then they all observe the speed limit for a while, but when the cop leaves the beat, speeds begin to creep back up.” Mr. Chairman, it has been too long since the tax cop has been out circling the neighborhood in his black and white.

While fraud is the focus of this hearing today, preparer error is a major cause of noncompliance. We all know the tax code is too complicated. Unfortunately, too many preparers who are open for business today fail to attain adequate training and education or do not undergo the necessary annual investment in time and money to keep up with the constantly changing tax code. Mr. Chairman, it is important to place negligence and incompetency on an equal footing with intentional fraud when attempting to understand the magnitude of the non compliance problem among unregulated preparers.

#### **What can be done?**

Mr. Chairman, we all acknowledge that the tax code is exceedingly complex. Dramatically simplifying the code would likely reduce incidences of noncompliance. However, absent significant simplification, we must deal with the situation as it currently exists.

NAEA strongly endorses the concept of regulating *all* unenrolled paid return preparers, requiring an initial test for competency, background checks, annual minimum continuing education requirements and compliance with the current Circular 230 ethical standards. Additionally, the Office of Professional Responsibility needs adequate resources to both enforce the rules and promote all preparers covered by Circular 230.

After many months of working with the current regulated groups—the enrolled agents, lawyers and CPAs—in addition to the unenrolled preparers, Senators Bingaman, Grassley and Baucus have developed thoughtful legislation that addresses most of these elements. NAEA has endorsed this legislation as the most comprehensive roadmap to address the problem of unregulated preparer noncompliance. While any legislation can be improved, we would urge the Subcommittee to use this legislation as your base for drafting a House bill. If you choose to start from scratch, though, we would urge you to consider the following principles in developing your legislation.

#### **Principle 1. The legislation should contribute significantly to taxpayer access to competent and ethical tax preparation services**

The legislation should require all paid preparers not currently governed by Circular 230 to pass IRS’ initial competency examination testing understanding of basic individual income tax laws and ethical standards. We urge you to avoid a scenario where preparers can fulfill this requirement by taking one of a multitude of different tests created by various outside groups. The public needs to have full confidence that their licensed preparer has passed the initial examination and met all the basic standards established by the Treasury Department. Further, paid preparers should be required to complete annual continuing education and be subject to the ethical standards of Circular 230. These changes will contribute significantly to the use of qualified and ethical individuals preparing returns.

#### **Principle 2. Build on the existing regulatory framework and consolidate enforcement under one entity**

Rather than constructing a parallel regulatory framework and enforcement entity for different groups of paid preparers, the legislation should consolidate all persons preparing returns (enrolled agents, lawyers, CPAs, and paid preparers) under the current regulations (Circular 230) and the existing Office of Professional Responsi-

bility. In other words, there should be one ethical code, one set of coordinated exams that would allow for advancement within the profession, and standardized continuing education requirements all administered under the current regulatory system.

In addition to being cost effective, this consolidation would ensure uniformity of standards and enforcement across all preparers.

**Principle 3. Ensure adequate resources for administration, promotion and—most importantly—for enforcement**

The legislation should allow OPR to retain all registration fees for administration of the program, including policing all practitioners and preparers under its jurisdiction. Most importantly, the authorization to retain these fees would ensure that the office would have adequate resources to investigate and penalize unlicensed individuals. This would go a long way toward discouraging taxpayers from shopping for the “best deal” among preparers and will help shut down many EITC mills across the country.

Additionally, the bill should authorize OPR to retain penalties administered under the program for promotion of all Circular 230 preparers to the general public. This will assist the public in understanding the importance of paying only licensed individuals for tax preparation and will assist the public in understanding the difference between the various groups allowed to do paid preparation.

**Principle 4. Strike a correct balance for creating a new tax practice credential**

Congress needs to be cognizant of the ramifications of creating a new credential in the world of tax administration. Currently, the general public is presented with three options for individuals that are authorized to practice before the IRS: EAs, lawyers, and CPAs. Circular 230 is very specific as to how these individuals may advertise and generally present themselves to the public. A new credential that implies a higher level of authority and competency than merely preparing basic individual tax returns will cause confusion and undermine the general intent of the legislation.

For example, since the passage of the IRS Restructuring and Reform Act, there has been a great deal of confusion as to the credentials and *bona fides* of Electronic Return Originators or EROs. The IRS has issued signage denoting official endorsement of individuals qualifying as EROs, as well as financed a public awareness campaign in support of the program. Anecdotal evidence (the appearance of billboards and bus stop signage) in poorer neighborhoods claiming a government stamp of approval demonstrates the danger of putting out to the public confusing titles or credentials that overstate competency.

Additionally, state regulators would be very leery if not outright hostile toward the creation of a new credential in the accounting/tax preparation marketplace. States regulate the use of credentials and many list a litany of titles (e.g., certified tax consultant, chartered accountant, registered accountant) and abbreviations likely or intended to be confused with CPA that may not be used. After years of conflict, the majority of state boards of accountancy have accepted that a person recognized by IRS as being enrolled may use the enrolled agent name and EA abbreviation. Creating nomenclature that might overstate its intended mission is likely to re-ignite this battle, and at the very least potentially counter the underlying intent of the legislation.

**Closing**

In closing, Mr. Chairman, we stand ready to work with you in developing legislation to regulate unenrolled paid preparers. As I have said before this Subcommittee at an earlier hearing, most people would be astounded to find out that while their barber or manicurist is licensed, that their preparer may not be. Comparing the downside of a bad hair cut to incorrect tax return, it is time to establish federal standards to ensure basic competency and ethical behavior.

Your own hearing announcement confirmed the large number of taxpayers who use paid preparers. Whether it be due to the complexity of the Internal Revenue Code or to a healthy fear of the IRS or simply a service that the average person doesn't want to be bothered with, taxpayers do seek professional assistance. It stands to reason that an ethical and competent tax preparer is a taxpayer's best and lowest cost insurance against IRS problems and the Service's best and lowest cost assurance of return compliance.

Chairman RAMSTAD. Not at all. Thank you, Mr. Degen, for your testimony. Mr. Cross, please.

**STATEMENT OF ROBERT L. CROSS, CHAIRMAN, RIGHT TO PRACTICE COMMITTEE, NATIONAL SOCIETY OF ACCOUNTANTS**

Mr. CROSS. Thank you, Mr. Chairman, for this opportunity to share the thoughts of the National Society of Accountants. We are kind of a diverse group. We have CPAs. We even have a couple of Juris Doctorates in our membership and EAs and a lot of these unenrolled tax preparers. I would direct you simply to the summary of the testimony that we put and I want to talk about just two of these issues, because I know we are pressed for time. The first one that I want to talk about is the fact that we support the idea of registration and have supported it since we first advanced this idea several years ago. We also support the idea of an initial exam, but we think that there should be a waiver of that initial examination for people who have already demonstrated both their competence and their knowledge of the tax laws. We think that there are three groups of people who are qualified for this type of an exemption from taking an exam.

The first ones are people who hold a credential already established by a national credentialing body, such as the credentials that I hold, an accredited Business Accountant and an accredited Tax Advisor from the Accreditation Council for Accountancy and Taxation. We are required to maintain 40 hours of annual Continuing Professional Education (CPE) just to keep that up, in contrast to the 16 hours that an EA is required to put in every year.

The second group are people who hold an accountancy license from a State Board of Accountancy. Now, this is the same board that regulates CPAs, but a lot of States have a second tier of license that are not equivalent to CPAs. Some of them are Licensed Public Accountants. Some have the title Public Accountant. Some of them have the title Accounting Practitioner. They have all established a license based on knowledge, based on experience, based on education, and based on an examination that has established their credential.

The third group are people like those in Oregon and California, who have a license to prepare tax returns in their State according to a scheme that was established under their State law. We think that those are legitimate tax return preparers and they should not have to go back out and reestablish their ability and their competency through this exam.

The next point I want to make is point six on our summary, and that is the adoption of some other independent exam for doing this. The IRS is currently trying to outsource the EA exam. They haven't accomplished that yet. To put a new exam requirement on top of them while they are trying to do that, we think is simply a burden that should be avoided. There are groups out there, such as the Accreditation Council for Accountancy and Taxation, who already have a psychometrically correct exam, verifiable exam that is out there. One of those exams—Oregon also has exams. There are exams available in the marketplace that would make it possible



to simply outsource this and have it handled perfectly. I think my time is up, so I am just going to close by saying I would be happy to answer your questions and yield the floor.

[The prepared statement of Mr. Cross follows:]

**Statement of Robert L. Cross, Chairman, Right to Practice Committee,  
National Society of Accountants**

Thank you, Mr. Chairman and members of the Committee, for this opportunity to testify before the Committee and share our views regarding the regulation of federal income tax preparers. My name is Robert L. Cross. I am the chairman of the Right to Practice Committee of the National Society of Accountants (NSA). I am a co-owner of Cross Business Services, Inc. Our firm provides accounting and tax preparation services to individuals and small businesses from offices in Northglenn, Colorado and Wheatland, Wyoming.

The National Society of Accountants (NSA) is a voluntary association of certified public accountants, enrolled agents, licensed public accountants, other licensees of state Boards of Accountancy, tax practitioners who are licensed by state agencies, and accountants and tax practitioners who hold credentials from a nationally recognized credentialing body. Many of these members are not currently subject to direct regulation by the Internal Revenue Service. NSA and its affiliated state organizations represent approximately 30,000 practitioners who provide accounting, advisory and tax related services to more than 19 million individuals and small businesses. In short, NSA represents accountants who serve *Main Street* rather than *Wall Street*.

As you know, Senate Bill S. 832 proposes new regulation for the federal tax preparation industry. This proposed legislation would have a significant impact on the profession and the Internal Revenue Service. Estimates of the number of tax practitioners required to register in the first year of the program range from 200,000 to as high as 600,000.

The Senate bill instructs Treasury to develop (or approve) and administer an eligibility examination designed to test the knowledge and technical competency of individuals who prepare federal income tax returns. NSA has supported the concept of registration for federal income tax preparers since we first introduced the concept several years ago. NSA further supports the use of an eligibility examination. However, NSA can fully support the Senate bill, and any similar legislation, only if it provides recognition of tax practitioners who have *already* demonstrated their professional competence and their commitment to life-long learning either by earning credentials offered by a nationally recognized credentialing body or by being licensed to practice accounting by a state Board of Accountancy or by being licensed to prepare income tax returns by an agency established under state law. Allowing individuals who possess such credentials or licenses to receive a waiver from the initial examination requirement will achieve that recognition. These individuals would still be required to register, pay the appropriate fees and meet the other requirements specified in the bill.

The Accreditation Council for Accountancy and Taxation (ACAT), a nationally recognized credentialing organization, offers three credentials that fully satisfy the competency and ethical standards that the Senate bill seeks to achieve. Those credentials are: *Accredited Business Accountant (ABA)*, *Accredited Tax Advisor (ATA)* and *Accredited Tax Preparer (ATP)*. Individuals who hold these credentials have demonstrated their knowledge and competency through a regimen that includes education, experience and examination on topics that include substantial taxation and ethical components. To maintain their credentials, they comply with rigorous annual continuing professional education requirements. More detailed information concerning ACAT's organization and mission is contained in the addendum attached to this testimony.

Any individual holding a license from a state Board of Accountancy has likewise demonstrated a level of competence that is based on a long-established regulatory standard that has education, experience and examination as required components. Every state accountancy regulatory scheme requires continuing professional education as a condition for license renewal.

The states of California and Oregon license tax preparers in their respective jurisdictions. The licensing qualifications differ slightly in each state, but both require a substantial educational element, including state and federal taxation and ethical conduct, as a prerequisite to granting a license. In both states, continuing professional education is a requirement for license renewals. California currently licenses

approximately 36,000 tax preparers and Oregon licenses approximately 8,000 preparers under their respective programs. These states already impose adequate and efficient licensing requirements on their tax and accounting professionals. We do not believe additional federal requirements should be imposed on these individuals or similarly situated individuals in other states.

In addition, the Internal Revenue Service has extended Circular 230 privileges to public accountants in the States of Pennsylvania, New Jersey and Rhode Island. Under the provisions of Circular 230, a “certified public accountant” is a person duly qualified to practice as a certified public accountant in any state, territory, or possession of the United States. Certified public accountants who are not currently under suspension or disbarment from practice before the Internal Revenue Service may practice before the Internal Revenue Service. A number of other states have a public accountant license class that has practice rights substantially equivalent, if not identical, to those granted to CPAs. These licensed public accountants, like their CPA counterparts, are subject to regulation and supervision by state Boards of Accountancy and must meet continuing education, professional standards and other requirements in order to maintain their practice rights. We firmly believe that if the Internal Revenue Service has already recognized the competence and integrity of these tax and accounting professionals in these states, Congress should as well.

NSA proposes that Treasury consider adopting an ACAT examination on taxation and ethics as the eligibility examination. ACAT examinations are psychometrically valid and are supported by a huge database of available questions that is updated annually. Iowa, Minnesota and Delaware currently use the ACAT ABA examination to qualify a second tier of accounting licensees. Alternatively, the proposed legislation should instruct Treasury to allow for the substitution of any test developed by a nationally recognized credentialing body provided the examination meets minimum standards. Allowing for the substitution of such exams will reduce the burden on Treasury and the practitioner community, while still achieving the public policy purposes of the legislation.

The Senate bill has a section that “clarifies” the Enrolled Agent credential. NSA supports this concept because it will establish a uniformity of regulation and eliminate ambiguities and conflicting restrictions that have evolved in many state regulatory schemes over time. The truthful use of earned credentials is an individual right that all responsible regulatory legislation should serve. National attention to this issue is both appropriate and overdue.

The descriptor used to identify this new class of regulated tax preparers deserves the attention of your Committee. The staff notes, accompanying the Senate bill, include the term “enrolled preparer” when referencing those individuals subject to the proposed regulation. NSA believes that this term diminishes the Enrolled Agent credential and has the potential to confuse the public. Further, it does not adequately describe the services performed by this group of tax preparers. We recommend that terminology used to describe this group be neutral. We suggest “Registered Federal Tax Return Preparer.”

Another section of the Senate bill provides for levying fines and then keeping the money to fund a public awareness campaign. We question the propriety of this provision and ask that Congress reconsider the potential for abuse. Principled legislation should allow Treasury to abate a punitive fine for an inadvertent human error. Perhaps there should be a “pattern of neglect or misconduct” before heavy fines are levied.

The “one-year from enactment” provision is another area that must concern everyone. Such a short time period to develop both a testing and a registration system certainly has the potential to disrupt the subsequent tax-filing season. The staff description of the Senate bill states, “efficiencies will be gained by coordinating the exam requirement with the enrolled agent exam.” Until such time as the enrolled agent exam is successfully outsourced and its structure entirely revised, we believe this conclusion is questionable at best and could lead to a disruption of the filing season in the first year of implementation. Processing the exams and the attending record keeping for 200,000 to 600,000 individuals certainly has the potential to overwhelm the system. A safer approach would be to instruct Treasury to devise a testing system independent of the Special Enrollment Examination that applicants could use throughout the year. Such a process would follow the proven model that the securities and insurance industries use. We think that development of a workable regulatory structure, as anticipated by S. 832, simply requires more time to both develop and implement. Extending the time frame to two years or perhaps three would be more realistic.

**In summary, NSA supports:**

1. The concept of registration of tax preparers

2. The use of an initial examination
3. A requirement for ongoing continuing professional education
4. The requirement for registration renewal every three years.
5. A waiver of initial examination for individuals who:
  - a. Hold credentials offered by nationally recognized credentialing bodies
  - b. Hold a license to practice accountancy from a state Board of Accountancy
  - c. Hold a license to prepare tax returns established under state law
6. The adoption of an ACAT exam for initial licensing or alternatively developing the initial examination separate from the Enrolled Agent exam
7. The clarification of the Enrolled Agent credential
8. Finding a better descriptor than 'enrolled preparer' ("Registered Federal Tax Return Preparer" for example)
9. Reconsideration of using preparer penalty money to fund public awareness efforts
10. Extending the time period for development and implementation of the structure

I am pleased to answer any questions you may have.

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Suggested language.

Inserting a new Section 4(b)(3) and renumbering the existing 4(b)(3) to 4(b)(4) would achieve statutory authority for examination waivers.

Proposed new Section 4(b)(3)

### (3) WAIVER OF EXAMINATION

(A) IN GENERAL—The regulations under paragraph (1) shall provide for a waiver of the examination described in paragraph (2) in those cases where an applicant for registration can demonstrate that their technical knowledge and competency has been established through a state licensing activity or by obtaining a credential from a nationally recognized credentialing body in accountancy or taxation.

(B) CONCURRENCY—An applicant for registration who requests a waiver of examination shall be required to submit evidence that establishes the fact that their license or credential is currently valid and that they have currently completed such continuing education requirements as may be required to maintain their license or credential.

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Since its inception in 1945, the purposes of NSA have been to promote and improve the profession as a whole and to provide its members with services directed to those purposes, including educational programs in accountancy and taxation. NSA has a long history of focusing efforts toward realistic and meaningful forms of uniform statutory regulation at both the state and national levels. NSA is guided by principles that strive to balance the public interest with the rights of regulated individuals and defend our common values.

Most NSA members are sole practitioners or partners in small to mid-sized firms. The NSA bylaws require our active members to either possess or obtain and maintain a license or a nationally recognized credential in accountancy or taxation. For these purposes, NSA recognizes credentials that are awarded by the Accreditation Council for Accountancy and Taxation. NSA members agree to adhere to a code of ethics and professional conduct as a condition of membership. NSA further requires continuing professional education as a condition of membership renewal. NSA has 48 state affiliates. For more information about NSA please visit our website at <http://www.nsacct.org>

### ACAT Addendum

Established in 1973, the Accreditation Council for Accountancy and Taxation® (ACAT) is a non-profit independent testing, credentialing and monitoring organization. The ACAT mission is to accredit practitioners who have:

- demonstrated knowledge of the principles, practices, and ethical standards of accounting, and taxation, and related financial services in order to provide the highest level of service to the public.
- committed to a rigorous standard of continuing professional education

- agreed to adhere to a strict Code of Ethics, embracing Circular 230 tenets

While ACAT's numbers include CPAs and state licensees, the ACAT-targeted practitioner is the accountant/taxation specialist who serves small- to medium-sized businesses. ACAT currently has approximately 5,000 credential holders.

Current holders of the ACAT Accredited Business Accountant, Accredited Tax Advisor and Accredited Tax Preparer credentials fully satisfy the competency and ethical standards that the Senate bill seeks to achieve. Individuals who hold these credentials have demonstrated their knowledge and competency through a regimen that includes education, experience, and/or examination on topics that include substantial taxation and ethical components. To maintain their credentials, they comply with rigorous annual continuing professional education requirements.

The Accredited Business Accountant earns the credential by passing an eight-hour, 200 question exam. The examinations are psychometrically valid and are supported by a substantial database of questions based on the ACAT Job Practice Analysis, conducted every five to seven years. Iowa, Minnesota and Delaware currently use the ACAT ABA examination to qualify a second tier of accounting licensees. Based on the validity of its examination ACAT has been invited to bid on the Enrolled Agent examination for the IRS. The Accredited Tax Advisor earns the credential through passing the EA or CPA exams or through an eight-course curriculum with examinations at the end of each course. The Accredited Tax Preparer has in the past qualified by taking a two-course curriculum with examination at the end of each course, or through demonstration that at least 60 hours of taxation CPE have been taken over the past three years. All credentials have a three to five year experience requirement. In December, ACAT will introduce an Accredited Tax Preparer examination based on the Ethics and Taxation portions of the Accredited Business Accountant examination.

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Chairman RAMSTAD. Thank you very much, Mr. Cross. Mr. Purcell, please.

**STATEMENT OF THOMAS J. PURCELL III, CHAIR, TAX EXECUTIVE COMMITTEE, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS**

Mr. PURCELL. Chairman Ramstad, Mr. Lewis, and Members of the Subcommittee, on behalf of the AICPA, I am very grateful to be able to testify here today. This afternoon, I have three main points. They, to some extent, are redundant with what the prior panelists have said, so I will try to put our specific concern on each one of them. First, we remain committed to tax preparers who have high ethical standards and competent professional knowledge. Second, we support the concept of registration of return preparers, subject to various implementation issues, but we also encourage further study of the specific abuses that might be the motivation for this hearing today. Then third, if a system is created that would provide for registration of preparers, there are a couple of implementation issues that we would like to see addressed.

So, with regard to that competent professional knowledge and high ethical standards, whatever system might come out—I think Mr. Gideon mentioned this also—there needs to be both the marriage of the competency, which is the technical piece, but also the motivation to aspire to higher standards, and that has to be enforceable. For the professions, we enforce it ourselves. For a system like this, it would be enforced from some other body on the outside, such as the IRS. So, you have to be cognizant of creating a new bureaucracy by doing this.

Second, the concept of registration is attractive, but if it is motivated by specific issues that you might address separately, it might

be more efficient to look at those. For example, Mr. Shaw mentioned in the earlier panel about the EITC. If you look at the significant complexity of that, found a way to carve out some of those issues so it became a much easier process to enforce, it takes away the ability to game the system and you make it a more efficient process. Also, you might want to look at the refund anticipation loans. If there are abuses of that, then maybe you should question whether these should even be an allowable method of financing for low-income people.

Finally, if you do create a system, a couple of issues to address, and I think some have already mentioned it, but to reiterate: we have a system, Circular 230, that enforces those of us at this table and we have a significant process that has already been created. Any system that you create has to be integrated with that to make sure that there is transparency and ease of transfer of professional expertise across those different criteria. You also would want to take a look at the ERO program to see if that is an appropriate surrogate for a system of enforcement.

We want to avoid any public confusion with regard to these new designations. I think Ms. Jardini mentioned in her testimony in response to Mr. Shaw's question, about a person who had come down to see—here is where you can get your maximum refund or here you can go to the professional who has certificates on the wall, and who says that they will do the best job that they can. The public would be motivated to perhaps go to the person promising the greater refund. Well, if you don't have appropriate regulation of this new system, you might still have that problem.

Plus, we also wouldn't want to create a situation where someone in the public would equate different levels of professional competency. There exists a potential problem of going to the lowest common denominator, and the public equating everyone who might be professionally certified to do anything with regard to tax, with regard to this new designation.

Finally, whatever the system might look like, to be equitable and to be fair in terms of competitive forces, it should be self-funding and have some components of self-enforcement. Those of us who are professionals pay significant development fees to get ourselves prepared to enter the profession. We pay significant fees on a regular basis to remain competent to practice our profession. We have mandatory CPE, which costs not only the dollars to get the training, but also the out-of-pocket costs for missing client services, and we have to pay professional organization fees to maintain enforcement mechanisms. So, if you are going to create a new system that regulates return preparers, to be equitable, it has to recognize these differences in the competitive marketplace. Thank you, and I will answer questions at the end if there is time.

[The prepared statement of Mr. Purcell follows:]

**Statement of Tom Purcell, Chair, Tax Executive Committee, American Institute of Certified Public Accountants**

Mr. Chairman and members of the House Ways and Means Subcommittee on Oversight, the American Institute of Certified Public Accountants thanks you for the opportunity to appear before you today. I am Tom Purcell, Chair of the AICPA Tax Executive Committee; and Associate Professor of Accounting and Professor of Law at Creighton University, Omaha, Nebraska.

The AICPA is the national, professional association of CPAs, with approximately 350,000 members, including CPAs in business and industry, public practice, government, and education; student affiliates; and international associates. Our members advise clients on federal, state, and international tax matters and prepare income and other tax returns for millions of taxpayers. They provide services to individuals, not-for-profit organizations, small and medium-sized businesses, as well as America's largest businesses. It is from this broad perspective that we offer our thoughts today.

We strongly support the implementation of high professional standards for tax practitioners; and for this reason, we applaud the Subcommittee on Oversight for holding today's hearing on the regulation of federal income tax return preparers. We understand that today's hearing is, in general, an oversight investigation regarding the concept of the federal regulation of tax return preparers. However, Senator Jeff Bingaman introduced legislation this year (S. 832, the Taxpayer Protection and Assistance Act of 2005) that specifically addresses some of these issues. When my testimony refers to the "preparer registration proposal," I am referring to the general concept of the regulation of federal income tax return preparers, and at other times I will specifically address relevant provisions of S. 832.

In summary, my testimony today focuses on the AICPA's positions on (1) high professional standards for tax professionals, (2) federal legislation that regulates unlicensed tax return preparers, and addresses the enforcement and consumer protection problems associated with the Earned Income Tax Credit and refund anticipation loan programs, (3) exempting CPAs, attorneys, and Enrolled Agents from regulation under any new legislation enacted to regulate federal income tax return preparers, (4) Congressional review of the current Electronic Return Originator application process and how that process might overlap even a "limited" registration process for federal income tax return preparers, and (5) ensuring that the persons subject to any preparer registration initiative be the persons who bear the cost of the new program, and not those tax professionals already subject to Circular 230.

#### **AICPA Commitment to Professional Ethics**

The AICPA commends Congress for passage last year of the anti-tax shelter provisions of the American Jobs Creation Act of 2004, and for the current focus on regulation of unlicensed income tax return preparers. This effort is consistent with our longstanding track record of establishing high professional standards for our CPA members, including the AICPA Code of Professional Conduct and our enforceable Statements on Standards for Tax Services. These standards provide meaningful guidance to CPA members in performing their professional responsibilities.

We have consistently supported protecting the public interest by prohibitions against misuse of our tax system. We continue to be actively engaged in proposing and evaluating various legislative and regulatory matters designed to identify and prevent taxpayers from undertaking, and tax advisers from rendering tax advice on, transactions having no purpose other than the reduction of federal income taxes in an abusive manner.

#### **Addressing EITC and Refund Anticipation Loan Problems**

Legislation to regulate preparers has generally been proposed by members of Congress as a partial response to (1) the high error rate associated with Earned Income Tax Credit (EITC) claims and (2) consumer protection concerns associated with refund anticipation loans.

Congress is rightly concerned with the high error rate associated with EITC claims and with the proliferation of high-interest, short-term refund anticipation loans (RALs). According to the Treasury Inspector General, an IRS study of 1999 tax returns suggests that—out of the \$31 billion in EITC claims by taxpayers that year—between 27 and 32 percent of those claims were erroneous.<sup>1</sup> With respect to the RALs, commercial preparers aggressively encourage the use of RALs by low income taxpayers, sometimes misleading these taxpayers about the true cost of such loans. These concerns have resulted in the introduction of bills such as S. 832. Among other provisions, S. 832 provides for the regulation of what the bill refers to as "income tax return preparers" and "refund anticipation loan facilitators."

In addition to any deliberations over the regulation of tax preparers, the AICPA also recommends that Congress consider proposals that directly address the enforcement problems associated with the EITC program and the consumer protection

<sup>1</sup> Testimony of J. Russell George, Treasury Inspector General for Tax Administration, Hearing on IRS's Fiscal 2006 Budget Request, Senate Committee on Appropriations, Subcommittee on Transportation, Treasury, the Judiciary, Housing, and Urban Development, and Related Agencies, April 7, 2005.

issues surrounding refund anticipation loans. By addressing the specific problems associated with EITC program and RALs, we believe such proposals may result in more tangible increases in compliance than a preparer registration proposal might alone yield.

#### **Exemption for CPAs, Attorneys, and Enrolled Agents**

The AICPA supports the language contained in S. 832 [Section 4(b)(1)(A)] that requires the IRS to prescribe regulations (within one year of the bill's enactment) regulating what the bill refers to as "compensated preparers not otherwise regulated under [31 USC 330]" (the enabling legislation upon which Circular 230 is issued). Since they are already regulated by Circular 230, CPAs, attorneys, and Enrolled Agents (EAs) would be exempt from the proposed new regulation regime imposed on currently unlicensed preparers. We commend the drafters of S. 832 for their recognition that CPAs, attorneys, and EAs are already subject to a regulation process imposed upon them by state boards of accountancy, state bars, court systems, and Circular 230, and recommend that any proposal continue to include such exemption.

#### **Public Awareness Campaign**

One important priority of the Service during the 2005 tax filing season was its public release of tips advising taxpayers how to choose a competent paid federal income tax return preparer. This publicity campaign resulted in wide coverage by U.S. newspapers and media outlets. We strongly support this recent publicity campaign and find it an excellent foundation for any future public information and consumer education campaign conducted in support of a preparer registration initiative, such as the one required under Section 4(f) of S. 832.

Any effective public relations campaign should be centered on educating the taxpaying public about selecting an ethical, competent federal income tax return preparer. S. 832 accomplishes this through the implementation of a public awareness campaign that (1) encourages "taxpayers to use for Federal tax matters only professionals who establish their competency" under Circular 230, and (2) informs "the public—that any compensated preparer—must sign the return, document, or submission prepared for a fee and display notice of such preparer's compliance" with such regulations.

As stated above, S. 832 requires that the IRS prescribe regulations (within one year of the bill's enactment) for the regulation of "compensated preparers not otherwise regulated under" Circular 230. In drafting regulations, we understand that a central feature of any public awareness campaign will likely involve the IRS's description or "title" that the agency gives to previously unlicensed tax preparers—but now, newly regulated as income tax preparers under Circular 230.

A major concern about any new registration regime is that it may be difficult for taxpayers to discern the competency level of these newly regulated income tax preparers as compared to professionals already regulated under Circular 230. In order to prevent confusion in the marketplace among the taxpaying public, we suggest that the IRS utilize a title for these newly regulated income tax preparers that is clearly distinguishable from the current professionals regulated under Circular 230; that is distinguishable from the words CPA, attorney, or EA.

While not included in the preparer registration proposal contained in S. 832, the Senate's 2004 version of the proposal<sup>2</sup> required the IRS to maintain a public list (in print and electronic media, including Internet based) of Federal income tax return preparers. We commend the current drafters of S. 832 for not including a requirement for the Service to maintain a public list of this sort. We believe that mandatory maintenance of this type of public list, while laudatory, may create redundancies with current IRS programs and initiatives. For example, Congress has requested that the IRS implement strategies designed to increase the electronic filing of tax returns. The IRS currently maintains a public list of companies or organizations that offer free tax filing and e-filing for low-income tax persons; and another list of tax professionals who have been accepted into the electronic filing program, whom the IRS calls "Authorized IRS e-file Providers" or Electronic Return Originators (EROs). We fear that the creation of an additional list of tax professionals at the IRS website may actually end up confusing or even diluting the IRS's current message and goals surrounding the promotion of e-filing.

#### **Electronic Return Originator Application Process**

Congress should consider reviewing the current Electronic Return Originator application process, and how the ERO process might overlap or duplicate even a "limited" registration process for tax return preparers. Under the current ERO applica-

<sup>2</sup>See section 141 of H.R. 1528, the Tax Administration Good Government Act, as passed the Senate on May 19, 2004.

tion process, IRS conducts a background check of all principals and responsible officials affiliated with a tax return preparer's firm. This background check includes: (1) an FBI criminal background review; (2) a credit history check; and (3) an IRS records check with respect to the preparer and the firm's adherence to tax return and tax payment compliance requirements, including a review of any prior non-compliance under the IRS e-file program. After such a review, Congress and the IRS might find it more beneficial (on a budgetary or resource allocation basis) to use or expand the current ERO public list of practitioners instead of creating a new, but separate list of professionals as envisioned by legislation regulating income tax return preparers.

#### **Development of an Examination for Income Tax Preparers**

As described above, one of the stated reasons for developing legislation to regulate unlicensed preparers involves the high error rate associated with erroneous Earned Income Tax Credit claims found on Form 1040, U.S. Individual Income Tax Return. However, Section 4(b)(2) of S. 832 mandates that the IRS develop examination procedures for unlicensed tax preparers testing the technical knowledge and competency of a preparer in the preparation of Federal tax returns, including individual and business income tax returns and specifically the EITC. There are significant differences in the competencies necessary to prepare individual returns and those needed to prepare business income tax returns. Before an examination can be prepared, there must be consistency between the purposes of the unlicensed preparer regulation regimen and the content to be tested. While we are not opposed to including questions on any such new examination covering business income tax returns, we believe it is important to recognize that such questions clearly delve into competencies that exceed basic income tax knowledge.

Should it be Congress' intent to specifically address errors on individual income tax returns (and even more specifically EITC errors), the examination should principally focus on basic individual income tax knowledge. However, the proposed S. 832 examination regimen would be much broader. In developing the examination content and approach, the IRS could implement a testing procedure that builds on existing examination models, such as the Service's testing for Volunteer Income Tax Assistance (VITA) volunteers and the Enrolled Agent (Special Enrollment) examination. We believe that the examination developed for any new preparer registration regime should be sufficiently rigorous to test basic competencies and ethical standards.

#### **Administrative and Budgetary Concerns**

In addition to the implementing regulations required by a registration proposal, a whole new enforcement program would be required to be developed within the IRS's Office of Professional Responsibility, as envisioned by a legislative proposal like S. 832. This would place significant budgetary demands on the IRS and thereby place the Service in the unenviable position of having to allocate its fixed annual budget among a number of competing, but important priorities.

Should a preparer regulation regime be enacted into law, we strongly believe the most equitable way to fund the new examination and registration process would be to ensure that the persons subject to the new procedures (i.e., the previously unlicensed preparers)—be the persons who bear the cost of the new program, and **not** the CPAs, attorneys, and Enrolled Agents already subject to Circular 230. More specifically, these latter professionals are already subject to examination and regulation fees imposed upon them under other programs, such as by state boards of accountancy, state bars, court systems, and Circular 230.

S. 832 provides the IRS with the authority to utilize the funds collected through the assessment of preparer penalties for the funding of the public awareness campaign required by the legislation. The AICPA is concerned that this measure could create an inadvertent (and possibly an overt) incentive for Service employees to initiate overzealous and inappropriate enforcement actions against tax professionals and the preparer community. This could particularly become a problem should the "failure to sign" and the "failure to furnish identifying number" preparer penalties be raised ten-fold from \$50 to \$500 for each such failure, as provided for under S. 832. We believe that any funds collected through the assessment of preparer penalties should remain a funding source for the federal government's general revenues and not for the administration of a specific federal program such as a preparer registration initiative.

Thank you for the opportunity to share these views with you.





Chairman RAMSTAD. Thank you, Mr. Purcell. Mr. Gray, please.

**STATEMENT OF LARRY GRAY, GOVERNMENT LIAISON,  
NATIONAL ASSOCIATION OF TAX PROFESSIONALS**

Mr. GRAY. Chairman Ramstad, Ranking Member Lewis, and the Subcommittee, the National Association of Tax Professionals would like to thank you for the opportunity to speak to you today. As I am fifth in the order, I agree with almost everything that has been said in the prior statements and also some of the testimony from the earlier panel. I do believe any kind of regulation or licensure will raise the bar. I think any proposed regulation for paid preparers should be sure of fundamental things like, they sign the return, that they stand behind their work, and that they have continuing education to stay current. For example, I can tell you, as a speaker across the country doing continuing education on new tax law, between the changing of the laws and our profession becoming more dependent on computer technology, education is a real problem.

At the National Association of Tax Professionals, for years, we have had a code of ethics and we also have a standard of professional conduct. One interesting note on education is that we have surveyed our Members, because our Members are a cross-section of Circular 230 and non-Circular 230 Members, and the interesting note is the non-230 members actually average slightly more continuing education than the Circular 230 Members. Just a little sidebar note there. I think dealing with the unethical, unscrupulous preparers, if you go out in the public and look today, you are going to see that most of them are coming from under the auspices of Circular 230. They are CPAs, attorneys and EAs. I think that is because they do come under a much more stringent set of tests. So, if there was any kind of licensure that came about, I think that that may raise the bar to that group, but I think, also, it may be—we may find different statistics. So, I think as far as, will this help on the unethical preparers, I have to agree with earlier testimony in the first panel. I don't know that it will. One of the big concerns is that they may very well go underground.

I want to quote Nina Olson and the fact that she said that the greater tax practitioner community is honest, ethical, competent, and conscientious, and I think that is a true statement. I think that there are a few that ruin it for all of us. If you were to come up with legislation, just a couple of items of comment, and again, I kind of agree with some of the other panelists here today. I think that one of the issues, if we are going to have a campaign, that it is a public campaign about authorized preparers. Now, one thing you might note, there is already a public campaign out there that the IRS does each and every year. You go to walk into a tax office and it is a little yellow sign that says, "Authorized ERO". So, there is already a program that is advertising to the public. Keep that in mind, both from the compliance side and also from the marketing side. I think, and I again agree with an earlier statement, that any marketing must be very, very clear to the public. I think that if you walk into a practitioner's office and I said, well, I have

got a CPA, I have got an EA, and I have got this other item, whatever you are going to call it, authorized, registered, whatever, again, I think that that is just a minimum threshold that says they have got certain skills to do basic returns. I think, again, we have to be very cautious about marketing confusing information or titles.

Next, I think there should be a transition period or a grandfathering period, whichever may be. I don't want to get too specific because that will probably be for a later date for implementation, but I think, again, there should be some consideration there. For the reference of the earlier panel, 99.5 percent of the people out there that prepare returns do care. Again, please don't create another bureaucracy. I think there needs to be a partnering with the outside community, and I think there should be an equal playingfield with all organizations, because that is why we are here at the table.

Finally, in the area of testing, when you go to look at testing and you realize that last year there were approximately 131 million individual returns filed, 6 million corporate returns, 3 million partnerships, 1 million trusts, estates, and similar, that means that 93 percent of the returns filed last year were individual returns. So, I think what you have to look at there—the testing needs to reflect the type of business the person is going to do and not require him to know everything about all because that could be virtually impossible. At this point in time, in order to take questions, again, I would like to thank you for allowing the National Association of Tax Professionals to speak and I am open for questions.

[The prepared statement of Mr. Gray follows:]

**Statement of Larry Gray, Government Liaison, National Association of Tax Preparers**

Chairman Ramstad, Ranking Member Lewis, and Members of the House Subcommittee on Oversight, thank you for the invitation to participate in today's hearing to consider concepts of enhanced regulation of paid tax return preparers.

My name is Larry Gray and I am a CPA and managing partner of Alfermann Gray & Co. I am currently serving on the Electronic Tax Administration Advisory Committee of the IRS, and a past member of the IRS Commissioner's Advisory Group and on various Subcommittees, including Compliance and Small Business.

Our society and the business environment have become so complex that, despite repeated efforts on behalf of Congress and the regulatory agencies, the process of computing and reporting accurate tax liabilities on the part of citizens has also become complex. Licensing and/or registration is a step toward ensuring that taxpayers receive professional and credible services from currently unlicensed paid tax preparers. Any proposal to regulate paid preparers should ensure that they sign the returns they prepare, stand behind their work, continue their education to stay current on tax laws and regulations, and maintain the highest ethical conduct while servicing taxpayers.

For reasons put forth by Nina Olson in her recent reports to Congress, the time may be right for tax return preparers to register with the IRS (or the Treasury) and be prepared to demonstrate reasonable competency through minimum requirement testing. One of Nina's primary goals is to protect the taxpayers from unethical preparers. Both the Taxpayer Advocate and the Commissioner of the Internal Revenue Service, however, have acknowledged that the tax practitioner community at large is honest, ethical, competent and conscientious. Taxpayers should be able to rely on licensed or registered preparers as competent guides in tax matters and as preparers of tax returns.

Relying on all of them for ethical and scrupulous conduct is another matter, however. Licensing and/or registering tax return preparers will likely not solve that problem. A quick review of disbarment and suspension cases as well as civil and criminal tax cases will reveal that most prosecuted perpetrators of fraud, schemes

and other forms of tax system abuse are already licensed and authorized to practice before the IRS. The reason for that may be that those currently authorized to practice before the IRS (attorneys, CPAs, EAs, etc.) are under a scrutiny not experienced by unlicensed tax return preparers.

Certainly there is a significant problem with erroneous and fraudulently filed EITC and other such abuses of the tax system as it relates to low income citizens. Reasonable speculation is that these problems are likely perpetrated primarily by unlicensed tax return preparers. The additional scrutiny of unlicensed tax return preparers may very well serve good purpose if that speculation turns out to be factual. It would seem logical that regulation of unlicensed paid preparers can only raise the bar. That, in itself, seems a worthy goal. The fact is, however, that the population of unscrupulous and unethical tax return preparers is not defined and is currently not determinable.

Despite our best efforts, there is a strong likelihood that unscrupulous and unethical tax return preparers not already licensed or regulated will simply “go underground” when registration and regulation is required. Better to have them there than operating in the “open” as they currently do. In its effort to make tax return filing easy and economical for the American public, Congress and the IRS have unintentionally fostered an environment where such dishonest and unprincipled people can readily have free and easy access to software and electronic filing capability. Those issues must be tackled from a compliance and enforcement standpoint.

The fact is that the greater tax practitioner community, acknowledged as “honest, ethical, competent and conscientious” by both Nina Olson and the Commissioner of Internal Revenue, will likely welcome licensing or registration as a means to put distance between themselves and “fly-by-night” charlatans that bilk the American public every tax season. Those that are unlicensed want to distance themselves from any perception that, just because they are unlicensed, they are somehow not knowledgeable or straightforward in their practice. Many of these unlicensed individuals have degrees in accounting, taxation and other disciplines as well as decades of experience in the field.

There needs to be some way to easily identify qualified tax return preparers and inform the public of who is authorized to prepare their tax returns. Taxpayers must have a clear understanding of where to go for professional service in getting their returns completed. The American public deserves that. Terminology used to identify such preparers must be clear to the public, clear to the tax administration system and clear to the tax preparation community. Any government marketing effort to educate the public regarding newly licensed preparers must distinguish them so as not to confuse the public with existing credentials already in use such as Certified Public Accountant, Enrolled Agent, and attorney.

There must be a transition from being unlicensed or unregistered to becoming licensed and/or registered. There should be a reasonable phase-in period to allow current unregistered preparers to become registered before they are prohibited from preparing returns. Registration and licensing has the potential to negatively affect the livelihood of hundreds of thousands of small businesses, self-employed individuals and millions of their taxpayer clients. It could seriously and negatively impact the ability of the tax administration system if significant numbers of otherwise competent and legitimate tax return preparers currently servicing that system close their doors because of costly; redundant; overly burdensome; and ineffective regulation.

Care needs to be exercised not to create another government domain to add more bureaucracy, red tape, and consequent taxpayer cost to the tax system. It would be a gross disservice to taxpayers and the tax administration system to drive “good preparers” out of business to reduce the number of “bad preparers.”

For the same reasons, care needs to be exercised in the requirement of examination to demonstrate competency. A sizable portion of the tax professional community works only with individual returns. This fact isn’t hard to understand when one considers that there are approximately 131 million individual returns prepared annually compared to 6 million corporate returns, 2 million partnership returns and 1 million gift, trust and excise tax returns. What is the sense in requiring all paid preparers to demonstrate competency across the entire spectrum of possible tax returns? It is not reasonable to test specialists in areas that they do not practice.

The purpose of these comments is not to object to the requirement of competency in any way, but rather to speak to the practicalities of the way the industry operates, the need to maintain a stable tax administration system, and the need for taxpayers to have economical access to good professional assistance and advice. Any proposal will need to give the Secretary of the Treasury the flexibility to accommodate an efficient, high quality tax administration system sensitive to the needs of the tax preparation industry and taxpayers as a whole.

We would hope that, as regulation of paid preparers is debated and enhanced, direction would be given the Treasury to keep the licensing process efficient, fair and economical. We would also hope that legislation would provide the Commissioner of the IRS with the resources needed to enforce already existing law enacted to stamp out unethical and unscrupulous behavior within our tax system. We point out that this behavior is also demonstrated by some taxpayers—those prone to “shop” the tax professional community to see who will provide them with the best tax result or highest refund.

Thank you for your time and consideration of my comments. Chairman Ramstad and members of the Subcommittee, I look forward to our dialog and your questions on this issue.

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Chairman RAMSTAD. Thank you, Mr. Gray. The Chair thanks all five of you truly expert witnesses for your testimony today, representing a real cross-section of the practice, to be sure. I am going to be brief so that I can defer to my colleagues, but it seems to me that there is a consensus. In fact there is unanimity among this panel, all five of you favor some form of licensing or registration for tax preparers with certain caveats. Is that a fair statement?

Mr. GIDEON. That is correct, Mr. Chairman.

Chairman RAMSTAD. Mr. Degen?

Mr. DEGEN. Yes, that is correct.

Chairman RAMSTAD. Mr. Cross?

Mr. CROSS. Yes.

Chairman RAMSTAD. Mr. Purcell?

Mr. PURCELL. Yes.

Chairman RAMSTAD. Mr. Gray?

Mr. GRAY. Yes.

Chairman RAMSTAD. Of course, that raises the threshold question as far as Congress' involvement is concerned, as to the proper Federal role in this area. More specifically, whether licensing or registration of Federal income tax return preparers should be a function of the Federal Government or the States, as we are now seeing played out in California and Oregon. Just a one word or one sentence from each of you. Should this be a Federal function or a State function? Mr. Gideon?

Mr. GIDEON. I think a national system is preferable here because these are national returns being filed.

Chairman RAMSTAD. Mr. Degen?

Mr. DEGEN. I would agree. This is a Federal Tax Code. We need Federal regulations and not 50 different sets, because people move constantly. Someone in New York will go to Texas, go to Oregon. They have to have uniform protection.

Chairman RAMSTAD. Mr. Cross?

Mr. CROSS. One of the reasons that we support this is because it is anticipated to be Federal. We have had a lot of regulatory problems because of working with individual State boards.

Chairman RAMSTAD. Thank you. Mr. Purcell?

Mr. PURCELL. Federal.

Chairman RAMSTAD. Mr. Gray?

Mr. GRAY. Federal. I am a CPA. I am licensed by a State board, but my test was a national standards test.

Chairman RAMSTAD. The Chair is not at all surprised by the responses. It certainly makes sense; we are talking about Federal

taxes, the IRS and the Federal Tax Code. Again, thank you for your response to that. Another two quick questions, trying to survey and take advantage of your expertise here today. One, should there be an initial examination? Mr. Gideon?

Mr. GIDEON. As I said in my testimony—

Chairman RAMSTAD. In fact, let me ask both questions in concert so you can respond to both simultaneously. Should there be an initial examination, and should there be a continuing educational requirement for preparers?

Mr. GIDEON. Yes, to both with a caveat for some grandfathering as has been mentioned.

Chairman RAMSTAD. Mr. Degen?

Mr. DEGEN. Yes, to both unequivocally.

Chairman RAMSTAD. Mr. Cross?

Mr. CROSS. Yes to both with the waivers we talked about.

Chairman RAMSTAD. Mr. Purcell?

Mr. PURCELL. Yes to both, but I think we would want to study the grandfather issue also.

Chairman RAMSTAD. Mr. Gray?

Mr. GRAY. Yes to both as far as an initial exam and, again, either grandfathering or phasing in.

Chairman RAMSTAD. Again the Chair thanks all five of you for your responses. You probably are unprecedented as a five-person panel for the brevity of your responses and I am very grateful for that as well. The Chair would at this time recognize my friend, the distinguished Ranking Member from Georgia, Mr. Lewis.

Mr. LEWIS. Thank you very much, Mr. Chairman, and I join you, Mr. Chairman, in thanking Members of this panel for their wonderful and meaningful testimony. You made a lasting contribution to the work of this Committee and we really appreciate it. I will be very brief also, Mr. Chairman. Mr. Cross, your Members will not directly be affected by the proposal to regulate preparers, correct?

Mr. CROSS. Yes, they would.

Mr. LEWIS. They would?

Mr. CROSS. We have a cross-section. We have three different—four different classifications and probably 50 to 55 percent of our Members are currently not regulated under Circular 230 and would be required to become regulated if this were to go into place.

Mr. LEWIS. Let me ask you further, Mr. Cross, is there any organization that represents unenrolled preparers? And if so, what group is that?

Mr. CROSS. Our group represents unenrolled preparers and so does—

Mr. LEWIS. Mr. Gray's group?

Mr. CROSS. Yes.

Mr. LEWIS. Could maybe one of you tell me or tell Members of the Committee how many unregulated preparers there are out there? You have any idea? You do not represent all of them, do you?

Mr. CROSS. No. Our Membership is—

Mr. LEWIS. You would not want to represent some of them, right?

Mr. CROSS. Yes. We represent some of them. Now we represent around 30,000 people, and I would say probably somewhere 15- to 20,000 of those people that we represent through our Membership, direct membership and Membership of our affiliates are in that group of some 200,000 on the downside to 600,000 that Ms. Olson was referring to. So, those people are not represented. They do not want belong to—a lot of those people do not belong to an association of any kind.

Mr. GRAY. There is also a large group out there of unregulated preparers that do not sign returns. So, when you start doing that—

Mr. LEWIS. You say someone will prepare a return for someone and they will not sign it?

Mr. GRAY. Yes, and that is the unknown unknown. So, when you go to address those, that is where you can see—I have seen estimates within the IRS, upward of a million if you take all those too. So, I think what they were referring to earlier, whether it is 2-, 4- or 600,000—they were referring to signatures if I heard their testimony correctly—but that does not include all those people that are underground. There is a whole underground out there and they just buy computer software and it says, by paid preparer and you can transmit it. We have got to realize the world we are in and technology of today. In 3 minutes I can have software running and do somebody's return and it will print at the bottom of it, "self-prepared." So, that is the larger unknown.

Mr. LEWIS. Let me ask you this. Inform me, should there be a condition, law or regulation that if someone prepares your return for you, you should be required to sign it?

Mr. GRAY. Right, and I agree with you because in my statement that was the first thing that I said any legislation—

Mr. LEWIS. You think that should be part of the legislation?

Mr. GRAY. That should be the very first thing is that they would be required to sign that return.

Mr. LEWIS. Thank you very much.

Mr. Purcell, should refund anticipation loans be banned?

Mr. PURCELL. That is not a question that I am competent to answer, representing the Institute. Now as a person—

Mr. LEWIS. I just want you to just speculate, what do you think?

Mr. PURCELL. As an individual who has helped with volunteer income tax clinics and worked with low-income people I find them very difficult to justify. I think they are predatory and potentially unfair methods of financing for low-income people. So, I would seriously look at those as possible ways to be fixed, but AICPA does not have an official position.

Mr. LEWIS. Thank you very much. I appreciate that response. Thank you, Mr. Chairman.

Chairman RAMSTAD. The Chair thanks the Ranking Member for your great leadership and your many contributions to the Subcommittee. The distinguished gentleman from Colorado, Mr. Beauprez.

Mr. BEAUPREZ. Thank you very much, Mr. Chairman. Mr. Gray, to you first of all and then to which other Members of the panel may want to respond. You mentioned just a minute ago tax returns that are prepared now with the assistance of technology.

We all know that. I want to explore for just a second with you, if we go down this path that you are all advocating, are we taking care of the problems in the future, or the problems in the past or both? Your industry is the way that Americans collectively are preparing their tax returns. Is it changing so rapidly with the advent of technology that maybe we are behind the curve?

Mr. GRAY. Actually I would like to divide that into two parts. I think we have to look at the population that is trying to comply and then those that are not going to comply. So, I will excuse the ones that are going to ignore the law no matter how many rules you have. If somebody just robbed a bank and the speed limit is 55 miles an hour—

Mr. BEAUPREZ. Bad choice. I was a banker. Do not say robbed a bank.

Mr. GRAY. Yes, but you are not there any more so that is the past. I listened to your earlier remarks. Anyway, of the other group, I think what happens is is that we have a tendency to get so busy in today's world and we get so dependent on technology that we forget education and we start to get these crutches out there. Last week I was in Houston and surveyed several hundred practitioners, 230 and non-230, and it is amazing how many tax questions they get wrong. It is because, again, we think it is a button on the computers. Now as far as those other returns out there, those self-prepared, that is the people over there that are just trying to get around the system. Those people may continue to try to get around the system. If I can go to a local store and buy software and print it out, then I am going to do that if I am trying to go underground.

Mr. BEAUPREZ. Anyone else?

Mr. CROSS. I think there is a real problem with tax software because you need to identify it. The fact that the software simply prints out and says, self-prepared. It is self-prepared if John Doe went to Office Depot and bought it. However, John Doe could go to Office Depot, buy that software, and prepare somebody else's return and it still says self-prepared.

Mr. GRAY. Right, it is just like the car dealership ad you played earlier. You go down there; that is an ERO. Well, somebody had to put the information in the computer, and I would imagine you go down there they are going to say, we do not prepare returns here. Somebody had to get it off the paper into the computer for the ERO to transmit. Those are the real world issues that you are dealing with.

Mr. CROSS. So, identifying that software is part of—and controlling that, is going to be part of the solution.

Mr. BEAUPREZ. Thank you. Mr. Degen?

Mr. DEGEN. Just to go back to your original question, I do not believe the technology, the increase is going to change the problem. The problem is, the conduct of tax preparers, whether they be fraudulent or incompetent or whatever. What the technology does is enable people to do it easier without having paper and pencil. If a person doesn't know, for example, that a taxpayer took a distribution from a plan and rolled it over and they do not know how to put it in, the program is going to produce—

Mr. BEAUPREZ. The input side.

Mr. DEGEN. Exactly. I just want to make one other comment to Congressman Lewis. Sir, in the Internal Revenue Code right now is a requirement that paid preparers are to sign tax returns. The penalty, I believe, is \$50 or something very, very low and not very meaningful. So, I just wanted to point that out.

Mr. BEAUPREZ. Let me ask the five of you, if I might, another question. Having been on the business side, which I already disclosed, I find it interesting—I certainly—you make a compelling case, I will give you all that, but I find it interesting that an industry is coming to the Federal government saying regulate us. The old cliché, “Be careful what you ask for or just just might get it,” comes to mind. What is the downside, gentlemen? Why don’t you just run down very quickly and answer the question of, if we go this route what is the potential downside, too much bureaucracy? I have heard that, or a new bureaucracy. What else might concern you if we go down this path? What should we avoid?

Mr. GIDEON. I think that if the program is carefully administered and targeted at individual return preparation, as has been said, I do not think there is much potential for much going wrong. I think that if the program tried to expand beyond that compass then I think you get into areas of worrying about overregulation, making people qualify, get knowledge that they really do not need to be individual return preparers and the like. I think if, as I think the kind of shared view of what this program would be, if it stays in that compass, it ought to be fairly simple to do and it ought to raise the standard of individual return preparers.

Mr. DEGEN. The only downside I see, conceptually I think this is perfect. We may disagree on some of the words, but the concept of protecting two—there are two things here. We want to protect the taxpayer, but we also want to protect the system, and I think that is what this whole concept is about. I do think that the only downside is the lack of funding. IRS would need money on two ends. Number one, to promote the legislation, promote it correctly. One of the big problems, and I am sure others on the panel have the same problem is, in this credentialing we see people that have billboards, huge billboards that say, I will prepare your taxes; I am an ERO. Then they have that huge blowup of the ERO symbol, that little blue logo that the IRS has. That is a problem. We cannot have that. So, IRS has to have the money to promote the credentials of whatever you decide.

The second thing is, the Congress has to give IRS the money to enforce this. I was listening before to poor Ms. Jardini. Her hands are tied by funding. They only have a certain amount of people. There needs to be more funding both on the promotion side and on the enforcement side.

Mr. BEAUPREZ. My red light is already on but if you have got a—with the indulgence of the Chair, if you have got a quick comment on that point.

Mr. CROSS. I have one comment and that is that we have to be certain that we do not create a roadblock to new people coming into the profession. We have to be able to get them in minimally and welcome them so that—and then build their competency afterward.

Mr. GRAY. I agree with that. Testing is a minimum threshold. It is not where you should be performing at. I think the other thing



that this could do is, in your low-income areas you may have less availability because, what about if I am a volunteer? Can I volunteer or do I come under this also? Just be aware, if you start making exceptions to anybody preparing—in that case they are not receiving for a fee—there can be just as much confusion on putting the stuff on the right line on the right return if they have not met that threshold.

Mr. BEAUPREZ. Mr. Purcell?

Mr. PURCELL. The only downside I would see in addition to what I have heard is that this would create, I think, an unfortunate reinforcement in the public's mind that our tax system is so darn complex that we have to regulate a bunch of people so they can get their individual tax return prepared, even though it contains just very few issues that are on the return, because we have made something like the EIC so complex that they cannot do it themselves.

Mr. BEAUPREZ. I thank the panel and I thank the Chair.

Chairman RAMSTAD. Thank you, Mr. Beauprez. You mean our tax system is not complex?

Mr. PURCELL. It is too complex.

Chairman RAMSTAD. The Chair certainly agrees. I am sure every Member of this Subcommittee agrees. Well, let me again thank all five of you expert witnesses. Thank you for your very important testimony on this very important issue. We certainly appreciate you taking time from your busy schedules to help enlighten us and to contribute to the discourse here. Thank you very much. Since there is no further business before the Subcommittee, this hearing is adjourned.

[Whereupon, at 4:48 p.m., the hearing adjourned.]

[Submissions for the record follow:]

Fairfax, Virginia 22931  
July 19, 2005

Mr. Chairman and other Members of the Subcommittee on Oversight

Alvin Brown and Associates is a tax law firm specializing in IRS issues and problems. I had a 25 year career in the Office of the IRS Chief Counsel. In my current tax practice I have tax return preparer clients ("Preparers") who have been or are presently being examined by the IRS. Some of my Preparer clients are under IRS criminal investigation. I have some first-hand insight into the problems of the Preparers, the reasons for the examination, and how the IRS conducts their investigations and brings fraud charges in most of the situations.

The most important fact that I can give this Committee from my personal experience is that the Preparer technical knowledge of the tax law and procedures is grossly inadequate. There are no statutory, educational, or experience requirements for any person to qualify as a "Tax Return Preparer." Some Preparers barely know the English language and their English communication skills are poor; some do not have technical skills to work with software. These Preparers are not attorneys, accountants or enrolled agents. It is my personal opinion that the problems that Preparers get into with the IRS are caused by their lack of training and lack of knowledge which correspondingly results in the negligent preparation of U.S. tax returns. Preparers are not required to be licensed by the IRS. Any person who is not a minor can become a tax return preparer without any qualifications to engage in the business of tax return preparation, including incarcerated felons. There is no requirement for any tax return preparer to even warn a customer of their lack of knowledge or training. It follows that excessive error will occur in the preparation of tax returns by unqualified and inexperienced Preparers. As one might expect, incompetent, inexperienced and untrained Preparers have been the cause of negligently filed tax returns thereby causing a significant negative impact on tax revenue.

It is my opinion that basic educational/experience requirements will eliminate a

large amount of tax return preparer negligence. There are standards for Enrolled Agents (those who qualify to represent taxpayers before the IRS). It makes sense to provide qualifying standards for those who wish to become professional tax return preparers.

I also believe that the Internal Revenue Service should be charged with the responsibility of formulating a licensing requirement in order to permit individuals to practice as professional Tax Return Preparers.

My personal experience in representing return Preparer clients is that their errors arise from **negligence**—not from fraud. The IRS, appropriately, is aggressive in investigating tax return preparers. I respect that effort and encourage that effort. But there is a very obvious difference between “negligence” and “fraud”—and is very easy for the IRS to spin negligence into fraud. In any investigation of a tax return preparer, the IRS will always ask the preparer’s customer whether the errors on their tax return were caused by their (customer) input or the input of the tax return preparer. This question and those like it are quite intimidating to the customer. If the customer says: “Yes, that is my number or data,” that person (in his own mind) is likely to think that he will be charged with “fraud” by the IRS Agent for providing erroneous data to the tax return preparer, for not having proper documentation, or because they think they might be audited. On the other hand, if the customer says that the number or data was provided by the Preparer, then the customer is not at risk. The Preparer will likely be charged with fraud by the IRS if there are multiple customers who are similarly intimidated by an IRS investigation who state that the data was sourced from the Preparer. It is my personal opinion that most of the tax return preparer investigations involve elements of IRS **intimidation** of the customers of the Preparer. Therefore, I believe that the IRS should not be able to bring a fraud charge against a tax return preparer if the charge is based solely upon the testimony of customers who are concerned about **self-incrimination**, the basis of their perceived “intimidation.” The problem of IRS “intimidation” to customers who are not under investigation is very substantial. That intimidation results in the conversion of acts of negligence into tax fraud cases in many instances. The Preparer is at a disadvantage if the data received from the customer to the Preparer is communicated orally, because the source of the data used in the tax return cannot be traced.

In summary, I have the following observations and recommendations:

- A great deal of the distortions in tax determined by Preparers arises from negligence and lack of tax technical training and experience. The IRS can easily remedy the problem by licensing tax return preparers. In that licensing requirement, the IRS can create the necessary standards and qualifications for licensing. The cost of that effort and the monitoring of that effort can be covered by licensing fees. Since the IRS provides testing for Enrolled Agents, they can easily formulate appropriate educational/experience requirements for tax return preparers. A licensing requirement will bring with it professional standards and accountability. **The reduction of negligence of return preparers will also reduce the amount of tax revenue lost by negligence.**
- Fraud charges against tax return preparers should not be supported if based *solely upon* testimony from customers. The customer appears to have a conflict of interest when confronted by an IRS Examiner because they have in their own minds great concern about their own self-incrimination risk during the IRS interview—particularly in fraud cases. I have seen criminal charges brought with just five witnesses with significant conflict of interest pressures on the customers (e.g., fraud, loss of employment if a fraud charge is brought, and fear of audit). Although customer testimony is probative, that testimony should not be treated as conclusive evidence of fraud.
- In order to reduce the IRS “intimidation” factor by the IRS to customers of tax return preparers, it would be helpful to be able to identify the source of the data used in the tax returns at the time the tax returns are filed. This can be done with a few questions in the tax returns to establish if all of the deductions, exemptions and credits be documented. If there are any estimated numbers, a question can be asked about who provided the estimates. Attachments can be required by the IRS for explanations of undocumented data or estimates. Since the key question asked by an IRS Examiner to a Preparer customer is whether the data was provided by the preparer (to document a fraud issue), that issue

can be eliminated by having that data specified in the customer's income tax return.

Respectfully submitted,

Alvin S. Brown, Esq.  
Tax Attorney

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### Statement of Bill Parrish, Kansas City, Missouri

Congressman Ramstad, thank you to you and your committee for providing the opportunity to submit comments regarding the proposed regulation of tax professionals as contemplated under S B 832.

I am Bill Parrish, the founder and CEO of (oneplusone)<sup>3</sup>, an affiliation of tax and accounting professionals serving taxpayers and small businesses in 17 states. Collectively, we serve over 69,000 individual taxpayers and 12,000 small business clients as we aid them in their accounting and tax compliance needs. I am a Past President of the Accreditation Council for Accountancy and Taxation (ACAT), an independent credentialing organization offering accounting and tax credentials based upon demonstration of successfully mastering the 3 "e's", education, examination, and experience. I am also a Past President of the Coalition for Affordable Accounting, an organization representing some 124,000 accounting and tax professionals. I have been a speaker at the Internal Revenue Service's Tax Forums and a guest on the Internal Revenue Service's Tax Talk Today.

As cited in your announcement of this committee hearing, "According to the U.S. Government Accountability Office, more than 70 million of the 131 million tax returns filed last year were prepared by a tax professional." This truly demonstrates the impact tax return preparers have on the compliance system within the U.S. tax system. Your announcement continues to refer to 3 recent examples of tax preparer malfeasance and alludes to 343 active investigations of tax professionals. We are told that the IRS cannot tell us with certainty how many paid tax return preparers there are in the U.S. today. The ranges of numbers we hear are from 300,000 to 600,000 and just recently, we heard that there were 1.2 million preparers who signed a tax return as the preparer last year. No matter which number you rely upon, it is a huge number.

The thrust of recent activity has been to curtail the abusive tax shelter industry, and appropriately so. Taxpayers have been bilked out of millions of dollars, the proper tax amounts have not been paid by the innocent purchasers of such tax schemes, and the rest of the honest taxpayers have to make up the difference. Such practices need to be stopped and now. However, if we compare the 343 cases to 1.2 million preparers, or 600,000 or even 300,000 paid preparers, it appears we are hunting ants with a canon. Legislation, as it is being proposed, is aimed at the entire profession, not just the abusive section within the community. The related costs of implementation and monitoring will be disproportionate to the segment at which regulation needs to be aimed.

Everyone agrees that regulation is appropriate for this industry, but let's look at some of the impacts of the current proposals.

Is such regulation going to identify all paid preparers? I submit that it will not. Currently, there is an "underground community" of paid tax preparers. They show up in January, usually in neighborhoods where many residents may be uninformed immigrants or with low levels of education. The preparers set up shop and prepare thousands of returns, often not signing the returns they prepare. Their work is at best less than acceptable and is often bogus, creating huge refunds which are fraudulent. At the end of the tax season, the underground office is closed and the operators have disappeared leaving the taxpayer to deal with the authorities on their own. Next year, the same underground practitioners set up shop in yet another neighborhood and continue their ruse. This regulation, while imposing a heavier penalty on preparers who do not sign the returns they have prepared, does nothing to step up the efforts to put these unscrupulous preparers out of business permanently. Instead, some portions of this proposal may drive some marginal preparers underground, therefore adding to the problem. **Consideration needs to be given to attacking the different parts of the problem of tax preparer regulation rather than a broad brush stroke intended to fix everything at once.**

Is the proposed implementation timeframe long enough to allow Treasury and the IRS to work jointly on developing a sufficient solution? I submit that the timeframe is not sufficient. Currently the IRS administers the examination and compliance monitoring for the Enrolled Agents Status. This special enrollment empowers des-

ignated practitioners to “represent” taxpayers before the IRS. The process begins with a uniform exam, administered once a year. Currently, we are advised the IRS is seeking to outsource this examination to provide for more efficiency. Under this proposal, the IRS will be further burdened with developing an exam to be used for registration of tax preparers. The contemplation appears to be “an” exam which therefore would not be specific to the type of return(s) being prepared. It could become a “cookie cutter” approach. If the examination bar is set too low, it will not differentiate between those who are poor, adequate, or superior. In fact, such an approach would only result in a registration process but the public might believe their preparer, no matter what level of knowledge they possess, are “up to par” since they passed the exam and are enrolled. If the desired result is simply a registration, then the exam is superfluous. Conversely, if the examination pass bar is set too high, many existing practitioners who are quite capable of providing a quality service at the level which their clients require would not pass such an exam. It is conceivable that if the exam pass bar were set too high, there would not be enough enrolled tax preparers to serve the U.S. taxpayers in the first year. Such a process should also recognize that not all tax preparers are good test takers. Such recognition must be a part of a well balanced system. **Time needs to be given Treasury and the Service to adequately prepare and finally implement an examination process which matches the types of returns being prepared.** A preparer who only prepares 1040 EZ or 1040 A returns should not be required to pass an exam based upon the knowledge necessary to complete a Corporate Income Tax Return, form 1120. **A phase in over a 5 year period would allow ample time for such design and testing.**

Have the anticipated administrative burden and related costs been fully examined? I am confident the Treasury and the IRS have put their collective pencil to this, and am equally confident the burden and costs are both excessive and overwhelming. If such a registration process is enacted with the stroke of a presidential pen on a bill passed by both houses, almost immediately the IRS will be faced with a massive education process to locate all paid preparers and educate them on the new requirements for registration. Those preparers who are most accessible are those who are regularly attending continuing education events and conferences therefore already sharpening their preparation skills. It is the other segment of this profession, those who are not updating their skills regularly, that most need this contact yet will most likely fall through the cracks the first year. The service would be faced with not only developing an exam in a hurry, but locating testing sites across the country if not around the world, and finally giving such an exam. Then comes grading and notifying the participants of the results; the creation of an adequate database of the enrolled preparers needs to be developed and tested; an ongoing process of notification of renewal processes and requirements would need to be implemented. Such regulation, as proposed, demands almost immediate implementation of a very complex system. Can we really expect such a process to not be expensive and almost impractical? **Study needs to be given to an act that contemplates implementation at affordable costs and with the least strain upon existing resources both for the government and the tax professional community. Ultimately, all of these costs will be passed on to the U.S. taxpayers.**

Has an adequate level of thought been given to the classes of practitioners who may be exempted from registration? While other designations may be appropriate for exclusion on their face, careful study needs to be given to the criteria for maintenance of other credentials. As an example, several state boards of accountancy have now adopted a non-active status for Certified Public Accountants. Such a status may be available for someone who has met all of the requirements to be granted the designation, CPA, some are not required to maintain the current requirements for renewal because they are not in public practice. As contemplated under this act, all of those who have qualified and hold a current certificate or license will be exempt from registration. **Other highly qualified practitioners, such as those who have earned designations from credentialing organizations such as the Accreditation Council for Accountancy and Taxation are, however, required to register and pass an exam. Through such processes as ACAT imposes, the practitioner has demonstrated minimum levels of education, have demonstrated their knowledge through the passing of a rigorous exam on tax and ethics, and have demonstrated a minimum of 3 years experience in public practice. It appears redundant to again subject practitioners to such additional requirements.**

Many taxpayer advocacy groups and individuals are calling for the immediate regulation of the tax preparation profession, an idea that is perhaps long overdue. It is my hope that an approach can be developed that is well thought out and is both

practical and affordable. I propose that we not throw out the baby with the wash, but instead, bring forth positive legislation that will cause positive impact upon the system as a whole, a system that will offer greater security to the taxpayer community, greater pride to the tax preparer profession, and greater faith in the system on the part of government. We are in this partnership and we all need to be working towards commonly supported goals.

I appreciate the opportunity to provide my thoughts and suggestions on this subject and would be delighted to provide further thoughts, should the opportunity arise.

(oneplusone)<sup>3</sup> is a national cooperative alliance of independent tax and accounting practitioners who provide services to the general public in 17 states. (oneplusone)<sup>3</sup> provides educational services to the independent practitioners as well as practice management information, access to products and services at discounted prices, and provides a venue for dialogue amongst the member practitioners. A condition of membership is the strict adherence to a professional code of ethics and a commitment to ongoing professional education.

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#### Statement of Joshua N. Pritikin, Santa Barbara, California

Tax fraud is indeed a vexing problem. Instead of more vigilant enforcement, I believe a better solution is to adopt the FairTax.org proposal. The FairTax (HR 25) would replace all income taxes with a progressive national retail sales tax. A NRST would be easier to enforce compared to an income tax because there are fewer points of collection. There are only about 20 million retail businesses as compared with approximate 150 million individuals. Assuming the same amount of money for tax enforcement efforts, almost ten times as much money would be available per filer. The simplicity of tax collection compared to other tax proposals is a major advantage FairTax HR 25.

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July 20, 2005

Dear Subcommittee on Oversight, Committee on Ways and Means,

As you examine fraud in income tax return preparation and federal regulation of tax preparers, we refer you to our co-authored academic paper entitled "**An Education and Enforcement Approach to Dealing with Unscrupulous Tax Preparers**" that was published in *The American Taxation Association (ATA) Journal of Legal Tax Research*, Volume 2, June 11, 2004. You can access the paper at <http://aaahq.org/ic/index.htm>. We provide an abstract of the paper below which states our support of education and enforcement rather than regulation to curb these abuses.

**ABSTRACT: ("An Education and Enforcement Approach to Dealing with Unscrupulous Tax Preparers,"** *The ATA Journal of Legal Tax Research*, Volume 2, 2004, June 11, 2004, by C. Bauman and K. Mantzke)

In both her 2002 and 2003 Annual Reports to Congress, the National Taxpayer Advocate (NTA) proposed national registration, examination, certification, and enforcement requirements for all Federal Tax Return Preparers (FTRPs). An FTRP is defined as someone, other than an attorney, CPA, or enrolled agent, who prepares more than five federal tax returns in a calendar year. This proposal was primarily motivated by the NTA's experience in dealing with taxpayers who were exploited by unscrupulous tax preparers, especially with respect to the earned income credit (EIC). Although the IRS believes that all taxpayers should have access to quality tax return preparation, it contends that it is premature to consider a legislative remedy to tax preparer problems since the full extent of the problem is unknown and the related financial impact on limited IRS resources has not been quantified.

The purpose of this paper is to examine the proposed regulation of FTRPs by reviewing the development of similar regulatory proposals over the past several decades, outlining current and proposed federal regulation of tax preparers, discussing state regulation of tax preparers, describing concerns with increased regulation, and

offering alternative recommendations to regulation, specifically education and enforcement.

Respectfully submitted,

Christine C. Bauman  
Associate Tax Professor  
University of Northern Iowa

Katrina L. Mantzke  
Assistant Tax Professor  
University of Northern Illinois

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**Statement of Chi Chi Wu, National Consumer Law Center, Boston,  
Massachusetts**

**“Fraud in Income Tax Return Preparation”**

We are pleased to submit for the Subcommittee’s consideration a recent report issued by the National Consumer Law Center entitled “Corporate Welfare for the RAL Industry: The Debt Indicator, IRS Subsidy, and Tax Fraud.” In addition to a number of other issues, this report examines the role of refund anticipation loans (RALs) and the IRS-supplied debt indicator in potentially boosting tax fraud, including fraud perpetrated by tax preparers.

The IRS and Treasury terminated the debt indicator in 1994 due to fraud in electronically filed returns, but then reinstated it in 1999. According to one IRS official, currently 80% of fraudulent electronically filed returns are tied to a RAL or other refund financial product.<sup>1</sup> Since the IRS reinstated the debt indicator in 1999, fraud appears to have increased. E-file fraud had increased several-fold since 1999—approximately 1 in every 1,200 e-filed returns is phony, compared with a rate of about 1 in every 5,000 four years ago. The Treasury Department’s Financial Crimes Enforcement Network (FinCEN) has raised similar concerns about the role of RALs in promoting tax fraud. FinCEN issued a warning to banks in August 2004, noting that RAL fraud had multiplied between 2000 and 2003.<sup>2</sup>

Thus, we believe one way to reduce tax fraud by preparers is to reduce the number of RALs and to once again eliminate the debt indicator. Thank you for your consideration

**CORPORATE WELFARE FOR THE RAL INDUSTRY:  
THE DEBT INDICATOR, IRS SUBSIDY, AND TAX FRAUD**

**Executive Summary**

- The debt indicator is an acknowledgement from the IRS telling tax preparers whether a taxpayer’s refund will be paid versus intercepted for government debts. The debt indicator has proven to be a substantial benefit to the refund anticipation loan (RAL) industry, as it about doubles the number of RALs made by the industry.
- The debt indicator has helped boost RAL profitability. The IRS terminated the debt indicator in 1994 due to RAL fraud, and the price of RALs rose significantly, from \$29–\$35 to \$29–\$89. The IRS reinstated the debt indicator in 1999 partly to lower RAL prices. RAL prices dipped for a year in 2000, but have gone back up to pre-indicator levels. Meanwhile, the amount of RAL fraud has multiplied since the debt indicator was reinstated.
- The debt indicator raises significant privacy issues. It is unclear whether taxpayers realize they are allowing the IRS to provide sensitive personal information to tax preparers about debts owed to the federal government, such as child support and student loan debts.

*A. History of the Debt Indicator*

<sup>1</sup> Allen Kenney, *IRS Official Shines Spotlight on E-Filing Fraud*, 2004 Tax Notes Today 130–4, July 6, 2004.

<sup>2</sup> FinCEN, SAR Activity Review, Issue 7, August 2004, at 15, available at [www.fincen.gov/sarreviewissue7.pdf](http://www.fincen.gov/sarreviewissue7.pdf).

The debt indicator is a service provided by the Internal Revenue Service that screens electronically filed tax returns for any claims against a taxpayer's refund.<sup>3</sup> The debt indicator informs the preparer whether a taxpayer's full refund amount will be paid and not offset by other obligations collectible by the federal government, such as prior tax debt, child support arrears, or delinquent student loan debt.<sup>4</sup>

When the IRS first provided the debt indicator in the early 1990s, it was called the "direct deposit indicator." In 1994, the IRS terminated the debt indicator due to concerns over massive fraud in e-filed returns that involved refund anticipation loans (RALs).<sup>5</sup> The elimination of the debt indicator elicited "screams of rage" by the RAL industry.<sup>6</sup> In addition to cutting into their profits, the RAL industry claimed there would be multitudes of disappointed clients who could not get their RALs.<sup>7</sup> Two of the four major RAL lenders, Mellon Bank and Greenwood Trust, stopped making RALs and left the market.<sup>8</sup>

Over the next few years, the RAL industry pressed for reinstatement of the debt indicator.<sup>9</sup> Then, in 1998, Congress imposed a goal on the IRS to have 80% of returns electronically filed.<sup>10</sup> Not coincidentally, a year later, the IRS announced it was re-instating the Debt Indicator.<sup>11</sup> However, note that the Congressional 80% e-file goal is not mandatory, but merely exhortatory, in that the statutory language actually states "it *should be the goal* of the Internal Revenue Service to have at least 80 percent of all such returns filed electronically by the year 2007; . . ." <sup>12</sup>

The first year of the reinstatement of the debt indicator was a pilot.<sup>13</sup> Subsequently, the IRS decided to make the debt indicator permanent and provide it for all e-filed returns, not just returns associated with a RAL application.<sup>14</sup>

#### B. The Debt Indicator Increases RAL Volume

The debt indicator has had a dramatic effect on the volume of RALs and electronically filed returns. In 1994, prior to the elimination of the debt indicator, the number of RALs had risen to 9.5 million.<sup>15</sup> After the termination of the debt indicator, RAL volume dropped and by 1999, the numbers of RALs had fallen to 6 million.<sup>16</sup> When the debt indicator was reinstated effective the 2000 tax season, the number

<sup>3</sup> IRS, Publication 1345, at 32. See also George Guttman, *IRS Reinstates Debt Indicator to Increase Electronic Filings*, 85 Tax Notes 1125, Nov. 29, 1999 [hereinafter "Guttman, *IRS Reinstates Debt Indicator*"].

<sup>4</sup> *Id.*

<sup>5</sup> Ryan Donmoyer, *IRS Takes Aim at RAL Fraud, Hits Preparer Profits*, 66 Tax Notes 1750, February 20, 1995 [hereinafter "Donmoyer, *IRS Takes Aim at RAL Fraud*"]. See also Malcolm Sparrow, *Fraud in the Electronic Filing Program: A Vulnerability Assessment Prepared for the Internal Revenue Service*, September 1, 1994.

<sup>6</sup> See Robert Scott, *E-Filing Vendors Outraged Over Death of DDI*, Accounting Today, November 21, 1994, at 2. See also Timothy J. Mullaney, *IRS Fraud Watch Cuts Refund Loans*, Baltimore Sun, March 12, 1995, at 1D ("The refund loan industry paints the story as a tale of Big Government beating up on the entrepreneurs who made the loans a multi-billion industry between 1990 and last year.").

<sup>7</sup> Susan Edelman, *There's Trouble in Rapid City*, New Jersey Record, February 19, 1995 at b1.

<sup>8</sup> Donmoyer, *IRS Takes Aim at RAL Fraud*, 66 Tax Notes at 1088.

<sup>9</sup> See Council For Electronic Communication Advancement, *Testimony before the Subcommittee on Oversight—House Ways and Means Committee*, March 23, 1995 (statement of industry group advocating for revival of the debt indicator); Stuart Kahan, *Blackout on Electronic Filing*, Practical Accountant, September 1, 1995, at 50.

<sup>10</sup> Pub. L. 105-206, 112 Stat. 723, § 2001(a)(2) (1998).

<sup>11</sup> Internal Revenue Service, Announcement of Opportunity to Obtain a Debt Indicator in a Pilot Program for Tax Year 1999 Form 1040 IRS E-file and On-Line Returns, 64 Fed. Reg. 67,621 (December 2, 1999).

<sup>12</sup> Pub. L. 105-206, 112 Stat. 723, § 2001(a)(2) (1998) (emphasis added).

<sup>13</sup> Internal Revenue Service, Announcement of Opportunity to Obtain a Debt Indicator in a Pilot Program for Tax Year 1999 Form 1040 IRS E-file and On-Line Returns, 64 Fed. Reg. 67,621 (December 2, 1999).

<sup>14</sup> Internal Revenue Service, *Publication 1345A—Filing Season Supplement for Authorized IRS e-file Providers* (Rev. January 2002).

<sup>15</sup> Donmoyer, *IRS Takes Aim at RAL Fraud*, 66 Tax Notes at 1088.

<sup>16</sup> Guttman, *IRS Reinstates Debt Indicator*, 85 Tax Notes at 1125. We were unable to find industry RAL volume data from 1995-1998.

of RALs rose sharply to 10.8 million.<sup>17</sup> The number of RALs continued to increase to 12.1 million in 2001 and 12.7 million in 2002.<sup>18</sup>

Data from individual companies in the RAL industry showed similar trends. In 1994, the nation's largest commercial preparation chain, H&R Block, processed 5.5 million RAL applications.<sup>19</sup> After the debt indicator was eliminated, that number dropped to less than half, 2.35 million in 1995.<sup>20</sup> By 1999, that number was at 2.8 million.<sup>21</sup> When the debt indicator was reinstated, RAL volume rose to 4.8 million for Block.<sup>22</sup>

Year	Overall # of RALs	H&R Block # of RAL applications <sup>23</sup>
1994	9.5 million	5.5 million
1995	NA	2.3 million
1996	—	2.4 million
1997	—	2.6 million
1998	—	2.4 million
1999	6 million	2.8 million
2000	10.8 million	4.8 million
2001	12.1 million	4.5 million
2002	12.7 million	5.2 million

<sup>23</sup> Based on H&R Block Form 10-Ks for respective fiscal years.

Other industry player reported similar trends. In 1994, all but 10,630 of the returns prepared by Jackson Hewitt were associated with RALs.<sup>24</sup> After the debt indicator was dropped, the number of returns without RALs at Jackson Hewitt rose to 138,000 by late February 1995.<sup>25</sup> RAL lender Santa Barbara Bank & Trust reported a sharp increase in loans versus non-loan refund anticipation checks following reinstatement of the debt indicator.<sup>26</sup>

The debt indicator also had similar effects on the volume of electronically-filed returns in general. The IRS reported there were 14 million e-filed returns in 1994, but only 12 million in 1995.<sup>27</sup> H&R Block reported that its e-filed returns declined

<sup>17</sup> The IRS reported that there were 12 million requests for the Debt Indicator in 2000. (Statistic provided by the Internal Revenue Service, on file with the author). We assume that each of these requests for the Debt Indicator was for purposes of a RAL application. Since 90% of RAL applications result in an approved loan (see note 37 below), this means there were about 10.8 million RALs in 2000. Note that even when a RAL application is denied, the consumer is usually flipped into a refund anticipation check, which is the non-loan tax financial product offered by RAL banks, and still must pay a fee. See also Chi Chi Wu, Jean Ann Fox, and Elizabeth Renuart, *Tax Preparers Peddle High Priced Tax Refund Loans: Millions Skimmed from the Working Poor and the U. S. Treasury*, National Consumer Law Center and Consumer Federation of America, January 31, 2002, [hereinafter "NCLC/CFA 2002 RAL Report"], available at [www.consumerlaw.org/initiatives/refund-anticipation](http://www.consumerlaw.org/initiatives/refund-anticipation).

<sup>18</sup> Based on 13.4 million RAL applications in 2001 and 14.1 million RAL applications in 2002. Chi Chi Wu and Jean Ann Fox, *The High Cost of Quick Tax Money: Tax Preparation, 'Instant Refund' Loans, and Check Cashing Fees Target the Working Poor*, National Consumer Law Center and Consumer Federation of America, January 2003, at 3 [hereinafter referred to as "NCLC/CFA 2003 RAL Report."]; Chi Chi Wu and Jean Ann Fox, *All Drain, No Gain: Refund Anticipation Loans Continue to Sap the Hard-Earned Tax Dollars of Low-Income Americans*, January 2004, at 4 [hereinafter referred to as "NCLC/CFA 2004 RAL Report."].

<sup>19</sup> Gene Meyer, *H&R Block Joins Program That May Trim Cost of Fastest Refunds*, Kansas City Star, November 17, 1999.

<sup>20</sup> H&R Block Inc., *1995 Form 10-K: Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934*.

<sup>21</sup> H&R Block Inc., *1999 Form 10-K: Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934*, at 5-6.

<sup>22</sup> H&R Block Inc., *2000 Form 10-K: Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934*, at 4.

<sup>24</sup> James Denn, *IRS's Hunt for Tax Cheats to Delay Refund Checks*, Albany Times Union, February 19, 1995, at A1.

<sup>25</sup> *Id.*

<sup>26</sup> Pacific Capital Bancorp, *2000 Form 10-K: Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934*, at 23. [hereinafter "PCB 2000 Form 10-K"]

<sup>27</sup> Stuart Kahan, *Blackout on Electronic Filing*, Practical Accountant, September 1, 1995, at 50. See also NACTP *Steps Up Communication Efforts*, Accounting Today, August 21, 1995, at S22.



22% in 1995.<sup>28</sup> This decrease reflects the close link between e-filed returns and RALs that existed in the mid-1990s.<sup>29</sup>

When the IRS reinstated the debt indicator, it publicly acknowledged that it expected the program to produce 2 million more e-filed returns than if it were not reinstated.<sup>30</sup> With the close link between e-filing and RALs, the IRS surely must have been aware that there would be a corresponding increase in the number of RALs. Indeed, RAL issuers predicted that the reinstatement of the debt indicator would increase RAL demand by 50%.<sup>31</sup> These predictions proved correct, as Block alone nearly doubled its RAL volume and made 2 million more loans (and thus e-filed returns) in 2000. Thus, much of the expected increase in e-filed returns was actually an increase in the number of RALs.

#### C. *The Debt Indicator and RAL Approval Rates: The IRS Security Blanket*

The debt indicator promotes RALs by assuring lenders that the taxpayer's refund will be issued and thus the loan will be repaid. For the pre-1995 debt indicator, if the indicator came back showing there was no federal offset, there was an over 99% chance the IRS would issue the refund.<sup>32</sup> At that time, the approval rate for RALs was 92%—and all but 0.5% of loan denials were turned down based on the debt indicator.<sup>33</sup> As one IRS employee stated, the debt indicator was a “federally supplied security blanket” and “we were doing their credit check for them.”<sup>34</sup>

The elimination of the debt indicator in 1995 significantly lowered RAL approval rates. The approval rate for Beneficial (which became Household) dropped from 92% to 78%.<sup>35</sup> This 78% rate includes partial approvals; the approval rate for a RAL of the taxpayer's full refund was only 40–50%.<sup>36</sup> Banc One's approval rate for RALs also dropped by 25–30%.<sup>37</sup> Even with the decrease in approval rates, Beneficial ended up with significant losses on RALs in 1995.<sup>38</sup>

With the reinstatement of the debt indicator, RAL approval rates appear to be back around 90%.<sup>39</sup> Thus, the debt indicator helps increase RAL approval rates and RAL profits. Of course, this service is not without its cost. One question is how much does it cost IRS to provide the debt indicator? While we do not have definitive information, note that in 1994, the IRS suggested imposing a fee for the debt indicator of \$8 per return.<sup>40</sup>

#### D. *Reinstatement of the Debt Indicator Has Not Lowered RAL Fees*

The existence of the debt indicator has had an impact on RAL fees as well, although in the end it appears to be more of a profitability boost for RAL lenders. Prior to the elimination of the debt indicator, the loan fee for RALs was approxi-

<sup>28</sup> H&R Block Inc., *1995 Form 10-K: Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934*. See also Timothy J. Mullaney, *IRS Fraud Watch Cuts Refund Loans*, Baltimore Sun, March 12, 1995, at 1D.

<sup>29</sup> See NCLC/CFA 2002 RAL Report at 19–20.

<sup>30</sup> Guttman, *IRS Reinstates Debt Indicator*, 85 Tax Notes at 1127.

<sup>31</sup> *Id.*

<sup>32</sup> Guttman, *IRS Reinstates Debt Indicator*, 85 Tax Notes at 1125.

<sup>33</sup> *Id.*

<sup>34</sup> Timothy J. Mullaney, *IRS Fraud Watch Cuts Refund Loans*, Baltimore Sun, Marh 12, 1995, at 1D (quoting an IRS spokesperson in Baltimore).

<sup>35</sup> James R. Kraus, *Beneficial's Tax-Refund Lending Program Seen on Course After Pullout from Earned-Income Side*, American Banker March 8, 1995.

<sup>36</sup> Susan Edelman, *There's Trouble in Rapid City*, New Jersey Record, February 19, 1995 at b1.

<sup>37</sup> *Id.*

<sup>38</sup> Daniel Dunaief, *Deals: Mellon Leads \$1.25B Loan to Underpin H&R Block's Tax-Refund Loan Program*, American Banker, November 7, 1996, at 20. However, much of the defaults were recovered, probably through the rather heavy-handed tactic of cross-lender debt collection. See NCLC/CFA 2002 RAL Report at 24. Beneficial alone expected to collect \$180 million in bad loans in 1997. Daniel Dunaief, *Deals: Mellon Leads \$1.25B Loan to Underpin H&R Block's Tax-Refund Loan Program*, American Banker, November 7, 1996, at 20.

<sup>39</sup> Household International, *Exploring the Refund Anticipation Loan (RAL): Questions and Answers*, on file with the authors. This 90% approval rate is reflected in H&R Block's SEC filings as well. In 2003, H&R Block stopped reporting in its 10-K the number of RAL applications it processed, and started reporting the number of RALs that were actually made. Block processed 5.15 million RAL applications in 2002. H&R Block, 2002 Form 10-K, at 4. Of those, 4.67 million loans were approved. H&R Block, 2003 Form 10-K, at 5. The latter number divided by the former is 91%.

<sup>40</sup> Robert W. Scott, *IRS Mulls New RAL Charge; Banks Likely to Pass It On*, Accounting Today, July 11, 1994. It is unclear whether the \$8 represented the cost of the debt indicator or was a revenue enhancer for the IRS.

mately \$29 to \$35.<sup>41</sup> The largest RAL lender, Beneficial, charged a flat fee of \$29 per RAL.<sup>42</sup> Bank One charged a flat fee of \$31,<sup>43</sup> while the lender for Jackson Hewitt charged \$29 to \$35.<sup>44</sup>

After the debt indicator was eliminated, RAL fees jumped dramatically. Beneficial began using a tiered fee structure, with fees of \$29 to \$89, depending on the size of the loan.<sup>45</sup> Banc One began charging \$41 to \$69 and Jackson Hewitt charged \$69 to \$100.<sup>46</sup> By 1999, Beneficial loans made through H&R Block cost \$40 to \$90.<sup>47</sup>

One of the benefits that the IRS and industry touted for reinstating the debt indicator was lower RAL fees.<sup>48</sup> In fact, lower RAL fees constituted one of four measures by which the success of the pilot program for reinstatement was to be judged.<sup>49</sup> The IRS Assistant Commissioner for Electronic Tax Administration, Bob Barr, threatened to end the debt indicator if RAL prices did not decrease.<sup>50</sup> Industry expressed its agreement that fees would decrease, with one RAL issuer claimed that its fees would be reduced 30 to 40%.<sup>51</sup>

When the debt indicator was reinstated, RAL fees did go down. However, this decrease turned out to be temporary. For example, RAL fees at H&R Block and Household Bank dropped for one year, but then shot back to pre-Debt Indicator levels. After the IRS reinstated the debt indicator, Household and Block's fees went from \$40-\$90 to \$20-\$60 for the 2000 tax season.<sup>52</sup> Both the IRS<sup>53</sup> and industry touted this decrease in RAL fees.<sup>54</sup> However, fees went back up in 2001, with Block/Household charging \$30 to \$87—close to the fees charged prior to reinstatement of the debt indicator.<sup>55</sup>

Also, part of the decrease in RAL fees in 2000 occurred because Block offered a “no fee” RAL in six markets, including entire state of California.<sup>56</sup> However, Block and Beneficial appear not to have offered this “no fee RAL” after the 2000 tax season. One reason was probably that the “no fee RAL” program was subject of a lawsuit for deception by a competitor.<sup>57</sup>

RAL fees never went down again after 2001, but RAL profits have increased. The increase in RAL fees from 2000 to 2001 for H&R Block/Beneficial resulted in Block's RAL revenues increasing by 49% from 2000 to 2001.<sup>58</sup> Most of the revenue increase appears to be the result of the higher RAL fees, because per-RAL-revenue rose by 43.9%, while sales volume only increased by 2.7%.<sup>59</sup>

<sup>41</sup>These figures and the figures used in the following discussion include only the loan fee, and do not include the administrative fee charged by the tax preparers for processing the RAL application.

<sup>42</sup>Timothy J. Mullaney, *IRS Fraud Watch Cuts Refund Loans*, Baltimore Sun, March 12, 1995, at 1D; Susan Edelman, *There's Trouble in Rapid City*, New Jersey Record, February 19, 1995 at b1; James Denn, *IRS's Hunt for Tax Cheats to Delay Refund Checks*, Albany Times Union, February 19, 1995, at A1.

<sup>43</sup>Susan Edelman, *There's Trouble in Rapid City*, New Jersey Record, February 19, 1995 at b1.

<sup>44</sup>James Denn, *IRS's Hunt for Tax Cheats to Delay Refund Checks*, Albany Times Union, February 19, 1995, at A1.

<sup>45</sup>George Guttman, *Electronic Filing: Who Pays, Who Benefits*, 66 Tax Notes 1750, March 20, 1995; Susan Edelman, *There's Trouble in Rapid City*, New Jersey Record, February 19, 1995 at b1.

<sup>46</sup>James Denn, *IRS's Hunt for Tax Cheats to Delay Refund Checks*, Albany Times Union, February 19, 1995, at A1.

<sup>47</sup>Guttman, *IRS Reinstates Debt Indicator*, 85 Tax Notes at 1127.

<sup>48</sup>*Id.*; PCB 2000 Form 10-K, at 23.

<sup>49</sup>Amy Hamilton, *Taxwriter Zeroing in on 'Rapid Refund Loans'*, 91 Tax Notes at 192-193. The other measures were significantly increased levels of e-filing, increased service to taxpayers, and effectiveness of refund lenders in identifying fraudulent returns.

<sup>50</sup>Guttman, *IRS Reinstates Debt Indicator*, 85 Tax Notes at 1127.

<sup>51</sup>*Id.*

<sup>52</sup>Refund Anticipation Loans May Include Several Fees, St. Louis Dispatch, Feb 22, 2000, at C6.

<sup>53</sup>*Preliminary IRS Modernization Conference Transcript*, 2000 Tax Notes 24-65, Jan. 14, 2000.

<sup>54</sup>Statement of Mark Ernst, President and CEO of H&R Block, Testimony Before the Subcommittee on Oversight of the House Ways and Means Committee, April 3, 2001.

<sup>55</sup>Chris Serres, *Speedy Refunds, Hefty Fees*, Raleigh News and Observer, February 25, 2001, at E1. Pamela Yip, *Personal Finance Column*, Dallas Morning News, February 25, 2001.

<sup>56</sup>Amy Hamilton, *Taxwriter Zeroing in on 'Rapid Refund Loans'*, 91 Tax Notes 189, 192 (April 9, 2001).

<sup>57</sup>*JTH Tax v. H&R Block Eastern Tax Services*, 128 F. Supp. 2d 926, 938 (E.D. Va. 2001), *aff'd in part, vacated in part, and remanded in part*, 2002 U.S. App. LEXIS 477 (4<sup>th</sup> Cir. January 10, 2002).

<sup>58</sup>H&R Block, *One to One: 2001 Annual Report*, at 23.

<sup>59</sup>*Id.*

Thus, the main effect of the debt indicator appears to be, not in lowering RAL fees, but in higher RAL profits. If the reinstatement of the debt indicator had really lowered RAL fees back to pre-1995 prices, a RAL would only cost a flat fee of \$37.53 or \$45.91 in 2005 (the equivalent of \$29 or \$35 in 1994 adjusted for inflation).<sup>60</sup> Instead, they currently cost about \$35 to \$115, with Block and its lending partner charging a fee of \$100 for RALs for the average refund of slightly over \$2,000.<sup>61</sup> These fees translate into effective annual interest rates (APR) ranging from about 40% to over 700%.<sup>62</sup>

Year	RAL Price— Beneficial/Household & Block <sup>63</sup>	RAL price— Bank One <sup>64</sup>	RAL Price—Jackson Hewitt <sup>65</sup>
1994	\$29	\$31	\$29 to \$35
1995	\$29 to \$89	\$41 to \$69	\$69 to \$100
1996	\$29 to \$89	—	—
1997	\$40 to \$90	—	—
1998	\$40 to \$90	—	—
1999	\$40 to \$90	—	\$49 to \$80 <sup>66</sup>
2000	\$20 to \$60	—	—
2001	\$30 to \$87	—	—
2002	\$30 to \$90	\$34 to \$87	—
2003	\$30 to \$90	\$34 to \$89	\$34 to \$89
2004	\$30 to \$100	\$34 to \$89	\$29 to \$94 (& \$5 for EITC)
2005	\$30 to \$110	\$34 to \$99	\$29 to \$99 (& \$5 for EITC)

<sup>63</sup> From: George Guttman, *Electronic Filing: Who Pays, Who Benefits*, 66 Tax Notes 1750, March 20, 1995;

<sup>64</sup> From the Taxwise website at [www.taxwise.com/banks/bankone.asp](http://www.taxwise.com/banks/bankone.asp).

<sup>65</sup> For 2003 to 2005, these are the prices of Jackson Hewitt's lending partner, Santa Barbara Bank & Trust, from the Taxwise website at [www.taxwise.com/banks/santabarb.asp](http://www.taxwise.com/banks/santabarb.asp).

<sup>66</sup> *Beware of Those Who Offer Tax Refund Loans 'A Bad Buy'*, Roanoke Times, February 22, 1999.

It appears the debt indicator is an IRS subsidy that increases profits for the RAL industry. The debt indicator has made each individual RAL more profitable, encouraging RAL lenders to aggressively promote RALs and increase RAL volume.

#### E. Privacy Issues

In addition to being a taxpayer-funded subsidy to the RAL industry, the debt indicator program raises significant privacy concerns. In fact, the IRS may be violating its own privacy law in providing the service to tax preparers. The IRS Code contains broad and strong privacy protections for taxpayer information. Section 6103 of the IRS Code states that all “[r]eturn and return information shall be confidential” and shall not be disclosed.<sup>67</sup> “Return information” is broadly defined and includes the taxpayer’s “nature, source, or amount of his—liabilities. . . .”<sup>68</sup> Therefore, information as to whether a taxpayer is subject to a refund offset would be information about the nature or amount of a taxpayer’s liabilities.

It would seem that the information disclosed by the IRS to a RAL provider would constitute a violation of the IRS privacy statute, unless there is an exemption. One possible exemption would be the provision that allows the IRS to disclose return information with a taxpayer’s consent.<sup>69</sup> However, the IRS regulations set forth clear and definite requirements for such consent, including that the consent be set forth in a separate written document pertaining to the disclosure, and that the document reference the particular data item of return information to be disclosed.<sup>70</sup>

A document that conceivably grants such consent is IRS Form 8453, which is used to authenticate an e-filed return. Yet the consent to disclose information in Form 8453 is not a separate, stand-alone document pertaining solely to the disclosure.<sup>71</sup> Furthermore, the consent is buried in small print inadequate to clearly inform tax-

<sup>60</sup> According to the Department of Labor’s cost of living calculator at [www.bls.gov](http://www.bls.gov)

<sup>61</sup> Chi Chi Wu and Jean Ann Fox, *Picking Taxpayers’ Pockets, Draining Tax Relief Dollars: Refund Anticipation Loans Still Slicing Into Low-Income Americans’ Hard-Earned Tax Refunds*, National Consumer Law Center and Consumer Federation of America, January 2005, at 12.

<sup>62</sup> NCLC issues a series of annual reports on the RAL industry, which are available at [www.consumerlaw.org](http://www.consumerlaw.org). The last report documented how RALs drained over \$1 billion in loan fees, plus \$389 million in separate fees charged by tax preparers, from the wallets of more than 12 million American taxpayers in 2003.

<sup>67</sup> 26 U.S.C. § 6103.

<sup>68</sup> 26 U.S.C. § 6103(b)(2)(A).

<sup>69</sup> 26 U.S.C. § 6103(c).

<sup>70</sup> 26 C.F.R. § 301.6103(c)–1(b) and (b)(iii).

<sup>71</sup> The IRS also requires that tax preparers who receive the debt indicator to have return preparation software that includes a mandatory consent to disclose the debt indicator. IRS Publica-

payers that they are permitting the IRS to disclose personal financial information to their tax preparers about whether they owe a child support or student loan debt.

Another exemption allows the IRS to send an acknowledgement to an e-file provider without the need for a stand-alone consent form, along with “such other information as the [IRS] determines is necessary to the operation of the electronic filing program.”<sup>72</sup> Because RALs increase the number of e-filed returns, the IRS may argue that this language permits it to send the debt indicator in the e-file acknowledgement (as it currently does) without a stand-alone consent form. However, while it increases the number of e-filed returns, that is not a factor that is “necessary” to the operation of the e-file program.

Even if IRS can legally provide the debt indicator, there still remain significant privacy issues regarding the program. With the debt indicator, the IRS is providing an indicator that communicates personal and potentially embarrassing financial tax information to the tax preparer.<sup>73</sup> Indeed, when the IRS proposed requiring a similar indicator on tax returns filed through the Free File Alliance, commercial preparers objected strongly, citing privacy concerns.<sup>74</sup> National Taxpayer Advocate Nina Olson noted ironically “These businesses already rely heavily on returns flagged with an indicator to tell them that this return has other outstanding refund offsets” and “Let’s use the same argument to say the debt indicator should be eliminated.”<sup>75</sup>

Given the lack of prominence of the consent in Form 8453, it is unclear whether most taxpayers actually realize they are giving permission for IRS to reveal the presence of government debts to their preparer. It is even unclear whether they know about the debt indicator itself or understand what it is.

#### F. *Re-Emergence of Fraud*

The debt indicator represents an IRS subsidy in another respect, that is, in the amount of fraud it promotes and the taxpayer dollars spent combating that fraud. As discussed above, the IRS dropped the debt indicator in 1994 due to concerns over mounting fraud in refund claims.<sup>76</sup> IRS data had indicated that 92% of fraudulent returns filed electronically involved RALs.<sup>77</sup> It was believed that the debt indicator led to tax fraud because of its role in supporting RALs, whose quick turnaround period makes fraud detection difficult.<sup>78</sup>

The elimination of the debt indicator seems to have had its intended effect. According to the Assistant Attorney General in charge of the Tax Division at the Department of Justice, eliminating the debt indicator, along with other fraud prevention measures, successfully reduced the number of fraudulent claims.<sup>79</sup>

When IRS reinstated the debt indicator in 1999, it attempted to address the fraud issue by requiring tax preparers to institute fraud prevention measures. The first year of the debt indicator was termed a pilot, and only certain tax preparers who entered into memoranda of agreement with the IRS were eligible to receive the debt indicator.<sup>80</sup> As a condition of the agreement, tax preparers were required to actively screen returns for potential fraud and abuse, using measure such as requiring two valid forms of identification and verifying questionable W-2s.<sup>81</sup> However, after the 2000 tax season, the debt indicator is no longer a pilot and is provided to all tax-

<sup>72</sup> 26 C.F.R. § 301.6103(c)-1 (d).

<sup>73</sup> While the tax preparation process often results in taxpayers divulging their personal financial information to a tax preparer, the debt indicator may reveal additional information that would not necessarily be part of that process, and would be sensitive since it involves delinquent debts owed to the government.

<sup>74</sup> Amy Hamilton, *Businesses Resist IRS Requests to Flag Taxpayers Using Free File*, Tax Notes Today, December 1, 2003, at 1062.

<sup>75</sup> *Id.*

<sup>76</sup> Malcolm Sparrow, *Fraud in the Electronic Filing Program: A Vulnerability Assessment Prepared for the Internal Revenue Service*, September 1, 1994. Robert D. Hershey, *I.R.S. Fraud Found to Net Big Refunds*, New York Times, October 6, 1994, at A21.

<sup>77</sup> George Guttman, *Improper Refunds Sapping Billions*, 66 Tax Notes 19, October 3, 1994, at 23.

<sup>78</sup> *Id.* Note that tax refund fraud is often perpetrated, not by taxpayers, but by unscrupulous preparers. The taxpayer is often herself a victim of the fraud.

<sup>79</sup> John Tighe & Linda Lacewell, *Tax Litigation—Interview with Loretta C. Argrett—Part II*, New York Law Journal, July 17, 1997. See also *NACTP Steps Up Communication Efforts*, Accounting Today, August 21, 1995, at S22.

<sup>80</sup> Internal Revenue Service, *Announcement of Opportunity to Obtain a Debt Indicator in a Pilot Program for Tax Year 1999 Form 1040 IRS E-file and On-Line Returns*, 64 Fed. Reg. 67,621 (December 2, 1999).

<sup>81</sup> IRS Publication 3614, *Application for Memorandum of Agreement—Debt Indicator*.

payers who e-file.<sup>82</sup> Thus, it is unclear whether these fraud prevention measures are still mandatory.

Whether or not these fraud prevention measures are in effect, fraud is still a significant issue with respect to RALs. Gary Bell, Director of the IRS Criminal Investigation Division's Refund Crimes Unit, noted that currently 80% of fraudulent e-filed returns are tied to a RAL or other refund financial product.<sup>83</sup> Furthermore, fraud appears to have increased since the debt indicator was reinstated. Bell noted that e-file fraud had increased by more than 1,400 percent since 1999 (when the debt indicator was reinstated), and that approximately 1 in every 1,200 e-filed returns was phony, compared with a rate of about 1 in every 5,000 four years ago.<sup>84</sup>

The Treasury Department's Financial Crimes Enforcement Network (FinCEN) has raised similar concerns about the role of RALs in promoting tax fraud. FinCEN issued a warning to banks in August 2004, regarding RAL fraud.<sup>85</sup> In this report, FinCEN also noted that RAL fraud had multiplied between 2000 and 2003.<sup>86</sup> FinCEN noted that "To make this type of loan appealing to the public, funds are made immediately available, leaving little time for the lender to perform due diligence to prevent fraud."<sup>87</sup> As one commentator noted, the IRS has a fraud detection system, but "it may take the IRS three or more weeks to process the return, especially in the peak of the spring filing season. Meanwhile, the RAL lenders have processed the loan within a couple of days of the return being filed, the money is in the hands of the bad guys, and they can disappear without a trace, . . ."<sup>88</sup>

#### G. Conclusion

As it did in 1994, the IRS should terminate the debt indicator. The program represents a form of corporate welfare and government subsidy of an industry already rolling in profits from making usurious loans to low-income taxpayers. It has increased profits for the RAL industry, while resulting in no permanent price decreases for consumers. Not only does the RAL industry siphon off hundreds of millions of tax dollars by skimming the Earned Income Tax Credit from working poor families, the IRS abets this drain and makes it more profitable by conducting part of the RAL lenders' credit checks using taxpayer-funded resources. Furthermore, the debt indicator represents even more of a subsidy, in that it generates more fraud related to RALs, which the IRS must spend enforcement dollars to address.

The National Consumer Law Center is a non-profit organization specializing in consumer issues on behalf of low-income people. NCLC works with thousands of legal services, government and private attorneys, as well as community groups and organizations, who represent low-income and elderly individuals on consumer issues.

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<sup>82</sup> IRS Publication 1345A—Filing Season Supplement for Authorized IRS e-file Providers (Rev. January 2002).

<sup>83</sup> Allen Kenney, *IRS Official Shines Spotlight on E-Filing Fraud*, 2004 Tax Notes Today 130–4, July 6, 2004.

<sup>84</sup> *Id.*

<sup>85</sup> FinCEN, SAR Activity Review, Issue 7, August 2004, at 15, available at [www.fincen.gov/sarreviewissue7.pdf](http://www.fincen.gov/sarreviewissue7.pdf).

<sup>86</sup> *Id.* at 17.

<sup>87</sup> *Id.* at 17.

<sup>88</sup> Gail Perry, *Electronic Filing Fraud: Latest Tax Scam's Got Legs*, Accounting Today, August 9, 2004, at 3.