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PAID TAX PREPARERS

Most Taxpayers Believe They Benefit, but Some Are Poorly Served

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Mr. Chairman and Members of the Committee:

I am pleased to be here today to discuss our on-going study of paid tax preparers. The Internal Revenue Service (IRS) estimates that there were up to 1.2 million paid tax preparers in 1999. These paid preparers are important to taxpayers, as underscored by the fact that in tax year 2000, over half of the 130 million individual filers paid someone to prepare their tax return. Taxpayers paid an estimated \$14.7 billion for individual return preparation. Numbers like these suggest that taxpayers believe that paid preparers provide a valuable service.

Given the complexity of the tax code, it is easy to understand why so many taxpayers depend on the assistance of a paid preparer. The need for the assistance of a paid preparer, combined with the fact that our tax system relies on taxpayers accurately completing and filing their returns, means that paid preparers play a critical role in the functioning of the nation's tax system.

Despite the importance of paid preparers, minimal data exist on the quality of services they provide. However, there are indications that some preparers make errors on taxpayers' returns that can result in taxpayers overpaying or underpaying their taxes. For example, last year we estimated that over 2 million taxpayers overpaid their 1998 taxes by \$945 million because they claimed the standard deduction when it would have been more beneficial to itemize.¹ Half of these taxpayers used a paid preparer. While taxpayers undoubtedly contributed to some of these errors, these data raise questions about the extent of errors caused by paid preparers.

In light of the importance of paid preparers to the functioning of our tax system and the lack of information about the quality of service they provide, you asked us to (1) obtain the views of taxpayers who used paid preparers and provide examples of paid preparer performance, including the type and what is known about the extent of problems caused by paid preparers and (2) identify common sense steps taxpayers can take to help ensure that they benefit from using a paid preparer.

My statement today is based primarily on a nationwide representative survey of taxpayers; in-depth interviews with a judgmental sample of taxpayers regarding their experiences with paid preparers; phone calls to a limited number of preparers in which we posed as potential clients asking about services and fees;

¹*Tax Deductions: Further Estimates of Taxpayers Who May Have Overpaid Federal Taxes by Not Itemizing* (GAO-02-509, March 29, 2002).

interviews with large and small tax preparation firms, IRS's National Taxpayer Advocate, IRS officials, and several tax clinics offering tax help to low income taxpayers; and a review of IRS's closed case files on preparers investigated for fraud or other misconduct.

Anyone can be a paid tax preparer. No laws or regulations limit who can sell tax preparation services. The types and training of paid preparers vary widely. They range from attorneys and certified public accountants (CPA) to preparers who are not licensed and have no formal training. Commercial preparers may hire any of these and may also provide their own training. However, IRS does place limits on paid preparers who can represent taxpayers in matters before IRS. Those representing taxpayers are collectively referred to as practioners and can be attorneys, CPAs, enrolled agents—that is, former IRS employees or individuals tested in tax laws. All others are referred to as “unenrolled agents.” Practioners are governed by IRS Circular 230 regulations that prescribe standards of conduct and sanctions for violating the standards.

In summary, our work to date shows a range of paid preparer performance:

- Most taxpayers who used a paid preparer believe they benefit by doing so. In addition, most taxpayers reported that they did not pay more in taxes than was legally due and that their preparer knew enough about their personal tax situations to accurately prepare their returns. Paid preparers told us that asking probing questions about their clients' personal circumstances or seeing documentation of income and potential deductions were important components of providing quality services.
- However, some taxpayers using a paid preparer end up overpaying their taxes or preparer or underpaying their tax liability because some preparers did not adequately probe into or pay attention to taxpayers' personal circumstances, made computational errors, provided questionable advice, or, in rare cases, engaged in fraudulent activities.

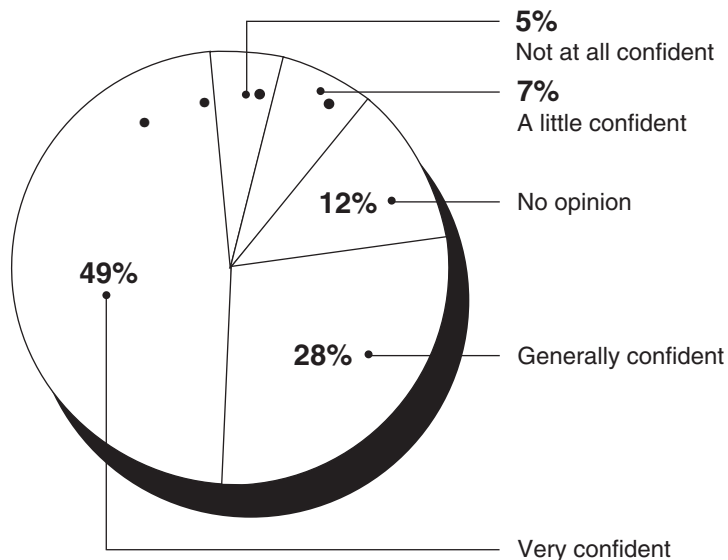
Our work also shows that despite the use of paid preparers, taxpayers are ultimately responsible for the accuracy of their tax returns. Taxpayers can take some common sense steps to ensure they benefit from using a paid preparer, including providing complete and accurate information to their paid preparers.

Most Taxpayers Are Confident They Benefit from Using Paid Preparers

Taxpayers choose to use paid preparers for a variety of reasons. Many of the taxpayers we spoke to told us they used a paid preparer because they did not understand the tax laws. One taxpayer, for example, said she began using a paid preparer 9 years ago to help her with estate tax issues following the death of her father. Other taxpayers said they lacked the time or patience to complete their return on their own. For example, a mother of four who operates her own business part-time and is finishing her degree at night said she simply does not have the time to do her own taxes. Other taxpayers stated that they paid someone to prepare their taxes in hopes of obtaining a larger and/or quicker refund.

Most taxpayers who used a paid preparer believe they benefit from doing so. We estimate, based on our representative sample of taxpayers, that 77 percent of taxpayers who used a paid preparer are very or generally confident that they did not pay more in taxes than was legally required, as shown in figure 1. In addition, based on our survey results, we estimate that 87 percent of taxpayers would use a paid preparer in the future.

Figure 1: Paid Preparer Users' Confidence That They Did Not Overpay Their Taxes



Source: GAO Nationwide Survey of Taxpayers.

Note: The estimates have a 95 percent confidence interval of plus or minus 5.23 percent or less.

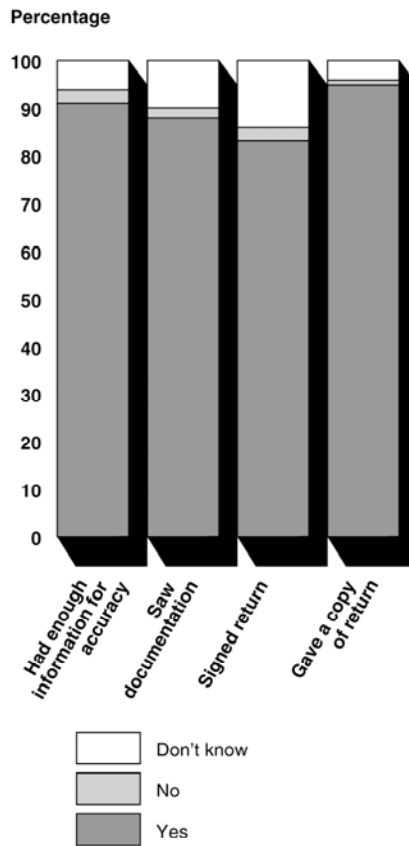
A word of caution about our survey: it reflects taxpayers' perceptions and may overstate the quality of service paid preparers are providing. Most of the taxpayers we talked to in-depth said they used a paid preparer because they found IRS tax forms and documents too complicated or they were confronting an

unusually complicated tax situation. Thus, the taxpayers in our survey may not understand the tax laws well enough to evaluate the performance of their paid preparers. Evidence that some taxpayers who used preparers overpaid or underpaid their taxes also suggests that taxpayers confronted by complicated IRS forms and a confusing tax code may be unable to identify errors made by preparers. For these reasons, the percentage of taxpayers who were confident they did not overpay their taxes may be overstated. There are no reliable data on the extent of the overstatement.

Despite this caveat, paid preparers can benefit their clients in several ways. First, probing about taxpayers' personal circumstances can help paid preparers ensure their clients do not overpay or underpay their taxes. Paid preparers told us they use a variety of techniques, including personal interviews and questionnaires, to get information about their clients' dependents, mortgages, other deductible expenses, or asset sales. Some paid preparers maintained contact with their clients during the year, allowing them to become intimately aware of the financial issues facing their clients and to make meaningful suggestions to reduce future liabilities. Based on our survey results, taxpayers were very confident that their preparer did sufficient probing or took other steps to ensure an accurate return. We estimate that about 91 percent of taxpayers believe their preparers had enough information about their personal circumstances to accurately prepare their tax returns, as shown in figure 2.

Paid preparers also can benefit their clients by reviewing income and expense documentation. To do this, most of the preparers we talked to said they ask their clients to provide documentation to support claimed income, deductions, and credits, such as W-2 forms from employers or 1099 forms from financial institutions. Taxpayers in our survey confirmed that this is a common practice. We estimate that 88 percent of paid preparer users were asked for supporting documentation, as shown in figure 2.

Figure 2: Client Perceptions on Aspects of Paid Preparer Performance



Source: GAO nationwide survey of taxpayers who filed in 2002.

Note: The estimates have a 95 percent confidence interval of plus or minus 5.23 percent or less.

Another way paid preparers can benefit their clients is educating them about the tax laws. Such efforts can help ensure taxpayers neither overpay nor underpay their taxes and may promote overall compliance. For example, one preparer who works primarily with immigrants said he and his staff spend considerable time explaining to their clients that paying taxes is part of the civic responsibilities they assumed in immigrating to this country. Other preparers told us they often have to educate taxpayers on more complex concepts, such as computing the basis, or the investment made in a property for tax purposes, to determine how much of a real estate sale would be taxable. Another preparer told us he found that a taxpayer had overpaid his taxes by more than \$6,200 over a 3-year period because the taxpayer had overlooked earned income and child tax credits. Still, another preparer told us he helped a taxpayer receive a refund in excess of

\$19,000 when he found out that the taxpayer, who had moved twice in less than 2 years, had missed out on deductions for moving expenses due to job relocations.

Paid preparers are also required by law to take certain steps when filling out returns for their clients, including signing the return and giving their clients copies of the completed returns. We estimate that a vast majority of paid preparers signed and provided their clients a copy of their return, as shown in figure 2.

Evidence Suggests That a Small Percentage of Taxpayers Are Poorly Served Because of Problematic Preparer Performance

A variety of evidence shows that some taxpayers are poorly served by their paid preparers. The available evidence does not allow a precise estimate of the percentage of taxpayers affected, but none of it suggests that the percentage is large. However, even a small percentage of the over 71 million users of paid preparers in 2000 can translate into millions of affected taxpayers. Furthermore, the consequences for these taxpayers may be significant. They may overpay their taxes, overpay their preparers, or underpay their taxes and be subject to penalties and interest.

A Variety of Evidence Suggests That a Small Percent of Taxpayers Are Poorly Served by Their Preparer

Surveys of taxpayers, studies of filed returns, and interviews with knowledgeable observers all show that some taxpayers are poorly served by their paid preparer. We estimate that 5 percent of paid preparer users had no confidence that they had not overpaid their taxes, and another 7 percent had little confidence, as shown in figure 1. These results echo a 1997 Consumer Reports nonrandom survey of 26,000 of its readers, in which 6 percent said they discovered an error made by their preparers. Because these surveys are based on taxpayers' perceptions and ability to identify preparer errors, they may underestimate the extent of the problem. However, there is no evidence about the size of the underestimate.

Studies of filed returns also suggest that a small percentage of paid preparer users are poorly served. For example, we estimate that over 2 million of about 67 million taxpayers who used a paid preparer in 1998 may have overpaid their taxes by claiming the standard deduction when they would have been better off itemizing. Similarly, a January 2003 report by the Treasury Inspector General for Tax Administration estimated that there were approximately 230,000 returns filed by paid preparers in tax year 2001 where taxpayers appeared eligible for but did not claim the additional child tax credit. In addition, a 2002 IRS study of earned income tax credit returns for tax year 1999 estimated over- and under-claims of \$11 billion and \$710 million, respectively. IRS reported that paid preparers filed more than 65 percent of all earned income credit returns. It is not

clear how many of the over- or underpayments in these examples are the fault of the preparer and how many are the fault of the taxpayer. It seems likely that preparers bear responsibility for at least some of the over- or underpayments. But, taxpayers could be at fault if they provide the preparer with incorrect or incomplete information.

Knowledgeable observers confirmed that some taxpayers are poorly served by paid preparers. For example, in the fiscal year 2002 annual report, IRS's National Taxpayer Advocate recommended requiring minimal levels of competency for paid preparers in order to better serve taxpayers and improve compliance. In another example, an IRS official responsible for overseeing the local paid preparer penalty program told us that based on the problems that he has seen and the amount of penalties he has issued, he believes poor service is more common among unlicensed preparers.

Overall, the evidence from taxpayer surveys, studies of filed returns, and knowledgeable observers demonstrates that some taxpayers are poorly served by their preparers. The evidence does not allow a precise estimate of this problem. The only representative information available—from taxpayer surveys—suggests that a small percentage of taxpayers perceive problems with their preparers. However, even a small percentage of all taxpayers who use preparers equates to millions of people.

Problematic Preparer Actions and Inactions Result in Poor Service to Taxpayers

Paid preparers can poorly serve taxpayers through a variety of problematic actions and inactions. For example, preparers may fail to adequately probe and understand taxpayers' personal circumstances. We estimate that 3 percent of users did not believe that their preparer had enough information to accurately complete their return. Such lack of probing could explain the examples of taxpayers overpaying or underpaying their taxes.

A more egregious example is ignoring known information about a taxpayer's personal circumstances. In one instance, a paid preparer told us of a disabled taxpayer with limited English skills who overpaid his taxes by about \$3,500 to \$5,000. The taxpayer had received notices for several years from IRS stating he might be eligible for the earned income tax credit. Each year, he took the notices to his preparer but the preparer took no action. Eventually he changed preparers and his new preparer is working to amend the returns.

Other lapses are less severe because they are caught and corrected by IRS and account for a small percentage of returns completed by paid preparers. For example, in tax year 2000, IRS identified 357,000 computational errors on returns filed by paid preparers.

Some preparers provide questionable advice, which could contribute to taxpayers owing additional taxes, interest, and penalties. For example, one paid preparer told us of another preparer who set up certain trusts, claiming that the trusts were legitimate tax shelters. IRS later determined that the shelters were not legitimate. We do not know whether the taxpayer was complicit with this scheme; however, the taxpayer, a successful businesswoman, now owes a large amount of tax. In a related example, another paid preparer advised a married couple with two children that it was appropriate to file two tax returns with each claiming the head of household status, claiming one child, and receiving the earned income tax credit. The adjustments made to the taxpayers' accounts in subsequent examinations resulted in a bill in excess of \$4,000, which the taxpayers have no means to pay.

In extreme cases, some preparers engage in clear-cut fraud. Identified instances of fraud are rare—IRS recommended prosecution on 162 cases in calendar years 2001 and 2002. However, the consequences for taxpayers and the government can be severe. For example, one preparer, who was a former police officer, cost the Treasury about \$1.1 million. After providing clients with copies of their tax returns, this preparer altered the returns, adding fraudulent dependents, child credits, and earned income credits. The preparer filed all returns electronically, keeping part of the refunds as a fee, unbeknownst to some clients. The clients received the remainder of their refunds, which were inflated by an average of \$1,860. The IRS audited almost 700 of this preparer's returns, with many clients owing additional taxes and interest for multiple years. The preparer was ordered to pay \$342,446 in restitution to the IRS, but this did not help clients pay their back taxes. Eventually, this preparer was sentenced to 51 months in prison.

In another example, one paid preparer told his elderly client to provide him with the checks to make her quarterly estimated payments. Although he claimed these payments on the client's tax return, he never gave the checks to IRS—he kept them for himself. After receiving notices from IRS, the taxpayer visited the paid preparer who told her that IRS must have made a mistake. The preparer is now in jail.

Problematic preparer behavior may not always result in taxpayers over- or underpaying their taxes, it may also result in taxpayers overpaying for services they do not understand. Preparers offer packages of services geared toward accelerating the receipt of refunds, a service that can be particularly appealing to low income taxpayers who often want or need their refunds quickly. These packages typically include electronic filing and Refund Anticipation Loans (RAL). RALs are short-term loans arranged by preparers, issued by financial institutions, and secured by a taxpayer's refund. After the return is filed

electronically, the preparer is notified by IRS whether or not the taxpayer has outstanding tax debts or selected other debts (e.g., student loans, child support). If the RAL is approved, the taxpayer receives the loan and his or her refund is directly deposited into the preparer bank account. Taxpayers who buy these services can get a loan on their refund in 0 to 2 days, while taxpayers who file electronically receive their refund in 10 days. Although some people are willing to pay for the faster services, advertisements that promote RALs or large refunds, such as those excerpted in figure 3, may leave taxpayers confused about the benefits of the services they are purchasing.

Figure 3: Excerpts of Preparer Advertisements for Large or Accelerated Refunds

REFUND/24hr Tax Prep Tax Loans
Fast loans on refunds
Get Your Money Back in 24 Hours
No More Audit Worries
24 hours
Get FREE "101 hot tax tips"
and save \$3000 or more on
your taxes
It's tax time again and you may be expecting
a refund. Why wait 6-8 weeks to receive it?

Tax Cash in 24-48 Hours
Lots' of Cash Back

Source: Various Paid Preparer Advertisements.

These advertisements were not selected to represent the entire industry. However, two tax clinic directors told us that some preparers do not always explain the full costs of the services. Specifically, some taxpayers are confused about the cost associated with RALs, alternatives to using RALs, and the related interest costs. Consequently, taxpayers cannot weigh the cost of the service against the benefits that they might receive.

Based on information we gathered, fees for these packages vary widely. For example, while some preparers charge nothing for e-filing services, one preparer we spoke to (while we were posing as a potential client) said he would charge us between \$210 and \$250 to file electronically. Another preparer said he would charge \$130 for a RAL on a \$1,200 refund due, which equates to an annual interest rate of about 400 percent. In another example, one preparer said he would charge \$174 for a RAL on a \$700 refund due, which equates to an annual interest rate of over 900 percent. These examples are not representative of all preparer fees; the exact amounts of preparer fees for accelerated refunds depend on various individual circumstances, such as the financial institution the preparer uses to finance the loan and the amount of refund due.

Yet, such fees can significantly reduce the refund a taxpayer receives. One tax clinic director informed us of a disabled taxpayer who was due a refund of \$1,230 on a simple return. After paying various fees, such as return preparation and a RAL, she received a check from her preparer for \$414—about 34 percent of her expected refund. Taxpayers are using these refund acceleration services in increasing numbers. Based on IRS data, the National Consumer Law Center estimates that 12.1 million people received a RAL in 2001, up from 10.8 million in 2000. Taxpayers paid 907 million for these services in 2001, up from 810 million in 2000.

Another form of overpayment is purchasing services that may not be needed. In an interview with an IRS employee, we learned of a taxpayer who, for 2 years, went to a large tax preparer and paid about \$200 for returns that were not required to be filed. The elderly taxpayer's sole income came from Social Security and a small pension—about \$6,000 per year—and was below filing thresholds.

Although IRS is not responsible for ensuring the quality of service paid preparers provide, it does have the authority to monitor and take action against paid preparer misconduct. Specifically, there are three key offices with a responsibility for detecting and taking action against cases of paid preparers misconduct: (1) the Office of Professional Responsibility, which sanctions attorneys, CPAs, and enrolled agents for ethical or conduct violations; (2) Examination, which assesses penalties to any paid preparer for violations discovered during an audit; and (3) Criminal Investigations, which prosecutes preparers for fraudulent or other criminal activities. IRS has taken action against some preparers. For example, according to IRS, Examination issued 987 penalties totaling over \$4 million in fiscal years 2000 and 2001. Additional information on programs administered by these offices will be included in our follow-up report, which is planned for issuance this summer.

Taxpayers Can Take Steps to Help Ensure They Benefit from Using a Paid Preparer

Without paid preparers' expertise, many taxpayers would be unable to submit accurate tax returns. However, taxpayers who use a paid tax preparer are still responsible for the accuracy of their return. According to the law, taxpayers take responsibility for the accuracy of their returns when they sign them. Even if the preparer is at fault, it is the taxpayer who is ultimately responsible for any additional tax, interest, and/or penalties.

Paid preparers are not always the cause of the problems discussed in this statement. Taxpayers can contribute to these problems in several ways. Paid preparers told us that they rely heavily on their clients' oral statements and documentation to complete tax returns. Paid preparers take various steps to ensure that the tax returns they complete are accurate, such as probing about personal circumstances and reviewing income and expense documentation. However, the effectiveness of such steps depends, in part, on the taxpayer. If taxpayers provide inaccurate or incomplete information about, for example, their social security or if they do not keep tax documents, such as wage or interest statements, preparers cannot complete an accurate return. Also, some taxpayers wait until the last minute to have their taxes prepared, which may limit the preparers' opportunity to probe.

IRS and other organizations, such as the American Bar Association and the Better Business Bureau, have produced guidance for taxpayers for selecting and working with paid preparers. Some of the most common advice from these organizations is shown in figure 4.

Figure 4: Precautions to Take When Using a Paid Tax Preparer

- When searching for a preparer, get recommendations from friends, co-workers, or other trusted people. Find out if you qualify for free services.
- Interview the preparer before hiring to check out qualifications, experience, discipline problems, and any history of complaints.
- Be sure you understand other services you will be getting, such as electronic filing or Refund Anticipation Loans. Find out whether these services are optional, what they will cost, and how they will benefit you.
- Don't hire a preparer who guarantees a refund before seeing your tax documents or whose fee is a percentage of your refund.
- Make sure your preparer understands your personal circumstances, income, and expenses. Show your official tax documents to your preparer, including W-2's and 1099s.
- Review your completed return before you sign it. Check that your tax information is correct. Even though someone else completed it, you are responsible for the accuracy of every item on your return.
- Don't sign a blank return and don't sign in pencil.
- Make sure your preparer's signature and tax identification number are on the return before you submit it. Keep a copy of the final return.
- Don't make checks for taxes due payable to preparers. Checks should be made payable to the United States Treasury.

Source: Internal Revenue Service, *Tax Topic 254 - How to Choose a Paid Tax Preparer* (Washington, D.C.); American Bar Association Section of Taxation, *Tips for Filing Your Return with a Tax Preparer* (Washington, D.C.); Better Business Bureau, *Tax Preparers*, (Arlington, VA); and Internal Revenue Service, *1040 Instructions* (Washington, D.C., 2002).

These precautions can help taxpayers avoid some of the problems we identified, such as overpaying their taxes or other more serious consequences, such as delinquent taxes, interest, and penalties owed to the Treasury.

Mr. Chairman, this completes my prepared statement. At this time, I would be happy to address any questions the Committee may have.

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