

**Statement of
Nina E. Olson
National Taxpayer Advocate
Internal Revenue Service**

Before the Senate Committee on Finance

April 1, 2003

Mr. Chairman and Distinguished Members of the Committee:

Thank you for inviting me to testify today about consumer issues relating to tax return preparation and filing. As you know, in my 2002 Annual Report to Congress I made a detailed proposal for the registration, examination, and certification of unenrolled federal tax return preparers. These are return preparers who are not certified to practice before the IRS as attorneys, certified public accountants, or enrolled agents. We estimate that unenrolled preparers constitute more than 50 percent of all preparers. Both the National Commission on Restructuring the Internal Revenue Service and the Commissioner's Advisory Group examined this subject. Recently, members of the Senate and this Committee have introduced bills proposing registration of return preparers.

I should state at the outset that I began my tax career in 1975 as an unenrolled return preparer and maintained a tax preparation practice for sixteen years before I became an attorney. I know first hand the important assistance these professionals provide to taxpayers nationwide. If unenrolled preparers did not exist, many taxpayers would be unable to afford professional advice and assistance in preparing their tax returns. It is clearly in the best interests of taxpayers and the tax system that unenrolled preparers continue to flourish.

However, the importance of unenrolled preparers should not mask legitimate concerns about the quality of their services or abusive practices. Returns prepared by unqualified or unscrupulous preparers have negative effects for both the taxpayer and the IRS. For

taxpayers, inaccurate returns mean overclaims as well as underclaims – either they pay more taxes than they should or their returns may be examined. For the IRS, these returns consume valuable resources, both in terms of processing original and amended returns or claims, and in the areas of examination and collection.

I first became concerned about the quality of return preparation by unenrolled preparers several years ago. During filing season, I was driving down a main street in the city in which I ran a low income taxpayer clinic. I noticed a sign in front of a used car dealer whose “mascot” was a duck. The sign read, “File your taxes with the Duck, use your refund for a truck!” It seemed rather unlikely to me that this car dealer possessed much tax law expertise; his obvious motivation for filing tax returns was to generate new car sales. And not incidentally, the dealer had a strong incentive to maximize the taxpayer’s refund, since that would have resulted in a larger down payment toward a more expensive vehicle.

I began to wonder about the long-term effects on taxpayer compliance of commingling such mercantilism with tax filing. My concern turned into alarm when I learned from clinics in other parts of the country about car dealers using refunds as down payments – through the device of a refund anticipation loan – toward the purchase of an automobile. If the refund is denied, the automobile is repossessed, and the taxpayer ends up with no refund in one year, no automobile, and a tax bill for the next year from cancellation of indebtedness income.

It is the linkage between these types of transactions and the IRS that causes me concern. I don’t want taxpayers to say: “I filed my taxes, and look what happened to me.” No tax agency can afford this type of “guilt by association.” The federal government, through its federal tax administrator, has an interest in protecting the integrity of the tax administration system. I believe that taxpayer willingness to participate in the tax system is bound to suffer over time if the taxpayer feels that

(1) he can’t file without assistance;

(2) that assistance is delivered by someone who is not well versed in tax; and

(3) the entity that is providing the assistance is also trying to sell the taxpayer an unrelated product.

Thus, the federal government has an interest in ensuring that products and services offered in conjunction with the taxpayer's filing, reporting, and payment obligations do not operate in such a way as to undermine the taxpayer's faith and participation in the tax system.

Our legislative proposal for regulating tax return preparers addresses this concern. We approached this issue from three different perspectives – first, by reviewing the most serious problems experienced by taxpayers; second, by consulting Taxpayer Advocate Service and IRS employees as well as tax practitioners and low income taxpayer clinics; and finally, through our overriding focus on taxpayer rights. The term “taxpayer rights,” as used in this context, refers to more than the legal rights accorded to a taxpayer under the Constitution or the internal revenue laws or regulations. This broader interpretation can best be summed up by the question: “What do taxpayers have a right to expect from their government/tax administrator in a voluntary tax system?”

Clearly, taxpayers who are asked to voluntarily file, report, and pay their taxes have a right to expect that the process of doing so will not be unnecessarily burdensome or complicated. Unfortunately, the complexity of the tax laws applicable to even low or middle income taxpayers prevents many taxpayers from feeling confident and comfortable in preparing their own taxes.¹ In fact, 53 percent of individual taxpayers today utilize the services of paid tax return preparers. In tax year 2000, nearly five percent of individuals used paid preparers to complete Form 1040EZ – the simplest version of the individual income tax return. Taxpayers filing individual returns with non-

¹ See National Taxpayer Advocate's FY 2001 Annual Report to Congress, Pub. 2104 (rev. 12-2001), pages 78-100 (uniform definition of a qualifying child) and pages 166-177 (alternative minimum tax); National Taxpayer Advocate's FY 2002 Annual Report to Congress, Pub. 2104 (rev. 12-2002), pages 231-242 (children's income).

farm sole proprietorship schedules employed preparers 68 percent of the time. Do taxpayers have the right to expect these preparers to be competent and professional? If so, how can a taxpayer tell whether a preparer possesses the requisite skills and ethics? Simply asking a friend for a recommendation is not sufficient – the basis for the recommendation may be that the preparer got the friend a large refund, or helped him get a large down payment for his truck. It may have nothing to do with the preparer’s tax expertise.

While it is difficult to obtain precise figures in the current unregulated environment, we estimate that there are between 700,000 and 1.2 million persons preparing taxes for a fee. Of these paid preparers, we estimate that more than half are subject to some form of examination, oversight, or discipline. The remaining 300,000 to 600,000, which I refer to as “unenrolled preparers,” are not regulated, except in a few states.²

In light of the current complexity of the tax laws, many taxpayers require assistance in fulfilling their obligation to voluntarily report their taxable income to the federal government’s tax administrator. There are many valid reasons why taxpayers may seek tax assistance from someone other than the government – not the least of which is that the government and the taxpayer may legitimately disagree about the correct amount of tax to be reported. Our tax system contemplates the possibility of such disagreement and provides various mechanisms to resolve it.

The fact that taxpayers have legitimate reasons for utilizing private tax return preparers does not mean that the government has no interest in the commercial tax return preparation industry. To the contrary, the very existence of regulatory schemes in other areas where the public seeks advice and assistance with respect to basic governmental functions – for example, law and accounting – indicates that government has an interest in ensuring that people who hold themselves out as an interface between the public and the government should be held to some minimum level of competency, performance, and integrity.

² See Cal. Bus. & Prof. Code § 22250-22259; Or. Admin. R. 800-25-0020.

In the tax world currently, this regulation applies to attorneys, certified public accountants, and enrolled agents, who represent the taxpayer before the IRS in collection, examination, appeals, and other matters. Historically, tax return preparation has been considered a largely ministerial act and therefore has not been regulated. However, with today's complex tax code, return preparation involves significant substantive decisions that can have serious downstream consequences for taxpayers. Simply determining a taxpayer's filing status – single, head of household, married filing separately or jointly – is often a complex and confusing exercise.

In the Taxpayer Advocate Service, we have seen numerous instances of paid preparers who have caused problems for the taxpayers whose returns they prepare because they have not kept current with the ever-changing tax laws or have not received formal training about return preparation. Consider one example I described in my 2002 Annual Report to Congress: A taxpayer relied on the advice of a tax preparer to determine his tax home for employee business expenses. The preparer relied on an outdated provision of the tax home rules that had been in effect more than 15 years earlier when preparing four consecutive years of income tax returns. The corrected tax bill ultimately exceeded \$40,000, and the taxpayer had to arrange for an installment agreement to pay it.³

There is, of course, a whole other category of return preparers who intentionally “broker” improper entries. These preparers may or may not appear as signatories on the tax return, even though they are required to sign the return since they receive a fee for preparation.⁴ The Taxpayer Advocate Service has witnessed several such schemes over the years, including inflated casualty losses in disaster areas and claims for fuel taxes. Recently, one of our Local Taxpayer Advocates was standing in line at a store and heard two clerks discussing a local tax return preparation business that was advertising to low income taxpayers. The clerks said that the business was

³ National Taxpayer Advocate's FY 2002 Annual Report to Congress, Pub. 2104 (rev. 12-2002) page 216.

⁴ IRC §§ 6061 & 6695(b).

encouraging low income taxpayers to come in for tax preparation and was providing clients with additional social security numbers to claim “dependents” in order to generate larger refunds and the earned income tax credit.

Then there are preparers who are too clever by half. We are seeing in this filing season certain unenrolled preparers who know that their clients have been examined and/or denied the EITC in previous years. These preparers are filing returns without such claims in order to offer Refund Anticipation Loans for the non-EITC portion of the refund. They later prepare amended returns for the EITC portion of the refund, knowing it will take a while and most likely will be subject to review. Not only does the taxpayer incur costs for the preparation of two returns (the original and the amended return) along with the RAL charge (and a fee for direct deposit and check cashing if the taxpayer doesn't have a bank account), but the IRS must process two returns.

All of these activities cost the government – and the taxpayers, directly and indirectly – in terms of increased examinations, litigation, processing, and collection. This represents time and money for both parties that could be better spent elsewhere.

So, what do we do about this? Even if we agree that commercial tax return preparers – unenrolled preparers – should be subject to some level of oversight, we must ask whether the federal government should be the overseer. Or should this regulation be left to the states?

In my annual report this year, I describe in detail two state regulatory schemes – California and Oregon – which seem to have some effect on the quality of return preparation in these states.⁵ Having studied these programs, we concluded that from the federal perspective, they impose a greater burden on the regulated party than is necessary to accomplish the federal purposes. Further, the fact that some states may seek to regulate federal return preparers while others do not creates a disparate,

⁵ National Taxpayer Advocate's FY 2002 Annual Report to Congress, Pub. 2104 (rev. 12-2002), pages 222-224.

uneven and anti-competitive environment, and does not provide a nationwide solution to the problems I've outlined above.

However, we can learn from the states. We can take the key elements of their programs and devise a nationwide program that establishes some level of proficiency in tax as the norm for return preparation. Here is how it would work. The central components are registration, examination, and certification. Persons who prepare more than five federal income tax returns for a fee would be required to meet each of these components.

Registration. Let's get preparers into the system. An estimated seven percent of individual returns are prepared by a third party for a fee and are not signed by that paid preparer.⁶

Examination. We propose two levels of examination so that unenrolled preparers must demonstrate some minimum level of competency in federal return preparation. This is not an exam to qualify preparers to represent clients before the IRS. Rather, the examination would be based on the tax return itself – line by line, with questions geared to show that the preparer has a basic understanding of what is being asked for on that return line and some of the most common intricacies that arise with that type of income or deduction.⁷

The initial examination would test a preparer's knowledge in either individual tax return preparation (including simple sole proprietorship schedules) or business return preparation. An annual refresher exam would enable the IRS to test preparers on recent tax law changes and the most common errors from the previous filing season. These exams could be completed on-line, or at annual Tax Forums for practitioners. Private entities could develop training and exam preparation classes.

⁶ This estimate is based on a study of taxpayers claiming the Earned Income Tax Credit and therefore is not necessarily representative of all returns.

⁷ The return preparer exam will be less rigorous than the IRS examination for enrolled agent status, which tests tax law and tax procedure knowledge.

In fact, many unenrolled preparers in large tax preparation firms or who are members of professional associations already attend trainings. We do not believe our proposed testing regimen will impose a significant burden on them. But the bottom line is that unenrolled preparers will have to demonstrate some level of competence before they receive their certification.⁸

Certification. Once a preparer has passed the examination, he or she will receive a certification card. The certification card would show that the preparer is authorized to prepare federal tax returns for the period covered by the certification. To enforce this program, we propose a multi-year campaign, which would include paid advertising, education and outreach and be operated cooperatively with community and professional groups, in which taxpayers are advised of two simple concepts –

- If you pay for tax preparation, ask to see the preparer's certification.
- If you pay for tax preparation, don't pay until you see the preparer's name, address, and certification number on the tax return and on your copy.

This message, reinforced from year-to-year, will eventually become an axiom in the tax consumer's consciousness, much like the EITC campaign has contributed to the high participation rate for that credit. The benefits of this consumer-driven approach include:

- Through the certification card, consumers will know that their preparer is in the system and possesses some competency in tax return preparation.
- The IRS will have the preparer's name, address, and certification number for oversight purposes.

⁸ H&R Block reports that it has approximately 90,000 active preparers, and Jackson-Hewitt reports that it has approximately 25,000 active preparers. See Internal Revenue Service, Task 124: Market Research for e-file Options: Tax Preparer Research & Analysis of Available Data (March 2001).

- Preparers who are not willing to meet these minimum professional standards or who are unscrupulous will become apparent.

It is true that some preparers may choose to “opt out” of certification by going underground. The registration/certification regimen draws a bright line – being qualified is now measured, and if a preparer chooses not to meet those standards or a taxpayer chooses to employ a preparer who does not meet those standards, then the preparer and the taxpayer will know that that choice has consequences.

If the IRS, through return processing and computer matching, determines that a preparer was not certified, or had not taken the exam, it could send a notice to the preparer advising him or her to take the exam within a specified period of time and to cease return preparation until the exam is passed. If the preparer does not respond, the IRS could, perhaps after another contact, send a letter to the taxpayer stating that the taxpayer’s return preparer is not certified. Taxpayers will thus enforce the regulatory scheme with their feet!

Ultimately the IRS could trace frequent offenders or careless preparers and even decertify them. Where enforcement actions are necessary, the regulatory program sets forth clear expectations and standards against which to measure behavior.⁹

We believe our proposal is administrable and efficient. While it will require resources to collect and input data, develop and update examinations, and maintain the preparer database, a portion, if not all, of these costs can be offset by user fees on the regulated population.¹⁰ Ultimately, more accurate returns will reduce the resources the IRS must devote to examining incorrect returns and collecting the resulting tax. A lynchpin of this proposal, however, is that it will not require an army of agents on the street to enforce

⁹ In addition to registering and thus “surfacing” return preparers, the IRS needs to step up its application and enforcement of current preparer penalties. For example, Section 6694 of the Internal Revenue Code authorizes the IRS to impose penalties on tax preparers for understating a taxpayer’s tax liability, yet for 2001, the IRS has imposed penalties under this authority totaling merely \$250.

¹⁰ The fee for taking the enrolled agent exam is \$55. See IRS Form 2587. The fee for applying for enrolled agent status is \$80. See IRS Form 23.

the provisions. The taxpayers themselves, through a quality consumer education campaign, will enforce these provisions through their market behavior. This is a narrowly crafted mechanism to address the government's legitimate interest in maintaining the integrity of the federal tax administration system.

Before closing, I would like to comment on a related issue. The Internal Revenue Service's legitimate need to have returns filed electronically has had some unintended consequences. The emphasis on electronic filing has opened up the tax preparation field to entities that historically did not prepare returns and whose interest in doing so is driven by the desire to sell ancillary products and services.

We note that Section 2001 of the Internal Revenue Service Restructuring and Reform Act of 1998 established a Congressional policy that "the Internal Revenue Service should cooperate with and encourage the private sector by encouraging competition to increase electronic filing of [tax] returns." The Conference Report states that the IRS and Treasury should "press for robust private sector competition." The conferees acknowledged that disputes would arise between the IRS and the private sector about whether IRS-offered services inhibited competition. In such instances, the conferees requested that the Electronic Commerce Advisory Group (now called the Electronic Tax Administration Advisory Committee or ETAAC) recommend an "appropriate course of action" to the Commissioner. The conferees also stated that, notwithstanding the goal of fostering private sector competition, the "IRS should continue to offer and improve its Telefile program and make available a comparable program on the internet." H.R. Conf. Rep. No. 105-599.

I believe that Section 2001 of this Act has had the unfortunate effect of inhibiting the IRS from undertaking a rigorous analysis of the products being offered in connection with tax return preparation, including electronic filing, or proposing guidelines or standards for these products and services. This vacuum of leadership has led to a proliferation of non-tax goods and services associated with return preparation, particularly electronic return preparation and filing, which raises the types of problems I described in the car

dealer example at the beginning of my testimony. I believe this issue is one that the Committee should also address.

Thank you for the opportunity to appear before you today to discuss these important issues.