

National Taxpayer Advocate

2008 Annual Report to Congress

*Annual Report to Congress*

THE NEED TO INCREASE  
PREPARER RESPONSIBILITY,  
VISIBILITY, AND COMPETENCE

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## The Need to Increase Preparer Responsibility, Visibility, and Competence

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### Introduction

#### Time to Change the Dynamics

My previous report submitted in connection with the National Taxpayer Advocate's 2007 Annual Report to Congress concerned the role of practitioners in taxpayer decisions to comply with the tax laws, with a focus on the Earned Income Tax Credit (EITC) and sole proprietor reporting of income.<sup>1</sup> My report described the significant usage of paid preparers and the high incidence of errors among those returns, summarized a significant amount of the research relating to the role of preparers in tax compliance decisions, and offered a preliminary typology identifying the various categories of preparers and how the various types of preparers may prepare erroneous returns.<sup>2</sup> As the Government Accountability Office (GAO) has reported, inaccuracies on preparers' returns are not necessarily the fault of the preparer.<sup>3</sup> Yet, limited quantitative data associates a significant amount of

\* I wish to thank the dedicated research assistance of John Brian Hudson, Villanova Law School 2010, and the efforts and insights of the research team at the Taxpayer Advocate Service. All errors and omissions are mine alone.

<sup>1</sup> See generally Leslie Book, *Study of the Role of Preparers in Relation to Taxpayer Compliance with Internal Revenue Laws* [hereinafter Book, *Role of Preparers*] in National Taxpayer Advocate, 2007 Annual Report to Congress vol. 2, 44-74 [hereinafter 2007 NTA Report vol. 2].

<sup>2</sup> See generally *id.* As in my initial report, this report focuses on ways that preparers can assist in reducing the underreporting portion of the tax gap, particularly with respect to issues not associated with legal ambiguity (like the potential classification of transactions as corporate tax shelters) or significant factual uncertainty (like valuation cases in transfer pricing cases). Those issues implicate different legislative and administrative responses, and, in particular, the ways that government can temper practitioners from improperly exploiting ambiguity. Current research suggests that preparers have tended to exploit ambiguity on behalf of their clients, but this report does not address that. In part, my decision to focus on these unambiguous issues is attributable to a prior lack of emphasis on the preparers' role in issues not involving significant legal or factual ambiguity, despite quantitative evidence showing heavy taxpayer reliance on preparers for issues like the reporting of income attributable to sole proprietors. See Government Accountability Office, *Tax Gap: A Strategy for Reducing the Gap Should Include Options for Addressing Sole Proprietor Noncompliance* (GAO-07-1014, July 2007) [hereinafter GAO, *Tax Gap*] (discussing a broad approach to reducing the underreporting gap among sole proprietors but failing to integrate preparer strategies in that approach).

<sup>3</sup> GAO, *Tax Preparers: Oregon's Regulatory Regime May Lead to Improved Federal Tax Return Accuracy and Provides a Possible Model for National Regulation* 7 (GAO-08-781, Aug. 2008) [hereinafter GAO, *Oregon/California Preparer Registration Study*] (noting, for example, that taxpayers providing incorrect information to preparers may trigger errors in such returns).

tax-reporting error to returns that are prepared by paid practitioners.<sup>4</sup> A growing amount of qualitative research — including some limited use of mystery shopper scenarios — identifies significant preparer misconduct, including misconduct that would potentially trigger the IRS imposing civil or criminal penalties.<sup>5</sup>

In my initial report, I called for additional qualitative research to better understand the dynamics of the taxpayer-practitioner relationship.<sup>6</sup> I likewise urged the IRS to better capture data as a prerequisite to further efforts relating to preparers’ ability to reduce systemic underreporting with respect to different areas of the tax law.<sup>7</sup>

This report discusses a number of prescriptive actions Congress and the IRS can take to change the posture of preparers with respect to compliance with unambiguous issues like claiming the EITC and reporting sole proprietor income. The common themes of the proposals are increasing the visibility of preparer and taxpayer conduct, and emphasizing the responsibility and accountability of preparers to the tax system, as well as to their clients. Because the relationship between the practitioner and the taxpayer is dynamic, some of the proposals look to the taxpayer and others to the preparer. As part of any meaningful strategy to reduce the tax gap, the IRS must more actively strive to understand the preparer community. As part of a preparer strategy, it must demonstrate engagement with issues

<sup>4</sup> The GAO has determined that a statistically significant difference in error rates exists between those returns prepared by the taxpayers themselves and those prepared by paid practitioners. GAO, *Paid Tax Return Preparers: In a Limited Study, Chain Preparers Made Serious Errors* 29 (GAO-06-563T, Apr. 4, 2006) [hereinafter GAO, *Limited Study*]. The following is a table of comparative error rates among Form 1040 filings by paid practitioners and by the taxpayers themselves, based on 2001 National Research Program (NRP) data.

Type of Return	Estimate (percent)
Prepared by a paid preparer	56%
Prepared by the taxpayer	47%
All returns	52%

*Id.* My initial report also quantified the limited data relating to relative error rates among types of return preparers. Book, *Role of Preparers*, *supra* note 1, at 68. That the IRS should readily capture data tying taxpayer error to preparer usage is an important first step in any systematic approach to focusing on the role of preparers in taxpayer compliance decisions. My suggestion that the IRS monitor preparers, and require a uniform preparer identification number, may help facilitate this. See *infra*, section III.A.

The following is a table of error rates among specific line items in Form 1040, relating to 2001.

Form 1040 Line Item	Self-prepared returns (percent)	Returns done by paid preparer (percent)
Deductions	23%	31%
Foreign tax credit	16%	6%
Earned Income Credit	45%	53%
Refund	43%	57%

GAO, *Limited Study*, *supra* at 29.

<sup>5</sup> See generally *id.*; Treasury Inspector General for Tax Administration (TIGTA), *Most Tax Returns Prepared by a Limited Sample of Unenrolled Preparers Contained Significant Errors* (2008-40-171, Sept. 3, 2008) [hereinafter TIGTA, *Limited Sample*]; see also Chi Chi Wu et al., *Tax Preparers Take a Bite out of Refunds: Mystery Shopper Test Exposes Refund Anticipation Loan Abuses in Durham and Philadelphia* (Apr. 2008) (finding a wide range of preparer errors and abuses despite the fact that quality of return preparation was not the focus of study).

<sup>6</sup> Book, *Role of Preparers*, *supra* note 1, at 51. See also Robert Kidder & Craig McEwen, *Taxpaying Behavior in Social Context: A Tentative Typology of Tax Compliance and Noncompliance*, in *2 Taxpayer Compliance* 47 (Jeffrey Roth et al. eds., 1989) (postulating that preparers can broker and facilitate both compliance and noncompliance).

<sup>7</sup> Book, *Role of Preparers*, *supra* note 1, at 74.

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that are systemic compliance problems through identifying preparers, communicating with preparers, and educating preparers and taxpayers,<sup>8</sup> all as part of a broad-based effort to achieve acceptable compliance levels.<sup>9</sup> In this report, I offer several steps that tie into my themes of responsibility, visibility, and competence. The steps include reforming due diligence rules by anchoring obligations to data reflective of systemic noncompliance, requiring the use of a common preparer identification number to facilitate the creation of a reliable database that will enhance the IRS's ability to tie specific preparers to returns that are likely erroneous, and registering and testing preparers to ensure a minimum competence level and inject a more uniform sense of professionalism into the industry. In addition, to emphasize accountability, visibility, and responsibility for taxpayers as well as preparers, Congress and the IRS should require more robust taxpayer self-reporting for items connected to systemic noncompliance. Examples of this include separately scheduling out items of gross receipts on Schedule C (such as credit card versus cash receipts) so taxpayers and practitioners bring areas of noncompliance to the surface.

While the increased expectations with respect to preparers should not fundamentally change the role they play in the tax system, it does assume that preparers have an affirmative obligation to enhance the tax system's integrity, especially in areas associated with unacceptable error rates and high preparer usage. Efforts to increase visibility and accountability can contribute to preparers taking responsibility for returns they submit, educating new entrants into the tax system, (or new entrants with respect to specific issues where data suggests areas of high noncompliance, as when there are new Schedule C filers visiting a preparer) and make bad actors fear IRS exposure and possible sanction through enhanced monitoring and data-tracking.

Others have written about the importance of education to tax compliance, with the need to tie in as part of any serious effort to increase compliance with a more robust effort at educating taxpayers.<sup>10</sup> The IRS can leverage the educational role that preparers can (and do) play in the system, through communicating with preparers — in person or in writing — who have a threshold of new Schedule C returns, for example, or other relatively new entrants to the tax system. With respect to targeting preparers who have prepared returns suggestive of high rates of noncompliance,<sup>11</sup> or some other benchmark significantly higher

<sup>8</sup> Marjorie Kornhauser, *Tax Compliance and the Education of John (and Jane) Q. Taxpayer*, *Tax Notes*, Nov. 10, 2008, 737, 740 [hereinafter Kornhauser, *Compliance and Education*] (discussing how any serious attempt at tax compliance must seek to educate taxpayers to increase tax morale, including linking taxes to the positive benefits of government to strengthen people's attitudes to the government). See also, Marjorie Kornhauser, *Normative and Cognitive Aspects of Tax Compliance: Literature Review and Recommendations for the IRS Regarding Individual Taxpayers*, in 2007 NTA Report Vol. 2, *supra* note 1, at 138-71.

<sup>9</sup> I take no direct position in this paper as to what an acceptable compliance rate is. Recent tax gap data, however, shows significant systemic areas of non-compliance associated with certain issues or taxpayers, including that associated with EITC claimants and sole proprietors. See Book, *Role of Preparers*, *supra* note 1, at 65-68.

<sup>10</sup> See generally, Kornhauser, *Compliance and Education*, *supra* note 8.

<sup>11</sup> For example, the Discriminant Function (DIF) scores—a metric of the likelihood of gaining additional tax payments in the case of an audit—for 1040-SS and 1040-PR (Self-Employment Tax Returns) are significantly lower than the DIF scores for Schedule C and F filings where the EITC is present and gross receipts are less than \$25,000, regardless of the type of preparer. (Unpublished IRS data on Average DIF Scores by Activity Code and Preparer Classification for Tax Year 2006 (2008)).

than industry or preparer averages, like information on client return Discriminant Function (DIF) scores that are outside the norm, math error activity on client returns, or examination results that are suggestive of higher adjustments than an appropriate benchmark, IRS efforts to communicate with preparers can demonstrate that preparer actions are visible, and allow the IRS to position itself as a service provider and educator to both the preparer and the taxpayer. The agency use of information to influence compliance through a tiered approach reflective of educating and progressing toward a more sanction-based approach to preparers is not my idea alone, but the need to tie in this approach to the IRS's more systematic capturing of preparer data is not a part of the IRS's implemented strategy.<sup>12</sup> In the near background, the IRS must have the tools to remind the potential bad actors that sanctions are always a possibility for egregious misconduct.

My proposals recognize that while enforcement at the back-end requires significant agency resources, an emphasis on front-end compliance efforts—like identifying preparers and testing competence, and communicating both in person and in writing—does not necessarily put the agency in the typical command-and-control regulatory posture, with the resource-intensive demands of preparer audits and the continued use of civil injunction powers to shut down bad preparers. First steps can be tied to educating, serving and informing preparers of best practices, so long as the IRS is willing to continue monitoring and to impose more intrusive sanctions on bad actors. The old audit-first approach cannot work, given agency resource issues and the backlash that would likely accompany a meaningful increase in IRS audits of preparers and small business taxpayers.<sup>13</sup> This approach, which borrows from the insights of scholars and regulators who have adopted a responsive regulation framework, is further discussed below in Section V.

### The Current Landscape

A common theme among those skeptical of additional government regulation of preparers is that adding new measures directed at preparers makes little sense given the limited information about the role that preparers play (namely whether errors are tied to poor scruples, or incompetence, or whether the errors are more properly attributable to some characteristic of the taxpayer), and the lack of meaningful or sustained governmental effort within the existing regulatory framework.<sup>14</sup> Despite the need for additional information and the admittedly inadequate attention given to preparers, the importance of preparers to tax compliance and the need for at a minimum a more robust understanding of the preparer community seems compelling. Consider the following:

<sup>12</sup> See Michael Albert, Kim Bloomquist & Ron Edgerton, *Evaluating Preparation Accuracy of Tax Practitioners: A Bootstrap Approach*, 2007 IRS Research Conference 77, 89 (2007) (“[W]e believe that a substantial reduction in the number of AUR [a noncompliance metric] discrepancies could be achieved by annually monitoring tax practitioners using data-driven techniques ... in combination with a program of outreach and education to the selected preparers”).

<sup>13</sup> This point is especially germane in times of economic difficulty, as materially increasing compliance efforts directed at small businesses, at times when small businesses are facing significant short-term economic pressures, would likely generate intense political pressure on the IRS.

<sup>14</sup> See H&R Block, *H&R Block Voices Concerns with Proposed Rules That Would Limit Solicitation of Refund Anticipation Loans*, Tax Notes, May 1, 2008, Lexis, 2008 TNT 85-21 [hereinafter *Block Comments*] at nn.100-03 and surrounding text; Christine C. Bauman & Katrina L. Mantzke, *An Education and Enforcement Approach to Dealing with Unscrupulous Tax Preparers*, 2 Am. Tax'n Ass'n J. Legal Tax Res. (June 11, 2004).

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- The use of paid preparers has been increasing significantly over the past several years;<sup>15</sup>
- The IRS does not know how many paid preparers there are;<sup>16</sup>
- Preparers often overlook current rules about preparer identification and due diligence (despite how limited they are), and the IRS often overlooks these violations;<sup>17</sup>
- The IRS does not meaningfully capture data to allow for monitoring or tracking preparer performance;
- Limited quantitative data suggest high error rates associated with returns that paid practitioners prepare and file on behalf of taxpayers;<sup>18</sup>
- In most of the country there is no requirement that preparers demonstrate any level of competence before they can begin to prepare tax returns, nor are there meaningful continuing education requirements despite the constant legislative changes to the tax law and a general sense that preparers' lack of understanding of some areas of the tax law contributes to both underreporting and missed opportunities for taxpayers;<sup>19</sup>
- Many preparers are engaged in return preparation as an ancillary business to the selling of other products or services, with (i) the increased profit potential from these ancillary sales raising questions about preparer incentives and motivation to professionalize their tax return preparation functions; and (ii) consumer demand for these products in close proximity to the return preparation process providing potential fuel for improper taxpayer or preparer conduct;<sup>20</sup>
- Among issues not characterized by legal ambiguity, preparers may limit personal responsibility by hiding behind a “don't ask, don't tell” approach to facts that may be germane to computing a correct tax return, which makes it difficult—if not impossible—for the government to assign responsibility for errors;<sup>21</sup>

<sup>15</sup> In 1996, approximately 63 million (53 percent) of individual income tax returns were prepared by paid practitioners. By 2005, that number had risen to over 80 million (62 percent). IRS, SOI Taxpayer Usage Study 1998 & 2006.

<sup>16</sup> “The IRS acknowledges that it does not know how many paid preparers exist and cannot determine the full extent of noncompliance and incompetence among practitioners.” TIGTA, *Most Returns Prepared by a Limited Sample of Unenrolled Preparers Contained Significant Errors* 2-3 (Ref. No. 2008-40-171, Sept. 3, 2008) [hereinafter TIGTA, *Unenrolled Preparers*]. Cf. GAO, *Limited Study*, *supra* note 4, at 5 (noting that not all paid preparers provide preparer information on returns they prepare).

<sup>17</sup> See TIGTA, *Unenrolled Preparers*, *supra* note 5, at 5 (noting 61 percent of returns prepared in mystery shopper study were prepared incorrectly); cf. *Regulation of Federal Tax Return Preparers, Hearing Before the S. Comm. on Finance*, 109th Cong. 6 (July 20, 2005) (written statement of Nina E. Olson, National Taxpayer Advocate) [hereinafter *Olson Hearing Testimony*], available at [http://www.irs.gov/pub/irs-utl/testimony\\_wm\\_oversight\\_returnpreparers.pdf](http://www.irs.gov/pub/irs-utl/testimony_wm_oversight_returnpreparers.pdf).

<sup>18</sup> GAO, *Limited Study*, *supra* note 4, at 23, 25, 28-29 (laying out tables comparing error rates between returns prepared by paid practitioners and returns prepared by taxpayers).

<sup>19</sup> “Most paid preparers are not subject to any education, testing, or registration requirements. Two states, California and Oregon, are exceptions in that... they have had their own requirements that apply to paid preparers working in their states.” GAO, *Oregon/California Preparer Registration Study*, *supra* note 3, at 1. Maryland has also recently imposed a registration requirement for return preparers, See below, at Part IV.

<sup>20</sup> National Taxpayer Advocate, 2007 Annual Report to Congress, 83, 86 [hereinafter 2007 NTA Report].

<sup>21</sup> Susan Cleary Morse, Stewart Karlinsky & Joseph Bankman, *Cash Businesses and Tax Evasion*, Stan. L. & Pol'y Rev. (forthcoming 2009) (manuscript at 24-25) (discussing practices of “don't ask, don't tell” preparers); Susan Cleary Morse, *Using Salience and Influence to Narrow the Tax Gap*, 39 Loy. U. Chi. L.J. (forthcoming 2009) (manuscript at n.76 and applicable text) (discussing interviews that suggest at least some practitioners fall into a “don't ask, don't tell” norm).

- When Congress and the IRS have changed the rules of the “don’t ask, don’t tell” approach, the changes have been insufficient and there has been a demonstrated lack of sustained governmental interest in enforcing the limited rules or making these changes visible to both taxpayers and the IRS itself;<sup>22</sup>
- The limited qualitative research suggests that preparers make errors characterized by both incompetence and lack of meaningful diligence;<sup>23</sup>
- Noncompliance among preparers and taxpayers may become habitual, which suggests that IRS monitoring and educating new taxpayers or preparers is important as a means of stemming years of possible problems;<sup>24</sup> and
- The possible concentration of incompetent or unscrupulous preparers and noncompliant taxpayers suggests that if the IRS meaningfully captures preparer data and correlates preparers with possible benchmarks of taxpayer noncompliance, and (DIF scores, industry averages, etc.), the IRS can efficiently touch significant levels of noncompliance.<sup>25</sup>

## Emphasizing Responsibility

### The Types of Taxpayers and Preparers—General Classification

Given the above, in this section I discuss specific proposals that build on the information that we know, and I highlight areas where immediate attention is required. As context for these proposals, I return to the challenges associated with identifying types of preparers and types of taxpayers. Mapping taxpayers and preparers is essential to assist the IRS and Congress in understanding the causes of noncompliance. The underlying reasons for errors will likely assist in formulating administrative or legislative solutions, and serves as an important backdrop to this and my prior report.

Many studies have been done about taxpayer compliance and the reasons behind decisions not to comply. Some economic deterrence models have studied the interaction between the taxpayer and the government as more of a “strategic game – where each party makes the best response to the other’s strategy in light of available information – rather than a static gamble.”<sup>26</sup> Although more advanced than the models that considered decisions between

<sup>22</sup> Olson Hearing Testimony, *supra* note 17, at 6-7.

<sup>23</sup> TIGTA, *Unenrolled Preparers*, *supra* note 5, at 5 (noting that some mistakes and omissions were the results of mistakes or misinterpretation of the tax law); GAO, *Limited Study*, *supra* note 4, at 17-25 (identifying sources of filing mistakes in mystery shopper scenario).

<sup>24</sup> See Kidder & McEwen, *supra* note 6.

<sup>25</sup> Albert et al., *supra* note 12 (looking at data within one state, and finding that a small number of preparers were likely responsible for a significant amount of errors in the Automated Underreporter Program, and also concluding that a program of monitoring and educating tax preparers may substantially reduce noncompliance); Stuart Karlinsky & Joseph Bankman, *Developing a Theory of Cash Business Tax Evasion Behavior and the Role of their Tax Preparers*, in 5th International Conference on Tax Administration 164 (2002).

<sup>26</sup> Sagit Leviner, *A New Era of Tax Enforcement: From ‘Big Stick’ to Responsive Regulation* 18 (Univ. Mich. Law Sch. Pub. Law & Legal Theory Working Paper Series, Paper No. 68, 2006).

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taxpayers and the administration to be independent of each other, this still fails to consider the role tax practitioners play in the mix.

In my initial study, I discussed research that examined the relationship between preparers and taxpayers, and how that relationship contributes to compliance decisions:

Some studies support the view that practitioners view taxpayers as instigators of aggressive advice, but also recognize that the search for a single model to explain the complex dynamics of practitioner/taxpayer interaction is likely to be futile. Sakurai and Braithwaite, for example, classify practitioners into three distinct types: 1) honest and risk averse, 2) cautious minimizers of tax, and 3) the creative and aggressive planner. Sakurai and Braithwaite concluded that the latter is the least popular in terms of taxpayer preference, but that this aggressive practitioner type is of particular concern. They suggested that taxpayers are inclined to seek out preparers who share their values. This insight is consistent with Karlinsky and Bankman's study of sole proprietor noncompliance, where sole proprietors intent on minimizing income sought preparers they knew who would be comfortable with their approach. It is also consistent with Albert, Bloomquist, and Edgerton's study of underreporting, which suggests that a relatively small number of practitioners are responsible for a disproportionate share of underreporting of certain types of income. Likewise, Kidder and McEwen, adapting a sociological approach, postulated that there are different types of practitioners, those that broker or facilitate compliant behavior, and those that facilitate noncompliant behavior.<sup>27</sup>

As my prior research suggests, there is a general understanding that taxpayers present themselves to practitioners in one of three ways:

1. They are intent on understating their liabilities or overclaiming refunds (Type 1 taxpayers);
2. They are indifferent about understating their liabilities or overclaiming their refunds (Type 2 taxpayers)—these taxpayers will likely defer to the practitioner's advice; or
3. They seek assistance in preparing their returns correctly (Type 3 taxpayers).<sup>28</sup>

Preparers, on the other hand, drawing on the Sakurai and Braithwaite, Bankman and Karlinsky model (and supported in part by my focus group research) generally fall into one of three categories:

1. They are intent on helping clients understate their liabilities or overclaim refunds (Type 1 preparers);

<sup>27</sup> Book, *Role of Preparers*, *supra* note 1, at 59-60. See also Albert et al., *supra* note 12; Yuka Sakurai, and Valerie Braithwaite, *Taxpayer's Perceptions of the Ideal Tax Adviser: Playing Safe or Saving Dollars?* (Centre for Tax System Integrity, Working Paper No. 5, 2001), available at <http://ctsi.anu.edu.au/publications/WP/5.pdf>; Karlinsky & Bankman, *supra* note 25; Kidder & McEwen, *supra* note 6.

<sup>28</sup> See Book, *Role of Preparers*, *supra* note 1, at 61.

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2. They are indifferent about whether their clients comply with their tax reporting or refund claiming (Type 2 preparers); or
3. They are intent on ensuring that clients properly report their liabilities or claim their refunds (Type 3 preparers).<sup>29</sup>

In my first report, I emphasized that the IRS would learn a great deal about possible solutions to the tax gap by exploring the relationship between taxpayers and preparers, focusing on the way that certain types of preparers interact with taxpayers who present different characteristics. Others have likewise emphasized that given the important role that preparers play, researchers and tax administrators should pay more attention to actual interactions between taxpayers and practitioners.<sup>30</sup> I will return to this classification scheme in Part III B when considering the ways the IRS can use mystery shopper scenarios to help gauge preparer motivations and reasons behind potentially erroneous returns.

This desire to appreciate the dynamic relationship should animate future research that the IRS conducts into the preparer's role in the decision to comply or not to comply with the tax law. Despite the current lack of information, there are specific steps that Congress and the IRS can take that build on what we know about the relationship between preparers and taxpayers. These steps will likely contribute to fewer errors associated with preparer-generated individual income tax returns.

### **It is Time to Tie Preparer Due Diligence to Areas of Systemic Noncompliance.**

#### ***Current Due Diligence Rules Are Not Adequately Designed to Ensure that Preparers Emphasize their Responsibility to the Integrity of the Tax System.***

As I and others have stated,<sup>31</sup> relying on due diligence rules to either temper practitioners' willingness to become type 1 or type 2 preparers, or check the appetites of type 1 taxpayers, is limited by the difficulty of attributing knowledge — for example, knowledge of a sole proprietor's unreported income — to the preparer.<sup>32</sup> Current rules provide that preparers may not ignore the implications of what they know and must make reasonable inquiries if

<sup>29</sup> See *id.* at 59 (citing Sakurai & Braithwaite, *supra* note 27, at iv). Sakurai and Braithwaite characterize preparers as “honest and risk averse,” “cautious minimizers of tax,” and “creative and aggressive planner[s].” Sakurai & Braithwaite, *supra* note 27, at iv.

<sup>30</sup> Margaret Mc KERCHAR, *Why Do Taxpayers Comply? Past Lessons and Future Directions in Developing a Model of Compliance Behaviour*, in *Tax Administration in the 21st Century* 225, 241 (Michael Walpole & Chris Evand eds., 2001) (emphasizing the importance of identifying various typologies of noncompliance and urging that additional studies be made relating to actual taxpayer and preparer behavior). Professor Tan, for example, notes that several areas are in need of research, including: (1) to what extent practitioners are willing to give in to client demands and to what extent clients are willing to adopt practitioners' advice; (2) whether the client or the practitioner has greater influence over tax decisions; (3) what (if any) effect the length of the working relationship between client and preparer has on tax decision making; (4) what factors steer the working relationship between client and preparer; (5) whether practitioner advice is affected by firm size; (6) whether practitioners are “client driven”; and (7) how the practitioner balances the requirements of the tax law, their clients' interest, their professional responsibilities, and the demands of the organization they work in. Lin Mei Tan, *Research on the Role of Tax Practitioners in Taxpayer Compliance: Identifying Some of the Gaps*, in *Taxation Issues in the Twenty-First Century* (ed. Sawyer) (2006).

<sup>31</sup> See Book, *Role of Preparers*, *supra* note 1, at 69-70 (laying out typology showing how different levels of preparer awareness of tax law and client motives affects compliance); Morse et al., *supra* note 21, at 23-24 (discussing how particular practitioners' compliance decisions are driven by amount of knowledge they have).

<sup>32</sup> Morse et al., *supra* note 21, at 18.

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information appears to be incorrect.<sup>33</sup> Yet, there is no sense of additional preparer obligations with respect to issues that are characterized by systemic noncompliance. Moreover, standards meant to inform preparers concerning when they are supposed to make further inquiry are tied to generally vague and adaptable common-law negligence standards, providing less than clear guidance and likely inconsistent application of the existing standards.<sup>34</sup>

One approach that I and others have emphasized as a general matter is that the IRS needs to move away from a one-size-fits-all approach to noncompliance.<sup>35</sup> If research suggests high areas of noncompliance associated with specific types of issues, our tax system should more affirmatively impose upon preparers an obligation to ask questions that relate to ferreting out facts that will at a minimum (i) place the responsibility for taxpayer actions squarely on the taxpayer's shoulders and (ii) discourage preparers from becoming facilitators of noncompliance by limiting their ability to hide behind clients and avoid any existing affirmative obligations by choosing not to ask relevant questions.

Consider the touchy subject of inquiring about a taxpayer's lifestyle if the preparer knows that the lifestyle is inconsistent with the information the taxpayer gives to the preparer.<sup>36</sup> It is difficult to calibrate preparer responsibilities because return preparers wishing to attract and retain clients properly do not view themselves as having to cross-examine them on subjects that have a potential to alienate them or bring into question the preparer's loyalty to those clients. Interviews with preparers who have ties to the cash economy illustrate

<sup>33</sup> See Morse et al., *supra* note 21, at 19-25. Penalties against noncompliant preparers are structured in a way to penalize more heavily those preparers who are more active in the filing of noncompliant returns. Those preparers who understate a taxpayer's liability due to an unrealistic position are fined either \$1,000 or 50 percent of the income derived, whichever is greater. Preparers who understate a taxpayer's liability through willful or reckless conduct are fined \$5,000 or 50 percent of the income derived, whichever is greater. Failure to exercise due diligence in determining EITC eligibility brings a \$100 fine per failure. See I.R.C. §§ 6694(a)-(b), 6695(g) (2006).

<sup>34</sup> A recent article considered the lawyer's ability to rely on a taxpayer's recitation of facts. See Jasper Cummings, *When Can a Tax Attorney Rely on Taxpayer's Representation of Facts*, Fed. Taxes Wkly. Alert, Aug. 21, 2008 (noting that preparers may generally rely on a taxpayer's representation of facts, subject to reason). Cummings notes, for example, that Treasury Circular 230 warns against "false statements," which have been interpreted as including "failure to ask an obvious question in a commonplace situation" and that "the absence of a fact or the untrustworthiness of the client may require the lawyer to go farther." Yet, Cummings notes that while there are myriad factors which may put the lawyer on notice that more inquiry is needed, the standard is tied to the reasonable standards associated with common law negligence, "with all of its nuance and adaptability." Cummings points to examples where the IRS has held that preparers had an obligation to ask additional questions of their clients, relating to (i) a client who claimed that he used his car in his work and the preparer failed to ask whether that involved nondeductible commuting, or (ii) a preparer who failed to inquire about the purpose of trips that a client claimed to be business-related. *Id.* (referring to Scenario of Disciplinary Action, 1997-13 IRB 32).

<sup>35</sup> See, e.g., Leslie Book, *Preventing the Hybrid from Backfiring: Delivery of Benefits to the Working Poor Through the Tax System*, 2006 Wis. L. Rev. 1103, 1146-49 (2006) [hereinafter Book, *Hybrid*] (proposing more stringent set of due diligence requirements for paid preparers); Alex Raskolnikov, *Beyond Deterrence: Targeting Tax Enforcement with a Penalty Default* 19-20 (Columbia Law & Econ. Working Paper No. 337, 2008). Cf. GAO, *Tax Gap*, *supra* note 2, at 26 ("Treasury's tax gap strategy does not discuss specific options to address the tax gap overall or sole proprietor income in particular").

<sup>36</sup> My focus group participants, for example, were asked the following:

Assume a potential new client comes to you and is interested in retaining you. You have seen this client around town, and know that he has recently spent hundreds of thousands of dollars on a major home renovation, that his kids go to the same private school as your children, and that he belongs to the poshest country club in town. Prior to the meeting, to be more productive, you ask to review the prior year's income tax returns. On the returns you review, you notice that the income claimed on the return seems low based upon the lifestyle that you have observed. What, if anything, should you do in terms of due diligence (i) prior to agreeing to be this individual's return preparer, or (ii) as part of your services in preparing his tax return if he only provides information that is consistent with the prior year's reported income?

See Leslie Book, *Focus Group: 2007 IRS Nationwide Tax Forum* (focus group data on file with author) [hereinafter Book, *Focus Group*].

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that some preparers engage in actively signaling to the taxpayer their lack of interest in knowing harmful facts.<sup>37</sup> My focus group research suggested that while some preparers indicated they would make inquiries to tie the taxpayer's circumstances to the information on the return, and turn away business if they were uncomfortable with an inconsistency with the taxpayer's general economic circumstances and the tax return information, that was by no means the norm. There was significant disagreement about what kinds of questions preparers should ask as part of the return preparation process and the preparers' role in asking questions, given that there may be legitimate reasons for the discrepancies (*e.g.*, inheritances and prior receipt of reported taxable income). This discomfort was exacerbated especially if there was only general awareness highlighting inconsistencies between the taxpayer's lifestyle and the information the taxpayer presented in the return.<sup>38</sup>

In addition, with the exception of the EITC, there is little connection between what preparers are required to ask taxpayers and the research that has identified systemic areas of high noncompliance. The current tax compliance regime does not tie due diligence to the underlying issues, but rather to the preparer's underlying knowledge of individual circumstances that would trigger a duty of further inquiry under general negligence principles. I believe it is time to tie preparer inquiry levels into research about systemic noncompliance problems within the tax system. This research should inform a preparer's specific due diligence obligations, at least to some degree, and facilitate specific guidance from the IRS as to what is important and perhaps what preparers should be required to ask. While Congress has legislated specific due diligence rules for the EITC, even when Congress or the IRS has instituted something beyond the normal posture that highlights the preparers' role in the system (and implicitly connects the due diligence obligation to systemic areas of noncompliance), the requirements do not emphasize the preparer's role in preventing errors nor do they require the preparer to ask sufficient questions to isolate responsibility for potential errors.

Some researchers have begun to identify the inadequacy of the current due diligence regime. As Morse indicates, Internal Revenue Code (IRC) § 6694 (even before the recent legislative change essentially restoring preparer standards to those of taxpayers for undisclosed return positions) and Circular 230 do not change preparer obligations to inquire into taxpayer circumstances,<sup>39</sup> and generally allow preparers to rely on taxpayer-provided information without any inquiry into its accuracy.<sup>40</sup> While the preparers cannot turn a blind

<sup>37</sup> See Morse et al., *supra* note 21, at 24-25 (discussing the "don't ask, don't tell" approach some paid practitioners use).

<sup>38</sup> See Book, *Focus Group*, *supra* note 36.

<sup>39</sup> Morse et al., *supra* note 21, at 24-25. See also Book, *Focus Group*, *supra* note 36. In focus group research I conducted for the IRS, I asked preparers about the due diligence they would engage in or the inquiry they would conduct with a client who reported income inconsistent with their lifestyle. See *id.* There was wide disagreement about the appropriate role that preparers should play when they have general information which is inconsistent with information on a tax return. A significant number of preparers cautioned against jumping to conclusions based on lifestyle, given the possibility that many people had sources of funds that were not inconsistent with the information presented to return preparers (*e.g.*, gifts, prior inheritances). *Id.*

<sup>40</sup> See *id.* Note that Congress has specifically legislated substantiation requirements with respect to some individual itemized deductions susceptible to abuse, thus triggering levels of inquiry and preparer due diligence to the substantive entitlement to the deduction. See, *e.g.*, I.R.C. § 274(d) (2006) (requiring strict substantiation for all travel expenses).

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eye to the implications of information given to them, or information actually known by the preparers, there is little in terms of practical advice given to preparers about the need to inquire further in light of information on general lifestyle, for example, or in the face of facts relating to tax issues reflective of systemic taxpayer underreporting of income.<sup>41</sup>

Prior congressional and administrative action directed at EITC claimants heightened due diligence requirements and attempted to address these general concerns. However, as the National Taxpayer Advocate has previously identified, the IRS's implementation of the rules has been inadequate, and there is ample opportunity for legislative changes to make the provisions more meaningful.<sup>42</sup> For example, implementing a tiered penalty structure, as well as requiring the preparer to sign under penalties of perjury and submit the due diligence attestation to both the IRS and the claimants, would increase the visibility and significance of the preparer action.<sup>43</sup> The IRS, apparently accepting the possibility that its due diligence rules in this area may play a more meaningful role, is investigating the possibility of refining the EITC due diligence requirements to require practitioners to ask claimants questions that correlate to higher error rates and perhaps identify documentary sources of evidence that, for example, tie qualifying children to the residence of the taxpayer.<sup>44</sup>

Changes to this effect would be significant and could likely influence taxpayer and practitioner conduct at minimal cost. Consider the residency requirement under the EITC rules, in which the taxpayer and the child must live together for more than six months.<sup>45</sup> The specific statutory EITC due diligence requirements for preparers have not pushed preparers to gather information that would flag likely errors relating to the residency requirement. Despite the fact that failing to meet the residency requirement is one of the largest sources of EITC errors,<sup>46</sup> in Form 8867, the EITC due diligence checklist, question 11 is the only question that addresses the residence of children. It reads as follows:

“Did the child live with the taxpayer in the United States for over half of the year?”<sup>47</sup>

<sup>41</sup> Morse et al., for example, discuss three different spending strategies cash business owners use to keep from reporting cash revenues as income: “spend it,” “hoard it,” and “invest it in the business.” Often, these actions are an attempt to hide the income from the accountant or the tax preparer. Some practitioners seek out correct information in order to foster compliance with the tax law, while others employ a “don’t ask, don’t tell” approach. See Morse et al., *supra* note 21, at 19-25. See generally Cummings, *supra* note 34. Widespread disagreement among my focus group participants, who were mostly enrolled preparers, reflects at a minimum the need to address what expectations the IRS should place on preparers in this context. See Book, *Focus Group*, *supra* note 36.

<sup>42</sup> Olson Hearing Testimony, *supra* note 17, at 6-8.

<sup>43</sup> Book, *Hybrid*, *supra* note 35, at 1146-49 (suggesting more stringent due diligence requirements on paid preparers); Olson Hearing Testimony, *supra* note 17, at 7 (proposing tiered penalty structure for violations of EITC due diligence requirements).

<sup>44</sup> Nicole Duarte, *Tighter Knowledge, Documentation Requirements Expected for EITC Claims*, Tax Notes, Sept. 9, 2008, Lexis, 2008 TNT 176-4.

<sup>45</sup> A qualifying child is a child “who has the same principal place of abode as the taxpayer for more than one-half of such taxable year.” I.R.C. § 152(c)(1)(B) (2006). Though a limited EITC is available for low wage workers between the ages of 25-64 who do not live with children, the presence of a qualifying child is a meaningful variable affecting both eligibility and amount of the EITC. I.R.C. § 32(c)(1).

<sup>46</sup> It is unclear, however, whether EITC errors are the result of actual failure to meet the residency requirement or an inability to provide adequate records to satisfy the requirement. Regardless, the size of the problem warrants more of the preparer’s attention. Janet Holtzblatt & Janet McCubbin, *Whose Child is it Anyway? Simplifying the Definition of a Child*, 61 Nat’l Tax J. 701, 712.

<sup>47</sup> IRS Form 8867.

This question is inadequate on a number of levels. While it does tie into connecting the child to living in the United States, that is a separate requirement apart from the residency requirement tying the taxpayer to living with the child,<sup>48</sup> and it diverts attention from the main issue at hand. Given the importance of residence to program error, the applicable form could specifically require the preparer to list the address (or addresses) of the children that the taxpayer has claimed throughout the year, with a specific notation in the form highlighting that this is an issue resulting in significant taxpayer error. It could additionally ask if the preparer has viewed documentary evidence that lists the child or children's address as an address that is consistent with information that the preparer has or knows about the taxpayer's address. This will likely result in some additional time to complete the return, and it could potentially increase the preparation cost. However, listing addresses and tying those addresses to time periods should take no more than five minutes for most claimants and would further highlight the issue's importance for both preparers and taxpayers.

When it comes to other relatively unambiguous issues, like sole proprietor compliance, the tax system defaults to a "don't ask, don't tell" possibility, meaning that preparers can largely hide behind a veil of ignorance, avoid responsibility for any errors on returns that they prepare, and direct responsibility for misconduct to the taxpayers themselves.<sup>49</sup> To avoid that default, Congress could consider expanding specific due diligence rules to other areas of systemic noncompliance, and the IRS should provide meaningful questions in tailored due diligence worksheets tied to a select few specific issues characteristic of both high preparer usage and high error rates. For example, for sole proprietors, a due diligence worksheet could specifically address questions regarding the different components of gross receipts, with the goal of ensuring that preparers ask sufficient questions so they can no longer safely hide behind the "don't ask, don't tell" wall that Morse identifies.<sup>50</sup>

In sum, the current rules emphasize that preparers have duties of further inquiry only in relation to specific information about a particular taxpayer. If, for example, the preparer has reason to believe the information is false, the preparer must ask further questions. I propose that Congress and the IRS heighten the preparer's responsibilities in response to research that suggests there is systemic noncompliance with specific issues. Their doing so will reflect a more nimble approach to tax compliance, allow for tailored responsibilities

<sup>48</sup> See I.R.C. § 32(c)(1)(D) (2006).

<sup>49</sup> Morse et al., *supra* note 21, at 24-25.

<sup>50</sup> See Morse et al., *supra* note 21, at 38 (putting additional disclosure obligations on preparers and sole proprietors themselves; for example, requiring sole proprietors and preparers to sign a statement that all reported income includes "all revenue, cash and otherwise, and that deductions are accurately reported"). See also *The Cash Economy*, in National Taxpayer Advocate 2007 Annual Report, *supra* note 20, at 35-65, at 40 (proposing amending Schedule C to enable IRS to more easily match income reported on Schedule C with income reported on Form 1099). Note that recent legislation heightens the possibility that the IRS and preparers can monitor sole proprietors who appear to be reporting low levels of cash receipts. Section 6050W provides new information reporting rules for third parties making reimbursements in settlement of reportable payment card transactions. Under the new provision, banks and other entities obligated to reimburse merchants using electronic payment card mechanisms will need to provide information returns to the IRS as well as the merchants. See I.R.C. § 6050W, Emergency Economic Stabilization Act of 2008, P.L. 110-343 (2008). This will allow a relatively easy determination of the percentage of gross receipts that reflect these reportable payments. See *The Cash Economy*, *supra*, at 40.

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that tie to specific systemic issues, and increase taxpayer and practitioner visibility and responsibility for presenting correct factual information on tax returns.

*The IRS Needs to Change the Norm of Ignoring the Due Diligence Rules.*

In addition to the due diligence rules failing to meaningfully connect the preparer's overall role in ensuring the integrity of our tax system, current research shows those preparers often ignore the existing due diligence rules.<sup>51</sup> The IRS must undertake a meaningful education and outreach program to clearly identify what its expectations are of preparers, to ensure that an increased use of due diligence is not met by a collective sigh or just the shuffling of additional pieces of paper.

Consider the EITC due diligence requirements.<sup>52</sup> The recent TIGTA mystery shopper scenario highlights the inconsistency and lack of compliance with respect to the information gathering process, even when there are fairly specific requirements associated with generating facts from clients.<sup>53</sup> In that study, while preparing the tax returns, many of the preparers did solicit probing questions prior to and in the midst of the preparation process. To establish eligibility determinations in cases when the preparers did not ask probing questions, the preparers usually took one of two avenues: formulating assumptions or relying on tax return preparation software. The preparers utilized numerous methodologies to obtain information from the mystery shoppers. In just over half of the visits (16 of 28) the tax return preparers had the TIGTA auditors complete an information worksheet. This information worksheet is used to collect data such as information regarding children that can be claimed as dependents or data concerning various sources of income. Of the preparers that had the auditors complete an information worksheet, only five of 16 properly completed the tax returns. The preparers in the remaining 11 visits merely asked for identification cards. With respect to the EITC, there was consistent noncompliance with the due diligence requirements. Although the seven EITC-return preparers did complete the required *Paid Preparer's Earned Income Credit Checklist*,<sup>54</sup> none of them asked all of the probing questions on the form.

This ignoring of responsibilities likely occurs because there is no requirement for the preparer to sign the appropriate due diligence checklist and submit that checklist to either the IRS or the taxpayer,<sup>55</sup> and the IRS has not meaningfully backstopped its requirements with enforcement.<sup>56</sup> While the mystery shopper scenario described above is limited, my

<sup>51</sup> The National Taxpayer Advocate has noted the inadequacies of IRS efforts in collecting on penalties that have been assessed. In calendar years 2001 and 2002, the IRS assessed \$2.4 million in preparer penalties, but collected only \$291,000 (12 percent) of those assessed penalties. National Taxpayer Advocate, 2003 Annual Report to Congress 270.

<sup>52</sup> IRC § 6695(g) (2006) (imposing \$100 fine for each failure to meet EITC due diligence requirements).

<sup>53</sup> See generally TIGTA, *Unenrolled Preparers*, *supra* note 5.

<sup>54</sup> IRS Form 8867.

<sup>55</sup> EITC preparers must complete an EITC checklist (Form 8867 or equivalent form), and complete the EITC worksheets in Forms 1040, 1040A, or 1040 EZ. The preparers must also not have any knowledge of any of the information being incorrect, and must retain this information for three years after the filing date. Reg. § 1.6695-2; Olson Hearing Testimony, *supra* note 17, at 6 nn.14-15; Book, *Hybrid*, *supra* note 35, at 1146.

<sup>56</sup> "[T]he IRS is virtually a nonexistent presence in the unenrolled preparer community." Olson Hearing Testimony, *supra* note 17, at 6.

sense is that it is reflective of many unenrolled preparers, and that there is a norm of non-compliance with the current due-diligence regime. If I am right, this suggests that the IRS will have significant (though not insurmountable) obstacles in getting preparers to comply with whatever additional requirements Congress and the IRS impose. Getting the IRS to ensure compliance with specific requirements imposed on preparers has as a prerequisite the agency's ability to track and monitor preparers, so that the agency can properly educate preparers about their specific responsibilities and also meaningfully backstop education with enforcement in the face of continued noncompliance. The importance of tracking and monitoring preparers is addressed in Section III.A.

### *The Next Steps with Due Diligence.*

The premise behind the heightened approach to due diligence that I suggest derives from the principle that additional preparer obligations into inquiring about client facts should follow from IRS data that suggest there is systemic noncompliance with respect to a particular area or issue. The EITC rules reflect a nascent but ineffective effort in that direction.

The government expects that preparers have a responsibility to the integrity of the tax system overall, in addition to serving their clients. The IRS and Congress should use the research which suggests that there is a significant usage of preparers in areas like the EITC and the reporting of sole proprietor income. This seems especially helpful for areas where there is relative legal clarity, and where taxpayers (or preparers) should not have varying risk tolerance or a strong appetite for challenging uncertain legal positions. After all, there is no uncertainty about the need to report gross income, and the presence of qualifying children does not generally involve issues subject to legal ambiguity.<sup>57</sup> It does not implicate, for example, the situation under IRC § 6694 (prior to its 2008 amendment that repealed a heightened level of disclosure for undisclosed positions), when the fear was that preparers and taxpayers had varying standards of certainty to avoid penalties.<sup>58</sup> When it comes to reporting gross income, or whether children lived with the claimant, there is not much in the way of legal wiggle room that potentially puts preparers and taxpayers at odds, and differing views of likelihood of success or risk tolerance should not create uncomfortable conflicts between the preparer and the taxpayer.

While a heightened due diligence regime might make some preparers uncomfortable, that discomfort should serve as a reminder that there are three parties at the table—the preparer, the taxpayer, and the IRS—and might serve to create or tip noncompliance norms that have settled in areas where taxpayers are used to misstating information to

<sup>57</sup> Cf. *Rowe v. Commissioner*, 128 T.C. No. 3 (2007). In a deeply divided Tax Court opinion, the Court held that a taxpayer's incarceration should be treated as a "temporary" absence from the home and thus allowed her to satisfy the six-month residency requirement rule for purposes of treating the child as a qualifying child. While *Rowe* does illustrate that legal ambiguity does exist in these areas, that is not the norm, nor does it typify the relationship between preparer and taxpayer in this context. In contrast, with respect to many other areas of the tax law, there is a significant interaction between preparers and taxpayers revolving around acceptable reporting positions in light of the possibility of IRS challenge, for example, to the amount or existence of a deduction or loss.

<sup>58</sup> Richard Lipton, *What Hath Congress Wrought? Amended Section 6694 Will Cause Problems for Everyone*, 107 J. Tax'n 68, 69-71 (2007). See P.L. 110-343, retroactively eliminated toughened standards and replaced it with an eased standard for returns prepared after May 25, 2007.

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their preparers.<sup>59</sup> To the extent there are conflicts between preparers and taxpayers, they should revolve around different views regarding the need to comply with the tax law. This proposal emphasizes the preparers' obligation to inquire about relevant facts, and inform taxpayers about why those facts are relevant to complying with the laws, areas that should not legitimately heighten or create preparer tensions with clients.

To be sure, any additional obligations the government imposes upon preparers create the possibility that taxpayers inclined to overstate credits or underreport income will turn away from preparers, and self-prepare returns, relying on increasingly user-friendly software to enable or facilitate the misreporting, especially with respect to Schedule C income. This is admittedly a possibility, but, at a minimum, enhanced due diligence will limit the finger pointing and reduce the difficult problems of proof that the government faces when the taxpayer blames the preparer, and the preparer in turn blames the taxpayer for not telling the truth or for giving incomplete facts. In addition, if the IRS is tracking preparers (as I suggest below in section III.A), the IRS should be able to monitor trends and focus its compliance efforts on those who fail to use reputable return preparers with lower risk of noncompliance.

## Visibility: Tracking and Communicating

### Tracking and Monitoring Preparer Performance

As my initial report described, exactly what effect paid preparers have on tax compliance is not entirely clear.<sup>60</sup> Despite the increasing use of preparers and an increased general sense that more research is needed to examine the role that preparers play,<sup>61</sup> both TIGTA and GAO have recently noted that the IRS is limited by the lack of information it captures about preparers, and the limited means of monitoring practitioner performance. The lack of identifying information about preparers is a significant handicap that limits the ability of researchers and policymakers to fully evaluate the types of problems different kinds of preparers are creating, and hampers meaningful consideration of a number of important prescriptive policy proposals.

According to TIGTA, “although paid preparers file the majority of income tax returns, the IRS has limited information on them and insufficient means by which to track or monitor them.”<sup>62</sup> Likewise, GAO states that:

IRS does little to monitor or track information about individual paid preparers. For example, IRS does not collect information on the type of preparers, such as whether the preparer is an enrolled agent or part of a commercial chain, or the number or types of

<sup>59</sup> See Leandra Lederman, *The Interplay Between Norms and Enforcement in Tax Compliance*, 64 Ohio St. L.J. 1453, 1503-13 (2004).

<sup>60</sup> See Book, *Role of Preparers*, *supra* note 1, at 74; 2007 NTA Report, *supra* note 20, at 95.

<sup>61</sup> See Eric Toder, *What is the Tax Gap?*, Tax Notes, October 23, 2007, Lexis, 2007 TNT 130-22 (“[A] key variable of interest would be relative compliance rates among taxpayers who prepare returns by hand, prepare returns with software, and use paid preparers.”).

<sup>62</sup> TIGTA, *Unenrolled Preparers*, *supra* note 5, at 12.

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returns filed by preparers. Having such information could allow IRS to better identify filing errors and target its outreach to specific preparers or preparer groups.<sup>63</sup>

TIGTA similarly notes that, in the current environment, preparer identification is a hodgepodge:

Preparers identify themselves on income tax returns they prepare by entering their Social Security number, Employer Identification Number, or Practitioner Tax Identification Number. A Practitioner Tax Identification Number is used by a preparer who does not want to disclose his or her Social Security number on tax returns he or she prepares. It is a nine-character alpha/numeric with the first character being “P” followed by eight numbers. An Employer Identification Number is a unique nine-digit number used to identify a taxpayer’s business account on IRS records.<sup>64</sup>

Given the above, it is not surprising that the IRS has a difficult time in the current environment getting even a general read on the role that preparers play in taxpayer compliance decisions:

The IRS does not have one list or database that collects information on preparers. For example, it does not have a list or database that shows the preparer’s name, associated identifying numbers, or whether the preparer is a practitioner or unenrolled preparer and/or an Electronic Return Originator. Preparers could be self-employed and use their personal Employer Identification Number or employed and preparing tax returns as part of a tax preparation company. In the latter instance, the preparer could use the Employer Identification Number associated with the tax preparation company and his or her personal Social Security number or Practitioner Tax Identification Number.<sup>65</sup>

In addition to these limitations, many practitioners fail to sign returns they prepare. While a preparer failing to sign a return can trigger a civil penalty, it does not trigger meaningful or systemic IRS enforcement; nor does it result in the IRS not processing these unsigned returns. As the GAO indicated, the IRS overlooks this because processing tax returns is a priority even if preparer information is not provided or is inaccurate.<sup>66</sup>

<sup>63</sup> GAO, *Tax Administration: 2007 Filing Season Continues Trend of Improvement, but Opportunities to Reduce Costs and Increase Tax Compliance Should Be Evaluated* 18, (GAO-08-38, Nov. 2007) [hereinafter GAO, *2007 Filing Season*]. The IRS is slowly awakening to the importance of tracking data relating to preparers. *Id.*

<sup>64</sup> TIGTA, *Unenrolled Preparers*, *supra* note 5, at 12.

<sup>65</sup> *Id.* at 12-13 (internal footnotes omitted). While the IRS does maintain a database of enrolled agents, the database is of limited use because enrolled agents are allowed to use a Practitioner Tax Identification Number, Social Security number, or Centralized Authorization File number. With multiple identifying numbers in the database, the IRS has not been able to determine this population with reasonable certainty. *Id.* at 13-14.

<sup>66</sup> For example, limited tests showed that more than 9,000 preparers used their Employer Identification Numbers as Social Security numbers to prepare more than 500,000 tax returns filed in calendar year 2008, thus creating additional challenges. TIGTA, *Limited Sample*, at 12-14. These variables make it difficult not only to identify the number of preparers but also to identify all the tax returns they prepared. GAO, *Fiscal Year 2009 Budget Request and Interim Performance Results of IRS’s 2008 Filing Season* 5 (GAO-08-567, Mar. 2008) [hereinafter GAO, *FY2009 Budget*].

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In light of the above, TIGTA has recommended that the IRS develop and require a single identification number that would facilitate controlling and monitoring paid preparers.<sup>67</sup> GAO has also recommended that the IRS require preparers to use a single identification number to provide the IRS with the means to track preparer performance.<sup>68</sup> The IRS has indicated that it is studying the issue.<sup>69</sup> I strongly support such a proposal, which would specifically require preparers to use a single preparer identification number, and I believe it will enable the IRS to educate and enforce in a much more systematic manner as well as make preparers more transparent players in the tax compliance decision.<sup>70</sup>

**Keeping Preparers Visible**

Research strongly suggests that the presence of information returns has a significant effect on tax compliance. In fact, recent tax gap data show that compliance among items disclosed to the IRS, even if not backstopped by withholding, leads to close to 95 percent compliance.<sup>71</sup> The importance of injecting additional visibility into the areas of systemic noncompliance has recently received significant attention, especially with respect to the possibility of increasing information reporting to service recipients and increasing the obligations with respect to reporting the basis in transactions involving the sale of securities.

At present, preparers are largely invisible from the process, with no systematic means available for the IRS to track preparer-generated returns.<sup>72</sup> Research has suggested that part of the reason why information reporting is successful for taxpayers is that taxpayers overestimate the possibility that the IRS will detect noncompliance when information is reported to the IRS.<sup>73</sup> Precisely the opposite scenario exists for preparers, who operate largely on the basis that their actions are immune and invisible.

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<sup>67</sup> TIGTA, *Unenrolled Preparers*, *supra* note 5, at 14.

<sup>68</sup> GAO, *FY 2009 Budget*, *supra* note 66, at 6.

<sup>69</sup> TIGTA, *Unenrolled Preparers*, *supra* note 5, at 15.

<sup>70</sup> One possibility is that IRS could create a preparer database that allows the IRS to capture compliance related information on each preparer, including, for example, the total number of clients and dollars a preparer has in the cash economy, and information on client return DIF scores that are outside the norm, math error activity on client returns, and examination results. Where a preparer is a member of a firm, that relationship presents the possibility of two different perspectives, one at the preparer level, and the other at the firm level, provided both the preparer and the firm can both be uniquely identified.

<sup>71</sup> Leandra Lederman, *Reducing Information Gaps to Reduce the Tax Gap 6* (2008) (unpublished manuscript, on file with author). See IRS News Release 2006-28, *IRS Updates Tax Gap Estimates* (Feb. 14, 2006) (accompanying charts).

<sup>72</sup> For instance, working with researchers from TAS, I attempted to determine a breakdown of compliance estimates by types of preparers, considering the number of returns prepared by these preparers. In this report, a significant portion of practitioners were labeled “Unclassifiable.” These unclassifiable preparers constitute just shy of 45 percent of all paid preparers, and prepare over 13 percent of practitioner-prepared returns. (Unpublished IRS data on *Compliance Analysis by Activity Code and Preparer Classification for Tax Year 2006* (2008)). TIGTA has also noted that the IRS does not have one list or database where information on paid preparers can be compiled. TIGTA, *Unenrolled Preparers*, *supra* note 5, at 12.

<sup>73</sup> Lederman, *supra* note 71, at 6-7.

Unlike taxpayers, preparers—especially those not governed by Treasury Circular 230—exist in a regime largely outside IRS visibility.<sup>74</sup> As I suggest below, a necessary condition to any increased reliance on preparers to positively influence taxpayer compliance decisions is changing that equation, and letting preparers know that the IRS is aware of their actions. For example, IRS outreach to preparers should be systematic and reflective of information that relates to the returns those preparers generate. With the increased usage of e-filing, and the possibility that even the IRS can scan or use bar-code data to enter information from paper-filed returns,<sup>75</sup> the IRS should connect trends in those returns or potential disparities that expand IRS knowledge. As a contrast, tax preparation software can tell taxpayers average amounts of charitable contributions, which can fuel taxpayer compliance decisions, but the IRS too could connect data from specific preparer-generated returns that are different from the norm or suggestive of errors. If, for example, one preparer's EITC returns reflect a significantly higher median refund or a particularly high percentage of Schedule C income rather than wage income, the IRS could contact those preparers quickly with letters alerting them that the IRS has noticed information that differs from the norm. There may be legitimate reasons for that difference. Now, this would only be helpful in the long run if the IRS connected these data to the possibility of audit if the data continue to suggest discrepancies, but it could also provide the possibility for preparer self-correction, without the immediate, heavy-handed, command-and-control approach typically associated with tax compliance. Ultimately, the IRS can ratchet up the pressure if preparers seem to ignore the IRS-generated information.

The prospect of data-driven increased visibility of preparer conduct is discussed further below in Section V concerning responsive regulation, when I consider the theoretical context of a more multi-faceted approach to interacting with preparers. While to some, it may smack of Big Brother, with the IRS capturing data and quickly touching preparers in a “soft” way if the data reflect variations from the norm – like a high percentage of expenses to profits on preparer-generated Schedule C returns, or a low percentage of cash receipts to credit card receipts on a modified Schedule C that would impose additional visibility requirements<sup>76</sup> – this could also tie in to the increased due diligence requirements (discussed above in section IIB) and allow the IRS to provide useful information to preparers to help them assist taxpayers with complying.

<sup>74</sup> For example, in my focus group research, a number of practitioners specifically mentioned the IRS's lack of effort to focus on improper preparer conduct as a reason for the continued presence improper return preparer conduct. See Book, *Focus Group*, *supra*, note 36. The National Taxpayer Advocate has noted on several occasions the serious need to understand the role that preparers play in taxpayer compliance decisions and the causes of preparer errors. See, e.g., National Taxpayer Advocate Fiscal Year 2009 Objectives Report to Congress 50-51; National Taxpayer Advocate Fiscal Year 2008 Objectives Report to Congress 57.

<sup>75</sup> See GAO, *2007 Filing Season*, *supra* note 63, at 3 (“Although IRS has done some research on bar coding and full transcription, it does not know the actions needed to require commercial software vendors to include bar codes on printed returns...”); see also Joab Jackson, *IRS Tests 2-D Bar Codes for Scanning E-Forms*, *Gov't Computer News*, May 3, 2004.

<sup>76</sup> See 2007 NTA Report, *supra* note 20, at 40 (recommending that a revised Schedule C form be issued to “break out income not reported on information returns”). See also I.R.C. § 6050W (2006).

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***The Importance of Targeting New Preparers***

The IRS, with the legislative registration and certification initiative facilitating the contact discussed below at Part IV, must affirmatively and promptly reach out to practitioners as they enter the tax profession. Habits start early, and research and intuition suggest that both practitioners and taxpayers themselves can become habitually noncompliant.<sup>77</sup> This early communication will accomplish a number of important objectives. It will let the practitioners know that the IRS is there as a resource to help practitioners understand the law so that they can apply the proper rules to their clients' situations. It will also help set compliance expectations, and allow the IRS to target information to specific types of returns that the preparer is preparing, and perhaps leverage the role that preparers can (and do) play in educating taxpayers about their rights and responsibilities.

Some recent information suggests that the IRS is striving to identify and target preparers who are new. Promising signs include the government reaching out in writing to first-time EITC preparers, including providing a list of common errors, preparer due diligence requirements and where preparers can turn if they need help.<sup>78</sup> This targeting acknowledges the significant differences that comprise the tax gap, and ties in to the need to foster acceptable practices at an early stage.

The IRS can take similar steps with new practitioners who prepare returns for sole proprietors, particularly those sole proprietors who have recently started their businesses. Erich Kirchler theorized that sole proprietor noncompliance is largely the result of a perceived loss of freedom in paying taxes.<sup>79</sup> Entrepreneurs who have taken on the risk of creating their own businesses, by their very nature are likely more independent, and are thus more likely to perceive taxes as an unjustified taking of their hard-earned income.<sup>80</sup> According to Kirchler, this perceived loss of freedom drives a reactance motive among sole proprietors to evade their taxes.<sup>81</sup>

Kirchler's research suggests that this resistance is related in part to the length of time that the proprietor has been in business.<sup>82</sup> Over time, the entrepreneur's expectations include an awareness of the tax system and the individual's obligations within that system, and they are more likely to take taxes into account in their business operation.<sup>83</sup> Newer entrepreneurs also seem to lack the skills, knowledge, and experience with taxes that allow them

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<sup>77</sup> Kidder & McEwen, *supra* note 6.

<sup>78</sup> *EITC: Due Diligence is More Than a Check Mark on a Form or Clicking Through Tax Preparation Software*, IRS Pub. 4687 (Revised June 2008) (explaining due diligence requirements for paid practitioners); Leslie Book, *Draft Form* (unpublished work, on file with author).

<sup>79</sup> See Erich Kirchler, *The Economic Psychology of Tax Behaviour* 156 (Cambridge Univ. Press) (2007).

<sup>80</sup> *Id.*

<sup>81</sup> *Id.* at 157.

<sup>82</sup> *Id.* ("Length of running a business determines perceived restriction of one's freedom and reactance motives and intention to evade taxes.").

<sup>83</sup> See *id.* at 157-58 ("Over time, adaption to the tax system as well as a separation of gross income from net income and taxes into separate accounts are likely to occur." (internal citations omitted)).

to comply even if they do not share or act upon the perceived lack of freedom.<sup>84</sup> As the business becomes better established, the entrepreneur is less likely to perceive taxes as a loss of their income and freedom and more likely to become more familiar with procedural requirements (including substantiation and recordkeeping), which increases tax compliance among these sole proprietors.<sup>85</sup>

One implication of Kirchler's research is that return preparers, with IRS help, can educate sole proprietors as to the importance of tax compliance and the means to do so.<sup>86</sup> A sole proprietor may have limited understanding of what his obligations are, and may think (rightly or wrongly) that others in his business are not complying with their tax obligations. To the extent that there is a continued pattern of underreporting in an industry or community, the preparer has an uphill struggle to convince or influence the taxpayer to adopt more positive behavior. This is still a useful avenue for IRS involvement, though, especially if there is a broad-based approach to reducing the systemic noncompliance through other measures.

### *Persuasive Communication*

Effective communication between the IRS and the practitioner is essential to encouraging preparer compliance in areas of systemic noncompliance. While there have been several studies focusing on the effect that persuasive communications have on encouraging tax compliance, two more recent studies—one conducted in Minnesota,<sup>87</sup> the other in the

<sup>84</sup> See Erich Kirchler, *The Economic Psychology of Tax Behaviour* 166 (Cambridge Univ. Press) (2007).

<sup>85</sup> *Id.*

<sup>86</sup> *Cf. id.* at 189 ("It is important to take into account that the perception of taxpayers and the resulting style of interaction determine the relationship between tax authorities and taxpayers.").

<sup>87</sup> In the Minnesota study, the Minnesota Department of Revenue decided to look into the impact that "moral persuasion communications" had on compliance. In this experiment, two groups of randomly selected taxpayers each received a certain treatment letter: one group receiving letters appealing to the taxpayer's conscience, and the other group receiving letters discrediting the notion that there is widespread noncompliance. The set of letters appealing to the taxpayer's conscience ("conscience letters") included a reminder that "when taxpayers do not pay what they owe, the entire community suffers." The compliant majority letters sought to drive home the notion that "if one wanted to belong to the majority community of citizens one should comply with the tax laws." The researchers then compared reported income and taxes paid for the recipients of the letters from tax years 1993 and 1994. While income reported and taxes paid by those who received the letter did increase after the letters were sent out, the increases were statistically insignificant when compared to a control group. This led the researchers to conclude that neither of the two approaches affected aggregate compliance, though they did add a caveat that similar appeals delivered in a different way, more frequently, or communications of a different sort might have an effect on compliance. See generally Marsha Blumenthal et al., *Do Normative Appeals Affect Tax Compliance? Evidence from a Controlled Experiment in Minnesota*, 54 Nat'l Tax J. 125 (2001).

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United Kingdom<sup>88</sup>—provide insight into how the IRS can tailor its communications with paid preparers to most effectively encourage their compliance.

These two studies provide some insight into how targeted appeals to taxpayers may affect tax compliance generally. An interesting idea that can be gleaned from these studies, particularly the United Kingdom study, is that compliance may be affected by something as simple as how the tax agency presents itself to the taxpayers. From the United Kingdom study, the letters that showed a greater involvement in the tax collection process, and a greater awareness of the goings-on in return preparation were met with a more substantial response by the taxpayers. As the agency presented itself as more in tune with the facts—or at least more willing to learn the facts—the more compliant the people that were contacted became. In response to the letters where the agency presented itself as a more passive body, simply waiting for the taxpayer to solicit its help, there was no change in taxpayer behavior. As the letters grew “tougher,” and presented a greater involvement and a greater understanding of the collection process, the taxpayers responded by becoming more and more compliant—or at least more cautious in their reporting.

While both of these studies focused on the effect of persuasive communication on the taxpayer, they do provide some insight to how a future study that focuses on preparers can be conducted. It would be interesting to see how similar letters would affect preparer action. If, for instance, the IRS were to send letters to paid preparers, the IRS would be able to track how preparers respond to offers of assistance, appeals to conscience, notification of areas of systemic noncompliance, and threats of guaranteed audits.

This type of study would provide insight into the source of noncompliance. Consider the following: Will the sanction-based letters drive Type 2 preparers to become Type 3 preparers? Can the letters influence Type 1 preparers to change their ways? Insight into these

<sup>88</sup> In this study, the Inland Revenue (The United Kingdom’s IRS equivalent) sent out five different letters to five different sets of sole proprietors, the contents of which ranged from simply offering assistance in filing an accurate return to notification of a preselected audit. The five letters were characterized as:

1. Enabling—offering advice and support in filing an accurate return;
2. Citizenship—containing both an element of the “conscience” and “compliant majority” letters from the Minnesota study;
3. Increased audit—notifying the taxpayer that there will be an increased number of audits of sole proprietor returns in the upcoming year;
4. Audit/penalties—notifying the taxpayer of an increase in the number of audits in the upcoming year while including a statement on penalties saying, “If we find that a return is incorrect, we may charge financial penalties as well as collect any unpaid tax”; and
5. Preselected audit—notifying the taxpayer of an increase in the number of audits in the upcoming year, and stating that the recipient has been preselected for an audit.

In the United Kingdom, sole proprietors who have annual turnover (sales) of less than £15,000 may file a simplified tax form, while those with annual turnover above £15,000 have much more stringent reporting requirements. This threshold plays a key role in proprietor compliance, as the increased compliance costs may provide an incentive to underreport turnover so they may file the simplified form. The researchers discovered that all of the groups had a higher proportion of sole proprietors claiming turnover above £15,000 than a control group, with the exception of those who had received the most benign letters. This, along with similar results for reported net income, led them to conclude that sanction-based letters could be an effective tool in increasing compliance among those sole proprietors who self-prepare their returns, though effectiveness over the long term would require a significant amount of resources to follow up with increased and targeted audits. Similar results and conclusions were reached among those who used paid preparers, though unlike those who self-prepare, letters that emphasized “being a good citizen” seemed to result in a notable increase in reported net profits.

See generally John Hasseldine et al., *Persuasive Communications: Tax Compliance Enforcement Strategies for Sole Proprietors*, 24 Contemporary Accounting Research 171 (2007).

questions will serve to illustrate where the IRS should focus its research and enforcement resources.

To be sure, this information, however, would only get the IRS so far. This information would have to be analyzed in conjunction with qualitative research (for example, through mystery shopper scenarios discussed below) that considers the dynamic relationship between the preparer and the taxpayer. It is unclear to what degree honest and diligent preparers who are intent on reporting their clients' tax information correctly (Type 3 preparers) can influence taxpayer compliance decisions when those taxpayers are intent on underreporting. If the taxpayers are responsive to practitioner efforts at compliance, then this could animate the need to focus our efforts to encourage preparers to change. If the taxpayer is not responsive to practitioners pushing them towards compliance, then that will open up an avenue for further inquiry and research.

### *Refining the Understanding of the Relationship Between Preparers and Taxpayers*

In my initial report, I suggested that the IRS should further study the interaction between preparers and taxpayers, with an eye toward examining the effect (i) that preparers can have on taxpayers' compliance decisions, and (ii) that different types of taxpayers reflecting different factual circumstances or motivations can have on preparer conduct.<sup>89</sup> Along these same lines, I emphasized that the IRS would learn a great deal about possible solutions to the tax gap by exploring the relationship between taxpayers and preparers, specifically focusing on the way that certain types of preparers interact with taxpayers who present different characteristics. Some qualitative and quantitative research appears to suggest that Type 1 taxpayers seem to seek out Type 1 preparers.<sup>90</sup> Others have likewise emphasized that given the important role that preparers play, researchers and tax administrations should pay more attention to actual interactions between taxpayers and practitioners.<sup>91</sup>

<sup>89</sup> Book, *Role of Preparers*, *supra* note 1, at 51.

<sup>90</sup> As mentioned above, taxpayers likely present themselves to preparers in one of three ways:

1. They are intent on understating their liabilities or overclaiming refunds (Type 1 taxpayers);
2. They are indifferent about understating their liabilities or overclaiming their refunds (Type 2 taxpayers)—these taxpayers will likely defer to the practitioner's advice; or
3. They seek assistance in preparing their returns correctly (Type 3 taxpayers).

And the preparers likely act in one of three different ways:

1. They are intent on helping clients understate their liabilities or overclaim refunds (Type 1 preparers);
2. They are indifferent about whether their client complies with their tax reporting or refund claims (Type 2 preparers); or
3. They are intent on ensuring that clients properly report their liabilities or claim their refunds (Type 3 preparers).

See Karlinsky & Bankman, *supra* note 25; Albert et al., *supra* note 12. For the typology of preparer and taxpayer types, see *supra* notes 28-29 and applicable text.

<sup>91</sup> Margaret Mc Kerchar, *Why Do Taxpayers Comply? Past Lessons and Future Directions in Developing a Model of Compliance Behaviour*, in *Tax Administration in the 21st Century* 225, 241 (Michael Walpole & Chris Evans eds., 2001) (emphasizing the importance of identifying various typologies of noncompliance and urging that additional studies be made relating to actual taxpayer and preparer behavior).

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Recent mystery shopper scenarios conducted by both TIGTA<sup>92</sup> and GAO<sup>93</sup> suggest that errors in the EITC and reporting sole proprietor income associated with preparers reflect both willful and negligent conduct.<sup>94</sup> In my prior report, and in prior research, I have argued that delving deeper into the underlying reasons of why a particular practitioner prepares an erroneous tax return is a helpful tool for policymakers wishing to understand what (if any) administrative or legislative efforts can assist in reducing the error rate among those returns. To that end, I suggest the following nonexclusive reasons for errors among preparer generated returns with respect to the reporting of sole proprietor income and the EITC:

1. Ignorance or misunderstanding of the law – poor training, inadequate attention to changes in the law, or complexity of the law;
2. Misunderstanding or failure to understand or learn the facts – due to language or cultural barriers – can also be related to ignorance or understanding of the law, as the practitioner may not know what information is relevant;
3. Inability or unwillingness to detect false or incorrect information, though the inability or unwillingness or inability is not reflective of failing to exercise due diligence;
4. Facilitate noncompliance by not exercising appropriate due diligence to verify facts or information;
5. Aid and abet in noncompliance by advising taxpayers how to misstate or omit income, or claim inappropriate or excessive deductions or credits;
6. Facilitate continued noncompliance by advising taxpayers how to arrange affairs to minimize chances of detection, including advising taxpayers on practices or positions that are likely to otherwise generate IRS attention; and
7. Directed noncompliance – working in an environment where there is a culture of noncompliance, either through insufficient quality control or active and affirmative exhortations to take affirmative steps which are meant to minimize liabilities or maximize refunds.<sup>95</sup>

I believe this typology to be of use in areas reflective of systemic noncompliance, especially when the errors do not relate to legally ambiguous items—an area prior research has identified as being likely to generate a high degree of preparer-facilitated ambiguity exploiting.<sup>96</sup> As I indicate in this and my prior report, the high error rates among paid preparer returns

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<sup>92</sup> See generally TIGTA, *Unenrolled Preparers*, *supra* note 5.

<sup>93</sup> See generally GAO, *Limited Study*, *supra* note 4.

<sup>94</sup> For example, a recent TIGTA study examined 28 tax returns prepared by unlicensed and unenrolled preparers at 12 commercial chain and 16 small, independently owned, tax return preparation offices. TIGTA found that “of the 17 tax returns prepared incorrectly, 11 (65 percent) contained mistakes and omissions we considered to have been caused by human error and/or misinterpretation of the tax laws. However, six (35 percent) of the 17 returns contained misstatements and omissions we considered to have been willful or reckless.” TIGTA, *Unenrolled Preparers*, *supra* note 5.

<sup>95</sup> Book, *Role of Preparers*, *supra* note 1, at 69-70.

<sup>96</sup> *Id.* at 63.

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for issues like the EITC suggest, at a minimum, the need for a deeper inquiry into the relationship between preparers and the incorrect filing, and the possibility that preparers can steer taxpayers toward compliance,<sup>97</sup> rather than the taxpayer choosing other more willing preparers or continuing to file erroneously without the use of a preparer.

The mystery shopper methodology is one tool that the IRS should explore expanding and improving to generate information that will provide additional insights into the reasons for the high incidence of errors on preparer-generated returns.<sup>98</sup> As I mentioned above, recent mystery shopper scenarios suggest that there are both willful errors and other errors based on incompetence. I believe that the IRS should, in a robust manner, inquire into this relationship to explore more deeply the reasons behind the willful or incompetent conduct. The recent mystery shopper tests conducted by TIGTA and GAO provide a framework for the research, but the tests are geographically limited and fail to sufficiently isolate differences among preparer and taxpayer characteristics, making it difficult to take away more than just an anecdotal feel for the problems associated with the returns, and limiting the prescriptive value of the tests.<sup>99</sup>

To make the mystery shopper approach more useful and informative, research that uses the mystery shopper methodology should have the following characteristics:

- Future tests should work backwards from the noncompliance hypothesis that the IRS wishes to consider to specific attributes that may contribute to noncompliance;
- The test design should consider more rigorously the population of preparers that the IRS wishes to assess, with a close consideration of the hypothesis and specific attributes aiding in the selection of the target preparers;
- Future tests should limit the number of different auditors conducting the test to minimize the likelihood that tester differences account for preparer variations;
- Future tests should allow for the actual filing of a tax return to better correlate testing with actual experiences; and
- The tester should have a worksheet following the interaction to allow the tester to identify the likely reasons for the preparer's conduct, with the worksheet (i) mirroring the reasons that may contribute to noncompliance (and allowing for other explana-

<sup>97</sup> It is possible that, irrespective of efforts to improve the competence or scruples of preparers, taxpayers intent on underreporting income or overclaiming credits will seek out other accommodating preparers or choose to prepare their own incorrect returns. This is discussed above in connection with reforming preparer due diligence requirements. See *supra* section II. To the extent the IRS will be better able to capture data relating to preparers, it is possible that education or audit selection criteria will reflect these possible shifts to other preparers, and allow a more targeted government response directed at those preparers and their clients. To the extent that there is an increase in noncompliance among self-prepared returns, this could likewise drive IRS education efforts and compliance resources. Thus, even if there is not a direct effect on changing taxpayer behavior, these changes should allow the IRS to better target its efforts.

<sup>98</sup> Other qualitative means to generate information include case studies, personal experience, focus groups, interviews, and participant observation. Kidder and McEwen have actually suggested that researchers spend time as assistants to practitioners or take temporary jobs at a national chain in order to better observe and better understand the role of practitioners. Kidder & McEwen, *supra* note 6, at 69.

<sup>99</sup> The author is grateful for the advice of Jack Pund, Managing Director of JLP & Associates LLC, whose expertise in fraud investigations and forensic accounting provided valuable insights for this paper.

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tions to provide additional possible insight) and (ii) providing an opportunity for the tester to gauge the relative strength of a reason or reasons to allow for the possibility that multiple explanations animate preparer conduct.

***An Illustration***

For example, consider that the research sought to explore what circumstances suggest preparer incompetence as a reason for the presence of errors on tax returns claiming the EITC. To start, the research should target the strata of preparers that one wishes to assess. If the focus is on considering the differences between the various preparers, research could reflect the wide universe of the preparers who engage in EITC preparation (including enrolled versus unenrolled preparers), or closely target differences within a subset of preparers, such as franchise versus company-owned national-chain preparers. This selection will depend, in part, on what information the research is trying to generate. For example, it would be interesting and informative to test whether there may be a differing emphasis that corporate-owned stores place on training and quality control as compared with franchise-run outlets. A properly designed mystery shopper scenario can illustrate differences in competence between the two types of national chain offices. It might also consider other variables, including, for example, the length of time a respective franchise store has been in business. The researcher should create a script that injects a degree of legal complexity into the scenario, to allow for the tester to consider varying levels of expertise. For example, as the residency requirement and filing status are two important areas contributing to errors, a scenario should closely mirror legal issues implicated in those issues.<sup>100</sup>

Crucially, in light of possible errors that the tester detects in the return that a preparer is generating, the tester should be prepared to ask uniform follow-up questions reflective of a desire to understand why the preparer has offered incorrect return-preparation advice, to allow a greater likelihood for the research to yield tangible and measurable results. For example, some evidence suggests that preparers facilitate taxpayer errors on the EITC out of sympathy for taxpayer circumstances, and a taxpayer who presents information that is close to eligibility might generate a preparer response that elicits that sympathy (e.g., a taxpayer who lives with a child for less than six months but who has demonstrated attachment to that child). Alternatively, the preparer may generate an incorrect return in this circumstance because he feels that the erroneous position is likely not to be detected, and even if it were, would likely not produce any tangible negative consequences for the preparer. Faced with those circumstances, a preparer may generate an incorrect return without even discussing the scenario with the taxpayer. Without appropriate follow-up, it may be difficult to determine what the preparer's motives are, or why the return is not

<sup>100</sup> With residency, for example, the tester could implicate temporary absences as well as the more straightforward test as to whether the child lived with the taxpayer for more than six months.

properly prepared.<sup>101</sup> A return reflective of a lack of awareness with the legal rules warrants a different response when compared with a preparer whose error relates to sympathetic concern with the taxpayer's circumstances, and could animate IRS education or more invasive compliance efforts.

Follow-up studies that revolve around the same basic fact pattern and general strata of preparers visited, using a similarly trained tester who understands the scenario and goals of the inquiry could then add to the initial study with the presence of additional variables. For example, injecting the possibility of a refund product like a refund anticipation loan (RAL) would allow researchers to see how this variable might affect preparer interaction, considering, in particular, how preparers interact with taxpayers who begin with the stated objective of seeking a refund product, and alerting the preparer of the presence of additional potential profit from the transaction may motivate preparers to act improperly.<sup>102</sup>

### ***Preparer Reaction to Taxpayers' Express Desire to Underreport Income or Claim Inappropriate or Excess Credits or Deductions***

One other interesting avenue for research is to consider preparer response to taxpayers who approach a preparer with the expressed intent of underreporting income or overclaiming deductions or credits. I believe taxpayer conduct falls along a spectrum from most desiring to underreport income and seek active preparer facilitation to enable the deception on one side, to the presenting of information which should engender questions in light of the preparer's due diligence obligations on the other.<sup>103</sup> Thus, a possibility for the mystery shopper approach is to consider how preparers react in the face of express taxpayer desire to underreport income or overclaim deductions or credits. Limited current qualitative research suggests that with respect to sole proprietor reporting, for example, there frequently is likely a taxpayer driven search for accommodating preparers, with taxpayers inclined to underreport searching out either Type 1 or Type 2 preparers. It would be possible to try to gauge preparer reaction to taxpayers seeking to underreport or overclaim, and to try to determine to what extent preparers are willing to facilitate the noncompliance or turn a blind eye, or attempt to convince taxpayers to comply with their responsibilities. As noted above, awareness of the characteristics of the preparer who is willing to facilitate the misconduct

<sup>101</sup> For example, a tester should be prepared to ask the preparer follow-up questions, like "what is the test to claim a child for this credit—I thought it was six months" or if the preparer generates a correct return, allow the tester to push on the preparer's sympathy to determine if the preparer would be willing to bend to taxpayer preferences.

<sup>102</sup> It would be relatively easy to consider preparer reaction to the presence of income that the tester has received in a given year that is not subject to information reporting, to determine how a preparer's attitude to such casual income might affect taxpayer compliance decisions. TIGTA and GAO mystery shopper scenarios accounted for this. TIGTA, *Unenrolled Preparers*, *supra* note 5, at 8; GAO, *Limited Study*, *supra* note 4, at 19-20. This is particularly significant, as the IRS and Treasury have questioned whether the additional profits associated with the offering of products like RALs, refund anticipation checks, or audit insurance. See *Guidance Regarding Marketing of Refund Anticipation Loans*, 73 Fed. Reg. 1131 (Jan. 8, 2008).

<sup>103</sup> As I discuss above, I believe that preparers should have heightened due diligence obligations when it comes to the reporting of sole proprietor income, given the research reflecting that there is systemic underreporting in this area, evidence that taxpayers are failing to provide sufficient information to preparers to enable the preparers to prepare a correct tax return, and the possibility that asking additional questions or requiring additional documentary proof from the taxpayer will materially limit the taxpayer's possibility to keep his deception undetected. The use of additional qualitative research can enable researchers to determine the compliance with preparers' due diligence obligations. See TIGTA, *Unenrolled Preparers*, *supra* note 5 (showing preparer disregard for the EITC due diligence rules).

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or turn a blind eye to it would assist the IRS in identifying preparers who are not acting in accord with their overall obligations to the tax system's integrity.

To assist the research, I have refined the general three-pronged category of preparer classification and hypothesized that preparers respond to taxpayers who wish to understate their tax liability in one of six ways:

1. Refusing practitioners – these practitioners refuse to engage in a relationship with clients they suspect to be dishonest or overly aggressive;
2. Signaling practitioners – these practitioners will signal their unwillingness to prepare returns for clients they expect to be dishonest by making detailed inquiries or requesting backup documentation;
3. Facilitating practitioners – these preparers facilitate noncompliance by advising the taxpayer how to take improper return positions when they know or reasonably believe that the taxpayer is misstating facts;
4. Indifferent practitioners – these preparers are indifferent to the taxpayer's conduct and are willing to follow taxpayer preference and overlook noncompliance;
5. Incompetent or unsophisticated practitioners – given the due diligence requirements, these preparers should be able to recognize that the taxpayer is taking improper positions, but are unable to detect or suspect taxpayer misconduct because of lack of training, education sophistication, etc.; and
6. Reasonably unknowing practitioners – despite the client's misconduct, the practitioner does not and cannot reasonably know or suspect that the facts the taxpayer alleges are incorrect.<sup>104</sup>

One assumption I have made in this report is that the relationship between the preparer and the taxpayer is dynamic, and while the mystery shopper scenarios do not reflect actual taxpayer reaction (after all, the taxpayer in my scenario will be a tester rather than an actual taxpayer), they can gauge the approach that the preparer is willing to take to steer the taxpayer toward compliance or noncompliance. This could provide insight into whether the above reasons are illustrative of preparer conduct in the face of taxpayer desire to under-report income or overclaim deductions or credits.

Given the limitations of the research, it will not demonstrate the effect of preparer conduct determinatively, as it is possible that, in a genuine preparer-taxpayer interaction, a preparer will have no measurable ability to change the behavior of someone intent in underreporting or overclaiming. I believe, however, that at least at the margins, preparers can influence and educate taxpayers about compliance,<sup>105</sup> and steer taxpayers towards complying with

<sup>104</sup> Book, *Role of Preparers*, *supra* note 1, at 71.

<sup>105</sup> See *id.* at 57-63. Admittedly, more research is needed in this field.

their responsibilities. Accordingly, gauging and evaluating the characteristics of preparers who reflect an awareness of their responsibility to the system's integrity is important.

As I mention above, I do not believe, however, that changing taxpayer behavior when there appears to be a norm of noncompliance will be easy, nor will such behavioral changes be accomplished solely through efforts directed at the preparer. My hope is that the IRS will enhance its understanding and views of preparers in this context as part of its overall strategy to reduce the tax gap and better educate preparers about their obligations and the government's expectations of their conduct in an effort to reduce the tax gap.

### Registering and Testing Paid Preparers

As mentioned in my initial report, there are no federal registration, certification, education, or testing (RCET) requirements that apply to all paid preparers. For over 30 years there have been calls for increased regulation of all return preparers, including imposing federal RCET requirements for those currently not governed by Treasury Circular 230.<sup>106</sup> There is renewed interest in such proposals, in part due to the National Taxpayer Advocate's emphasis on the proposal in Reports to Congress,<sup>107</sup> testimony favoring such a regime,<sup>108</sup> proposed legislation that would provide for preparer registration,<sup>109</sup> and the experiences of Oregon and California, two states that have had regulatory regimes applying to paid return preparers since the 1970s.<sup>110</sup>

One common criticism of the possibility of requiring federal RCET requirements has been the absence of data relating to the Oregon and California programs.<sup>111</sup> It is likely that this interest will increase given a recent GAO study that looked at the Oregon and California regulatory regimes, and found that Oregon's paid-preparer individual-income tax returns were more accurate than the national average.<sup>112</sup> The extent of the difference in Oregon was large. Oregon's 2001 federal returns were on average about \$250 more accurate than the rest of country.<sup>113</sup> According to the GAO, "the odds that a return filed by an Oregon

<sup>106</sup> There have been calls to more closely regulate tax preparers since 1972, when the National Society of Accountants submitted an eight-point plan focusing on registering paid preparers. The issue gained new life in 1989, and again in 1994-95, when the IRS Commissioner's Advisory Group studied the issue and suggested registering and monitoring preparers. Most recently, in 2003, Senator Bingaman of New Mexico introduced the Low Income Taxpayer Protection Act of 2003 calling for registering paid preparers and RAL providers. See Bauman and Matzke, *supra* note 14.

<sup>107</sup> See National Taxpayer Advocate, 2002 Annual Report to Congress, 216 (*Regulation of Federal Tax Return Preparers*); National Taxpayer Advocate, 2003 Annual Report to Congress, 270 (proposing strengthening regulations on paid preparers).

<sup>108</sup> See *Fraud in Income Tax Return Preparation: Hearing Before H. Comm. on Ways and Means*, 109th Cong. 7 (statement of Nina Olson, National Taxpayer Advocate) (recommending professionalizing tax preparation industry); *Fraud in Income Tax Return Preparation: Hearing Before H. Comm. on Ways and Means*, 109th Cong. 7 (statement of Elizabeth Atkinson, President, Board of Trustees, Community Tax Law Project) (urging support for "appropriate regulations and safeguards for taxpayers").

<sup>109</sup> Low Income Taxpayer Protection Act of 2003, S. 685, 108th Cong. (2003) (containing provisions to regulate paid preparers).

<sup>110</sup> GAO, *Oregon/California Preparer Registration Study*, *supra* note 3. See also Maryland Individual Tax Preparers Act, 2008 Md. Laws 623 (imposing registration, testing and continuing education requirements for paid preparers).

<sup>111</sup> Bauman and Matzke, *supra* note 14.

<sup>112</sup> See GAO, *Oregon/California Preparer Registration Study*, *supra* note 3, at 3. The study also found that California's paid preparer individual returns were on average less accurate than the rest of the country. *Id.* For a discussion of the differences in the programs, see *infra* sections IV.A.2-3.

<sup>113</sup> *Id.* at 17.

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paid preparer was accurate were approximately 72 percent higher than the odds for a comparable return filed by a paid preparer in the rest of the country.”<sup>114</sup> In contrast, the odds that a comparable California return was accurate were approximately 22 percent lower than for other parts of the country.<sup>115</sup> With approximately 1.56 million individual income tax filers in Oregon, that state’s increased accuracy translates to about \$390 million more in income taxes paid than if Oregon’s paid preparer returns were prepared at the level of accuracy seen in the rest of the country.<sup>116</sup>

GAO’s conclusion after studying the regimes was that it was feasible to adopt a national regime that includes preparer education, registration, and, as in Oregon’s case, testing.<sup>117</sup> GAO cautioned that Oregon’s results did not “conclusively support or refute the idea that adopting some or all of the California or Oregon program elements at the national level would improve the accuracy of paid preparer returns or reduce the tax gap,”<sup>118</sup> but that Oregon’s requirements and GAO’s modeling suggests that “an Oregon-style approach to paid preparer regulation may be beneficial.”<sup>119</sup>

In this report, I argue that a tax system that values accountability and visibility for return preparers should impose RCET requirements, with one caveat: for a federal RCET program to succeed, the IRS must meaningfully track paid preparer performance so that the agency will be able to efficiently communicate with—and if necessary move up the enforcement pyramid to sanction—preparers who are either incompetent or unscrupulous. One important aspect of a federal RCET program is that such a program could facilitate preparer compliance with identification requirements and enable the IRS to capture data that would allow it to track preparers. I will discuss that below, as well as examine the elements of what I believe are important aspects of a RCET regime, highlighting some of the differences between the Oregon and California models, and suggesting differences that fit into the new paradigm of accountability, visibility and responsibility.<sup>120</sup> To explore those differences, it is necessary to look at the respective regimes in some detail.

<sup>114</sup> GAO, Oregon/California Preparer Registration Study, *supra* note 3, at 3. For example, GAO found that for a return of medium complexity, a return by an Oregon paid preparer had a 74 percent probability of being accurate, compared to only a 55 percent probability of accuracy in California. *Id.* at 16.

<sup>115</sup> *Id.* at 15-16.

<sup>116</sup> *Id.* at 17.

<sup>117</sup> *Id.* at 25.

<sup>118</sup> *Id.* at 25. The GAO study acknowledged that other factors may have led to the accuracy. For example, the data did not indicate whether there were higher percentages of CPA’s or other already licensed professionals preparing returns in Oregon. There was also no comparison of accuracy prior to California or Oregon’s regulatory regimes, and some other states without additional regulatory requirements are also above average in paid preparer accuracy, indicating that “regulation over paid preparers alone does not explain the differences that we found.” *Id.* at 17. GAO thus “cannot rule out the possibility that Oregon or California returns were no more or less likely to be accurate than they would have been without the regulation of paid preparers.” *Id.* at 4.

<sup>119</sup> GAO, Oregon/California Preparer Registration Study, *supra* note 3, at 25.

<sup>120</sup> An important caveat is that there are significant questions about the effect of a RCET regime on price of return preparation services. GAO specifically did not examine the effect of either California or Oregon’s regimes on pricing or supply, but it did note that Oregon taxpayers were less likely than taxpayers in other parts of the country to use paid preparers. *Id.* at 22. Interestingly, GAO considered the possibility that if the Oregon regime decreased the likelihood that noncompliant taxpayers would wish to use preparers, there might be a compliance effect on self-prepared returns. GAO, however, did not find that, and instead found that “[b]ecause Oregon self-prepared returns were no less accurate than returns elsewhere in the country, even if this switching occurred it likely would not completely offset the increased accuracy of paid preparer returns.” *Id.* at 17, note 33.

## An Examination of the Oregon and California Regulatory Regimes

### California

#### Registration

California paid preparers who are not attorneys, CPAs, or enrolled agents, must register with the California Tax Educational Council (CTEC) to become a CTEC Registered Tax Preparer (CRTP).<sup>121</sup> As of June 6, 2008, 41,755 paid preparers registered with CTEC.<sup>122</sup> In addition to registering with the CTEC, a CRTP must:

- Pay a \$25 registration fee to the CTEC and pay a \$25 renewal fee in subsequent years;
- Complete 60 hours of qualifying education and 20 hours of continuing education in subsequent years;
- Obtain a \$5,000 surety bond; and
- Submit renewal applications once a year to reregister with CTEC.<sup>123</sup>

Paid preparers who fail to register can be fined up to \$5,000.<sup>124</sup> Preparers will initially be fined \$2,500, a fine which will be waived if preparers register with the CTEC within 90 days.<sup>125</sup> If they fail to register within 90 days, the fine will increase to \$5,000.<sup>126</sup> There are no criminal background checks required in California and no qualifying competency tests.<sup>127</sup>

#### Enforcement

In California, CTEC reimburses the state Franchise Tax Board (FTB) for compliance costs.<sup>128</sup> FTB has one full-time and one part-time employee dedicated to the preparer regime.<sup>129</sup> Persons suspected of illegally preparing returns are issued penalty letters and encouraged to become preparers.<sup>130</sup> If they do not register within 90 days, FTB can issue fines of up to \$5,000.<sup>131</sup> In the twelve month period beginning June 2005, FTB identified 77 individuals as unregistered; 56 of those people registered within the 90 day period and were not fined.<sup>132</sup> Of the 21 who were fined, 11 registered in the following year, six were issued the

<sup>121</sup> GAO, Oregon/California Preparer Registration Study, *supra* note 3, at 9.

<sup>122</sup> *Id.*

<sup>123</sup> *Id.* at 9, 13-14.

<sup>124</sup> *Id.* at 10.

<sup>125</sup> *Id.* at 10, note 22.

<sup>126</sup> *Id.* at 10.

<sup>127</sup> *Id.*

<sup>128</sup> GAO, Oregon/California Preparer Registration Study, *supra* note 3, at 10.

<sup>129</sup> *Id.* at 19.

<sup>130</sup> *Id.* at 10.

<sup>131</sup> *Id.*

<sup>132</sup> *Id.* at 10, note 22 and surrounding text.

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\$5,000 penalty and four stopped preparing.<sup>133</sup> Many of these unregistered preparers were identified through on-site visits by two FTB employees.<sup>134</sup>

### *Oregon*

#### Registration

Oregon requires paid preparers who are not already licensed by the state as CPAs or attorneys, or working for a CPA, to obtain a state license to prepare tax returns.<sup>135</sup> The Oregon Board of Tax Practitioners (OBTP) issues two levels of paid preparer licenses: the Licensed Tax Preparer (LTP) license and the Licensed Tax Consultant (LTC) license.<sup>136</sup> Oregon's requirements for the two exams include:<sup>137</sup>

#### LTP Requirements:

- A high school diploma or its equivalent;
- Completion of 80 hours of qualifying education and 30 hours of renewing education;
- Passage of a state administered exam, scoring 75 percent or higher;
- Payment of an \$80 initial fee, an \$80 renewal fee; and
- All LTPs must work under the supervision of an LTC, CPA or attorney.

#### LTC Requirements:

- Completion of a minimum of 780 hours of working as a tax preparer in two of the last five years;
- Within one year of submitting the application, completion of a minimum of 15 hours of qualifying education if already an LTP, or completion of 80 hours of qualifying education if not already an LTP;
- Annual completion of 30 hours of continuing education;
- Passage of a more advanced exam with a score of at least 75 percent, though enrolled agents need only take the section focused on Oregon laws; and
- Payment of \$95 initial and renewal fees (for LTPs, fee is \$65).

#### Enforcement

In Oregon, the OBTP can issue fines for each return prepared without a license.<sup>138</sup> OBTP also has the authority to assess \$5,000 civil penalties or to revoke or suspend the license of someone who engages in fraud or illegal conduct or who violates other provisions of

<sup>133</sup> GAO, Oregon/California Preparer Registration Study, *supra* note 3 at 10, note 22 and surrounding text.

<sup>134</sup> *Id.* at 11.

<sup>135</sup> *Id.*

<sup>136</sup> *Id.*

<sup>137</sup> *Id.* at 11-12. For a graphical view of these requirements, see *id.* at 13-14.

<sup>138</sup> *Id.* at 12.

the Oregon preparer statutes.<sup>139</sup> OBTP may also order restitution to consumers harmed by fraud.<sup>140</sup> From March 2001 to November 2007, OBTP imposed about \$2 million in fines through 48 disciplinary actions, with one person being fined more than \$800,000.<sup>141</sup> Preparers in Oregon have administrative and judicial appeal rights relating to OBPR disciplinary actions.<sup>142</sup>

### *A Comparison of Oregon and California's RCET Regimes*

As GAO indicates, it is not clear why there are differing results in California as compared to Oregon. The study does indicate that there are significant differences between the two programs, and the following considers differences that may account for GAO's differing results.

#### **Two-Tier Structure**

Oregon uses a two-tiered structure, with a requirement that less experienced practitioners, LTPs, must work under more the experienced preparers, the LTCs.<sup>143</sup> Both tiers must pass examinations demonstrating competence, and LTP's are effectively required to work with more experienced practitioners.<sup>144</sup> The requirement that preparers work with more seasoned preparers (or an otherwise licensed professional, like a CPA or attorney), contributes to a possible mentoring relationship and also might check a new preparer with little institutional capital who might be more inclined to act unscrupulously.

#### **Education**

There are also additional education requirements in Oregon, compared with California, with 30 hours of continuing education in Oregon for both tiers, compared to California's 20 hours, and 80 hours of qualifying education in Oregon compared to 60 hours in California.<sup>145</sup> Given the frequency of tax law changes, the additional requirements may contribute to general competency and allow Oregon to focus preparers on new developments.

#### **Examination**

In addition, there is an entrance examination relating to competence in federal and state tax laws in Oregon for both tiers, and the test has a fairly high percentage of people failing: 46 percent of applicants failed the LTP test and approximately 70 percent failed the LTC test—the more experienced tier.<sup>146</sup> That a number of applicants seeking to prepare returns

<sup>139</sup> GAO, Oregon/California Preparer Registration Study, *supra* note 3, at 12.

<sup>140</sup> *Id.*

<sup>141</sup> Only a small percentage of these fines, however, are ultimately collected. Between 2005 and 2007, roughly \$867,000 in fines were imposed, but only about \$75,000 in fines and interest were collected. *Id.* at 12.

<sup>142</sup> Those penalized under the Oregon regime can appeal these decisions. OBTP has an arrangement with the Oregon Office of Administrative Hearings to provide an administrative law judge to hear these appeals. Appeals can also be brought in the Oregon Court of Appeals. *Id.* at 12-13.

<sup>143</sup> *Id.* at 11.

<sup>144</sup> *Id.*

<sup>145</sup> *Id.* at 9-11.

<sup>146</sup> *Id.* at 12.

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failed the tests suggests the possibility that a testing requirement might prevent incompetent or unskilled individuals from preparing returns.

### Minimal Education & Scruples Disclosure

Oregon requires that applicants have a high school diploma or its equivalent, and applicants must also disclose prior criminal convictions or indictments relating to an applicant's honesty.<sup>147</sup> There are no such education prerequisites in California, and California requires no criminal background check.<sup>148</sup> California's program confers no authority to deny registration as long as an applicant completes the education requirements and pays the annual fee.<sup>149</sup> It is possible that Oregon's minimal education requirement provides a higher floor for preparers, and that Oregon's additional disclosure requirement deters unscrupulous people from entering the paid preparer business.

### Small Size of Oregon's Preparer Community

Given the differences in population between the states, it is not surprising that Oregon has far fewer licensed tax preparers than California. According to recent census estimates, California's population as of July, 2007 is 36,553,215, compared to Oregon's population of 3,747,455.<sup>150</sup> The ratio of licensed preparers to population is similar, with California having 41,755 CRTPs and Oregon having 1,916 LTPs and 2,077 LTCs, or 3,933 total licensed preparers.<sup>151</sup> The smaller size of Oregon's preparer community may contribute to a more effective relationship between regulator and regulatee.<sup>152</sup>

### Money Spent on the Program and Enforcement Costs

California budgeted approximately \$1.2 million for administrative and enforcement costs, with most of the money coming from the \$25 registration fees and other income including fees paid by education providers.<sup>153</sup> Total cost per CRTP was about \$29.<sup>154</sup> Oregon also charges for initial registration and renewals (\$80 and \$95, respectively for LTPs and LTCs), and also imposes fees of \$50 to take the LTP exam, and \$85 to take the LTC exam.<sup>155</sup> Both states incur enforcement expenses, with CTEC essentially outsourcing its efforts to the FTB, and OBTP directly incurring the costs.<sup>156</sup> Oregon's enforcement costs are relatively higher

<sup>147</sup> GAO, Oregon/California Preparer Registration Study, *supra* note 3, at 11-12.

<sup>148</sup> See *id.* at 10.

<sup>149</sup> See *id.*

<sup>150</sup> See United States Census Bureau, *United States—States; and Puerto Rico: 2007 Population Estimates*, available at [http://factfinder.census.gov/servlet/GCTTable?\\_bm=y&-context=gct&-ds\\_name=PEP\\_2007\\_EST&-mt\\_name=PEP\\_2007\\_EST\\_GCTT1\\_US9&-CONTEXT=gct&-tree\\_id=807&-geo\\_id=&-format=US-9|US-9S|US-9Sa|US-9Sb|US-9Sc|US-9Sd|US-9Se|US-9Sf|US-9Sg|US-9Sh&-\\_lang=en](http://factfinder.census.gov/servlet/GCTTable?_bm=y&-context=gct&-ds_name=PEP_2007_EST&-mt_name=PEP_2007_EST_GCTT1_US9&-CONTEXT=gct&-tree_id=807&-geo_id=&-format=US-9|US-9S|US-9Sa|US-9Sb|US-9Sc|US-9Sd|US-9Se|US-9Sf|US-9Sg|US-9Sh&-_lang=en) [hereinafter Census Numbers].

<sup>151</sup> GAO, Oregon/California Preparer Registration Study, *supra* note 3, at 9, 12.

<sup>152</sup> Raskolnikov, *supra* note 35, at 36-37.

<sup>153</sup> GAO, Oregon/California Preparer Registration Study, *supra* note 3, at 18.

<sup>154</sup> CTEC's budget in 2007 was \$1.2 million, and CTEC reported 41,755 CRTPs in June, 2008, making the per-preparer cost of the program about \$29. *Id.*

<sup>155</sup> *Id.* at 19.

<sup>156</sup> See *id.*

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than California's, given the far fewer preparers that the OBTP was regulating.<sup>157</sup> Given the administrative and enforcement costs, GAO estimates that California spent approximately \$29 per licensee, and Oregon approximately \$123 per licensee.<sup>158</sup>

#### Additional Paid Preparer Costs

GAO found that education costs for preparers in both states were in the \$200-\$300 range per year, with the possibility of higher costs depending on type of program and whether the preparers were traveling to attend conferences or training sessions.<sup>159</sup> GAO estimated the total costs associated with Oregon's program to be \$6 million, with direct administrative costs amounting to \$490,000 of that total, and the balance reflective of preparer costs.<sup>160</sup>

#### *The Benefit of Oregon's Plan—Overall Impressions*

The GAO study is an important development in consideration of a possible regulatory regime relating to RCET requirements for all paid preparers. The states themselves have not meaningfully analyzed tax returns to track performance and error rates, or otherwise mined data that would allow for detailed evaluations of the program's effectiveness.<sup>161</sup> It is interesting, however, that both states believe that their programs have contributed to the professionalization of the industry and facilitated consumer confidence by, for example, allowing consumers to check quickly (*e.g.*, through online searches) as to whether a preparer is licensed.<sup>162</sup>

The GAO analysis strongly supports the benefits of a program like Oregon's. Oregon's costs, including direct administrative and preparer costs (though as mentioned above, GAO did not examine the effect of costs on taxpayers), were relatively modest at \$6 million, and there was an additional \$390 million of taxes paid in Oregon as compared to what would have been paid if the accuracy of Oregon returns was comparable to that of the rest of the country.<sup>163</sup> While the study does not prove conclusively that Oregon's requirements contributed to higher accuracy, or that any one aspect of Oregon's program was the factor contributing to the results, it suggests that even if only a small portion of the increased revenue is attributable to the program, it is a very good investment. As GAO points out, one aspect of evaluating the effectiveness of compliance decisions is in relation to general

<sup>157</sup> In California, CTEC paid FTB \$270,000 for enforcement activities in 2007, while OBTP incurred roughly \$93,000 in enforcement costs. GAO did note, however, that while California's operating budget is about twice as much as Oregon's, California registers and regulates more than 10 times more preparers than Oregon. *Id.* at 19-20.

<sup>158</sup> *Id.* at 18-19.

<sup>159</sup> *Id.* at 19-20.

<sup>160</sup> GAO notes that this estimate is conservative, as it counted preparer education time for all licensees, including enrolled agents and employees of national chains who already have existing educational and testing requirements. *Id.* at 20. It may underestimate costs in that it fails to include possible additional taxpayer preparation fees or possible additional taxpayer travel time if there are fewer preparer offices than would otherwise exist if no regulatory requirements were in place. *Id.* at 20.

<sup>161</sup> *Id.* at 22.

<sup>162</sup> *Id.*

<sup>163</sup> *Id.* at 25.

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cost benefit calculations, and the IRS typically expects a four to one return on compliance expenditures.<sup>164</sup>

Using the Oregon model as an estimate of a similar program's costs, it is of course likely that imposing a similar federal program will be a significant undertaking. The extent of the costs of such a program is limited by the lack of data the IRS currently has about the number of unenrolled preparers, but it is interesting that Oregon and California, while vastly different states, have a relatively similar ratio of paid preparers to the general population, with California's 41,755 paid preparers comprising 0.11423 percent of the population, compared to Oregon's 3,993 paid preparers comprising 0.10655 percent.<sup>165</sup>

This equates to a range of approximately 300,000 to 350,000 unenrolled preparers at a national level.<sup>166</sup> These numbers are admittedly lower than previous IRS estimates.<sup>167</sup> To the extent that the testing, registration, and education requirements impose costs on those seeking to become paid preparers, they will act as a barrier to entry into the paid preparation market. Assuming direct administrative costs roughly estimated at \$100 per preparer,<sup>168</sup> using Oregon's figures as a base but reflecting a discount for likely economies of scale, that would equate to approximately \$30 to 35 million in government-incurred costs, with approximate additional preparer-incurred costs of \$337 million to \$393 million, using the same ratio GAO used in conservatively allocating cost for preparer time and educational classes.

### ***How to Ensure that the Program Will Maximize Accountability, Visibility, and Responsibility***

One aspect of a national program that neither California nor Oregon emphasizes is the possibility that a federal program will significantly enhance communication and monitoring of preparer performance. While both states use their lists to contact preparers to remind them of requirements and to let them know about changes in the tax law, "neither state uses their preparer information to track paid preparer accuracy or for enforcement

<sup>164</sup> GAO notes that this estimate is conservative, as it counted preparer education time for all licensees, including enrolled agents and employees of national chains who already have existing educational and testing requirements. *Id.* at 20. It may underestimate costs in that it fails to include possible additional taxpayer preparation fees or possible additional taxpayer travel time if there are fewer preparer offices than would otherwise exist if no regulatory requirements were in place. *Id.* at 21.

<sup>165</sup> California has 41,755 paid preparers at last count; Oregon has 3,993. *Id.* at 9,12. California and Oregon's respective population estimates are 36,553,215 and 3,747,455. Census Numbers, *supra* note 151.

<sup>166</sup> Using the above figures, Census Numbers, *supra* note 151, as endpoints, the exact range is 321,577-344,541 preparers. (Figures calculated by author).

<sup>167</sup> In 1999, the IRS estimated that there could be as many as 1.2 million paid preparers, though this number was given as a very rough estimate, with the IRS noting that the actual number could be significantly higher or lower. GAO, Oregon/California Preparer Registration Study, *supra* note 3, at 6. The National Taxpayer Advocate has estimated that of this 1.2 million preparers, as many as 300,000 to 600,000 are not subject to any licensing and educational requirements. National Taxpayer Advocate, 2003 Annual Report to Congress, 270.

<sup>168</sup> The costs would have to reflect that preparers and education providers would likely be the significant, if not whole source of these costs, through fees that would vary based upon the design of any program. The cost estimates below are estimates that assume that direct administrative costs of any national program would comprise approximately 8.16 percent of total costs, exclusive of additional costs that may be passed on to taxpayers in the form of increased preparation costs. This is the same ratio that GAO used in considering Oregon's direct and preparer costs, *i.e.*, \$490,000 of total \$6 million were direct administrative costs.

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purposes.<sup>169</sup> California does not require preparers to use registration numbers on returns they prepare, and while Oregon requires LTCs and LTPs to use registration numbers, the requirement is not consistently followed, as preparers use either their Preparer Tax Information Number, Social Security number, or an Employer's Identification Number.<sup>170</sup> And the GAO has noted that "neither state has a reliable means to track or analyze returns prepared by registered or licensed paid preparers in their states."<sup>171</sup>

To emphasize accountability, visibility, and responsibility, a federal undertaking would have to be backstopped by an identification requirement that the IRS would meaningfully enforce, as I suggest above in Part III.A. The current regime of the IRS not even being able to tell the number of preparers highlights the lack of scrutiny that preparers currently enjoy. To increase visibility of preparer actions, the IRS, if administering a federal program, should communicate with preparers to provide them information that bears on the likelihood of returns' accuracy or particular preparers' needs. This written communication could take different forms, including the issuance of an annual data sheet to preparers that would be delivered just prior to filing season. For example, that data sheet could inform preparers of the total number of returns they prepared last year, identify information about those returns (such as average tax owed or number of returns claiming refunds), and also emphasize data about issues that are related to areas of systemic noncompliance. In that report, the IRS could identify data points that demonstrate the preparers' differences from other benchmarks. For example, the IRS could inform preparers who prepare a significant amount of Schedule C returns of a low percentage of gross receipts to expenses, or for EITC preparers, of higher average or median refunds compared to other taxpayers in a region or state, or other similarly situated preparers.<sup>172</sup> In effect, the IRS could demonstrate to preparers that their actions are visible, and borrow from some of the insights that have accompanied high compliance rates associated with items reported to the IRS.<sup>173</sup> The IRS could also identify and report trends that indicate potential compliance and service challenges to preparers, such as a high percentage of newly licensed preparers in an office, or a high concentration of returns claiming a particular credit at a rate inconsistent with national figures. To make this communication most effective, and to take into account

<sup>169</sup> GAO, Oregon/California Preparer Registration Study, *supra* note 3, at 13.

<sup>170</sup> *Id.*

<sup>171</sup> *Id.*

<sup>172</sup> One question for such a program is whether the national system would borrow from Oregon's two-tier approach, with the requirement that preparers work with more experienced preparers. I take no position as to whether such a requirement is feasible on a national level, or, even if feasible, desirable, given potential additional costs, although I note that the presence of more seasoned professionals may be a means of inculcating a sense of professionalism in an industry that appears to be lacking in a uniform sense of professionalism. If such a tiered approach is part of a national program, the senior preparer would receive information relating to preparers who identified him or her as their supervisor, to facilitate office responsibility for preparer conduct. Even if such a program is not adopted, any identification scheme would have to reflect and allow the IRS to track preparers within offices, especially given the prevalence of national chain preparers. I would expect that the IRS would have authority to share that information with national affiliates of chain offices, irrespective of whether the office were franchise-run or run directly by the chain itself.

<sup>173</sup> Leandra Lederman, *Tax Compliance and the Reformed IRS*, 51 U. Kan. L. Rev. 971, 973-74 (2003) (noting that scholars have pointed to several factors, including trust in government, taxpayer morale, and the use of tax compliance as a signal to explain compliance rates that exceed what would be expected if audit rates and penalties alone drove tax compliance).

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other resource demands on the IRS, the communication season should coincide with the time period prior to the beginning of filing season.

The benefits of such an approach are, in my view, significant. It reflects the possibility that the IRS, like modern service or product providers, can track data to more effectively tailor its communication, communicate the possibility of a potential sanction as a result of preparer noncompliance, and generate possibilities for preparers to meaningfully ask the IRS about resources that will enable preparers of good faith to do their jobs. Just as when I log on to the website Amazon.com my portal reflects recent purchases and likely future interests, the IRS can likewise effectively push out targeted information to its audience, in this case preparers. That many future services to preparers will be provided in an online environment enhances the potential for use of information and data, once mined.

The above assumes that a program will not have significant negative unintended consequences (such as pushing those who do not comply to self-prepare, or materially increase preparation costs), nor will it drive preparers underground to avoid additional federal responsibilities. Any federal program will require systematic evaluation of its effectiveness<sup>174</sup> and costs. Moreover, it is vital that enforcement backstop any program, with a special emphasis on preventing unlicensed preparers from entering and remaining in the system, and requiring preparer compliance with any identification requirements. The latter point will likely require a commitment on behalf of the IRS to emphasize the identification requirement, through on-the-ground investigators<sup>175</sup> and perhaps the possibility of expanding whistleblower provisions to include private reward for individuals who identify unlicensed preparers to the IRS.<sup>176</sup>

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<sup>174</sup> I note that GAO cautioned that other factors in its study had significant influence over whether returns were accurate, and especially noted the lower chances of accuracy among EITC and sole proprietor returns. GAO, *Oregon/California Preparer Registration Study*, *supra* note 3, at 32. It would be helpful to isolate effectiveness of additional regulation with respect to specific issues, including those primarily identified in this report, *i.e.*, EITC noncompliance and sole proprietor reporting of income.

<sup>175</sup> Oregon kept one full-time investigator on staff in the OBTP to impose fines on registered and unregistered preparers for misconduct. *Id.* at 19. Projecting this out on a national scale, using Oregon's 3,993 registered preparers as a baseline, would call for roughly 100 investigators working in a similar capacity at the IRS.

<sup>176</sup> Dennis J. Ventry, Jr., *Whistleblowers and Qui Tam for Tax*, 61 *Tax Law.* 357, §§ V, VI (2008) (urging that whistleblower provisions be expanded to allow private citizens to bring *qui tam* actions against taxpayers for violations of internal revenue laws). For a history of whistleblower laws, and their extension allowing the IRS to pay for tips they receive from people noticing tax problems at their workplace, in their day-to-day business, see *id.*, § II. The whistleblower regime pegs recovery to total tax recovered, thus limiting it as a model for preparers, but one possibility to make this more feasible in this context is to tie informant rewards to numbers of returns that an unlicensed preparer generates, rather than total amount of tax or other penalty recovered.

## The Insights of Responsive Regulation

### The Theoretical Background

Much has been written lately about the possible benefits of responsive regulation, both in the context of tax regulation<sup>177</sup> and government regulation more generally.<sup>178</sup> Responsive regulation is the idea that regulators must be responsive to the conduct of those they seek to regulate. The posture of regulator in a responsive regulatory regime is not adversarial—at least initially. The premise is that regulators should approach the group they seek to regulate cooperatively, with an eye toward solving problems collaboratively, changing toward a more adversarial environment only in the face of non-response or inadequate response to government efforts. A regulator, in “deciding whether a more or less interventionist response is required” must consider those who will be controlled by the regulations.<sup>179</sup> “Responsive regulation is not ‘a clearly defined program or set of perceptions concerning the best way to regulate’ but rather, a method that advances the proposition that regulation should be context-dependant.”<sup>180</sup> Responsive regulation sets forth a regulatory pyramid with a “series of options that a tax authority might use to win compliance, sequenced from the least intrusive at the bottom to the most intrusive at the top.”<sup>181</sup>

One key idea behind the insights from this approach is that in many (perhaps most) cases, the government does not need to automatically resort to coercion or sanction to produce its desired effect, given the resource-intensive nature of that approach and the potential that such efforts might backfire.<sup>182</sup> Rather than a system based upon this responsive regulation model, the United States tax administration has a “command-and-control operational system to accomplish their mission of catching ‘the scoundrels’ who do not pay their taxes.”<sup>183</sup>

There are several elements critical to effectively implementing a responsive regulatory program:<sup>184</sup>

It refers to the practice of (a) influencing the flow of events (b) through systematic, fairly directed and fully explained disapproval (c) that is respectful to regulatees, helpful in filling information gaps and attentive to opposing or resisting arguments (d) yet

<sup>177</sup> See Valerie Braithwaite, *Responsive Regulation and Taxation: Introduction*, 29 *Law & Pol'y* 3, 4 (2007) [hereinafter Braithwaite Introduction].

<sup>178</sup> See Ian Ayres & John Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate* (1992). See also Dennis Ventry, *The Collision of Tax and Welfare Politics: The Political History of the Earned Income Tax Credit, 1969-99*, 53 *Nat'l Tax J.* 983 (“[P]olicy alternatives, regardless of their theoretical or analytical appeal, will have to complement rather than conflict with social and cultural forces to prove successful.”).

<sup>179</sup> Braithwaite Introduction, *supra* note 178, at 4.

<sup>180</sup> Sagit Leviner, *A New Era of Tax Enforcement: From ‘Big Stick’ to Responsive Regulation*, at 264 in *Recent Research on Tax Administration and Compliance: Special Papers Given at the 2006 IRS Research Conference, June 14-15, 2006*, (quoting Ayres & Braithwaite, *supra* note 179) (internal footnotes omitted).

<sup>181</sup> For a more detailed discussion of the regulatory pyramid, see Braithwaite Introduction, *supra* note 178, at 4.

<sup>182</sup> *Id.* (emphasis original).

<sup>183</sup> *Id.*

<sup>184</sup> John Braithwaite, *Restorative Justice and Responsive Regulation* (Oxford University Press) (2002).

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firm in administering sanctions (e) that will escalate in intensity in response to the absence of genuine effort on the part of the regulatee to meet the required standards.<sup>185</sup>

Tax administration usually operates on the presumption that tax law will influence the flow of events when sanctions are sufficiently certain and severe to offset the gains of non-compliance (*i.e.*, the traditional rational actor model).<sup>186</sup> Responsive regulation on the other hand “assumes that there is a responsible moral self that can be drawn out by a good regulator and that will enable offenders to change their ways and self-regulate more effectively in the future.”<sup>187</sup>

Recent scholars have noted that IRS general compliance policy has suffered from a one-size-fits-all model,<sup>188</sup> and have questioned the ability of the IRS to act more nimbly as is required of a regime that incorporates at least some elements of a responsive regulatory framework. In my initial report and prior research I have emphasized that the IRS must more appropriately consider the varied nature of the tax gap.<sup>189</sup> To the IRS’s credit, it is acknowledging this in recent proposals to address the tax gap.<sup>190</sup>

How do the insights of responsive-regulation scholars intersect with the reality of today’s relationship between the IRS and unenrolled paid preparers? Consider Professor Raskolnikov:

Success of responsive regulation depends critically on a regulator being able to decide whether regulatee is willing to comply voluntarily, needs a gentle nudge, a threat of substantial sanctions, or a full blown penalty and perhaps even criminal prosecution in order to cooperate or comply. To make this determination, the regulator must engage with each regulatee on a continuous basis.<sup>191</sup>

Raskolnikov notes that given these conditions, it is not surprising that until recent application in the Australian, New Zealand and East Timor tax systems, it was not surprising that the responsive-regulation concept has largely been applied to smaller regulatory communities, where there is more face-to-face contact between regulator and regulatee.<sup>192</sup>

<sup>185</sup> Braithwaite Introduction, *supra* note 178, at 5.

<sup>186</sup> *Id.*

<sup>187</sup> *Id.*

<sup>188</sup> Raskolnikov, *supra* note 35, at 36-37.

<sup>189</sup> “Both gross and net tax gaps can be subdivided into three main components: the non-filing gap, the underreporting gap, and the underpayment gap.” Book, *Role of Preparers*, *supra* note 1, at 48 (citation omitted); see also *id.* at 51, 73 (discussing the IRS’s need for more complete understanding of nature of tax gap and ability to develop programs to remedy problems; Leslie Book, *Freakonomics and the Tax Gap: An Applied Perspective*, 56 Am. U. L. Rev. 1163, 1167-68 (discussing several sources of tax gap); GAO, *Filing Season*, *supra* note 63, at 3 (“[D]ue to lack of reliable data, IRS’s [tax gap] estimate does not include some types of noncompliance... Also, IRS is concerned with some of the outdated data and methodologies used to estimate the tax gap. Finally, it is difficult for IRS to identify and measure noncompliance ... when IRS has little or no information from third parties about payments made or taxes withheld.”).

<sup>190</sup> GAO, *Filing Season*, *supra* note 63, at 18 (discussing recent IRS efforts to remedy lack of information).

<sup>191</sup> Raskolnikov, *supra* note 35, at 37.

<sup>192</sup> *Id.* at 37 n.176.

Underlying this report is that the IRS increase preparer visibility and responsibility.<sup>193</sup> Relying on technology, the IRS can begin the task of understanding the preparer community. The current situation of the IRS not even having reliable estimates of the total number of paid preparers makes it difficult if not impossible for the IRS to meaningfully interact in the manner that will allow the IRS to gauge the appropriate conduct toward preparers.<sup>194</sup>

### Application to the EITC

In addition to providing a helpful framework for the need to provide service to preparers, the responsive-regulation approach offers additional insights with respect to preparers who are engaged in preparing and filing EITC returns. For example, responsive regulation changes the previously binary view of preparers associated with the EITC as either facilitators of fraud, or possible case workers to be employed in the traditional benefits model.<sup>195</sup> Administrators should emphasize explicitly what is implicit in the current arrangement with preparers: that there is a partnership between taxpayers, preparers and the government. The need to reward good behavior, rather than just ferret out bad actors, could change the dynamic in the partnership, and contribute to reinforcing compliance.<sup>196</sup> In addition, it provides a theoretical context for innovative proposals to encourage industry self-regulation,<sup>197</sup> such as codes of conduct or best practices, and allows the IRS to reward those who reach quality benchmarks or attend training programs that exceed what might even be required under a regulatory regime that contemplates licensing and registering preparers.

As others have written, the trick is to encourage positive behavior while keeping the powder dry to deal with those who need more than reward and encouragement.<sup>198</sup> This may be difficult if other actors are behaving improperly, but there are tools that the IRS and Congress can use to steer claimants toward better preparers. For example, with respect to EITC preparers, positive rewards include favored refund time, differing access to the Debt Indicator program or access to IRS information generally, differing recordkeeping or due

<sup>193</sup> See *supra* section IV.A.

<sup>194</sup> I had asked the IRS to develop a report that classified tax returns by their preparers and analyzed the data to estimate compliance benchmarks. The report was difficult to create, given the limited information available to the IRS. TAS researchers worked exceptionally hard putting it together, but despite all the hard work and effort, were still unable to classify a significant percentage—over 13 percent—of the returns. (Unpublished IRS Preparer Classification Analysis (Sept. 8, 2008)).

<sup>195</sup> See Jeff Engerman, “Administering the Earned Income Tax Credit: Paid Preparers, Problems, and Possibilities” 11-15 (May 13, 2006) (unpublished work, on file with author) (discussing the traditional caseworker model for public assistance programs, where the eligibility is determined *ex ante*, and the EITC model, where the self-reported tax filing undergoes an *ex post* review for eligibility).

<sup>196</sup> See Dennis J. Ventry, *Cooperative Tax Regulation* (Am. Univ. Washington Coll. of Law, Working Paper No. 2008-47, 2008) (describing a regulatory scheme that would “raise compliance by explicitly rewarding compliance”); Susan Cleary Morse, *The How and Why of the New Public Corporation Tax Shelter Norm Compliance*, 75 *Fordham L. Rev.* 961, 1012-13 (2006) (describing the Compliance Assurance Program as a cooperative program between corporate tax decision-making groups and the IRS); David Schizer, *Enlisting the Tax Bar*, 59 *Tax. L. Rev.* 331, 355-371 (proposing a regulatory framework to align the government’s and lawyers’ interests in tax administration).

<sup>197</sup> Block Comments, *supra* note 14, at nn. 120-125 and surrounding text (urging that industry self-regulation can play a role in alleviating concerns of non-compliance).

<sup>198</sup> Other metaphors include the velvet glove/iron fist duality or the talk softly and carry a big stick. Raskolnikov, *supra* note 35, at 36. See Ventry, *supra* note 197, at 16 (citing Leviner, *supra* note 180). Ventry offers an example of incentivizing timely and correct return filing by offering rebates. *Id.*

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diligence requirements, or explicit discretion from Congress for the IRS to modify or waive certain requirements or penalties for preparers who meet certain low-error thresholds. In addition, IRS recognition or publication of those who meet accuracy benchmarks or who otherwise employ best-practice approaches can help encourage those taxpayers who wish to comply to seek better preparers. Such an approach would also carry an implicit or even explicit threat that using preparers who are at different stages of the pyramid entails additional audit risk.

### The Australian Example

An interesting example of how the IRS can climb the responsive-regulation pyramid comes to us by way of Australia. The Australian Taxation Office's (ATO) efforts to address noncompliance among barristers in New South Wales (NSW) show how agency action can respond to the actions of those the agency is regulating.<sup>199</sup>

In 1999, a tax officer at the ATO noticed that those in the legal profession under her review had exceptionally high debts to the ATO.<sup>200</sup> While investigating the cause, bankruptcy came up as the source of the debts time and time again.<sup>201</sup> Doubting that the legal market was doomed, she continued the investigation and discovered that wealthy lawyers were dodging income tax by repeatedly declaring bankruptcy, leaving the ATO as their only real creditor.<sup>202</sup>

Starting at the bottom of the responsive regulation pyramid, the ATO initially approached the NSW Bar Council to address the issue, seeking a self-regulatory solution as opposed to a more forceful intervention.<sup>203</sup> The Bar Council considered the problem, and thought it more appropriate to have it regulated under the NSW Legal Services Tribunal as opposed to self-regulation.<sup>204</sup> The Tribunal did not have the best track record with addressing problems of noncompliance by barristers, and the ATO quickly moved up the pyramid, aggressively bringing the most egregious cases before the courts.<sup>205</sup> The Commissioner also spoke publicly about these schemes, and soon enough, the media got involved.<sup>206</sup> Government officials quickly got into the mix, and began intimating that reform in the bankruptcy law might be in order.<sup>207</sup>

<sup>199</sup> See John Braithwaite, *Markets in Vice, Markets in Virtue* 178-81 (Oxford Univ. Press) (2005) (telling story of ATO efforts to fight noncompliance among barristers in Australia).

<sup>200</sup> The rate of debt default was ten times higher than the rest of the Australian population. *Id.* at 178.

<sup>201</sup> *Id.*

<sup>202</sup> The ATO identified 62 licensed barristers who had declared bankruptcy between 1991 and 2001, with a third of them declaring bankruptcy repeatedly. Some of the lawyers had declared bankruptcy as many as three times in a decade. It was also revealed that barristers were one of the most active demographic groups investing in mass marketed aggressive tax planning schemes. *Id.* at 178-79.

<sup>203</sup> John Braithwaite, *Markets in Vice, Markets in Virtue* at 179.

<sup>204</sup> *Id.*

<sup>205</sup> *Id.*

<sup>206</sup> The Sydney Morning Herald, for instance, ran a series of front-page stories on the lifestyles of these bankrupt barristers. *Id.* at 180.

<sup>207</sup> *Id.*

The possibility of prohibiting recently bankrupted attorneys from practicing law seemed to light a fire under the NSW Bar Association, which became interested in dealing with the problem.<sup>208</sup> The end result of this turned out to be some “modest law reform,” efforts to de-license those barristers with the most egregious histories of noncompliance, and some considerable self-regulatory reform, all of which had the effect of increased tax payments by barristers, increased enforcement against those barristers who remained noncompliant, and a substantial increase in the number of barristers remaining current with their tax returns.<sup>209</sup>

Though the ATO’s efforts were focused on aggressive tax shelters and outright tax avoidance, the IRS can take a page from the ATO playbook in addressing supply-side and preparer-initiated errors in returns. Under this type of regulatory scheme, the IRS could seek out those return preparers with unacceptably high error rates, bring the problem to their attention, and work with those preparers to create internal controls to ensure increased compliance. An approach like this would likely involve more stringent preparer reporting requirements for a number of years. Those preparers who are able to demonstrate the internal controls’ success resulting in increased compliance would have lesser or more relaxed reporting requirements, or perhaps report at less regular intervals. The IRS would move up the regulatory pyramid for those who are unable to make a similar showing, subjecting them to audits and other more intrusive regulatory efforts.

## Conclusion

The insights from the responsive-regulation literature present an intriguing model for IRS interaction with preparers, and provide a theoretical context for a more nuanced approach that the IRS should adopt when considering its return preparer strategies, and the specific proposals I prescribe for Congress and the IRS to adopt. To some extent, the IRS’s current emphasis on preparer education, including the significant resources expended on tax forums and other general outreach programs, reflects the IRS’s awareness that its interaction with preparers must take a varied approach. This report in part, though, is premised upon a paradigm of more personal contact with preparers, with those contacts facilitated by heightened identification requirements and a more dedicated IRS effort to mine preparer data, which will improve its ability to target communications. Thus, a prerequisite for this type of approach is that the IRS must have sufficient information regarding who the good and bad actors are in the return preparation industry. There is a deep need for the IRS to collect information by type of preparer, and to have a nuanced understanding of error rates by preparer and by issue, with a healthy dose of qualitative on-the-ground resources backing-stopping and contributing to understandings that the numbers suggest.<sup>210</sup> Encouraging

<sup>208</sup> The Sydney Morning Herald, for instance, ran a series of front-page stories on the lifestyles of these bankrupt barristers.

<sup>209</sup> John Braithwaite, *Markets in Vice, Markets in Virtue* at 180.

<sup>210</sup> Cf. GAO, 2007 Filing Season, *supra* note 63, at 18 (discussing the IRS plan to develop a database to “serve as a centralized repository of paid preparer information”).

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good behavior must start with the IRS knowing and acting on information about how certain preparers are interacting with taxpayers.

Changing preparer conduct through audits, heightened penalties, and the use of civil injunction proceedings should be undertaken only after the IRS encourages more positive steps, and only after the IRS communicates disapproval of what it perceives to be improper preparer conduct. For example, rather than defaulting to audit when faced with information about likely errors associated with a specific geographic region of a national chain, one approach would involve the IRS visiting preparers to discuss best practices, or consider why the preparer believes its practices are sufficient. Then, the IRS could reveal the existence of information suggesting impermissible error rates associated with that preparer's returns. The IRS could ask that the preparer report back on its internal quality control measures, review corporate culture and education, and encourage self-regulation before resorting to the resource-intensive exercise of audits, and the potential use of civil penalties and injunctions. The compliance stick would come at the tail end of government interaction.

The steps mentioned above are measures that Congress can take to encourage the IRS to move in this direction. For example, the possible legislative change that would require registration and certification of preparers<sup>211</sup> could help facilitate this.<sup>212</sup> This possible additional regulation could be the trigger for the IRS to meaningfully track information related to preparers and encourage better behavior, while at the same time keeping its powder dry for the egregious actors who need more traditional sanction-based approaches. It is to be hoped that the approaches I suggest will contribute to greater preparer visibility, responsibility and competence, and will ultimately allow for the IRS and preparers to genuinely work together to improve the accurate reporting of information on tax returns as well as make it more difficult for preparers to pass on inaccurate information to the IRS.

<sup>211</sup> See Tax Administration Good Government Act, H.R. 1528, 108th Cong. § 141(a)(1)(A) (2004) (granting Secretary of Treasury with the power to require registration of federal income tax return preparers).

<sup>212</sup> See GAO, 2007 Filing Season, *supra* note 63, at 18 (noting that in the event that Congress requires registration of preparers, a database could be used as a tracking system for enrollment and testing of preparers).

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