



TAX PREPARATION SERVICES FOR LOWER-INCOME FILERS: A GLASS HALF FULL, OR HALF EMPTY?

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In this article, O'Connor reports his findings on the need for and use of commercial tax preparation services by lower-income filers, and the incidence of EITC compliance problems for certain types of preparers. He reviews the lack of licensing requirements for commercial income tax preparers and notes the limited enforcement of existing standards of practice. O'Connor recommends amendment of Circular 230 to require enrollment of tax preparers, and he further recommends creation of a grant program to support expansion of the VITA program.

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I. Introduction

During the 1990s, the Earned Income Tax Credit grew rapidly, and is now one of the nation's principal income transfer programs for lower-income persons. For the 1999 tax year 19 million taxpayers received just over \$30 billion.¹ The federal government expenditures

¹U.S. General Accounting Office, "Tax Administration: IRS' 1999 Tax Filing Season," GAO/GGD-00-37, Appendix I, p. 70 (December 1999). Internal Revenue Service, "Selected Historical and Other Data," 18 *Stat. of Income Bull.* 153 (Spring 1999).

for the EITC exceed amounts expended for the food stamp program, Supplemental Security Income (SSI), and the Temporary Assistance to Needy Families (TANF) program. In recent years, academic conferences and government agencies have churned out scores of reports and papers on the EITC program, pointing out that the EITC is responsible for moving over 2.3 million children out of poverty, more than any other program,² and that expansion of the EITC was responsible for up to 60 percent of single mothers entering the workforce.³

The success of EITC has not been entirely free of controversy. Reports of compliance problems and excessive claiming of EITC benefits by ineligible persons have led to significant investments by Congress and the IRS to increase screening and reviewing EITC returns. The role of tax preparation services and the need for tax counseling services have rarely been the principal topic in the published papers⁴ and in most cases when mentioned at all, the topic is given but passing reference.

This report responds to this gap in the literature by undertaking a review and analysis of some aspects of tax preparation and tax counseling services for lower-income taxpayers: reasons for current utilization rates of tax preparation services by lower-income filers; compliance problems among various types of services; and a review of regulatory, licensing, and oversight functions of the IRS, as well as state government. The report provides an assessment of the functions and capacity of the VITA program, and concludes with a review of policy options and recommendations.

II. Why Lower-Income Filers Use Tax Prep. Services

For purposes of this analysis, three sources of tax preparation exist: returns that have been prepared by a paid preparer, returns prepared by a recognized volunteer program, either Volunteer Income Tax Assistance (VITA) or Tax Counseling for the Elderly (TCE), and self-prepared returns.

The use of paid tax preparation assistance has been rising nationally, in step with the increasing complexity of the tax code. In 1990 48.3 percent of tax returns listed a paid preparer; in 1994 49.9 percent of all tax returns listed a paid preparer, and in 1997 the number increased to 51.8 percent. The number of taxpayers "assisted" by volunteer tax preparation ser-

vices, VITA and TCE, was 3.1 million in 1990, which increased to 3.5 million in 1999.⁵

The IRS does not maintain data, in a manner accessible to the public, on use of types of preparers by level of income or type of return. However, a recent IRS math error report indicates that a paid preparer signed 60 percent of EITC returns, a significantly higher proportion compared to the entire population.⁶ For the year covered by the math error report, 1997, 51.8 percent of all taxpayers used a paid preparer.⁷ Reasons for higher rate of reliance on tax preparers include complexity in the tax laws, problems with literacy, IRS compliance initiatives, and fear of the IRS. Taxpayers who speak English as a second language also have unique incentives to seek tax preparation assistance.

A. Complexity

While much of the public debate on complexity in the tax system has focused on middle-income concerns related to problems with the alternative minimum tax, multiple phaseout rates, and compliance challenges for small businesses, lower-income filers have quietly taken on a substantial share of this burden. Almost annual changes in the EITC program have been a primary source of this complexity. A major expansion of EITC occurred in 1990 when Congress increased the benefits and also broadened the definition of qualifying child.⁸ As a result of the new definition of a qualifying child, the IRS produced a new form, Schedule EIC. Beginning in the 1991 tax year, all filers claiming EITC with a qualifying child must complete Schedule EIC. The form collects information on the name, taxpayer identification number, age, residence, and relationship of each qualifying child.

The definition of a qualifying child has three components:

1. Age: the child must be under age 19 at the end of the tax year,

But, there are two significant exceptions for a child who

Is age 19-23 and a full-time student⁹

Or, is of any age if totally and permanently disabled.

²Council of Economic Advisors, "Good News for Low Income Families: Expansions in the Earned Income Tax Credit and the Minimum Wage," p. 3 (December 1998).

³B. Meyer and D.T. Rosenbaum, "Welfare, the Earned Income Tax Credit, and the Employment of Single Mothers," Department of Economics, Northwestern University (1998).

⁴Janet Spragens, "Welfare Reform and Tax Counseling: Overlooked Part of the Welfare Debate?" *Tax Notes*, Oct. 21, 1996, p. 353.

⁵Internal Revenue Service, "Selected Historical and Other Data," 18 *Stat. of Income Bull.* 153 (Spring 1999), at table 21 and 22, pp. 236-38. As discussed *infra* at note 83 and accompanying text, the number of returns prepared by volunteer programs is substantially less than the number of taxpayers assisted.

⁶Internal Revenue Service, Brooklyn District Office of Research and Analysis, "EITC Math Errors Profile Report," at p. xiv (1999).

⁷Internal Revenue Service, Statistics of Income Division, Table, "Use of Tax Preparers for All Returns and Returns With Earned Income Tax Credit, Number of Returns by Size of Adjusted Gross Income, 1997" (May 8, 2000).

⁸Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, sec. 11111, 104 Stat. 1388-408.

⁹Full-time student is defined as attending school for at least one semester, carrying a course load defined as full time by the institution.

2. Residence: the child must live with the taxpayer for at least six months (except a foster child must live with the taxpayer for the entire calendar year).

3. Relationship: the child must be a biological child, stepchild, grandchild, adopted child, or foster child.

Another layer of complexity on top of this definition of qualifying child is the so-called "AGI tie-breaker rule." Section 32(c)(1)(C) provides that if two individuals can claim the same qualifying child, then only the individual with the highest modified AGI may take the credit. This provision causes endless confusion in extended families with grandparents and other relatives who have earnings that are higher than the parent.

Over the past six years, several amendments changing EITC eligibility have further complicated the process of calculating benefits. In 1995 Congress amended section 32 to provide that taxable interest, dividends, net rental income, or royalties exceeding \$2,350 would totally disqualify an individual from receiving the EITC.¹⁰ In 1996 Congress, as part of the welfare reform legislation, the Personal Responsibility and Work Opportunity Reform Act (PRWORA), made several more amendments to section 32. One amendment made a significant restriction in eligibility requiring that the taxpayer must have a valid social security number.¹¹ In prior years undocumented persons who worked in the United States and were legally required to file a tax return despite their undocumented status could qualify for the EITC. In the 1996 PRWORA Congress also added capital gains and net passive income to the list of disqualifying income, and changed the amount to \$2,200.¹² Also in 1996 Congress created a "modified adjusted gross income" calculation that requires excluding, for purposes of calculating income that determines EITC benefits, the following:

- losses from sale or exchange of capital assets
- losses from nonbusiness rents and royalties; and
- 50 percent of the net loss from a trade or business.¹³

Congress also required that modified AGI, for EITC purposes, *include* tax exempt interest and pensions or annuity payments not already included in taxable income. The following year, in the 1997 Taxpayer Relief Act, Congress changed the 50 percent disregard of net losses from a trade or business to 75 percent.¹⁴ The Taxpayer Relief Act also excluded workfare payments made by state or county welfare departments from the definition of earned income for the EITC.¹⁵

All of these amendments to the EITC program reflect responses to legitimate public policy concerns, largely related to targeting benefits. Some of the amendments address concerns in a reasonable and effective manner; other amendments may be subject to debate as to their reasonableness or effectiveness. Nevertheless, the amendments exist, and they are not likely to disappear in the short term. In the aggregate, EITC amendments have created a thicket of rules, exceptions, and exceptions to exceptions that directly affect the overall need for tax preparation assistance. IRS Publication 596 explains all aspects of the EITC and provides 54 pages of guidance and tables, including six separate worksheets. According to the American Institute of Certified Public Accountants, its members, while they do not often prepare EITC returns, find such returns to be more challenging than completing a Form 1040 with Schedule A.¹⁶ The National Taxpayer Advocate, in his most recent annual report to Congress, listed administration of the EITC as the third most serious problem facing taxpayers.¹⁷

Although the principal focus of this report is on EITC filers, lower-income filers may qualify for certain additional tax benefits that add further layers of complexity to their tax returns. The Child and Dependent Care Credit is available for wage earners with work related child care expenses, and a separate Form 2441 must be completed and attached to the Form 1040 to claim this credit. Families with three or more children may qualify for the additional child tax credit, and must use Form 8812. The HOPE and lifetime learning credits are available for qualified tuition and related expenses, but the taxpayer must complete Form 8863. A single parent with three young children and income from wages in the amount of \$22,000 may need to complete, in addition to Form 1040, four separate schedules. Moreover, self-employed taxpayers must complete Schedule C and Schedule SE. Each year about 3.2 million EITC returns (17 percent of all EITC returns) report self-employment income.¹⁸

B. Literacy Problems

Limited literacy among EITC filers presents another motivation for using tax preparation services. The National Adult Literacy Survey (NALS) is a massive study conducted through interviews with approximately 26,000 individuals during the period 1988-92. NALS assessed literacy by creating five skill levels, with Level 5 being the highest, and Level 1 being the lowest. NALS also measured literacy in three dimensions:

¹⁶Testimony of David Mares, Chair, Tax Executive Committee, American Institute of Certified Public Accountants, before the Oversight Committee of the Committee on Ways and Means of the United States House of Representatives, at p. 13 (June 23, 1998) <http://www.aicps.org/members/div/tax/sim98.htm>.

¹⁷National Taxpayer Advocate, *FY 1999 Annual Report to Congress*, at I-9 (December 1999).

¹⁸Internal Revenue Service, "Individual Income Tax Returns," 18 *Stat. of Income Bull.* 41, table 4 (Fall 1998).

¹⁰Pub. L. 104-7, section 4(a) (1995).

¹¹Pub. L. 104-193, section 451(b).

¹²Pub. L. 104-193, section 909 (1996).

¹³Pub. L. 104-193, section 910, adding a new subparagraph (5) to section 32 (a) (c).

¹⁴Pub. L. 105-34, section 1085(b).

¹⁵Pub. L. 105-34, section 108 (c).

- Prose literacy includes finding information in texts, integrating information in texts, and writing new information related to the text.
 - Level 1 literacy tasks require a reader to locate a single piece of information that is identical to or synonymous with the information given in the question, when the text is short; or when plausible but incorrect information is either not present, or is located away from the correct information.

21 percent of all adults (40 million persons) performed no higher than this level; a subgroup in this category, consisting of 8 million adults, could not perform even the simplest tasks.
 - Level 2 literacy tasks require the reader to locate a single piece of information in the text, compare and contrast easily identifiable information based on a criterion provided in the question, or integrate two or more pieces of information when distracters are present; or when low-level inferences are required.

27 percent, or 52 million adults performed no higher than this level
- Document literacy, the ability to locate and integrate information from various parts of a document, and write new information in appropriate places in a document.
 - Level 1 literacy tasks require a reader to locate a piece of information based on a literal match, or enter information onto a document, when little, if any, distracting information is present.

23 percent, or 44 million persons performed at this level.
 - Level 2 document literacy tasks require the reader to match a single piece of information, cycle through information in a document, integrate information from various parts of a document, or generate written information by entering requested information in the proper place, when several distracters are present, or when the match requires low-level inferences.

28 percent, or 54 million adults performed at this level.
- Quantitative literacy involves the ability to interpret graphs and charts, locate quantities, repeat the search as needed to find all the numbers, integrate information from various parts of a document, infer necessary arithmetic operation, and perform arithmetic operations.
 - Level 1 quantitative literacy tasks require a single relatively simple arithmetic operation, such as addition, when the numbers to be used are provided and the arithmetic operation to be performed is specified.

22 percent, or 42 million adults performed at this level.

- Level 2 quantitative literacy tasks require locating numbers by matching the needed information with that given, inferring the necessary arithmetic operation, or performing a single arithmetic operation, when numbers and the operation to be performed are stated in the task.

25 percent, or 48 million adults performed at this level.¹⁹

In summary, NALS found a total of 21-23 percent of American adults to be functioning no higher than level 1 literacy. That is, their literacy test scores indicated that they could perform some or all the functions listed for level one, but they could not be expected to perform functions listed for level two. Persons at this level usually cannot perform tasks such as locating eligibility data from a table, or entering information on a social security card application.²⁰ NALS found a total of 25-28 percent of the adult population to be functioning within the range of Level 2 literacy. Persons at this level usually cannot integrate information from dense texts from different documents, and cannot use multiple charts to make calculations. In other words, NALS found that 46-51 percent of the nation's adult population lack the most basic skills to prepare a tax return.

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For purposes of this analysis, in reviewing the need of lower-income filers for tax preparation assistance, it is important to note that the incidence of literacy limitations is sharply higher among lower-income adults. A related study on the Literacy Skills of Welfare Recipients in the United States reviewed NALS data and concluded that up to 76 percent of the adult food stamp recipients in the United States have Level 1 or Level 2 literacy levels in one or more of the three literacy dimensions (prose, document, or quantitative).²¹ Overwhelmingly, EITC claimants are very-low-income workers; 12.2 million EITC claimants earned less than \$15,000 in 1997.²² The incidence of limited literacy for this group is likely to be substantially above the national average.

In light of these extensive literacy problems, it is surprising that no formal research has been found that attempted to measure how reading skills affect the accurate completion of an income tax return. However, a study concerning literacy and errors in the 1990 Census may help illuminate this issue, albeit indirectly. In 1991

¹⁹Center for Education Statistics, *1992 National Adult Literacy Survey*, Overview at pp. 3-9 <http://nces.ed.gov/naal92/overview.html>.

²⁰National Institute for Literacy, "The State of Literacy in America" at pp. 1-5 (1998).

²¹Paul E. Barton and Lynn Jenkins, Policy Information Center, "Literacy and Dependency," at pp. 17-20 (1995).

²²Note 7 *supra*.

researchers initiated a qualitative field study designed to examine how low-income census respondents conceptualized and responded to the 1990 census. The census was readministered to an ethnically diverse group, and the results were tabulated and analyzed. The study found between one quarter and one third of the questionnaire content consisted of errors in response.²³ Researchers concluded that “findings from both the statistical and qualitative analyses suggest that literacy skills and interpretive issues — singly and together — were associated with errors in census information. . . .”²⁴

Literacy research data and the analysis of literacy and census errors indicate that a substantial majority of EITC filers have such limited literacy as to seriously compromise their capacity to prepare their own tax return. Moreover, the NALS study also found that self-awareness of literacy limitations is not keen. For adults scoring in the lowest literacy level, 66-75 percent described themselves as being able to read or write English “well” or “very well.” The same response was recorded by 93-97 percent of all adults in the second lowest literacy level. Only 14-25 percent of adults in Level 1, and 4-12 percent of adults in Level 2 literacy reported that they got a lot of help from family members with everyday document or quantitative literacy tasks.²⁵ This lack of self-awareness suggests that some of the more than 6 million individuals who do not receive tax preparation assistance for their EITC tax returns may need some encouragement to obtain assistance. However, the cost barriers limiting access to commercial preparers, and the limited capacity of volunteer tax preparation programs discussed *infra* may also be contributing factors.

C. Compliance Initiatives

Other amendments to EITC were intended to address compliance concerns, but also have an impact on overall complexity of the EITC program. Compliance initiatives therefore increase need for and reliance on tax preparation services. In 1994 Congress required that all qualifying children have a taxpayer identification number.²⁶ This necessary step provided the IRS with the information to verify certain qualifications of a qualifying child, but also raised the bar for taxpayers with regard to completeness and accuracy of information provided on the tax return. A second step occurred in the 1996 PRWORA legislation, when Congress expanded the math error authority of the IRS to cover EITC returns that had errors related to taxpayer identification numbers.²⁷ The original math error program allows the IRS to summarily correct, without following usual assessment procedures, certain errors on tax

returns before issuing refunds.²⁸ Math error authority allows the IRS to issue a letter advising that the return has been changed; the taxpayer has 60 days to respond, after which the change becomes final. Within 60 days, the taxpayer can request that the usual deficiency procedures be followed, which allow much more time for preparing a response, and also permit appeal of an adverse decision. However, it is unlikely that EITC claimants with limited literacy skills understand these procedures.

By comparison, the normal assessment procedure requires the IRS to issue a deficiency letter which provides 90 days for response, and allows for an administrative appeal as well as the opportunity for a petition to Tax Court. The '96 amendment extended math error procedures to cover errors in TIN²⁹ for both taxpayers and qualifying children. Beginning in tax year 1997, the IRS began crosschecking social security numbers (SSNs) on EITC returns with Social Security Administration records. Where name and SSN did not match, the IRS issued a “math error” letter denying the EITC refund. Using this summary assessment procedure the IRS identified 2.7 million math errors in 1997 EITC returns, and 2.0 million errors in 1998 EITC returns.³⁰ This substantial increase in correspondence from the IRS likely increased the need for further tax preparation assistance as filers sought help in understanding the letters and determining how best to respond. That less than half of the taxpayers who received EITC-related math error notices responded in 1998 does not undercut this conclusion. To date, there has been no reported assessment concerning the reasons for lack of responses to math error reports, an omission that has been criticized by the General Accounting Office.³¹

Correspondence audits represent another significant source of letters from the IRS to EITC filers. These audits are initiated by one of the service centers that process income tax returns. The service center sends an initial letter requesting certain information to verify or clarify an issue identified in the return. The taxpayer has 30 days to respond, and the examiner then may close the case, request additional information, or issue a letter assessing additional taxes. The taxpayer then has 90 days to respond to the assessment letter. The taxpayer has the right to administrative and judicial review of the assessment.³² According to a GAO

²⁸Section 6213(b)(1).

²⁹TIN refers to taxpayer identification number, which is usually an individual's social security number. When an individual is not eligible to obtain an SSN, the IRS will issue a special ITIN, or individual taxpayer identification number. IRS Form W-7 is used to apply for an ITIN. *See also* discussion at note 55, *infra*.

³⁰U.S. General Accounting Office, GAO/GGD-00-7, “Tax Administration: IRS' Use of Nonaudit Contacts,” p. 19, table I.1 (March 2000).

³¹U.S. General Accounting Office, “Tax Administration: Tracking Taxpayer Information About IRS Notices Could Reduce Burden,” GAO/GGD-00-54 p. 11 (March 2000).

³²*See* discussion in U.S. General Accounting Office, “IRS Audits: Weaknesses in Selecting and Conducting Correspondence Audits,” GAO/GGD-99-48 at pp. 14-15 (March 1999).

²³R. Iversen, F. Furstenberg Jr., and A. Belzer, “How Much Do We Count? Interpretation and Error-Making in the Decennial Census,” *Demography* Vol. 36, No. 1, at 131 (February 1999).

²⁴*Id.*

²⁵Note 21 *supra* at p. 8.

²⁶Pub. L. 103-465, section 742(a) amending section 32(c)(3)(D)(i).

²⁷Pub. L. 104-193, section 451 (c).

report, the number of correspondence audits tripled between 1994 and 1995, from 353,000 to 1.1 million, and then dropped to 758,000 in 1996 and 1997. The increase in 1995 was due to increased emphasis on EITC returns, and the drop in 1996 and 1997 was due to shifting many actions to the extended math error program discussed above. For the 1996 fiscal year, 58 percent of correspondence audits involved EITC returns, and 75 percent of all correspondence audits involved returns with AGI under \$25,000.³³ Despite a general decrease in IRS audit activities, the emphasis on EITC audits has continued. In 1999 the IRS audited 1.36 percent of all returns with AGI under \$25,000, compared to 1.15 percent of all returns with AGI exceeding \$100,000.³⁴ This surge in correspondence audits certainly increased the need for tax counseling assistance, especially among lower-income filers with limited literacy.

The Taxpayer Relief Act of 1997 imposed additional compliance measures regarding EITC returns. A new section 32(k) imposed a 10-year period of ineligibility on a taxpayer who fraudulently claimed the EITC, and imposed a two-year period of EITC ineligibility on a taxpayer who claimed the EITC due to negligent or reckless disregard of rules and regulations.³⁵ Section 32(k) also provides that any taxpayer denied EITC benefits under deficiency procedures (e.g., a 90-day letter) must, in a subsequent year that the taxpayer claims EITC, provide such additional information as the secretary may require to demonstrate eligibility for the credit. Regulations implementing this section establish a recertification procedure that requires a taxpayer to complete form 8862 and attach it to the subsequent year tax return. In January 1999, the IRS had identified 197,625 taxpayers who had been denied EITC on their 1997 returns, and were subject to the recertification process. In the 1998 tax year, 23,617 of those taxpayers filed EITC returns with Form 8862 attached. However, 63,372 of those taxpayers filed EITC returns with no Form 8862; all of this group received math error notices denying EITC claims. Only 6,992, less than 11 percent of taxpayers receiving this category of math error letter, later submitted a Form 8862.³⁶ All of this correspondence very likely created additional needs for tax counseling assistance, and the absence of response raises a question of the availability of assistance for at least some taxpayers.

The magnitude of the EITC compliance initiative is dramatically revealed by the Balanced Budget Act of 1997, in which Congress lifted discretionary spending caps, in the amount of \$716 million over five years, for EITC compliance activities. Although some components include expanded customer service and public outreach, a principal focus is on increased staffing to handle screening EITC returns, and the correspon-

dence that results from anticipated 440,000 audits, and 383,000 math error notices, each year.³⁷

D. Fear

Fear and anxiety are very real motivators leading many taxpayers across the entire economic spectrum to rely on tax preparation assistance. IRS audits, or the fear of an audit, cause taxpayers to take their responsibilities seriously. As recently noted by IRS Commissioner Charles O. Rossotti, reductions in audit rates for upper-bracket taxpayers risk creating an impression that the IRS "is not or cannot do anything about" non-compliance for that segment of the population.³⁸ The relative increase in audit rates for lower-income filers is ratcheting up the pressures on that population to be aware of and concerned about compliance. While most moderate-income taxpayers have a modest level of anxiety about the potential enforcement powers of the IRS, the perception of that threat is often more intense among lower-income filers. Anecdotal reports abound among staff of VITA programs, Low-Income Taxpayer Clinics, and national tax preparation companies concerning the intense anxiety levels of many clients.³⁹

E. English as a Second Language

Taxpayers who speak English as a second language (ESL) or who do not speak or read English at all constitute a very large category of individuals with unique incentives to rely on formal tax preparation assistance. In addition to motivation arising from all of the factors discussed above, ESL taxpayers must confront significant language barriers, and often experience ethnic isolation and fears concerning immigration status and risks of deportation. There are 25 million foreign-born persons residing in the United States; of that number, nearly 17 million are noncitizens. Noncitizens have a disproportionately high poverty rate, at 27.7 percent, or 4.6 million persons.⁴⁰ Moreover, all persons working in the United States, including those who are undocumented and are therefore working illegally, are required to file income tax returns if they incur any tax liability. This group is therefore especially vulnerable: They have relatively challenging tax preparation needs, yet they have relatively limited capacity to find capable, affordable tax preparation assistance in the general marketplace.

Taking into account these elements of motivation for lower-income filers — tax law complexity, high incidence of literacy limitations, increasing compliance

³³*Id.*, at pp. 3-5.

³⁴*New York Times*, p. 1, col. 6, Apr. 16, 2000.

³⁵Pub. L. 105-34, section 1085(a)(1).

³⁶GAO, note 1 *supra* at 49-50 (December 1999).

³⁷U.S. General Accounting Office, "Earned Income Credit: IRS' Tax Year 1994 Compliance Study and Recent Efforts to Reduce Noncompliance," GAO/GGD-98-150, at p. 26 (July 1998).

³⁸*New York Times*, Apr. 16, 2000, at p. 24, col. 2.

³⁹Note 4 *supra* at 354-5; see also H&R Block, "Tax Preparation Services for Lower-Income Filers: Comments on a Paper by Michael O'Connor for the American Tax Policy Institute," at p. 3 (July 13, 2000).

⁴⁰W. Zimmerman and K. Tumlin, "Patchwork Policies: State Assistance for Immigrants Under Welfare Reform," at table 1 and table II (Urban Institute, May 1999).

initiatives targeted on lower-income taxpayers, fear about IRS enforcement, and the special needs of foreign-born persons — one would expect virtually all lower-income filers, especially those claiming the EITC, to rely on tax preparation and tax counseling assistance.

III. Who Provides What Services?

This section surveys the types of preparers, the services provided, relative use of respective providers by lower-income filers, and, finally, barriers that limit access to tax preparation services for this population. For purposes of this analysis, there are essentially two types of preparer: paid income tax preparer and volunteer preparer.

A. Types or Categories of Preparers

There are three categories of paid preparers: professional preparers, national companies, and “other” or unaffiliated preparers. The first category of professional preparers includes attorneys, certified public accountants (CPAs), and enrolled agents. Attorneys are licensed by the states, only a relatively small portion specialize in the area of taxation, and an even smaller portion prepare tax returns for individuals. CPAs are also licensed by the states, and make up the vast majority of professional tax preparers. Enrolled agents number only 35,000 nationally, and are licensed by the IRS after passing a comprehensive examination. Only a relatively small portion, less than 9 percent, of EITC returns are prepared by paid preparers in this “professional” category.⁴¹

A second category of “paid preparer” consists of national companies, such as H & R Block, the largest company, and Jackson Hewitt. The H & R Block 1999 annual report states that its U.S. operation has 90,000 preparers in 9,000 offices that serve 16.5 million clients annually.⁴² A 1994 IRS compliance study found that these national chains completed 15.6 percent of EITC returns, a number that has likely increased in recent years.⁴³

The category “other paid preparer” consists of all others who prepare returns for a fee. Some income tax preparers in this category operate accounting or book-keeping businesses, and provide high-quality, professional tax preparation services during the filing season. Other tax preparers may operate only during tax season out of a storefront, a portion of a storefront, or even their own home. This category prepares the largest portion of EITC returns, nearly 30 percent according to the 1994 IRS compliance study.⁴⁴

In addition to paid preparers, there are volunteer preparers who work in formal, IRS-sanctioned programs, or informal arrangements. The formal volunteer

programs are Volunteer Income Tax Assistance (VITA) and Tax Counseling for the Elderly (TCE). The IRS has sponsored VITA since 1977, and TCE began in 1978. These formal volunteer programs, as well as the IRS delivery of tax preparation services at IRS walk-in offices, are described in more detail *infra*. It is noteworthy that the 1994 compliance study found that volunteer programs prepared only 1.6 percent of EITC returns, or about 300,000 of more than 19 million EITC returns.⁴⁵

B. Range of Services Available

For lower-income taxpayers, assistance from paid preparers can include a broad range of services. In addition to preparing the tax return and related schedules and worksheets, preparers offer advice and assistance with matters such as withholding adjustments that can be made through changes in the W-4 form. Some commercial preparers offer assistance outside the regular tax filing season — January through April 15. This additional assistance may include advice in responding to correspondence from the IRS concerning a return, or it may involve advice about the tax implications of a change of employment or a change in family composition. The substantial compliance initiatives may also create the necessity to file an amended return to correct mistakes. Other taxpayers who have not filed at all may need assistance in preparing prior year returns.

Electronic filing of the tax return is often offered as a supplemental service. Many preparers charge an additional fee, but others may include electronic filing as part of their overall tax preparation fee structure. Refund anticipation loans, or RALs, also may be offered to taxpayers who expect a refund exceeding several hundred dollars. The RAL is essentially a bank loan secured by the anticipated refund. With the preparer acting as an intermediary, the taxpayer directs the IRS to wire the refund to the bank, and authorizes the bank to use the proceeds to pay off the loan. RALs allow a taxpayer to receive the proceeds of a refund in as few as 2-3 days. However, the cost of the loan and the preparer’s fees are deducted from the loan amount.

The usefulness of RALs for lower-income taxpayers is open to question on several levels. Admittedly, the RAL can produce cash in only a couple of days, and some families in a financial crisis may find this service well worth the cost. However, with electronic filing of a return and direct deposit of the refund to a taxpayer’s bank account, the refund can be available in 10-20 days from the date of filing. The cost of \$70 or more to expedite a refund by as little as 10 days is not fully explained to most customers. Moreover, because the loan may be paid off in only 10-20 days when the IRS wires the refund to the bank, the cost of the loan, expressed as an annual percentage rate or APR, can be as high as 1,500 percent.⁴⁶ In the flurry of paper work that occurs as the transaction is completed, it is unlikely that most customers realize the full cost incurred for the services they receive.

⁴¹This estimate is taken from the 1994 IRS Compliance Study; see J. McCubbin, “Non-Compliance and the Optimal Design of the Earned Income Tax Credit,” at p. 16 (1999)

⁴²H&R Block, *1999 Annual Report*, p 7.

⁴³Note 41 *supra* at p. 16.

⁴⁴*Id.*

⁴⁵J. McCubbin, note 41 *supra*, at note 31.

⁴⁶*New York Times*, Business Section, July 2, 2000, pp. 1, 12.

The cumulative cost for these services can be substantial, from the perspective of a lower-income taxpayer. The average tax preparation fee in 1999 for H & R Block was about \$85, an increase of 37 percent in five years.⁴⁷ Fees for electronic filing are generally separate, and average \$30-40, although some preparers may bundle this fee with the tax preparation fee. Bank fees for the RAL depend on the size of the refund, and are in the \$60-85 range for the average EITC refund.⁴⁸ Therefore, the total cost for an EITC return can exceed \$150. The cost for preparing an amended return or prior-year return is usually at least as much as the cost for preparing a current-year return. Electronic filing and RALs are not available for prior-year and amended returns.

The revenue for individual preparers cannot be determined, but the annual report of H & R Block provides some useful insights. For its U.S. tax operations during the period 1997-98, revenue increased 8.4 percent, to \$1.047 billion, even though the total number of clients served was flat. During the following period, 1998-99, there was another increase in revenue, up 20.1 percent, as the number of clients crept up only 4.5 percent. This surge in revenue occurred in part because of an increase in prices, and in part because of increased complexity of the tax laws, which increased the number of forms and schedules for each return, and further increased fees for each client.⁴⁹

C. Barriers

In the context of the multiple, substantial incentives for lower-income persons to utilize tax preparation assistance (that is tax law complexity, literacy limitations, reaction to compliance initiatives, and fear of the IRS), it is important to ask why as many as 40 percent of EITC filers do not use tax preparation assistance. The answer lies in one or more of several barriers that limit access to affordable tax preparation assistance. Geographic limitations are certainly a factor. Paid preparers may not be available in some rural areas and inner-city neighborhoods, where a limited concentration of taxpayers able to afford paying fees for this service may not support opening and operating an office. Language barriers and ethnic isolation may also limit access to capable tax preparation services for some of the 25 million foreign-born persons residing in the United States.⁵⁰

Affordability is another critical factor. The most basic return preparation fee, excluding the extras fees for electronic filing and a refund anticipation loan, rarely is less than \$50, and often may be much more. A single mother with wages that place her at the poverty level may well not have that cash available, so she

may rely on a relative or friend for help, prepare the return on her own, or perhaps not file at all.

The paid preparer industry stresses RALs in its marketing, and this is a strong incentive for EITC filers, who often have immediate needs for the refund. Another significant factor in use of the RAL is that the fees are deducted from the refund. Therefore a single mother who uses a paid preparer and claims a total refund, including an EITC in the amount of \$2,500, may receive a RAL check in the amount of \$2,350. The \$150 balance would be allocated to the preparer for the return preparation and electronic filing fees, and to the bank for the RAL fee.

This arrangement finesses the cost barrier for many EITC filers, but not all lower-income filers qualify for an RAL. These loans are not available for filers whose refund is less than several hundred dollars. Also, RALs are not available to filers who have an intercept listed against their refund for a prior year tax liability, or for a debt to another federal or state agency. In 1998 2.4 million taxpayers had a tax refund offset, and were therefore not eligible for an RAL.⁵¹ In these cases, the taxpayer must pay the fee up front. For lower-income filers, the other options include a less costly and most likely a less capable preparer, a friend or relative with, most likely, little or no expertise, or simply not filing at all. This last option is surprisingly common, even among filers who are due a refund. A recent IRS press release estimated that 1.6 million taxpayers had failed to file their 1996 tax returns and were entitled to refunds totaling about \$2 billion.⁵²

IV. Tax Preparation Services and Compliance

A critical question in assessing tax preparation services for lower-income persons is whether the service results in improved compliance with tax laws. Two IRS studies provide partial responses to this question: a 1994 IRS Compliance Study, and a 1999 IRS Math Error Study. A third study, a 1997 EITC Compliance Study, was not available to the public at the time this research was conducted.

A. 1994 IRS Compliance Study

In April 1997, the IRS released a report, "Study of EITC Filers for Tax Year 1994," that evaluated 2,046 returns that claimed an EITC.⁵³ The study included both paper and electronic returns filed between January 15, 1995, and April 21, 1995. For each selected return, a Special Agent from the IRS Criminal Investigation Division (CID) was assigned to contact the taxpayer, preparer, electronic return originator, and the employer if wages were the source of EITC-qualifying income. The study sought to test the accuracy of qualifying income, filing status, and the qualifications of

⁴⁷*Wall Street Journal*, Feb. 28, 2000, p. R6, col. 3.

⁴⁸Because the loan may be paid off in only three weeks, when the IRS wires the refund to the bank, the cost of the loan, expressed an annual percentage rate or APR, can exceed 300 percent.

⁴⁹H&R Block, *1999 Annual Report*, pp. 17-18.

⁵⁰Note 40 *supra*.

⁵¹Internal Revenue Service, "Selected Historical and Other Data," 19 *Stat. of Income Bull.* No. 3, at p. 144, Table 19, (Winter-Spring 1999-2000).

⁵²Internal Revenue Service, "Taxpayers Must File Soon to Claim \$2 Billion in 1996 Refunds," IR 2000-09, Feb. 16, 2000.

⁵³Internal Revenue Service, "Study of EITC Filers for Tax Year 1994," at pp. 5-7 (April 1997).

qualifying children listed on Schedule EIC. The results were screened and compiled. Comparisons were also made to other databases; for example, to check other returns that may have listed the same qualifying child, and to match W-2 and 1099s filed with the Service against reported income. The report found that of the total \$17.2 billion in EITC benefits claimed during the study period, 26 percent, or \$4.4 billion, was overclaimed.

Repeat use of ITINs is an especially egregious error for a paid preparer.

The majority of errors concern eligibility of qualifying children, accounting for 69 percent of total amount of overclaimed EITC benefits. Other categories of errors are misreported income (11 percent of overclaimed EITC benefits), and incorrect filing status (31 percent of overclaimed EITC benefits). These categories include returns with multiple compliance problems, so the total exceeds 100 percent. The study was not designed to detect or quantify EITC claims that could have been filed, but were not in fact filed. For example, the AGI tiebreaker accounted for \$782 million in overclaimed EITC benefits, but the study did not assess the level of EITC benefits available to the other family member who should have filed for EITC. In some cases, the family member with higher AGI would have been ineligible; in other cases that family member would have income that qualified for an EITC benefit, but did not claim it. Therefore, the amount of overclaiming based on the AGI tiebreaker was somewhat less than the amount reported. In addition, the study was not designed to assess whether errors were fraudulent, negligent, or the result of misunderstanding, nor did the study assess numbers of EITC-eligible persons who failed to claim it.

The study found that error rates, at 26 percent, were about equal for self-prepared returns, and returns with a paid preparer. TCE and VITA programs prepared only 1.6 percent of returns, a number so low that assessment for compliance was not feasible for this group of volunteer preparers.⁵⁴ Further analysis of error rates among categories of paid preparers showed some significant differences. Professional preparers — attorneys, CPAs, and enrolled agents — completed less than 9 percent of EITC returns, and the error rate for this group was 14.8 percent. A second category, national tax preparation companies, accounted for 15.6 percent of EITC returns, with an error rate of 23.1 percent. The third “other” category of paid preparers accounted for nearly 30 percent of EITC returns, and had an error rate that was 30.6 percent.

These results are troubling: a large portion of EITC filers completed returns unassisted, with an error rate of 26 percent, and nearly one-third of EITC filers relied on paid preparers that produced error rates of 31 percent, a rate significantly higher than the error rate for

self-prepared returns. Moreover, the error rate for the national companies, 23 percent, is only slightly below the rate for self-prepared returns.

B. 1999 MEA Report

A second report released in 1999 is less focused in its assessment of categories of preparers, but nevertheless shows some additional disturbing information about the quality of some tax preparation services. The EITC Math Errors Profile Report analyzed the impact of extended Math Error Authority on EITC compliance for tax years 1997 and 1998. Math Error Authority (MEA) allows for a streamlined administrative response to certain errors in a tax return. Under MEA, the IRS makes a correction in the return, and sends a letter to the taxpayer advising that an error has been corrected. The taxpayer may respond within 60 days with additional information, or may insist that the IRS follow more formal deficiency notice procedures. If no response is made within 60 days, the change is final. In 1996 MEA was expanded to include a number of common errors identified in the 1994 compliance study discussed above. The following are the EITC compliance issues addressed in the expanded MEA:

- primary SSN does not match SSA records, or spouse's SSN is missing;
- primary taxpayer or spouse used ITIN;⁵⁵
- qualifying child listed with an ITIN;
- SSN for qualifying child is missing;
- SSN for qualifying child does not match SSA records.

The study reported that in tax year 1996 about 5 percent (937,000) of the approximately 19.5 million EITC returns had invalid or missing taxpayer identification (TIN) numbers. EITC benefits totaling \$1.3 billion were withheld pursuant to MEA. However, about 48 percent of those taxpayers responded with additional information that caused EITC benefits totaling \$540 million to be restored. For the 1997 tax year TIN-related MEA notices were issued for only 3 percent of EITC returns (621,000 returns). There was a slight increase in positive responses from taxpayers, with 52 percent of them responding successfully.

⁵⁵All taxpayers must list a taxpayer identification number (TIN) on federal income tax returns. Generally, a social security number is the identification number. However, for non-citizens who are not eligible to obtain a SSN, the IRS will issue an individual taxpayer identification number or ITIN. A taxpayer, or an individual listed as a dependent must who is not eligible to obtain an SSN, must request an ITIN by completing IRS Form W-7, and forwarding the form with appropriate documentation to an IRS office in Philadelphia. See reg. section 301.6109-1. Both the SSN and ITIN have similar series of digits, e.g., 000-00-0000. However, ITINs issued by the IRS begin with the digit 9 and are easily recognizable by tax practitioners. A valid ITIN begins with 9, and has the numbers 70-80 in the fourth and fifth digits. See generally IRS Publication 1345, “Handbook for Electronic Return Originators of Individual Income Tax Returns,” at p. 8 (1999). Beginning in the 1997 tax year, the taxpayer and qualifying children were required to have a valid SSN.

⁵⁴Note 45 *supra* at note 31.

The study also reported on the incidence of MEA notices for returns with a paid preparer, compared to self-prepared returns. Paid preparers handled 60 percent of the returns in this study, and they accounted for 45 percent of the TIN-related math errors. Unfortunately, this study did not break out error rates by type of preparer. However, the study tracked taxpayers who repeated math errors in consecutive years, and found a substantially higher rate of repeat errors in returns from paid preparers. The Math Error Report observed that:

The role of paid preparers is also problematic, based on this data. Paid preparers were responsible for about one half of returns which were submitted with TIN-related errors, including ITINs. Preparers were responsible for about 61 percent of EITC returns which repeat TIN math errors [in consecutive years] and for about 75 percent of the EITC returns with Schedule C's.⁵⁶

Repeat use of ITINs is an especially egregious error for a paid preparer. This practice was acceptable until the 1996 tax year, when Congress amended the code to require that the taxpayer and the child have valid social security numbers.⁵⁷ Because a professional tax preparer should readily perceive and distinguish ITINs and SSNs,⁵⁸ for a paid preparer to use an ITIN in the 1996 tax year EITC return reflects an unprofessional failure to keep up to date with changes in the tax laws. To repeat that error in a second year reflects either gross negligence or fraudulent intent. This evidence of negligent, reckless, and even fraudulent tax preparation services revealed in the two IRS studies raise serious questions concerning the need for licensing and regulatory controls in the commercial tax preparation industry.

There are, of course, many different ways for fraudulent or negligent errors to occur. A paid preparer who fraudulently or negligently completes a return that understates the taxpayer's tax liability may primarily cause some errors. Other errors may be entirely caused by the taxpayer who deliberately or negligently misleads a conscientious tax preparer. Another category of errors may be the result of negligent or fraudulent collusion between the taxpayer and the tax preparer. In many individual cases it may be difficult to categorize an error as deliberate, negligent, or an honest mistake. None of the compliance studies have attempted to categorize the nature of compliance errors.

It is also important to acknowledge that professional tax preparers apply multiple skills in the preparation of a tax return. One important set of skills concerns

acquired knowledge of the tax laws, and an understanding of how the policies should be applied to individual circumstances. Another set of skills concerns interviewing techniques. Although a tax preparer is not required to demand verification of information provided by a taxpayer, the preparer should be alert to inconsistencies in information received. For example, if an unmarried taxpayer reports earnings and also reports two young children in his household, the tax preparer should inquire about how long the children resided in the taxpayer's home.⁵⁹ Moreover, the tax preparer should inquire about child care expenses that may qualify for the child care credit. A response indicating a total lack of child care expenses should trigger an inquiry concerning how the person was able to work with two young children. The taxpayer's response could provide a plausible explanation (e.g., a relative living next door provided free child care), or perhaps raise more questions about the status of qualifying children.

C. 1997 Compliance Study

The Treasury Department recently released a follow-up study that assessed EITC compliance for 1997. For this study, the IRS randomly selected 2,221 EITC returns for 1997 that claimed and received EITC benefits. All of the returns were filed between January 1998, and May 28, 1998. IRS staff audited each of the returns, and conducted interviews with the taxpayers to verify information contained in the return. The study found that about 25 percent, or \$7.8 billion of EITC benefits were paid out to taxpayers who were not eligible.⁶⁰

The report listed the following primary reasons for overclaimed EITC benefits

Reason	Percentage of Overclaimed EITC
Ineligible child	22 percent
AGI tiebreaker	17 percent
Income error	14 percent
Filing status error	10.5 percent ⁶¹

The report does not provide an analysis of compliance errors for self-prepared or paid preparer returns, nor does the report provide a breakout of compliance errors by type of preparer. However, there is little in the report to suggest that the rates of errors for type of preparer changed between 1994 and 1997.

The 1994 IRS study concerning compliance problems, and the analysis of compliance problems among categories of tax preparers prepared by Janet McCubbin clearly shows that "professional" preparers

⁵⁶Internal Revenue Service, National Office Research and Analysis, Brooklyn DORA, "EITC Math Errors Profile Report," at p. 29 (August 1999).

⁵⁷31 U.S.C. section 32M, added by Pub. L. 104-193, section 451(b) (1996). Effective for the 1996 tax year, the taxpayer, the taxpayer's spouse, and each qualifying child must list a SSN to qualify for EITC.

⁵⁸See discussion in notes 29 and 55 *supra*.

⁵⁹See IRS Form 8867, which provides a checklist for preparers to assure compliance with "due diligence" requirements imposed by section 6695(g). See also IRS Notice 97-65, 1997-51 IRB 14.

⁶⁰U.S. Department of Treasury, Internal Revenue Service, "Compliance Estimates for Earned Income Tax Credit Claimed on 1997 Returns," p. 3 (Sept. 22, 1999).

⁶¹*Id.*, Table 2 at p. 11.

— attorneys, CPAs, and enrolled agents — have far superior compliance rates. This difference is most likely due to greater expertise in tax laws, and also better skills in interviewing clients and obtaining accurate, complete information. The “other” category of preparers, that is, unaffiliated preparers have a substantially inferior compliance rate, worse than the self-prepared returns. This data suggests that the “other” category of preparer, at least in some instances, have inferior knowledge of the tax laws, and inadequate interviewing skills.

V. Licensing and Regulatory Controls

There are in total about 1.2 million commercial tax preparers in the United States.⁶² An important series of questions concern the licensing and regulatory controls that govern this commercial activity, and the requirements regarding skills, training, and other minimum standards that must be met by individual practitioners.

A. Circular 230

The Treasury Department is vested with authority to establish standards of conduct for those who practice before it and to impose penalties on those who fail to meet established standards.⁶³ Under this authority, the Secretary of the Treasury has issued regulations, commonly referred to as Circular 230.⁶⁴ Generally, the term “practice before the IRS” includes not only appearing as the taxpayer’s advocate at hearings, but also includes representing the taxpayer in negotiations and in filing documents with the IRS on behalf of the taxpayer. Eligibility to practice before the IRS is generally limited to attorneys, certified public accountants, and enrolled agents. The first two categories are licensed in their respective states. Enrolled agents are licensed by the Director of Practice, an office located in the IRS. A tax preparer who is not an attorney, CPA, or enrolled agent has the right to undertake limited practice on behalf of a taxpayer whose return was prepared by the preparer. Circular 230 provides for triennial reenrollment, conditioned on meeting an additional requirement that the practitioner have 72 hours of formal continuing education, including not less than 16 hours per year.

Circular 230 also imposes due diligence requirements in the preparation of tax returns.⁶⁵ Circular 230 further establishes certain ethical standards, barring false or fraudulent advertising, and prohibits making misleading or deceptive statements or claims.⁶⁶ Additional standards of conduct prohibit an enrolled agent from signing a return unless the practitioner determines that there is a realistic possibility of being sustained on positions taken in the return. Moreover, Cir-

cular 230 allows a practitioner to rely on information provided by a client, without verification, but requires reasonable inquiries if information appears to be incorrect, inconsistent, or incomplete.⁶⁷ Finally, the Director of Practice is vested with authority to suspend enrollment of any person who exhibits incompetent or disreputable conduct, refuses to comply with Circular 230 requirements, or knowingly misleads or threatens a client.⁶⁸

In view of the substantial stake of the federal government in ensuring compliance with all the complexities of the tax code that affect individual taxpayers, it is interesting that there are no licensing requirements for an individual to be an income tax return preparer. Circular 230, section 10.7(e), provides that any individual may prepare a tax return. The Internal Revenue Code defines “income tax return preparer” as anyone who prepares for compensation, or who employs one or more persons to prepare for compensation.⁶⁹ Treasury regulations provide that “a person may be an income tax return preparer without regard to educational qualifications and professional status requirements.”⁷⁰ The code and regulations are silent with regard to standards or expectations regarding skills, knowledge of tax rules and regulations, training, proficiency in the English language, or other basic requirements for a minimally competent income tax return preparer.

B. Statutory Standards

The code does impose penalties for violations of certain standards in the preparation of returns. Section 6694 imposes a penalty for:

- a) understatement of tax liability due to an unrealistic position — that is, one which the preparer knew or should have known could not prevail — in the amount of \$250 for each occurrence;
- b) understatement of tax liability due to willful or reckless disregard of rules or regulations, in the amount of \$1,000 for each occurrence.

Section 6695 imposes a \$50 penalty on an income tax return preparer for each of the following:

- failure to furnish a copy of a return to the taxpayer
- failure to sign the return
- failure to furnish an identification number on the return
- failure to retain a copy of the return

In addition, section 6695 imposes a \$500 penalty against a preparer who negotiates a refund check issued to a taxpayer.

Another element of the statutory scheme regulating tax preparers is section 7407, which authorizes the IRS to commence a civil suit to enjoin a preparer from

⁶²Interview, Robert Curran, Internal Revenue Service, May 8, 2000.

⁶³31 U.S.C. section 330, 96 Stat. 884 (Sept. 13, 1984).

⁶⁴31 C.F.R. Part 330

⁶⁵Circular 230, section 10.22.

⁶⁶Circular 230, section 10.30.

⁶⁷Circular 230, section 10.34.

⁶⁸Circular 230, section 10.50.

⁶⁹Section 7701(a) (36).

⁷⁰31 C.F.R. section 301.7701-15(a)(3).

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engaging in some practices. Proscribed conduct includes activities subject to penalties under sections 6694 or 6695, as well as a fraudulent or deceptive practices. However, there have been no reported cases where injunctive actions have been filed against preparers of EITC returns.

In response to the compliance problems noted in the 1994 compliance study that were linked to tax preparers, Congress amended section 6695 to add “due diligence” requirements for EITC returns.⁷¹ Section 6695(g) imposes a \$100 penalty for each return claiming EITC where the preparer fails to comply with due diligence requirements established by the Secretary. Implementing regulations require that a preparer of a return claiming EITC must complete Form 8867, Paid Preparer’s Earned Income Credit Checklist, or otherwise record information necessary to complete Form 8867 in the preparer’s paper or electronic files. Form 8867 is a checklist covering 14 of the most basic elements of EITC eligibility. For example, the preparer must check off boxes confirming that the taxpayer, spouse, and qualifying children have social security numbers, and that for the taxpayer(s) the SSN must be one that permits work. The due diligence regulation also requires the preparer to complete the EIC worksheet in the Form 1040 instructions regarding computation of the credit, or otherwise record the information in the preparer’s paper or electronic files. These items must be retained for a period of three years.⁷² The assessment of the efficacy of the due diligence requirements must await publication of subsequent evaluations and compliance studies. One early report is not promising; in the first year of enforcement of due diligence requirements, only 149 preparers were assessed due diligence penalties under section 6695(g).⁷³

It is surprising that despite the extended controversy over EITC noncompliance, the evidence of high non-compliance rates for “other” paid preparers, and the substantial investment in efforts to improve compliance, the assessment of penalties against income tax preparers is quite low. The following is a summary of preparer penalties; the numbers reflect the number of preparers assessed respective penalties. Some preparers may have received multiple penalties.

Year	Section 6694 Penalties	Section 6695 Penalties
1993	2,392	381
1994	2,259	236
1995	1,121	190
1996	1,541	*
1997	1,636	243
1998	1,326	199
1999	1,276	268 ⁷⁴

*data missing for that year
This table represents penalties assessed against the entire population of 1.2 million paid tax preparers in the United States.

In view of more than 2 million math error and correspondence audit letters sent out each year for, with more than half of all returns completed by a paid preparer, the incidence of preparer penalties seems startlingly low. Whatever reasons may account for this result, enforcement of existing standards of practice for income tax return preparers is likely hampered by the failure of the IRS to routinely verify the social security number or preparer identification number when one is listed on a return.

C. California Preparer Regulations

The State of California requires that any person who for a fee, assists with or prepares a state or federal tax return must comply with the Tax Preparers Act.⁷⁵ The act imposes the following requirements:

- 60 hours of training from an approved provider, or two years experience;
- maintain \$5,000 surety bond;
- 20 hours continuing education from an approved provider each year;
- initial application fee of \$25; and
- annual renewal application fee of \$25.

In 1997 the California legislature shifted responsibility to administer the Tax Preparers Act to the California Tax Education Council (CTEC). CTEC is a trade association made up of one representative from each professional society, association, or other entity operating in California as a nonprofit organization that chooses to participate in CTEC and represents taxpayers, attorneys, certified public accountants, or enrolled agents, with a membership of at least 200. Each for-profit tax preparation company with at least 200 employees also may place a representative on CTEC’s board.

CTEC maintains a list of approved education providers, which currently consists of 32 providers.

⁷¹Taxpayer Relief Act of 1997, Pub. L. 105-34, section 1085(a)(2).

⁷²Reg. section 1.6695-2T, 63 *Federal Register* 70339 (Dec. 21, 1998).

⁷³Phone interview, Candice Cromling, National Program Manager, Earned Income Tax Credit, Internal Revenue Service, Apr. 20, 2000.

⁷⁴Phone interview with Robert Curran, Internal Revenue Service, May 8, 2000. The 1999 figure for section 6694 penalties is annualized based on the first two quarters’ data. The 1999 figure for section 6695 penalties does not include the 149 penalties under section 6695(g) discussed above.

⁷⁵California Business and Professions Code, chapter 14, section 22250-22259.

The cost for the basic 60-hour course ranges from about \$200 to more than \$400. Five of the 32 approved providers offer correspondence courses.⁷⁶

The California Tax Preparers Act also provides for penalties and enforcement measures. Any violation of the act is a misdemeanor, punishable by a fine up to \$1,000 and up to one year imprisonment in a county jail. The act also provides for a private right action for injunctive relief against any person who acts as a tax preparer in violation of the law. An additional remedy is authorized for anyone to file suit to recover a civil penalty of \$1,000, plus attorney fees and costs.

Unfortunately, formal public investment in enforcement of the Tax Preparers Act seems lacking. For example, the Franchise Tax Board, the California tax collection agency, does not appear to be involved in enforcing these provisions. Moreover, that agency does not routinely verify that the names of paid preparers on California returns are indeed registered with CTEC.⁷⁷

D. Other State & Private Regulations and Remedies

Tax preparation services are subject to controls under state consumer fraud and deceptive practice statutes. Generally, states have passed laws to establish protections for consumers regarding the sale of goods and services. State statutes usually provide a range of remedies including civil fines, injunctive relief, and criminal penalties.⁷⁸ Typically, a consumer fraud department in the office of the state attorney general is charged with enforcement of these statutes. A phone survey directed to five states (Arkansas, Illinois, Massachusetts, Mississippi, and New York) confirmed that tax preparation services are within the jurisdiction of these statutes, and that complaints are received regarding fraudulent or grossly negligent tax preparation services. However, all states reported that the number of complaints in this category were very, very small, and only one state maintained a record of the number of complaints in this category. Massachusetts reported that its consumer fraud office received 15 complaints regarding tax preparation services over the past two years.⁷⁹

The national network of Better Business Bureaus (BBB) represents another resource for monitoring and controlling fraudulent or grossly negligent tax preparers. The Council of Better Business Bureaus promotes and fosters ethical business practices

⁷⁶This and other information about CTEC operations is available at its web site: <http://www.ctec.org>.

⁷⁷Phone interview, Pat Pavone, Director, Filing Services Bureau, California Franchise Tax Board, May 12, 2000.

⁷⁸See, e.g., Article 22A, Consumer Protection From Deceptive Acts and Practices, N.Y. C.L.S. Gen. Bus. section 349 (1999); Consumer Protection, Deceptive Trade Practices Act, Stat. Ann. section 4-88-101, *et seq.* (1999); Regulation of Business Practices for Consumers Protection Act, Mass. Ann. Laws, Ch. 93A, section 4 (1999).

⁷⁹Phone interview, Muriel Hervey, Director of Consumer Complaint Section, Office of the Attorney General, State of Massachusetts, Mar. 8, 2000.

through voluntary self-regulation, and consumer and business education. The council includes 180 local Better Business Bureau affiliates, which are supported by 270,000 businesses. The council also operates programs that include mediation and arbitration services for resolving consumer-business disputes, consumer and business information services, and voluntary industry guidelines for advertising and selling products and services. In 1998, the most recent year for which data was available, the council assisted more than 25 million consumers. Among those assisted were nearly 14 million persons making inquiries about a business before purchasing goods or services. In addition, 2.7 million persons filed complaints with a local BBB and received assistance through counseling and mediation or referral to other agencies. In 1998 the council reported that it received 5,612 inquiries nationwide concerning tax preparation services. In addition, the council received 282 complaints concerning tax preparation services.⁸⁰

E. Training and Skill Levels in the Industry

There is an exceptionally broad range of training and skill levels among income tax preparers. In the "professional" category, the level of training and skills is the most substantial. Attorneys must typically complete four years of college, three years of law school, and pass a multi-day bar exam. Character and fitness of candidates for admission to the bar are also screened. However, a relatively small proportion of attorneys practice in the area of taxation (of the ABA's 300,000+ attorneys, about 20,000 are members of the Section on Taxation), and an even smaller number engage in tax preparation services for individuals. It is likely that the number of attorneys preparing lower-income tax returns is quite small. A second category of professional preparers, CPAs typically have at least four years of college, and pass a rigorous multi-day exam administered by a state licensing agency. However, not all CPAs engage in tax preparation services; many work exclusively in business, engaged in conducting audits, preparing budgets, and providing other financial services. The third category of professional preparers, enrolled agents, consist of individuals who are admitted to practice before the IRS under the terms of Circular 230 discussed above. There are about 35,000 enrolled agents, but the number engaged in tax preparation for lower-income persons has historically been quite small. Moreover according to the National Association of Enrolled Agents, their members are cutting back on the number of EITC returns in reaction to the complexity of compliance requirements and the low fees that are available.⁸¹

The national companies, including H&R Block and Jackson Hewitt, account for as many as 150,000 tax

⁸⁰Council of Better Business Bureaus, "Annual Inquiry and Complaint Summary," at p. 1, and table 1 (1998).

⁸¹Statement of Gregory H. Steinbis, EA, CPA, Immediate Past President, National Association of Enrolled Agents, before the Subcommittee on Oversight of the House Ways and Means Committee, at pp. 5-6 (Mar. 28, 2000).

preparers. These companies operate training programs that are open to the public, for a tuition fee of about \$200. The H & R Block course takes about 45-66 hours over 11 weeks, and requires a written exam at the conclusion. Individuals who pass the exam may be offered employment at an H & R Block site. Of course, tax preparers for the national companies also work under the supervision of more experienced staff.

There is evidence that much of the 'assistance' provided by VITA programs consists of handing over forms rather than preparation of tax returns.

The "other" category of tax preparer may have training and experience that rivals the level of the "professional" category of tax preparers. Many individuals may not have formal licensing credentials, yet may have formal education, and may have attended courses sponsored by local bar associations and CPA associations, and offer wholly competent tax preparation assistance. On the other hand, the individual may be entirely self-taught, may have a high school education, or less, and may have no access to professional publications, other than those produced by the IRS. Moreover, the analysis of extensive literacy limitations among 50 percent of the adult population, and the constrained self-awareness of impaired literacy is another source of concern. Too often individuals in the category of "other tax preparer" whether motivated by greed or simply lacking essential skills and expertise, wreak havoc on the tax returns of lower-income filers.

VI. Volunteer Programs and IRS Walk-In Offices

There are three sources of free tax preparation assistance for lower-income taxpayers: the Volunteer Income Tax Assistance (VITA) program; Tax Counseling for the Elderly (TCE), and IRS walk-in offices. The following is a brief critical assessment of each of these resources.

A. VITA

Volunteer Income Tax Assistance, or VITA, is one of two formal volunteer programs sponsored by the IRS. VITA programs are operated by local organizations in libraries, community centers, and other facilities open to the public. During fiscal year 1999, there were 7,701 VITA sites nationally, with nearly 40,000 volunteers who assisted 1.88 million taxpayers.⁸² Unfortunately, the actual service provided by VITA programs, in terms of tax returns completed, is far less than what is indicated by these numbers. In addition, the program has numerous constraints and limitations that further reduce its usefulness for lower-income taxpayers.

⁸²Internal Revenue Service, *Taxpayer Education Statistical Report*, Table 4 (Oct. 4, 1999).

There is evidence that much of the "assistance" provided by VITA programs consists of handing over forms rather than preparation of tax returns. According to data tabulations by the IRS Statistics of Income Division, the number of returns completed by VITA programs is relatively small. For the 1997 tax year, VITA prepared just under 500,000 returns, and 17.7 percent of that number showed adjusted gross income exceeding \$30,000. The SOI report indicates VITA completed only 101,000 EITC returns for the 1997 tax year.⁸³

The limited capacity of VITA to respond to the unmet need for tax preparation assistance is due in part to the lack of funding. Local sponsors must raise funds to support the recruitment and supervision of volunteers, and the marketing of the program in their respective communities. There is at present no funding available from the IRS to support VITA programs. The IRS offers support through assignment of staff for training volunteers, publishing training materials, and through provision of bulk quantities of forms and publications. With the exception of VITA sites on military bases, there are only a handful of multi-site VITA program that complete 5,000-10,000 returns.⁸⁴

A second general limitation of VITA concerns the types of returns that volunteers may prepare. Generally, the IRS does not encourage VITA volunteers to prepare tax returns with self-employment income, and the VITA training manual does not address this topic.⁸⁵ This limitation bars the 17 percent of EITC recipients who have self-employment income. Some taxpayers in this category, such as a single mother whose \$8,000 annual income consists of child care services provided in her own home, may have real difficulty paying the \$100-\$200 fee for a commercial preparer. Another service excluded from VITA concerns prior year returns and amended returns. Generally, VITA programs do not stock the publications necessary to calculate tax

⁸³Internal Revenue Service, Statistics of Income Division, "Use of Tax Preparers for All Returns and Returns With Earned Income Tax Credit, Number of Returns by Size of Adjusted Gross Income, 1997" (May 8, 2000) (unpublished table provided to the author). The SOI tabulation may reflect an undercount of the actual number of returns completed by VITA volunteers. Generally, VITA programs receive bulk quantities of forms from the IRS, and the tax returns provided VITA programs, Forms 1040 EZ and 1040, are printed with a large VITA imprint over the signature space for a paid preparer on the return. Volunteers are not required to sign the return; however, if a volunteer does not use the VITA printed version, and also fails to write "VITA" onto the signature line for the paid preparer at the bottom of the form, it will not be logged as a VITA-prepared return, and will instead be treated as a self-prepared return. It would seem plausible that some undercount of VITA returns may be occurring for these reasons, but there is no way to estimate the potential size of the undercount.

⁸⁴Large, multi-site VITA programs managed by a single organization and serving 5,000-10,000 persons operate in only four cities; much smaller VITA programs operating in seven other cities serve from 200 to 1,500 persons in each city. See *The Tax Directory*, Table 1, p. 896 (2000 Edition).

⁸⁵Internal Revenue Service, *Volunteer Assistor's Guide*, Publication 1155 (1999).

liabilities for years other than the current filing season. This omission creates another hardship for very low-income taxpayers who have not filed at all in one, two, or even three prior years, but may be due a refund. Other lower-income filers have made an error (either on their own, or using a paid preparer) and need assistance to prepare and file a 1040X that corrects the error. For these individuals, a paid preparer is often the only available option.

A third limitation in VITA programs concerns the period of tax counseling operations each year. Almost all VITA programs operate only during the tax filing season, from late January through April 15. The hundreds of thousands of EITC filers who receive math error letters or correspondence audit letters often need assistance during the late spring, summer, or fall to decipher what is being asked of them and how best to respond. Many commercial preparers also do not operate outside the tax filing season, and those commercial preparers who are accessible outside of the tax filing season may charge an additional fee for additional consultation. The lack of response by a substantial portion of EITC filers to correspondence from the IRS is likely due in part to the lack of accessible and affordable tax counseling assistance outside of the regular tax-filing season.⁸⁶

A fourth limitation concerns the need for professional supervision of volunteers. Availability of paid staff to supervise volunteers is extremely rare. Although a small number of VITA programs operate with professional supervision on a volunteer basis, the vast majority of volunteers have relatively limited on-site supervision. Although the IRS operates a special hotline for VITA volunteers, the need for direct, on-site supervision of the performance of volunteers must be a serious concern in light of the compliance problems noted above. The availability of training for VITA volunteers does not remove this concern. The entire VITA training curriculum consists of an introduction, 12 lessons, and "Comprehensive Problems" for a grand total of 27¼ hours of instruction time. By comparison, California requires 60 hours of training to be licensed as a paid preparer. While volunteers may not be held to the same standard as an independent commercial preparer, a lower level of expertise clearly increases the need for direct supervision and oversight by a tax professional.

Other elements of the VITA training program raise additional concerns. For example, Lesson Seven, with suggested teaching time of two hours, covers tax credits, and includes all of the following topics:

- Child tax credit
- HOPE scholarship credit
- Lifetime learning credit
- Credit for child and dependent care expenses

⁸⁶The IRS provides grants for operation of Low-Income Taxpayer Clinics (LITC) to represent lower-income taxpayers in disputes with the IRS and state revenue agencies, and also to provide assistance to taxpayers for whom English is a second language. There are 85 programs operating, and only 55 offer representation of taxpayers.

- Mortgage interest credit
- Foreign tax credit
- Earned income credit

This appears to be an enormous amount of material to cover in two hours, if there is an expectation that the volunteer will complete tax returns involving any or all of these credits. By comparison, it is interesting that Lesson 10 in the VITA training manual concerns sale of stock, and lists a suggested teaching time of four hours.⁸⁷ Effective interviewing is a topic covered in the introduction, on a single page of the 560-page training manual.⁸⁸

B. TCE

Tax Counseling for the Elderly (TCE) operates in a manner similar to VITA programs, with the exception that the program offers assistance primarily to taxpayers age 60 or older. Generally, younger taxpayers may receive assistance at TCE sites only if all seniors have been assisted. In 1999, TCE operated 10,562 sites with 32,032 volunteers, and assisted 1.6 million taxpayers.⁸⁹ As with VITA, the actual number of returns tabulated by the IRS Statistic of Income Division was far lower. TCE completed only 493,000 returns, including a mere 59,000 EITC returns.⁹⁰ TCE programs receive support from the IRS that tracks support provided to VITA, including training materials, IRS staff assigned as needed for training volunteers, and provision of bulk quantities of forms. However, through an annual appropriation by Congress, the IRS provides grants in the amount of \$3 million per year. About 90 percent of the funds are allocated to the American Association of Retired Persons (AARP), which operates almost all of the TCE sites.

C. IRS Tax Preparation Services

The IRS has in recent years begun to provide tax preparation assistance at its "walk-in" offices. During the 2000 filing season, from January through mid-April, IRS employees prepared 850,000 income tax returns, an increase of 20 percent over the previous year. This service absorbed 500 person-years from the ranks of IRS staff, and required pulling employees from other functions, such as examination and collection activities.⁹¹ Information concerning the number of EITC returns, or the number of returns completed for taxpayers earning more than \$30,000 was not available. If an IRS professional staff person costs \$100,000 per year including salary, fringe benefits, and nonpersonnel overhead for office space, phone, etc., then the cost of providing free tax preparation assistance would be \$50 million. The cost for each IRS-prepared return would be \$58.

⁸⁷Internal Revenue Service, Publication 1155, *Instructor Guide: Volunteer Assistor's Guide*, at p. 0-2 and pp. 10-1 through 10-44 (1999).

⁸⁸*Id.* at p. 0-15.

⁸⁹Note 82 *supra*.

⁹⁰Note 83 *supra*.

⁹¹Interview with John B. Gunner, National Director, Education, Walk-In, and Correspondence Improvement Division, Internal Revenue Service, July 13, 2000.

The forgoing review of tax preparation services offered without charge by local volunteer programs and by IRS staff indicates current capacity in the amount of about 1.7 million returns per year. However, a substantial minority of those returns are completed for EITC-eligible taxpayers. VITA and TCE prepared a combined total of 160,000 EITC returns in 1997. The two programs completed a nearly equal number of returns, 153,000 for taxpayers with adjusted gross income exceeding \$30,000. This limited capacity to offer free tax preparation assistance to lower-income taxpayers is cause for concern in view of the tax preparations needs and barriers discussed in the first portion of this report. Moreover, the IRS estimates that as many as 1.6 million taxpayers fail to file a return and fail to receive a refund may be due in part to the lack of access to free, capable tax preparation assistance.

VII. Summary

The foregoing review and analysis of tax law complexity, literacy limitations, expanded compliance initiatives, and heightened levels of fear and anxiety all lead to a conclusion that an overwhelming majority of EITC filers should rely on competent tax preparation assistance. That 35-40 percent of EITC filers complete returns with no formal assistance is a matter of concern, in view of the high level of compliance problems reported over the past several years. The emphasis on compliance has somewhat obscured an equally important concern that persons eligible for EITC should receive that benefit on a timely basis. Lack of access to affordable tax preparation services is certainly a significant factor for the 1.6 million nonfilers each year who lose an estimated \$2 billion in refunds (the number of nonfilers who are eligible for EITC is not known).

For the 60 percent of EITC filers who rely on paid tax preparation assistance, there is evidence that a major category of preparers, completing 30 percent of all EITC returns, register an error rate that exceeds the error rate for EITC returns completed without formal assistance. The 1999 IRS Math Error Report shows that some errors are committed at a higher rate by returns listing a paid preparer compared to self-prepared returns. Congress should address the absence of controls over entry into this industry, the lack of requirements for maintaining minimum skills and expertise, and the inadequate capacity of existing volunteer programs.

VIII. Public Policy Recommendations

Three options are considered here: tax simplification, regulating commercial tax preparers, and expansion of VITA. For reasons set out below, comprehensive tax simplification does not appear a realistic goal in the near term, and therefore Congress should enact an effective regulatory framework for paid tax preparers, and should further authorize a substantial expansion of the VITA program.

A. Tax Simplification

The increasing complexity in the nation's tax system over the past 10 years has generated a broad range of

recommendations for simplification. Just during the current calendar year, several major proposals have surfaced. In his Annual Report to Congress, the Taxpayer Advocate noted that tax complexity was a major problem, and he listed 53 legislative proposals, 19 of which were "new" and were listed for the first time. Five of the listed proposals concerned the Earned Income Tax Credit.⁹² Two months later, The American Bar Association Section of Taxation joined with the AICPA and the Tax Executive Institute to announce a series of recommendations for simplification, with an emphasis on filing status, dependency exemptions, and Earned Income Tax Credit.

In May 2000, the Economic Policy Institute issued a bold and imaginative proposal for a Universal Unified Child Credit (UUC) that would replace the dependency exemption, EITC, child credit, and additional child credit.⁹³ The UUC would apply a relatively simple measure of income, earnings from labor, but would retain exclusion of eligibility for certain unearned income such as interest or dividends. The proposal does not provide an overall definition of qualifying child, and so it is not clear to whether a simplified definition eligible child will arise from the combination of dependency exemption, EITC, child credit, and additional child credit. Other compliance problems noted in the 1994 and 1997 IRS studies, especially the AGI tie breaker and filing status disqualifications, are not addressed in the UUC proposal. Nevertheless, the UUC could present a significant step toward reducing complexity in the tax return filing process.

In connection with the release of the 1997 EITC Compliance Study, the Treasury Department announced several legislative proposals aimed at simplifying the EITC filing process.⁹⁴ Treasury recommends waiving the support and household maintenance requirements for married taxpayers who have lived apart for at least six months. This would have a significant impact on major area of noncompliance identified in the 1994 and 1997 EITC compliance studies, and will ease a variety of other compliance problems tied to taxpayers who must now file as married-separate because they cannot meet the support test or household maintenance requirements. A second proposal from Treasury would simplify the AGI tie-breaker by allowing the lower-income taxpayer, if a parent, to claim EITC if the higher-income taxpayer has income under the maximum EITC income limit. This will ease somewhat the rate of compliance problems that are now caused by the AGI tie-breaker rule. Treasury also urges passage of pending legislation introduced by Sen. Jay Rockefeller, D-W.Va., that would simplify the definition of dependent, by removing the support test, and making the definition conform more closely to the definition

⁹²Note 17, *supra* at pp. IV-1 through IV-45.

⁹³Robert Cherry and Max Sawicky, "Giving Tax Credit Where Credit Is Due: A 'Universal Unified Child Credit' That Expands the EITC and Cuts Taxes for Working Families," Economic Policy Institute Briefing Paper (April 2000).

⁹⁴U.S. Department of Treasury, Press Release, Sept. 22, 1999.

of qualifying child.⁹⁵ The Rockefeller bill would also simplify the calculation of earned income by removing nontaxable earnings, such as contributions to a 401(k) plan from the definition of income used to determine EITC benefits.

Other more radical proposals have been considered. In 1987 the IRS, under direction from Congress, explored the feasibility of a return-free tax system. Under this alternative, taxpayers could designate the IRS to compute their tax liabilities and prepare a return, using information supplied by the taxpayer on a postcard, and information from employers. Although this process could be used by up to 55 million taxpayers, the IRS concluded that a return-free system was not viable.⁹⁶ Because the return-free system would shift to the IRS the burden of calculating tax liability for taxpayers electing this option, the IRS estimated it would cost more than \$1 billion and require about 17,000 additional staff. In view of rapidly expanding computer technology and capabilities, one commentator has recommended further consideration of this option.⁹⁷ However, a return-free option would have limited impact on lower-income taxpayers who qualify for refundable credits.

A larger problem with proposals for tax simplification has two components. First, all of the proposals listed above for the current year would, if adopted, make useful but incremental reductions in EITC complexity. None of the current proposals reach the level of comprehensive tax simplification, and there is no evidence that Congress is ready to give serious consideration to comprehensive tax simplification proposals. There is no commission or other formal body looking at tax simplification options. Moreover, the just-concluded presidential campaign produced a flurry of proposals regarding tax reduction alternatives, but no candidate has made an effort to address tax simplification in a comprehensive manner. This does not mean that tax simplification is a lost cause; however, the current evidence suggests that Congress will not enact comprehensive tax simplification legislation in the near term. In the absence of comprehensive tax simplification legislation, and as a complement to pending incremental simplification proposals, the two other policy options reviewed below take on more compelling basis for prompt, serious consideration by Congress.

B. Regulating Paid Tax Preparers

The issue of regulating paid income tax return preparers has received careful consideration in several forums. Most recently, in 1997 the National Commission on Restructuring the IRS recommended that all paid preparers be subject to regulation under Circular

230.⁹⁸ The commission concluded that “regulation of all preparers under Circular 230 is important to the development of an improved relationship between preparers and IRS, since it applies enforceable rules of conduct to all return preparers. . . . Uniform requirements will increase professionalism, encourage continuing education, improve ethics, and better enable the IRS to prevent unscrupulous tax preparers from operating.”⁹⁹ Unfortunately, Congress declined to include this recommendation in the IRS restructuring bill passed the following year.

During a series of meetings in 1994-5, the IRS Commissioner’s Advisory Group (CAG) recommended also that commercial tax preparers be subject to enrollment under Circular 230. The minutes of an Advisory Group meeting in June 1994 note that the issue was being raised for consideration, after having been studied in 1989 without any action being taken. The CAG Ethics Subgroup reported that Oregon had initiated licensing of commercial tax preparers and that incidence of fraud had been reduced.¹⁰⁰ In January 1995, the CAG reviewed a formal proposal calling for amendments to Circular 230 that would regulate commercial tax return preparers.¹⁰¹ However, the recommendation was not implemented.

In light of the foregoing analysis of the tax preparation needs of lower-income taxpayers and the incidence of compliance problems for certain segments of the commercial tax preparation community, prior recommendations of the National Commission on Restructuring the IRS, and recommendations of the CAG should be reconsidered. Moreover, the following additional recommendations are offered regarding regulation of paid tax preparers. Congress should amend 31 U.S.C. section 230 to require regulatory controls over the commercial tax preparation industry. Circular 230 should be amended to provide a separate category of enrollment for income tax return preparers, with minimum standards regarding skills, expertise, ethical behavior, and continuing education requirements. The following is a brief review of a number of subsisting policy issues that must be addressed in making and implementing this recommended policy change.

A fundamental question concerns the skill levels that should be required, and the manner of verifying that an individual meets those skills. The IRS currently administers a two-day test for individuals seeking to become enrolled agents. The burden of administering even a two-hour test for up to 1.2 million tax preparers is a daunting administrative task. The California experience may offer a useful template. That state re-

⁹⁵U.S. Senate, S. 2825, introduced by Sen. Jay Rockefeller (June 29, 2000).

⁹⁶Internal Revenue Service, *Current Feasibility of a Return-Free Tax System* (1987).

⁹⁷Jonathan B. Forman, “Simplification for Low-Income Taxpayers: Some Options,” 57 *Ohio State Law Journal* 145, at 197 (1996).

⁹⁸Report of the National Commission on Restructuring the IRS, “A Vision for a New IRS,” Appendix G, at pp. 29-30, June 25, 1997.

⁹⁹*Id.*

¹⁰⁰IRS Commissioner’s Advisory Group, “Report of the CAG Subgroup on Regulation and Registration of Commercial Tax Return Preparers” (June 1994).

¹⁰¹IRS Commissioner’s Advisory Group, “Regulation and Registration of Commercial Tax Return Preparers,” Jan. 18, 1995.

quires completion of 60 hours of training and passing a written test administered by an approved training entity. The administering authority reviews curricula of various agencies, and approves those that meet minimum standards. In the alternative, an individual can demonstrate minimum skill levels by showing two years of professional tax preparation experience.

It may be useful to designate multiple levels of expertise, with one rank permitted to complete relatively simple individual returns with schedules for various credits; a second rank for relatively complex individual returns with Schedule F or Schedule E; and, finally, business returns. However, the CAG declined to recommend multiple levels of enrollment, to simplify administration and minimize disruption to the current system.

Another question concerns the scope of the requirement that paid preparers be enrolled. California provides an exception for attorneys, CPAs, and enrolled agents. Under Circular 230, attorneys and CPAs are automatically admitted to practice, based on their licensure in their respective states. For purposes of enrolling tax preparers, a better policy may be to require all paid preparers to enroll, and to require use of a specially issued preparer number on all returns. Only enrolled agents would be automatically enrolled as tax preparers under this approach. Attorneys and CPAs should be required to apply for enrollment as a paid preparer, and should certify, as part of the application, both licensure as an attorney or CPA, and prior tax preparation experience. In addition, 60 hours' training could be waived for attorneys, CPAs, and others who document two years of experience. A comprehensive enrollment strategy will facilitate tracking paid preparers by requiring all paid preparers to apply for enrollment and to obtain an enrollment identification number. In the absence of a comprehensive enrollment strategy, a paid preparer may elect not to enroll based on his status as an attorney or CPA. Such a preparer would list a social security number on a return; verification would require a cross-check against state licensing rolls, and could impede enforcement efforts.

A reasonable fee in the amount of \$50 could be assessed for each application to be enrolled as a paid income tax return preparer, and an additional fee for annual recertification. There should be a provision for continuing education requirements, with an annual certification of CE credits from an approved provider to maintain status as an enrolled preparer. The California requirement of 20 hours per year of continuing education requirements seems reasonable, and could be adopted as a requirement for enrolled preparers. The Office of Practice could focus its work on screening and certifying training entities, and processing applications for enrollment. This approach would limit the administrative burdens in controlling entry into the commercial income tax preparation industry, and the application fee would make the process self-sustaining without additional public expense for registration.

Enforcement is a critical area for any regulatory initiative, and several measures should be considered for any real impact to be realized. As part of the California regulatory framework, the legislature authorized a

private right of action, which may be brought by any individual to enforce the requirements of the licensing act. The action may be brought for injunctive relief, for a civil penalty of \$1,000, and attorney fees. Congress should also authorize a private right of action as an enforcement tool. However, because many of those victimized by fraudulent or inept preparers are not able to hire legal counsel, and because the availability of attorney fees against an individual with no assets will not be attractive to a private attorney working on a contingency basis, additional options should be considered to improve effectiveness of this enforcement mechanism. One alternative would be to expand the authority of the low-income tax clinics to pursue legal action against unenrolled or fraudulent income preparers. Additional appropriations for this activity should be considered by Congress. Another option would be to encourage state consumer fraud agencies to monitor and participate in enforcement of enrolled preparer requirements. It would also be useful for the IRS to seek a partnership with the national network of Better Business Bureaus to promote awareness of enrollment requirements for paid preparers.

After a phase-in period, the IRS should routinely verify the special preparer identification number on all returns that bear a paid preparer's signature. Where there is no match between the number on the return and an enrolled preparer, the IRS should decline to issue the direct deposit indicator. Such returns should be flagged for further review.

The incidence of paid preparers who do not sign a return is likely to increase in a regulatory environment. This form of noncompliance is difficult to monitor, but certain compliance initiatives could be adjusted to capture additional information. For example, math error notices and correspondence audit letters generated for returns that appear lack a paid preparer's signature could have a box added with the following:

Did you pay someone to prepare your return? If yes, please provide the name, address, and phone number of the person or company that prepared your return for a fee.

This information could be forwarded to the Director of Practice for enforcement activities.

Commercial software used for income tax preparation offers another option to facilitate enforcement. There is some anecdotal evidence that software sold for use by individual taxpayers is being used improperly on a commercial basis by paid preparers who fail to sign the return. An effective response from the IRS would be to insist that software companies, who must meet IRS specifications, require the user of each software package to record his name and social security number as part of the process of loading the software into a personal computer. The software would automatically list the SSN on all returns printed out, and would embed the SSN in the electronic return transmitted to the IRS. Although an individual could legitimately use the software to prepare returns for family and friends without a fee, this software requirement would provide a basis for tracking high-volume use of individual tax return software.

The imposition and enforcement of regulatory controls is likely to have a significant impact on compliance, by driving the most marginal preparers out of the industry, and by increasing the perception of risk for preparers engaged in outright fraud. However, several negative results may occur, at least in the short term. First, the cost of tax preparation services is likely to increase, to reflect the greater investment in training that will be required of many preparers. For lower-income filers, this will further limit access to capable tax preparation assistance. Second, shortages of tax preparation assistance may occur in certain rural and inner city areas, as under-performing preparers withdraw from the business. These factors indicate that efforts to regulate the tax preparation industry must be accompanied by an expansion of the VITA program.

C. Expansion of VITA

A second public policy recommendation concerns expansion of the Volunteer Income Tax Assistance (VITA) program to assure that lower-income filers have access to capable tax preparation assistance. Effective implementation of this recommendation requires several steps:

- a) Congress should authorize the IRS to issue grants to local nonprofit organizations that sponsor VITA programs, and Congress should appropriate amounts for this purpose. Grants to local programs should provide for restricting services to persons who meet the income eligibility requirements of the EITC program;
- b) The authority in section 7526 (b)(1)(A)(ii)(II) to operate programs to inform individuals for whom English is a second language about their rights and responsibilities should be moved from the low-income taxpayer clinics (LITC) to the funded VITA programs. Local sponsors should be eligible to seek support for funded VITA (which would include support for ESL taxpayers), or LITC, or both, depending on organization interest and capacity;
- c) Funded VITA programs should be required to develop marketing plans in collaboration with local government, private business, and community agencies; marketing plans should respond to all significant non-English speaking groups in the program's jurisdiction;
- d) The IRS should ease restrictions on VITA, and encourage programs to undertake preparation of relatively complicated returns, including returns with self-employment income, prior-year returns, and amended returns to correct errors. VITA training should be expanded to address these issues;
- e) Grant-funded VITA programs should be expected to maintain limited capacity for assistance to eligible taxpayers outside the regular filing season, with regard to counseling on responses to math error letters and correspondence audits;
- f) Grant-funded VITA programs should assure professional supervision of all volunteers, and

take other necessary steps to maintain high-quality service; and

- g) Local sponsors of funded VITA programs should be subject to matching fund requirements. State governments with state income taxes should be encouraged to offer financial and other support for expanded VITA operations; local government, private foundations, and local businesses represent other sources of matching funds.

IX. Cost/Benefit Analysis

The costs and benefits associated with implementation of the two policy recommendations are difficult to determine, but certain general estimates can be offered. With regard to the regulation of preparers, two significant cost components will arise. The first component concerns cost for registration and enrollment of tax preparers who meet minimum requirements. It is proposed that a registration fee be set to cover this cost, and a projected fee of \$50 could be adjusted if actual administrative costs are somewhat more or less. A second cost component concerns enforcement. It will be essential that vigorous enforcement occur to create an impression in the commercial tax preparation industry that genuine risk of sanctions exist for those who fail to enroll or fail to comply with Circular 230 requirements governing enrolled preparers. If 2 percent of existing preparers were identified as violating the enrollment requirement, or violating other provisions of an amended Circular 230, that would mean enforcement action in the form of civil penalties, against 20,000 preparers. If the average administrative cost for imposition of civil penalties against a preparer is \$2,500, then the budget for enforcement would be \$50 million.

Costs for the VITA program expansion depend in part on the projected costs per return, and the number of returns targeted for completion. Based on interviews with the managers of the four largest VITA programs serving civilians, the median cost per federal return for full service VITA programs is about \$25.¹⁰² This cost includes expenses for volunteer recruitment and training, marketing the program, supervision of volunteers, and follow-up, post-filing season assistance. Included in this cost is the preparation of state and municipal income tax returns. These programs also prepare a substantial number of electronically filed returns. It should be noted that the cost may be somewhat higher in remote rural areas and some inner-city neighborhoods. The projected need for VITA prepared returns is at least 4 million returns. This number is extracted from portions of nonfilers who come forward when access to tax preparation assistance is available; from EITC filers currently using paid preparers and who find that com-

¹⁰²Interviews by the author with: David Marzahl, Executive Director, Center for Law and Human Services, Chicago; Jennifer Robey, Community Action Program of Tulsa County, Tulsa, Okla.; Cynthia Tanner, Accounting Aid Society, Detroit; and Jill Schwimmer, Minnesota Accounting Aid Society, Minneapolis.

mercial preparers either drop out of the business or raises rates excessively; and from filers who currently prepare their own return, and respond to the opportunity to obtain capable tax preparation assistance without charge. These projections suggest a VITA program budget in the amount of \$100 million. However, with a 50 percent local match requirement, the federal cost would be \$50 million.

The benefits from these two initiatives primarily arise from improved compliance. The principal impact will be on the category of "other preparers" who completed 30 percent of all EITC returns, with a 30 percent error rate. It is likely that a relatively small portion, perhaps 5-10 percent of the "other preparers" cause 50 percent of more of the compliance problems in that category. If an effective regulatory and enforcement effort is successful, it is reasonable to expect at least half of those marginal preparers to be driven out of the industry. If the noncompliance rate for those returns drop from 30 percent to 18 percent, there would be more than 700,000 additional EITC returns that are compliant, with a savings of more than \$768 million.¹⁰³ Another benefit from expansion of VITA will be a reduction of demand for return preparation at IRS walk-in offices. If the number of returns prepared by IRS staff is reduced by only half, from 850,000 to 425,000, the IRS will save about \$25 million (250 person years) now allocated to tax preparation work. Offsetting these benefits will be EITC claims filed by non-

¹⁰³If "other paid preparers" prepare 30 percent of 19.86 million EITC returns, and if those 6 million returns have a 30 percent error rate, that sector will prepare 1.8 million returns that incorrectly claim EITC. If regulatory and enforcement action reduces the noncompliance rate for those 6 million returns to 18 percent, the number of noncompliant EITC returns drops by more than 700,000. The resulting savings, at an average \$1,098 (the average overclaimed EITC in the 1997 Compliance Study), will total about \$770 million.

filers and others who lacked access to capable tax preparation assistance. The amount of this offset is difficult to estimate, but, for public policy reasons, should not be considered part of a cost of improving compliance, but rather treated as part of the cost of the EITC program benefits claimed by eligible persons.

X. Conclusion

The evidence is overwhelming that EITC filers and other lower-income filers are challenged by tax law complexity, limited literacy, as well as fear and anxiety related to IRS enforcement. Moreover, many of the 25 million immigrants residing in the U.S. have additional burdens caused by language barriers and ethnic isolation. Compliance studies indicate that many individuals preparing their own returns make significant errors. An overwhelming majority of EITC filers rely on, or should rely on, tax preparation assistance, yet the lack of regulatory controls has allowed a fringe element in the commercial tax preparation industry to prepare returns with a higher error rate than self-prepared returns. VITA, the primary resource for lower-income families who cannot find capable and affordable tax preparation assistance, can document only 100,000 EITC returns each year. The lack of access to capable, affordable tax preparation assistance leads too many taxpayers to undertake self-prepared returns, or to seek assistance from fraudulent, negligent, or incompetent preparers, or join the ranks of 1.6 million nonfilers who are entitled to refunds.

A silver bullet in the form of comprehensive tax simplification might mortally wound this dragon, but no such remedy appears likely in the short term. Two policy options suggested here, regulation of paid preparers and expansion of volunteer tax preparation programs, offer targeted, effective remedies that will improve compliance, reduce tax expenditures to ineligible claimants, and increase participation by families eligible for EITC.

What is the IRS doing now in the insurance area?

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