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**BEFORE THE**

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

**ON**

**REGULATION OF FEDERAL TAX RETURN PREPARERS**

**JULY 20, 2005**

Mr. Chairman and distinguished Members of the Subcommittee:

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

**The Case for Regulation**

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

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

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

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

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

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

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

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

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

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

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

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

### **What’s the Solution?**

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

The components of my original proposal include:

- *Registration.* Each person who prepares more than five federal tax returns for a fee in a calendar year and is not an attorney, CPA, or enrolled agent would be required to register with the IRS and pay a fee.
- *Testing.* As originally described, each applicant would be required to complete a test that demonstrates competency in certain returns. The proposal recommends two tiers of testing, based on the complexity of returns. Tier 1 would include the 1040 series, including simple sole proprietorship schedules (Schedule C); Tier 2 would include business and employment tax returns.

The original proposal also recommended that each preparer be required to pass an annual refresher examination, reflecting tax law changes and the most common preparer return errors for the preceding year.

- *Certification.* The IRS would issue to successful applicants a certificate containing a certification number and expiration date. The preparer would enter the certification number on every return he or she prepares for a fee.

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

- *Maintenance of Public List.* The IRS would be authorized to maintain a public list (in print and electronic media) of return preparers who are registered and certified, who are registered but not certified, and whose registration has been revoked. This list should also be available on the Internet and be searchable.
- *Consumer Information Campaign.* The IRS should be authorized to conduct an extensive public awareness campaign that informs taxpayers of the need to look for a preparer's registration certificate before paying the preparer to prepare a tax return.
- *Oversight and Penalties.* Return preparers who fail to register would be subject to a scale of progressive deterrents ranging from educational notices and warnings to monetary penalties. The IRS would be authorized to notify the taxpayer if the taxpayer's return preparer was not registered with the IRS within the required time frame.

I have since modified this proposal to permit the annual competency requirement to be met either by testing or completion of continuing professional education.<sup>8</sup> We also think it may make sense to register all return preparers, including those licensed as attorneys and CPAs.<sup>9</sup> In response to the IRS's concern that it cannot commit resources to administering a registration program, we have clarified our intent that some of these duties can be administered by professional groups and that the IRS can contract out much of the program's administration on a self-funding basis. Indeed, one such entity has already drawn up a proposal.<sup>10</sup>

### **IRS "Link and Learn Taxes"**

The IRS itself has already designed a modest but effective version of a testing and certification program – and did so within a one-year timeframe. "Link and Learn Taxes" is an online training program that allows Volunteer Income Tax Assistance (VITA) volunteers to receive the training and certification necessary to

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

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

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

prepare tax returns at VITA sites. The IRS estimates that about 10,000 volunteers received certification through this program for the 2005 filing season.

The program consists of six modules:

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

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

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

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

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

### **Improving the Oversight of All Preparers**

Regulation of preparers will go a long way toward increasing the accuracy of tax returns and providing taxpayers with some confidence that they are receiving assistance from a preparer who meets a minimum level of competence. However, there will always be preparers who are negligent or even unscrupulous. Since 1976, Congress has recognized that an appropriate system

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

of penalties must exist to deter negligent or more serious preparer misconduct.<sup>12</sup> In my 2003 Annual Report to Congress, I identified the gaps and inadequacies of the current compliance regime for preparers and Electronic Return Originators (EROs). Given that the IRS is virtually a nonexistent presence in the unenrolled preparer community – levying only \$2.4 million in preparer penalties in calendar years 2001 and 2002, and collecting only 12 percent (or \$291,000) of those assessments<sup>13</sup> – and given that preparers can easily absorb these low-dollar penalties into the cost of doing business, I made the following recommendations:

- Increase the IRC § 6694(a) preparer penalty for understatements due to unrealistic positions from \$250 to \$1,000 and the IRC § 6694(b) penalty for intentional disregard of the rules and regulations from \$1,000 to \$5,000.
- Increase the preparer penalties under IRC §§ 6695(a) through (e) with respect to certain requirements for preparation of income tax returns for other persons (including signing the return and providing the taxpayer with a copy of the tax return), from \$50 per occurrence to \$100 per occurrence.
- Increase the preparer penalty under IRC § 6695(f) for negotiation of a refund check from \$500 per check to \$1,000 per check.

We know that preparers play a role in EITC noncompliance. Currently, EITC preparers are required to meet certain due diligence requirements<sup>14</sup> and are subject to a \$100 penalty for each failure to meet those requirements.<sup>15</sup> Where EITC overclaims result from either preparer incompetence or intentional disregard of the rules and regulations, the IRS often cannot recover any overpayments from the low income taxpayer. Moreover, many competent and scrupulous return preparers complain that they cannot compete with return preparers who are willing to turn a blind eye to taxpayers who are gaming the

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

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

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

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

system. Thus, to ensure that preparers conduct the proper due diligence in preparing EITC returns and to increase the personal risk for preparers who are more than merely negligent in preparing such returns, we made the following legislative recommendations:

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

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

- Amend IRC § 6695 to impose a penalty of \$100 per occurrence on persons who fail to sign or include certain information on specified IRS forms prepared by them for a fee, including applications for Offers-in-Compromise and financial information statements of individuals and businesses.
- Amend the Internal Revenue Code to authorize the Secretary to impose a \$1,000 penalty, per occurrence, against any person who willfully and intentionally misrepresents his or her professional status on a power of

attorney authorizing him or her to represent a taxpayer before the IRS or who willfully and intentionally practices before the IRS without proper authorization.

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

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

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

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

We recommend that Congress amend the Internal Revenue Code to authorize the Secretary to impose a \$1,000 penalty, per infraction, in addition to other available sanctions, on EROs who repeatedly or egregiously fail to comply with ERO Program requirements. Where preparers, including EROs, commit violations by charging a fee for services that is a percentage of the taxpayer's refund or is based on a return item, or by failing to advise the taxpayer of the fact

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

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



that a Refund Anticipation Loan product is a loan and the terms of that loan, the IRS should be authorized to assess a penalty equal to the greater of \$100 per occurrence or 50 percent of the fee for such service.<sup>18</sup>

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

## Conclusion

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

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

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

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

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