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*REPORT TO THE JOINT COMMITTEE
ON INTERNAL REVENUE TAXATION
CONGRESS OF THE UNITED STATES*



*BY THE COMPTROLLER GENERAL
OF THE UNITED STATES*

**No Apparent Need To
Regulate Commercial Preparers
Of Income Tax Returns**

Internal Revenue Service
Department of the Treasury

The pressure for regulation of commercial preparers of income tax returns presumes that their returns are less accurate than those prepared by professionals. However, this presumption is not borne out by GAO's study of the situation.

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To the Chairman and Vice Chairman
Joint Committee on Internal Revenue Taxation
Congress of the United States

This report, one of a series in response to a request
of your Committee, discusses whether commercial tax return
preparers need special regulation.

A handwritten signature in cursive script that reads "James A. Stacks".

Comptroller General
of the United States

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ABBREVIATIONS

CPA	certified public accountant
FTC	Federal Trade Commission
GAO	General Accounting Office
IRS	Internal Revenue Service
TCMP	Taxpayer Compliance Measurement Program

COMPTROLLER GENERAL'S REPORT
TO THE JOINT COMMITTEE ON
INTERNAL REVENUE TAXATION
CONGRESS OF THE UNITED STATES

NO APPARENT NEED TO
REGULATE COMMERCIAL PREPARERS
OF INCOME TAX RETURNS
Internal Revenue Service
Department of the Treasury

D I G E S T

The rapid increase in the number of firms and individuals specializing in preparing taxpayers' Federal and State income tax returns has been possible because there are no restrictions on anyone entering the field. As a result, the 200,000 to 250,000 individuals comprising the tax preparer industry have widely varying training, experience, and ethics.

The two principal groups of preparers are:

- Professional preparers, consisting of certified public accountants, public accountants, and attorneys.
- Commercial preparers, consisting of national and local firms and individuals who prepare tax returns for a fee.

Predictably, some preparers have been guilty of fraud and misconduct. Well-publicized Internal Revenue Service (IRS) actions against commercial preparers engaging in such activities led many people to presume that commercial preparers represented a special problem in the industry.

GAO tested this presumption and found that commercial preparers, as a group, are not a special problem. (See ch. 2.)

GAO reached no conclusion on whether regulation of the entire industry is desirable to improve overall performance because data on which to base an estimate of the potential benefits was unavailable. (See p. 20.)

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GGD-76-2

However, GAO sees a need to give IRS the authority to deal individually with any preparers who engage in fraud or other misconduct.

Legislative provisions considered by the House Committee on Ways and Means would permit IRS to identify and take corrective action against such preparers. These provisions would

- require preparers to submit certain information returns to IRS,
- establish civil penalties for preparer misconduct, and
- provide for injunctions against preparers who engage in specific categories of misconduct. (See pp. 13 and 14.)

IRS concurred with GAO's conclusions.

CHAPTER 1

INTRODUCTION

The Federal income tax system is based on voluntary compliance. Each taxpayer is responsible for (1) determining whether the law requires him to file a return, (2) determining the amount of tax owed, and (3) paying the amount due. The system assumes that the taxpayer can perform these steps.

The Congress made tax collection easier when it provided for employer withholding. However, determining the amount of tax owed has become progressively more difficult.

TAXPAYERS NEED HELP

For a growing number of taxpayers, preparing their annual Federal income tax return is a frustrating chore which they feel unprepared to tackle. Some turn to the Internal Revenue Service (IRS) for advice; others get help from friends and relatives. About half of all taxpayers pay someone to prepare their returns.

Because the tax law is complex, tax return instructions are difficult for many taxpayers to understand. This was highlighted by a Department of Health, Education, and Welfare-funded reading-power study using 1971 individual income tax forms and instructions. The study concluded that a taxpayer would probably have to read at the level of a college graduate to be able to comprehend--without assistance--the entire contents of the IRS tax instructions. Further, in April 1973 the Secretary of the Treasury informed the House Committee on Ways and Means that many tax law provisions which affect large numbers of individual taxpayers are inordinately complicated.

Other factors have caused taxpayers to seek assistance, contributing to the growth of the preparers' industry.

--The short Form 1040A was discontinued in 1969 and replaced by a 12-page booklet of forms, tables, and instructions, because IRS believed that many taxpayers were overpaying. However, taxpayers with little education were apparently confused, and many who had previously prepared their own return sought out a preparer. The short Form 1040A was reinstated for the 1973 tax filing period; however, many taxpayers continued to use return preparers.

--The return preparers' range of services includes the preparation not only of taxpayers' Federal returns, but also of State and local returns. At present, 43 States and numerous local governments (cities, counties, etc.) have imposed income taxes on residents. IRS will only help prepare Federal returns.

Because of individual taxpayers' inability to cope with complex tax law and the rising number of taxpayers who must file a tax return, the demand for assistance from the preparer industry has increased at a record pace. IRS has estimated that between 200,000 and 250,000 individuals and firms are in the tax preparation business and collect preparation fees exceeding \$600 million annually. This growth has been accompanied by certain abuses, including fraudulently and incompetently prepared tax returns and misleading advertising.

CONCERN ABOUT THE PREPARER INDUSTRY

Commercial preparers¹ of Federal returns are virtually unregulated. They are subject to legal qualifications in only a few States.

In 1972, IRS agents posed as taxpayers and had suspect preparers make out tax returns. Using this "shopping" technique, IRS found that 60 percent of the prepared returns were potentially fraudulent. After the publicity given to these findings, many proposals were made to regulate commercial preparers and various congressional committees held hearings to consider regulation.

Two frequently mentioned regulation methods were licensing and registration. Proposed licensing systems usually provide standards of character and conduct and require that competency be demonstrated by examination. IRS would determine qualifications, issue licenses, and regulate licensees. IRS has estimated the minimum cost of a licensing program at \$17.5 million a year.

The proposed registration programs usually required preparers to identify themselves, report certain information to IRS, and obey conduct rules, or lose their right to prepare tax returns. Under a registration program, IRS would not determine competency.

¹Although no official definition of "commercial preparer" exists, most individuals testifying at congressional regulatory hearings agreed that commercial preparers included local and national tax services.

IRS, the American Institute of Certified Public Accountants, and the American Bar Association favored information reports that IRS could use to identify incompetent or unscrupulous preparers. Other spokesmen generally favored a comprehensive system of preparer licensing or registration.

STUDY REQUESTED

The Joint Committee on Internal Revenue Taxation requested us, as its agent, to study whether commercial preparers of tax returns should be regulated to improve service to taxpayers.

SCOPE OF REVIEW

We reviewed sections of the Internal Revenue Code; IRS regulations, policies, procedures, and practices; and proposed congressional legislation and related hearings.

We also

- analyzed IRS data on certain audited tax returns for 1971, 1972, and 1973;
- examined the scope of IRS enforcement activities against problem (incompetent, unscrupulous, or fraudulent) preparers; and
- interviewed IRS personnel, return preparers (including officials of the four largest national tax services), and officials in two States that regulate preparers.

We made our review primarily at IRS' national office in Washington, D.C., and its Detroit district office. Information on 1972 and 1973 audit results was also compiled at IRS' Austin, Texas; Greensboro, North Carolina; Omaha, Nebraska; Portsmouth, New Hampshire; and Seattle, Washington, district offices.

BEST DOCUMENT AVAILABLE

CHAPTER 2

COMMERCIAL PREPARERS' QUALITY
FOUND TO THAT OF PROFESSIONALS

The tax preparer industry has two segments:

- Professional preparers: certified public accountants (CPAs), public accountants, and attorneys.
- Commercial preparers: nonprofessional firms and individuals who prepare tax returns for a fee.

Other persons (friends, relatives, coworkers, etc.) may prepare tax returns for a fee, but are not generally considered part of the preparer industry.

The pressure for regulation of commercial preparers arises from the presumption that their returns are less likely to be correct than those from professional and other preparers. To test this presumption, we compared commercially prepared to professionally prepared returns to determine whether a licensing or registration program would result in better prepared tax returns. Professional preparers, generally regulated by the States, must meet requirements similar to those contained in regulation proposals made to the Congress. Examples of such requirements are

- academic training, including the basics of tax law;
- passing an examination; and/or
- a code of ethics.

ANALYSIS BASED ON EVIDENCE
MEASURING TAXPAYER COMPLIANCE

Although there have been many proposals to regulate commercial preparers, the need for such regulation has not been studied. The only relevant comprehensive data base available to compare the quality of commercially and professionally prepared returns was the results of the IRS Taxpayer Compliance Measurement Program (TCMP) audits.

TCMP is an IRS audit program that estimates how well taxpayers are complying with the Nation's income tax law. The program thoroughly audits a scientifically selected sample of individual returns. Proportions, error rates, and tax change figures are derived to be representative of the total filing population.

The latest available TCMP study was for 1971 returns filed in 1972. Data was gathered by selecting 22,488 individual income tax returns for audit from 4 return categories. The results were projected to represent the total filing population in these four categories.

IRS uses this data for many purposes, including computing the compliance rate (the true tax liability that is voluntarily reported) and error rate (percentage of returns filed with a tax liability change of \$1 or more).

The 1971 TCMP data that we analyzed covered only the following four income categories:

- Nonbusiness, low income (adjusted gross income below \$10,000--excluding "1040A type" returns¹).
- Nonbusiness, medium income (adjusted gross income of \$10,000 to \$50,000).
- Schedule C, business, low income (adjusted gross income below \$10,000 from a business other than a farm).
- Schedule F, business, low income (adjusted gross income below \$10,000 from a farm).

Based on prior year data, about 70 percent of all commercially and professionally prepared returns fell in these four categories.

About 75.4 million 1971 individual tax returns were filed. TCMP data indicates that about 55 percent of these returns (42 million) were in the 4 return categories we analyzed. Over half the 42 million returns were prepared by either commercial or professional preparers.

¹The simplified and shorter 1040A tax return was not used for the 1971 tax year. All individual tax returns had to be filed using the Form 1040. However, the TCMP study excluded any returns which might have been filed on Form 1040A before it was discontinued in 1969.

Preparer	Number of returns				Total	Per- cent
	Low income	Medium income	Low income			
			Schedule C	Schedule F		
(000 omitted)						
Commercial	4,810	5,271	1,147	577	11,805	28.1
Professional	3,765	4,874	1,323	738	10,700	25.4
All other returns	<u>6,501</u>	<u>11,407</u>	<u>1,112</u>	<u>341</u>	<u>19,561</u>	<u>46.5</u>
Total	<u>15,076</u>	<u>21,552</u>	<u>3,582</u>	<u>1,856</u>	<u>42,066</u>	<u>100.0</u>

Quality of returns prepared is equal

TCMP data showed that commercially and professionally prepared returns contained errors totaling \$1.3 and \$1.5 billion, respectively. The average error over \$1 for commercially and professionally prepared returns was \$155 and \$218, respectively. The amount of error by each of the four categories follows.

	Nonbusiness		Low income business		Combined
	Low income	Medium income	Schedule C	Schedule F	
Total tax change (millions):					
Commercial	\$379.6	\$457.1	\$417.9	\$ 88.8	\$1,343.4
Professional	354.9	667.7	295.6	118.6	1,536.8
Tax change per incorrect return:					
Commercial	113	114	487	227	156
Professional	172	185	437	253	218

These figures reflect the total of all adjustments--both increases and decreases--made to returns.

Two ratios--percent of tax change for all returns and percent of tax change for incorrect returns--were used to indicate return quality. The percent of change for incorrect returns was the same--14.2 percent--for both commercially and professionally prepared returns. Also, the percent of tax change for all returns prepared by each group was about the same--10.9 for commercial preparers and 10.2 for professionals.

Percent of tax change

	Nonbusiness returns		Low income business		Combined
	Low income	Medium income	Schedule C	Schedule F	
	Incorrect returns:				
Commercial	21.7	6.4	99.5	56.8	14.2
Professional	34.4	7.3	80.3	59.1	14.2
All returns:					
Commercial	16.6	4.9	81.6	45.5	10.9
Professional	21.6	5.3	60.2	45.7	10.2

These two tables show that commercial and professional preparers have about the same percent of change per return, even though the professionally prepared returns contain larger dollar amounts of error. This is because (1) the average tax liability for professionally prepared medium-income returns (\$2,577) was greater than for commercially prepared returns (\$1,775) and (2) a higher percentage of commercially prepared returns had errors.

We believe that larger tax returns are generally more difficult to prepare than smaller ones. However, our comparison did not require us to establish that the returns by commercial and professional preparers were equally difficult to prepare or that one group was more competent than the other. We intended simply to compare the returns in terms of incorrect tax reported and decide whether commercially prepared returns presented a special problem.

The amount of error for any preparer is influenced by the preparer's intelligence, training, experience, and ethics; the difficulty of returns handled; and how well the taxpayer can support the figures he gives the preparer.

PREPARERS MAKE SAME KINDS OF ERRORS

To supplement the TCMP data, we analyzed data on 4,918 individual 1972 and 1973 returns audited over a 4- to 8-week period in 6 districts as part of IRS' normal 1974 activities. The numbers and types of returns included were

- 772 Form 1040A,
- 1,613 low-income,
- 2,474 medium-income, and
- 59 high-income.

We found that:

--Commercial services prepared 1,775 of the returns, 1,133 of which contained 2,113 errors (1.86 errors per incorrect return).

--Professionals prepared 854 of the returns, 527 of which contained 934 errors (1.77 errors per incorrect return).

Returns of both types of preparers contained errors in the same areas in about the same ratio.

Sections of returns where errors occurred	Preparer group errors			
	Commercial		Professional	
	Number	Percent	Number	Percent
Income section	468	22.2	260	27.9
Exemptions	205	9.7	47	5.0
	<u>673</u>	<u>31.9</u>	<u>307</u>	<u>32.9</u>
Itemized deductions:				
Medical and dental	223	10.5	102	10.9
Taxes	223	10.5	102	10.9
Interest	215	10.2	84	9.0
Contributions	186	8.8	101	10.8
Casualty and theft	82	3.9	33	3.5
Miscellaneous	367	17.4	137	14.7
	<u>1,296</u>	<u>61.3</u>	<u>559</u>	<u>59.8</u>
Other sections of return	<u>144</u>	<u>6.8</u>	<u>68</u>	<u>7.3</u>
Total	<u>2,113</u>	<u>100.0</u>	<u>934</u>	<u>100.0</u>

The most common error involved unsupported items--43.1 and 36.5 percent, respectively, for commercially and professionally prepared returns. The next most common error involved unallowable items--17.0 percent for commercial and 17.4 percent for professional returns. Other errors incurred by commercial and professional preparers included

--unclaimed deductions (8.7 and 12.7 percent, respectively),

--improper computation method (5.5 and 6.5 percent, respectively),

--unreported income (4.6 and 4.9 percent, respectively),
and

--math errors (1.4 and 1.6 percent, respectively).

Although IRS auditors did not cite the source of the errors, a review of the errors by type shows that some were caused by the preparer. For example, unallowable items, improper computation methods, and math errors were probably caused by the preparer. Responsibility for other errors, such as unsupportable items, could belong to either the taxpayer, the preparer, or both.

CHAPTER 3

IRS EFFORTS TO CONTROL PROBLEM PREPARERS

IRS has estimated that there are 200,000 to 250,000 people in the tax preparer industry. Of these, only a few thousand are considered to be problem preparers because of fraudulent returns or deceptive advertising.

FRAUDULENT RETURNS

In mid-February 1972, the IRS southeast region began a pilot investigation to identify fraudulent preparers. IRS agents contacted suspect individuals and had them prepare sample tax returns--a technique known as shopping. Based on shopping results, IRS decided if the preparer was potentially fraudulent and his returns should be audited.

The test program showed a high incidence of potentially fraudulent or incompetent returns by suspect preparers. As a result, the IRS national office directed the other regional offices to initiate similar return preparer programs. Overall, almost 60 percent of the shopping returns in 1972 were potentially fraudulent.

The shopping technique and the number of preparers investigated were expanded in 1973. About 40 percent of shopping returns in 1973 were considered fraudulently or incompetently prepared.

An IRS regulation (26 C.F.R. 1.6065-1(b)) requires that paid tax return preparers place their signature and identification number on returns they prepare. This information can be used to identify all returns prepared by a problem preparer. However, there is no penalty for failing to sign the returns.

IRS became aware, through its normal audit of returns and during the initial phases of its return preparer program, that many problem preparers were not signing the returns, signing them illegibly, or not providing their social security or identification number. Consequently, manual systems were developed to detect unsigned preparer returns and to check returns for preparer characteristics. The 10 IRS service centers are responsible for these manual systems.

According to service center officials, one manual system for identifying returns completed by preparers is a procedure called "fats and flats." Preparers often mail returns several to an envelope or in an envelope other than that provided taxpayers in their tax return packages. The fats and flats

procedure involves setting aside those envelopes which are odd sizes or appear to contain more than one return. The contents of these envelopes are then examined to see whether the returns were signed by a preparer, and if not, whether the returns were in fact completed by a preparer.

Another method of finding prepared returns is to look for forms other than those provided by IRS. Some preparers reproduce IRS tax forms or have created their own forms and schedules.

As part of the return preparer program, the service centers' audit division classification examiners are given "preparer profiles" outlining characteristics of suspect preparers. When returns are identified as being by a suspect preparer, they are sent to IRS district offices for audit.

Another service center technique used to detect problem preparers is the unallowable items program, which involves manual and computer screening of income tax returns for unallowable items. For instance, a deduction of more than \$100 in political contributions on a joint tax return clearly violates the law and should be identified and corrected by the program screening. IRS internal audit reviews have indicated that the unallowable items program effectively identifies unscrupulous preparers by picking out patterns of fictitious or inflated deductions.

Department of Justice prosecution

For the Department of Justice to take remedial action, the IRS district intelligence divisions must first investigate the preparer and recommend criminal action. The recommendation must then be reviewed and approved by the appropriate IRS regional counsel, IRS headquarters, and Department of Justice tax division personnel, who then submit the case to the appropriate U.S. attorney.

In the IRS Detroit district, we reviewed 16 preparer cases prosecuted from January 1968 through August 1975. Developing and prosecuting these cases took from 5-1/2 months to over 6 years. Following is a summary of the time required for the 16 cases.

<u>Months required</u>	<u>Number of cases</u>
Less than 6	1
6 to 12	3
12 to 24	9
More than 24	3
Total	<u>16</u>

National statistics confirmed that prosecution of preparers under IRS return preparer program was time consuming. As of March 31, 1975, for example, 83 of 182 open cases (cases being investigated or prosecuted, but not yet tried) had been begun in 1972 and 1973. Of the remaining 99 open cases, 83 had been begun in 1974 and 16 in 1975. The 182 open cases represented over 29 percent of the 630 cases in which criminal prosecution was being considered or taken. On March 31, 1975, the status of the 182 cases was as follows.

<u>Status</u>	<u>Initiated in</u>				<u>Total</u>
	<u>1972</u>	<u>1973</u>	<u>1974</u>	<u>1975</u>	
IRS district office	1	4	43	15	63
IRS regional counsel's office	-	10	21	1	32
Department of Justice	2	7	8	-	17
U.S. attorney	5	14	3	-	22
Arrested (not yet indicted)	-	1	-	-	1
Indicted (not yet tried)	<u>18</u>	<u>21</u>	<u>8</u>	<u>-</u>	<u>47</u>
Total	<u>26</u>	<u>57</u>	<u>83</u>	<u>16</u>	<u>182</u>

Between January 1972 and March 1975, IRS also identified 771 problem preparers who were not prosecuted due to lack of criminal potential. These cases were considered unprosecutable for such reasons as the preparer's age or poor health or the Department of Justice giving other cases a higher priority.

DECEPTIVE ADVERTISING

Section 5 of the Federal Trade Commission Act of 1914 directs the Commission to " * * * prevent persons, partnerships or corporations * * * from using unfair methods of competition in commerce and unfair or deceptive acts or practices in commerce." This authority, however, is limited to firms involved in interstate commerce.

Under this law, false and misleading advertising can be stopped through litigation against individual firms. The Federal Trade Commission (FTC) can issue a cease and desist order and can seek an injunction against unfair competitive practices.

In January 1971 IRS made an informal arrangement with FTC for a cooperative project to counter misleading advertising. FTC's Bureau of Consumer Protection made preliminary investigations of several nationwide tax services.

Beginning in 1971 IRS supplied FTC with data on firms believed to be using deceptive advertising. Based on this data FTC initiated 15 preliminary investigations. These investigations led to 10 formal investigations and complaints against preparers engaged in interstate commerce. The complaints were eventually resolved when offending firms agreed to end their questionable practices.

Both FTC and IRS officials believe that FTC's efforts have improved the accuracy of advertising by interstate preparation firms. However, FTC cannot legally help IRS with preparers who do not engage in interstate commerce.

ADDITIONAL ENFORCEMENT AUTHORITY REQUESTED

In 1971 IRS studied methods of dealing with problem preparers. The study group, which consulted interested IRS officials, spokesmen for professional organizations, and some commercial preparers, reported that

"* * * everyone thinks that the Service needs more authority to cope with the small fringe of preparers who are dishonest and unqualified. We all conclude that there is a big gap in enforcement procedures between the cumbersome fraud prosecution, at one extreme, and the mild procedures of the Federal Trade Commission at the other extreme. To fill this gap, we think we have devised some tools which the Service can use on a reasonable and selective basis * * *."

Many of the report's recommendations appeared in tax reform legislation proposed in 1974 by the House Committee on Ways and Means.

The legislative proposals contained the Department of the Treasury's and IRS' recommendations for regulating tax return preparers. The proposals included

- a requirement to file information identifying all tax return preparers;
- a requirement to furnish a copy of the return to the taxpayer, include the preparer's identification number on the return, and retain for 3 years a copy of the client's return;

- a \$5 to \$100 penalty for each failure to comply with the information requirements and the above provisions;
- a \$100 civil penalty for each case involving negligent or intentional disregard of rules and regulations;
- a \$500 civil penalty for each case of willful understatement of liability;
- injunctions against preparers engaging in specified categories of misconduct, including (1) conduct subject to penalties, (2) guaranteeing the payment of a tax refund, (3) conduct that interferes with administration of the internal revenue law, or (4) misrepresenting qualifications; and
- a requirement to furnish information on return preparers to State authorities charged with preparer regulation.

Penalties for preparer misconduct

According to an attorney with the Treasury's Office of Tax Legislative Counsel, criminal penalties are not effective deterrents against the problem preparer. He said the Department of Justice gives preference to the more flagrant cases, and even after a decision is made to prosecute, the case often takes years to complete. Meanwhile, these preparers can remain in business. The attorney said that, because criminal prosecutions were cumbersome, the civil penalty system should be expanded to cover return preparers.

IRS believes that civil penalties for individual taxpayers who do not follow the rules have worked well and assumes that they would also work against return preparers. The purpose of injunctive authority is to stop the repeated offender. This authority should permit IRS to petition the courts for injunction, not to directly enjoin the preparer.

In a February 1975 position paper, IRS indicated that many standards developed for civil cases against taxpayers would be carried over to tax preparers but that IRS would apply these penalties only against a clear-cut pattern of abuse.

CHAPTER 4

STATE REGULATION OF COMMERCIAL PREPARERS

Two States--California and Oregon--have enacted programs to regulate commercial preparers. National publicity questioning the competency and honesty of return preparers prompted the passage of both laws. Several other States are also considering regulatory legislation.

California requires tax return preparers to register with the State's consumer protection agency. Oregon requires preparers to have a license. Both States exempt professionals, who are already regulated.

Neither State had developed any data showing that unregulated preparers were preparing poor quality returns. Regulation was justified on other bases, such as preventing deceptive advertising, controlling transient preparers, and insuring that preparers are competent.

The California law became effective in January 1975, and the Oregon law in January 1974.

REGISTRATION IN CALIFORNIA

The California Department of Consumer Affairs held hearings in February 1972 on "fly-by-night tax preparers." The hearings disclosed that some audited taxpayers could not locate their return preparers. Other problems mentioned were

- deceptive advertising by some preparers;
- the absence of protection from untrustworthy, transient preparers; and
- the lack of requirements for preparers to maintain records.

State officials selected registration because the opposition of certain professional groups, such as the California Society of CPA's, to a competency test requirement would make passage by the California legislature difficult. The California Society of CPA's believed that licensing would not guarantee a tax preparer's competence and could therefore lead to unwarranted public confidence in preparers.

Provisions of the California law

The California registration law requires preparers other than those already regulated (CPA's, public accountants,

attorneys, etc.) to register with the Department of Consumer Affairs. A \$50 annual registration fee and a surety bond of \$1,000 are required. If a preparer has more than one location, \$10 for each additional location is charged. If a tax preparer has employees who would be subject to registration, there are added fees ranging from \$100 for 1 to 49 employees to \$1,500 for 500 or more employees. Total fees cannot exceed \$1,500 annually.

A tax preparer's registration may be refused, suspended, or revoked for fraudulent, untrue, or misleading statements or other misrepresentations. Similar action may be taken for

--disclosing or using taxpayer information in violation of section 7216 of the Internal Revenue Code or

--engaging in fraudulent conduct.

The law also gives the Department of Consumer Affairs injunctive authority if a person acts as a tax preparer in violation of the law. A fine ranging from \$50 to \$500 and/or a jail sentence of 1 to 60 days may also be levied for each violation.

LICENSING IN OREGON

According to members of the Oregon State Board of Tax Service Examiners and the Oregon Association of Tax Consultants, the Oregon licensing law resulted from 1972 IRS publicity regarding fraudulent and incompetent tax return preparers. They said a number of Oregon tax preparers believed the entire industry was being given an undeserved reputation. Consequently, several commercial preparers formed the Oregon Association of Tax Consultants, which was instrumental in getting Oregon's law enacted.

Members of the association believed incompetence to be a greater problem than fraud. Consequently, the association recommended a licensing law to identify tax preparers, set forth basic and continuing educational requirements, and assure a basic competency level in preparers. The Oregon State Board of Tax Service Examiners is responsible for insuring compliance, recommending changes to the law, and fining violators.

Provisions of the Oregon law

The Oregon Income Tax Services Law, enacted in 1973, requires that all tax return preparers, other than CPAs, public accountants, attorneys, Department of Treasury enrolled

agents, fiduciaries, and certain employees of the State, have licenses. The license, obtained from the board of examiners after passing an examination, must be renewed on or before January 1 of each year. The charge for taking the examination is \$20, and the fee is \$20 for a preparer's and \$30 for a consultant's license.

The preparer's license is issued to an employee of a licensed tax consultant who prepares or assists in preparing personal income tax returns. To obtain this license a person must pass the preparer's examination.

A tax consultant's license is issued to an independent person, corporation, firm, or partnership. The consultant's examination includes questions from the preparer's examination and others.

In addition, every tax consultant or preparer must be at least 18 years of age; have a high school diploma or equivalent; and have completed at least 60 hours in basic personal income tax law, theory, and practice. Any licensed tax preparer who wishes to become licensed as a tax consultant must, in addition to passing the consultant's portion of the Oregon licensing examination, be able to demonstrate that he was licensed and employed as a tax preparer for two tax seasons. The law also requires 80 hours of advanced personal income tax training during a 3-year period.

The board may (1) refuse to issue or renew a license, (2) suspend or revoke a license, or (3) reprimand a licensee. Such actions may be taken against persons for obtaining or attempting to obtain a license by fraudulent representation, failing to keep records of prepared returns, gross negligence or incompetence, or conviction for supplying any false or fraudulent information required under the tax laws of any State or of the United States. The board may take similar action against those who fail to comply with the continuing education requirements of the law or the "code of professional conduct prescribed by the board." The board may impose a civil penalty of up to \$1,000 for each violation of the Oregon Tax Service Law or any rule adopted thereunder.

PREPARERS' OPINIONS

We obtained the opinions of four Oregon return preparers who were subject to the Oregon law and six California preparers, three of whom were subject to the California law on preparer

¹ Individuals who have passed an IRS-administered test which qualifies them to represent taxpayers in official matters before IRS.

NOT AVAILABLE

regulation. All agreed on the need for preparer regulation, but not on its type, administration, or scope. Except for one of the California bills, all also agreed on the need for basic or continuing educational requirements, which are included in Oregon's law but not in California's.

LACK OF ACCESS TO TAX RETURNS
HAMPER EFFECTIVE STATE REGULATION

Both California and Oregon regulatory agencies lack the authority to review either Federal or State returns; therefore, their tasks are difficult.

California officials had hoped the registration law would overcome most of the problems with tax preparers. But because both the Federal and the California income tax laws prohibit disclosure of tax return information, no means exist to insure the competency of preparation or to determine whether preparers who sign Federal or State tax returns are registered. Department officials told us they will have to rely on tips and employ investigators to obtain maximum compliance.

According to representatives of the Board of Tax Service Examiners in Oregon, they are hampered in enforcing the licensing law because they are not allowed access to either State or Federal tax return information. However, the public is helping them to monitor preparers. Both anonymous callers and taxpayers have provided the names of persons who were preparing returns without a license. Also, full-time examiners visit preparers to see if they are licensed. As of August 1, 1974, there were about 1,900 licensed tax consultants and preparers in Oregon.

We believe it is necessary to review preparers' work for honesty and competence. Auditors in the agency responsible for tax law administration can best measure the quality of return preparation. That agency would be IRS for Federal returns and California's and Oregon's tax authorities for those States' returns.

OTHER STATES

Eight States are considering preparer regulation. Two additional States--Rhode Island and Tennessee--have laws which affect slightly the operations of paid tax return preparers.

Rhode Island law prohibits all return preparers from advertising. This law apparently has little impact--especially on the larger preparers--since they can advertise on television in nearby States. Such advertising, because of

the State's small area, can be received by Rhode Island residents.

Tennessee law regulates the preparers of State sales, franchise, and excise tax returns filed in certain counties. The law, which became effective in February 1970, carries criminal penalties, but because of the limited number of returns covered, has little effect on commercial preparers.

CHAPTER 5

CONCLUSIONS AND AGENCY COMMENTS

The rapid growth of the tax preparer industry was possible because anyone who chose to enter the field could do so. As a result, the estimated 200,000 to 250,000 paid return preparers vary widely in intelligence, training, experience, and ethics.

Predictably, some of these persons lack the competence to deal with the returns they prepare or, worse, engage in fraudulent or unethical practices. The reaction of IRS and others to such preparers focused attention on the fact that the preparer industry was unregulated and, together with some well-publicized cases of commercial preparer incompetence and fraud, led many to presume that commercial preparers were a special problem in the industry.

Our review was designed to test this presumption against available data. We found that commercial preparers, as a group, are not a special problem. A comparison of the returns prepared by commercial preparers with those prepared by professional preparers, a generally respected group, showed that the percentages of error in reported tax found by IRS were about equal. In addition, errors on the returns prepared by each appeared in the same places on the tax returns and were often made for the same reasons.

The question remains whether regulation of the entire industry, including the professionals and others, is desirable in order to generally improve performance.

We do not know. There is no data with which to estimate its potential benefits. Perhaps the experience of California and Oregon, States which recently adopted regulation, will provide some basis for future evaluation.

Although there is uncertainty as to the benefits, regulation would clearly involve costs to the Government. IRS has estimated the cost of licensing at about \$17 million per year.

Regulation might have other effects. For example, any requirements stringent enough to improve overall return preparation might diminish the number of tax preparers and therefore competition, resulting in higher prices and less convenience to the taxpayer.

Although we cannot determine whether regulation would provide a net benefit, we believe that IRS needs to have the

authority to deal individually with any preparer who engages in fraud or other misconduct. Such preparers present a special threat, because their actions undermine IRS' dependence on taxpayers' voluntary compliance with the tax law.

The only way IRS can presently deal with these situations, other than holding the taxpayer responsible for the resulting deficiencies, is to refer them to the Department of Justice for criminal prosecution. Criminal fraud prosecution is usually time consuming, and fraud is often difficult to prove. Furthermore, many cases of fraud are not suitable for prosecution, and all misconduct is not criminal.

In contrast, IRS has at its disposal various fines and other civil penalties, as well as criminal prosecution, when dealing with the taxpayer. We believe that IRS should also be able to impose civil penalties on problem preparers. This option not only would provide a swifter and surer response to misconduct but would make preparers aware that they share the responsibility for filing an accurate return. IRS also needs information reports from the preparers to enable it to review any or all of a preparer's returns.

The 1974 legislative proposals of the House Committee on Ways and Means would help IRS identify and take corrective action against these preparers. These provisions, discussed on pages 13 and 14, would

- require preparers to submit certain information to IRS,
- establish civil penalties for preparer misconduct, and
- provide for injunctions against preparers who engage in specific categories of misconduct.

The Commissioner of Internal Revenue, in commenting on a draft of this report, said that IRS agreed wholeheartedly with our conclusion. (See app. I.)

Department of the Treasury / Internal Revenue Service / Washington, D.C. 20224

Commissioner

October 29, 1975

Mr. Victor Lowe
Director, General Government Division
U. S. General Accounting Office
Washington, D. C. 20548

Dear Mr. Lowe:

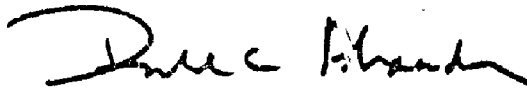
We appreciate having been given the opportunity to review your draft report to the Joint Committee on Internal Revenue Taxation entitled, "The Need to Regulate Commercial Tax Preparers is Not Apparent."

The report essentially confirms our own view that the provisions sought by the Service and reflected in the tax reform bill currently being developed by the Ways and Means Committee provide the best means to deal with preparers who engage in negligent tax return preparation, fraud, or other misconduct. Sweeping industry-wide regulatory measures are not as sound a solution.

We concur wholeheartedly with your conclusions.

With kind regards,

Sincerely,



Donald C. Alexander

Enclosure
GAO Draft Report

PRINCIPAL OFFICIALS RESPONSIBLE
FOR ADMINISTERING ACTIVITIES
DISCUSSED IN THIS REPORT

	<u>Tenure of office</u>	
	<u>From</u>	<u>To</u>
SECRETARY OF THE TREASURY:		
William E. Simon	Apr. 1974	Present
George P. Shultz	June 1972	Apr. 1974
John B. Connally	Feb. 1971	June 1972
David M. Kennedy	Jan. 1969	Feb. 1971
COMMISSIONER OF INTERNAL REVENUE:		
Donald C. Alexander	May 1973	Present
Raymond F. Harless (acting)	May 1973	May 1973
Johnnie M. Walters	Aug. 1971	Apr. 1973
Harold T. Swartz (acting)	June 1971	Aug. 1971
Randolph W. Thrower	Apr. 1969	June 1971