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BY THE COMPTROLLER GENERAL

# Report To The Joint Committee On Taxation

OF THE UNITED STATES

# IRS' Administration Of Penalties Imposed On Tax Return Preparers

For many years, IRS has experienced problems with incompetent, negligent, and/or fraudulent paid preparers of tax returns. To supplement existing criminal penalties and to provide IRS another means for dealing with those problems, the Congress, through the Tax Reform Act of 1976, authorized assessment of civil penalties against paid preparers.

Since the penalties went into effect, IRS has been very successful in getting an important segment of the preparer population--those who provide some but not all of the identification data required on tax returns--to more fully comply with disclosure requirements. In contrast, the extent to which IRS has been successful in dealing with other segments of the preparer population--those who commit conduct-related violations and/or do not identify themselves at all on returns they prepare--is unknown. This is because IRS' administration of conduct-related penalties has been uneven and because IRS has not developed needed management information. As a result, neither IRS nor the Congress has adequate assurance that the penalty provisions have achieved their desired effect.

IRS needs to develop a more accurate picture of the preparer noncompliance problem. It also needs to resolve questions about the appropriateness of certain compliance approaches, the consistency of penalty decisions, and the overall effectiveness of preparer penalties as compliance tools. IRS generally agreed with, and plans to act on, GAO's recommendations.

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COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON D.C. 20548

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The Honorable Robert J. Dole
Chairman, Joint Committee on
Taxation

The Honorable Daniel Rostenkowski
Vice Chairman, Joint Committee
on Taxation
Congress of the United States

This report, in response to your committee's request, discusses the Internal Revenue Service's (IRS') administration of the tax return preparer penalties authorized by the 1976 Tax Reform Act. The report points out that IRS has made progress in administering the penalties but that additional actions could better assure that the penalties achieve their desired effect.

We are sending copies of this report to other congressional committees, individual members of the Congress, and other interested parties.

Charles A. Bowsher

Comptroller General
of the United States

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

# IRS' ADMINISTRATION OF PENALTIES IMPOSED ON TAX RETURN PREPARERS

## D I G E S T

For many years, IRS has experienced problems with an unknown universe of incompetent, negligent, and/or fraudulent paid return preparers. To supplement existing criminal penalties and to provide IRS with another means for dealing with those problems, the Congress, through the Tax Reform Act of 1976, authorized assessment of civil penalties against paid preparers. The penalties, which range from $5 to $500 per violation, can be categorized into three types--disclosure, recordkeeping, and conduct.

Disclosure penalties may be assessed when preparers provide some but not all of the identification data required or do not identify themselves at all on returns they prepare. Recordkeeping penalties may be assessed when preparers do not maintain required lists of returns prepared and persons employed. Conduct penalties may be assessed when preparers negligently, intentionally, or willfully understate taxpayers' tax liabilities. Conduct penalties also may be assessed when preparers, with or without taxpayers' permission, endorse or negotiate the refund checks of their clients. During 1977 through 1981, IRS assessed more than 192,000 disclosure and recordkeeping penalties and more than 39,000 conduct penalties.

Since the penalty provisions went into effect, they have proven controversial. Individual preparers and preparer groups have complained about IRS' administration of the provisions. For this and other reasons, the Joint Committee on Taxation asked GAO to determine whether the provisions were achieving their desired effect of helping IRS to deal effectively with problem return preparers.

## DISCLOSURE AND RECORDKEEPING VIOLATIONS

Through penalty assessment, educational efforts, development and use of tolerance levels, and dialogue with industry representatives, IRS has been very successful in getting an important segment of the preparer population--those who provide some but not all of the identification data required on tax returns--to more fully comply with the disclosure requirements of the law. However, that success may prove short lived because, due to budget constraints, IRS discontinued this portion of its return preparer compliance program in 1982. (See pp. 7 to 9.)

In contrast, it seems questionable whether IRS has been as successful in dealing with a more troublesome segment of the preparer population--those who do not identify themselves at all on returns they prepare and/or do not keep required records. While available evidence indicates that there are a number of such preparers, the overall extent of the problem is unknown. IRS needs to gather and analyze data on these preparers with a view toward determining the extent of the problem and the relative effectiveness of its compliance activities in this regard. GAO suggested that the Service consider using an existing IRS data collection program as one means for obtaining some of the needed data. (See pp. 9 to 11 and pp. 35 to 37.)

## CONDUCT VIOLATIONS

For a variety of reasons, IRS' administration of conduct-related penalties has been uneven. Nonetheless, the Service's efforts have demonstrated that negligent and/or dishonest preparers still pose a threat to the tax system. To deal more effectively with these continuing problems, IRS needs to take steps to (1) further improve administration of the penalty for negligent misconduct, (2) clarify the circumstances under which the willful misconduct penalty ought to be asserted, and (3) reevaluate its compliance approach with respect to preparers who endorse or negotiate taxpayers' refund checks.

On the basis of general guidelines issued by IRS headquarters, IRS examiners began asserting penalties against paid preparers for negligent misconduct in October 1977. Almost immediately,

preparers began complaining that examiners were asserting the penalty on an inconsistent basis. As a result, IRS reevaluated its guidelines and subsequently made a strong effort to further clarify what exactly constitutes negligent misconduct. This should help assure application of this penalty on a more consistent basis. However, IRS still needs to resolve persistent confusion over the question of how examiners ought to take tax law complexity into account when making penalty assertion decisions. Otherwise, examiners will have to continue relying heavily on subjective judgement in determining whether a particular provision of the law is or is not complex. Also, IRS should ensure that case files contain the information IRS managers and internal auditors need to assess the appropriateness and consistency of examiners' penalty decisions. (See pp. 12 to 18.)

IRS' administration of the penalty for willful misconduct also has been hampered by inadequate guidelines. Examiners have been afforded only general guidance as to what constitutes willful misconduct. The lack of specific guidelines, together with minimal documentation in case files, has limited IRS' ability to assess the effectiveness of its efforts to detect and deter preparers who willfully understate taxpayers' tax liabilities. (See pp. 18 to 21.)

With respect to the preparer penalty for endorsement or negotiation of a taxpayer's refund check, IRS relied primarily on its existing enforcement mechanisms to detect violations. However, one district developed and used an innovative approach to detect violators. As a result, that district accounted for a majority of the refund check penalties assessed during 1980 and 1981. IRS' remaining 58 district offices have not detected nearly as many preparers who negotiated taxpayers' refund checks. (See pp. 21 to 23.)

PROGRAM ACTION CASES

Although IRS relied primarily on its existing enforcement structure to administer the preparer penalty provisions of the 1976 Tax Reform Act, it also recognized the need to supplement that approach with a special program aimed at detecting and deterring preparers who consistently violate the law. Such preparers are of

particular concern to IRS because they can undermine the tax system. Further, occasional penalty assessments may not effectively deter those preparers whose financial gains from violations of the law greatly exceed penalty amounts assessed against them.

To deal with this segment of the population, IRS sought to develop "program action cases." Through such cases, IRS sought to assert multiple penalties against preparers who committed multiple violations. Although IRS' approach to program action cases had some limitations, it did enable the Service to detect and deter some preparers who had committed multiple violations. However, primarily due to budget constraints, IRS stopped keypunching certain preparer-related information in service center computers in January 1982. This made it more difficult for IRS to detect preparers who committed multiple violations.

Subsequently, however, IRS concluded that there was a need to reconsider the decision to stop keypunching the preparer data. In June 1982, the Commissioner did so and decided to reinstitute a limited version of the keypunching operation. If sufficient funds are available, the revised keypunching operation will be implemented in January 1983. This should facilitate development of program action cases in future years. (See pp. 23 to 25.)

BETTER MANAGEMENT INFORMATION NEEDED

When IRS decided to seek the legal authority to assess civil penalties against paid preparers, it believed that such an enforcement tool would provide an effective means for dealing with what was believed to be a small group of problem preparers. However, GAO sent questionnaires to preparers and the results indicated that the preparer problem was, and still may be, larger than originally anticipated. In any case, IRS has not sought to specifically identify the size of the problem preparer group. (See pp. 26 and 27.)

Furthermore, IRS has not collected the data needed to assess the effectiveness of its administration of the penalty provisions. In particular, IRS lacks data on the extent to which penalties have been assessed consistently against the same preparers over the course of several years. In

this regard, if multiple penalty assessments have not caused a preparer to comply, then questions arise as to the utility of existing penalty provisions. IRS' Internal Audit Division alerted top Service managers to the need for management information in a January 1981 report. However, IRS has not yet collected the needed information. (See pp. 29 to 33.)

RECOMMENDATIONS

The Commissioner of Internal Revenue needs to collect and analyze better management information on the preparer population and on preparer penalties. Without such information, IRS cannot fully assess the extent of preparer noncompliance or the effectiveness of its overall compliance program. In addition, the Commissioner should resolve specific questions about the appropriateness of certain compliance approaches and the consistency of penalty-related decisions. GAO makes several recommendations on these matters. (See pp. 35 to 37.)

AGENCY COMMENTS

The Commissioner of Internal Revenue expressed general agreement with GAO's recommendations and specified that various corrective actions would be initiated. In GAO's view, however, the Commissioner could further assure consistent application of the willful misconduct penalty by seeking to develop guidelines which would better define for IRS personnel and preparers the circumstances under which that penalty may be asserted.

GAO also points out that current IRS plans call for substantial reductions in the Service's taxpayer assistance programs. These planned reductions may well have the effect of forcing many more taxpayers to seek assistance from paid preparers in future years. Thus, GAO suggests that, in developing a timetable for implementing corrective actions to the return preparer program, the Commissioner take into account the expected status of the taxpayer assistance program and the continuing problem of tax law complexity. (See pp. 37 to 39.)

# Contents



## ABBREVIATIONS

| | |
|---|---|
| GAO | General Accounting Office |
| IRS | Internal Revenue Service |

# CHAPTER 1

## INTRODUCTION

Because our tax laws have evolved into an extremely complicated array of exclusions, exemptions, deductions, and credits, many taxpayers need assistance in preparing their returns. To obtain that assistance, taxpayers often turn to volunteers, friends or relatives, the Internal Revenue Service (IRS), or commercial preparers. In 1980, over 196,000 individuals prepared 20 or more tax returns for a fee. In 1981, 88 million individual tax returns were filed. Of these, 39 million, or 44 percent, were prepared by individuals who charged taxpayers a fee for the service.

For many years, IRS has experienced problems with an unknown universe of incompetent, negligent, and/or fraudulent paid return preparers. Before 1977, however, IRS had only one enforcement tool with which to deal with such preparers--criminal prosecution. In the early 1970s, IRS determined that criminal prosecution alone was not an effective deterrent largely because the Department of Justice preferred to prosecute only the most flagrant cases of abuse.

Recognizing the need for other ways to deal with problem preparers, IRS set up a study group to evaluate the problem and to recommend solutions. The study group identified a need for civil enforcement penalties and recommended that IRS seek needed legislative authority for such penalties. IRS did so, and, in the Tax Reform Act of 1976 (P.L. 94-455, Oct. 4, 1976), the Congress authorized IRS to assess penalties against paid preparers. The penalties can be categorized into three types--disclosure, recordkeeping, and conduct. The specific penalties are summarized below and described more fully in appendix I.

| Category | Description | Amount per return |
|---|---|---|
| Disclosure | Failure to furnish a required signature or identification number on returns prepared | $25 |
| Recordkeeping | Failure to furnish taxpayer a copy of the return prepared or to maintain information on returns prepared and persons preparing them | $5 to $50 |

| Category | Description | Amount per return |
|---|---|---|
| Conduct | Understatement of taxpayer's tax liability because of negligent or intentional misconduct | $100 |
| Conduct | Understatement of taxpayer's tax liability because of willful misconduct | $500 |
| Conduct | Endorsement or negotiation of a taxpayer's refund check | $500 |

In addition, the act authorized IRS to obtain an "injunction" against preparers guilty of repeated violations. Under this authority, IRS can seek a district court decree against an individual return preparer. Specifically, IRS can seek to have the court (1) enjoin the preparer from engaging in conduct which is subject to the aforementioned penalties or (2) put the preparer out of business.

## IRS USED ITS EXISTING ENFORCEMENT STRUCTURE TO ADMINISTER THE ACT

In administering the act's penalty provisions, IRS' 10 service centers and 59 district offices 1/ assumed key responsibilities. Service centers were responsible for identifying preparers who only partially disclosed their identity; districts were responsible for detecting preparers who did not disclose their identity and also for detecting preparers suspected of committing recordkeeping and/or conduct violations.

In processing tax returns, service center personnel keypunched information shown on the returns. This information included each preparer's name and social security number and, for preparer firms, the employer's identification number. The preparer information was then entered into IRS' computer files and analyzed. Lists were printed showing preparers who provided only partial information, i.e., they had not included a signature, social security number, and/or employer identification number. Service center personnel screened these lists for accuracy and, when violations were confirmed, the service center billing unit assessed penalties against preparers who did not fully comply with the act's disclosure requirements.

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1/A March 1982 IRS reorganization added a 60th district office--the Foreign Operations District.

IRS district offices were responsible for detecting preparers who completely failed to identify themselves as well as preparers who failed to keep required records and/or committed conduct-related violations. While checking returns for compliance with Internal Revenue Code provisions as part of IRS' normal examination program, district examiners sought to identify violations by paid preparers. In certain circumstances, when there was reason to suspect a preparer or firm of a pattern of negligent or willful misconduct, districts selected and examined a number of returns the individual or firm had prepared. These activities were referred to as "program action cases." When the district found multiple violations via program action cases, the service center billing unit assessed multiple penalties. In addition, districts were responsible for using IRS' injunctive authority against repeat offenders.

In examining tax returns for disclosure and recordkeeping violations, district examiners were instructed to question taxpayers as to whether paid preparers had failed to identify themselves and to initiate penalty actions when violations were detected. Examiners were also instructed to ask taxpayers whether paid preparers had provided them with a copy of the tax return, as required by the act. And, if preparers were present for examinations, examiners were instructed to ask them whether they had kept the required lists or copies of returns prepared and the required list of persons employed to prepare returns.

Further, when a taxpayer's tax liability had been understated, examiners were required to decide whether the understatement resulted from negligent, intentional, or willful misconduct by a preparer. If so, a penalty was assessed against the preparer. Finally, IPS district offices also were responsible for identifying preparers who endorsed or negotiated the refund checks of their taxpayer clients. They sought to do so primarily by asking affected taxpayers and/or preparers, during examinations, to identify the party who had negotiated the refund check.

The penalties resulting from IRS' administration of the 1976 Tax Reform Act's paid preparer provisions for 1977 through 1981 are summarized in the following table.

NUMBER OF PENALTIES ASSESSED BY IRS

| Penalty category | Calendar year 1978 and prior (note a) | 1979 | 1980 | 1981 | Total |
|---|---|---|---|---|---|
| Disclosure (detected by service centers) | 105,369 | 33,937 | 15,028 | 3,241 | 157,575 |
| Disclosure and recordkeeping (detected by district offices) | 2,675 | 7,446 | 13,088 | 11,773 | 34,982 |
| Negligent or intentional misconduct | 1,889 | 6,287 | 9,377 | 7,229 | 24,782 |
| Willful misconduct | 384 | 1,228 | 2,745 | 3,910 | 8,267 |
| Endorsement or negotiation of refund check | 499 | 695 | 3,166 | 2,077 | 6,437 |

a/Service center disclosure statistics cover only the period from January 1978 to December 1981. Although some assessments were made in 1977, IRS stopped assessments, abated those already made, and refunded those which had been paid when it found that preparers were confused by the act's requirements. IRS did not include the 1977 assessments in its reports. Although district statistics include 1977 assessments, very few assessments were made that year because, under IRS procedures, examiners did not start examining returns filed in 1977 until October 1977. For example, of 3,041 district-initiated assessment case files we reviewed, only 3 related to 1977 assessments.

As of December 1981, the most current date for which information was available, IRS districts had used the injunctive provision of the Tax Reform Act against five paid preparers.

## OBJECTIVES, SCOPE, AND METHODOLOGY

The Joint Committee on Taxation, after receiving numerous complaints from the preparer industry, asked us to review IRS' administration of the Tax Reform Act's paid preparer provisions. Specifically, we were asked to evaluate whether the provisions were

--helping IRS to identify returns prepared by paid preparers (disclosure and recordkeeping provisions),

--deterring preparers from engaging in negligent or fraudulent practices designed to understate taxpayers' tax liabilities (conduct provisions), and

--deterring preparers from endorsing or negotiating taxpayers' refund checks (conduct provisions).

This audit was performed in accordance with generally accepted Government auditing standards. Broadly described, our audit work consisted of the following actions. By means of questionnaires, we queried random samples of paid preparers for their views on the effects of the penalty provisions and the equity of IRS' administration of the program. To further evaluate the effectiveness and consistency of IRS' administration of the penalty provisions, we reviewed IRS case files on a nationwide sample of district-initiated penalty assessments. This sample included all types of violations. We supplemented case file information through discussions with IRS personnel at four district offices and officials of selected preparer groups. In selecting samples and analyzing quantitative data, we used standard statistical techniques. Our methodology is described in greater detail in chapter 3.

## CHAPTER 2

## IRS NEEDS TO DEVELOP BETTER MANAGEMENT INFORMATION ON THE MAGNITUDE OF THE PAID PREPARER NONCOMPLIANCE PROBLEM AND THE UTILITY OF ITS CURRENT COMPLIANCE APPROACH

In administering the paid preparer provisions of the 1976 Tax Reform Act, IRS has generally relied on its normal enforcement procedures, primarily its examination program, to detect preparers who failed to comply with the law and to assess penalties as appropriate. This approach has enabled IRS to get many preparers to fully identify themselves on tax returns. On the other hand, IRS does not know whether it has been as successful in dealing with preparers who do not identify themselves at all on tax returns and/or do not maintain adequate records. Also unknown is the extent to which IRS has been successful in detecting and deterring conduct violations by the entire population of preparers.

IRS is not presently collecting and/or is not analyzing the data it needs to assess program effectiveness. In particular, IRS lacks data on preparers who commit multiple violations over the course of several years. Without adequate management information, IRS cannot assure the appropriateness of its compliance approaches and cannot identify any needed program revisions. In our view, a more systematic approach to the paid preparer compliance program is needed.

### DISCLOSURE AND RECORDKEEPING VIOLATIONS: IRS HAS MADE SOME PROGRESS BUT A POTENTIALLY SERIOUS PROBLEM PERSISTS

Since preparer penalties went into effect in 1977, IRS has dealt firmly, fairly, and effectively with preparers who only partially identified themselves on tax returns. Through penalty assessments, educational efforts, development and use of tolerance levels, and dialogue with industry representatives, IRS has been very successful in getting an important segment of the preparer population--those who only partially identify themselves on tax returns--to more fully comply with the disclosure requirements of the law. Although IRS has achieved success in this regard, that success may prove short lived. This is because, due to budget constraints, IRS stopped collecting certain data on return preparers in January 1982.

In contrast, it seems questionable whether IRS has been as successful in dealing with a more troublesome segment of the preparer population--those who do not identify themselves at all on

returns they prepare and/or do not keep required records. While available evidence indicates that there are a number of such preparers, the overall extent of the problem is unknown. IRS needs to gather and analyze data on these preparers with a view toward determining the extent of the problem and the relative effectiveness of its compliance enforcement activities in this regard.

## IRS has been successful in getting many preparers to fully identify themselves on tax returns

Although preparers seemed somewhat confused over disclosure requirements at the outset, even-handed administration of disclosure-related penalties has enabled IRS to achieve a key goal. Specifically, IRS has been very successful in getting an important segment of the preparer population to more fully identify themselves on returns. This is an important step because full disclosure by return preparers could enable IRS to develop a data base through which to monitor preparers' effectiveness over time. Unfortunately, it seems unlikely that IRS will soon develop that data base because it recently decided to dismantle this portion of its compliance program.

As previously discussed, IRS' 10 service centers were responsible for detecting preparers who did not fully identify themselves on returns. In January 1977, the effective date of the Tax Reform Act's penalty provisions, service centers began identifying and assessing penalties against preparers who had omitted a signature, social security number, or employer identification number. Preparer groups complained that IRS had moved too quickly in assessing penalties for partial disclosure. They pointed out that IRS had done little to alert preparers to the disclosure requirements and to the fact that the highly complex 1976 Tax Reform Act authorized IRS to assess penalties against preparers. Preparers also noted that IRS was assessing penalties for isolated errors. In response, IRS reevaluated its efforts and determined that preparers' complaints may have been justified. IRS therefore decided to abate all penalties assessed during January through May 1977.

Meanwhile, IRS mounted an education campaign aimed at alerting preparers to disclosure requirements (as well as conduct and recordkeeping requirements) and to the fact that penalties would be assessed for noncompliance. Among other things, IRS used pamphlets, newsletters, warning letters, articles in trade journals, and appearances before preparer groups to educate preparers. By January 1978, IRS felt that it had made a very strong effort to alert preparers to the requirements imposed on them by the law. In addition to its educational efforts, IRS also began developing

some guidelines aimed at ensuring that disclosure-related penalties were not assessed for isolated errors. Specific tolerance levels in this regard were established in April 1978.

IRS followed up on its educational efforts and revised guidelines by vigorously identifying violations and assessing penalties against preparers who only partially identified themselves on returns filed in calendar year 1978. In that year, IRS assessed 105,369 such penalties. Although many of those penalty assessments subsequently were contested by preparers and abated by IRS, the Service clearly got its message across--preparers should expect to be penalized for partial disclosure violations. That message, together with the implementation of tolerance levels and maintenance of a steady compliance program, brought good results. In calendar year 1979, for example, the number of penalties assessed for partial disclosure violations declined by 68 percent to 33,937. In 1980, only 15,028 such penalties were assessed. And, in 1981, that figure further declined to 3,241.

Thus, through dialogue with preparer groups, educational efforts, development of tolerance levels, and use of its authority to assess and abate penalties, IRS has been able to get an important segment of the preparer population--those who are willing to at least partially identify themselves on returns--to more fully comply with disclosure requirements. Getting preparers to more fully identify themselves on returns constitutes an important achievement for IRS. With full disclosure by a major segment of the preparer population, IRS has a great deal of basic information about preparers and the tax returns they prepare. Without this basic information as a starting point, IRS will be hard-pressed to evaluate preparers' performance over time and to correct deficiencies. And, as discussed on pages 26 to 33, IRS needs to develop better management information on preparers' performance and the utility of its current compliance approach.

Ironically, the success of IRS' partial disclosure compliance program has made it unlikely that the Service will develop the aforementioned data base. In 1981, as part of the Administration's Government-wide cost cutting program, IRS sought to identify areas where it could achieve savings. One area identified was the service centers' paid preparer disclosure program. Because compliance had improved so dramatically, IRS felt that it could best absorb some budget cuts by cutting back on the preparer program, as opposed to some other programs. Thus, in January 1982, IRS stopped keypunching preparer-related information from returns filed and basically dismantled the service center portion of its disclosure compliance program. IRS estimated that it would achieve annual cost savings of $4.5 million by eliminating this portion of the paid preparer compliance program.

In future years, IRS plans to rely solely on district offices to detect partial disclosure violations. However, as discussed below, district offices use examinations as the primary means for detecting paid preparers who violate the law. And fewer than 2 percent of tax returns filed are examined annually. Thus, through this approach, IRS would be unable to detect as many partial disclosure violations. Further, as discussed on pages 23 to 25, elimination of the service center keypunching operation also has reduced IRS' ability to detect preparers who commit multiple violations. And, even though IRS now plans to reinstitute a limited keypunching operation in January 1983, it does not plan to reinstitute the service center portion of the partial disclosure program.

## Despite IRS' efforts, violations of disclosure and recordkeeping requirements persist

Although IRS has been successful in getting many preparers to fully identify themselves on returns, problems with another segment of the preparer population have proven more difficult to solve. Each year, IRS has detected numerous preparers who do not identify themselves at all on returns they are paid to prepare. Also, IRS annually detects many preparers who do not keep required records. While the extent of these problems is unknown, their nature is serious enough to dictate a need for further IRS analysis including a reevaluation of current compliance enforcement approaches.

Rather than start an entirely new and costly program aimed at detecting preparers who failed to identify themselves on returns and/or failed to keep required records, IRS decided to use its existing examination program to detect violators. In addition to carrying out their normal duties, IRS examiners were directed to ask taxpayers whether they had paid to have their returns prepared and whether they had received a copy of the return from the preparer, as required by the law. If a preparer accompanied a taxpayer during an examination, IRS examiners were to ask the preparer whether the required lists or copies of returns prepared and the list of persons employed had been maintained.

This compliance approach enabled IRS to identify some problem preparers and to assess penalties against them. The following table shows the number of penalties IRS assessed in calendar years 1978 through 1981 for nondisclosure and for inadequate recordkeeping.

| Calendar year | Number of penalties assessed for: Nondisclosure (note a) | Inadequate recordkeeping (note a) |
|---|---|---|
| 1978 (note b) | 1,953 | 722 |
| 1979 | 5,436 | 2,010 |
| 1980 | 9,554 | 3,534 |
| 1981 (note c) | 8,594 | 3,179 |
| Total | 25,537 | 9,445 |

a/IRS statistics did not distinguish between nondisclosure and recordkeeping penalties. On the basis of our randomly selected sample, however, we determined that 73 percent of IRS' universe for the two penalties related to nondisclosure while the remaining 27 percent related to recordkeeping violations. The above statistics were derived by projecting those percentages over the IRS universe. Further details on our methodology in this regard are discussed on pages 40 and 41.

b/These statistics may include a small number of penalties assessed in the last quarter of 1977.

c/These projections are based on the assumption that IRS continued assessing nondisclosure and recordkeeping penalties at a ratio of 73 percent to 27 percent in 1981. Our sample results, on which that ratio is based, pertained specifically to calendar years 1978 through 1980.

Thus, each year, IRS has detected a significant number of instances in which preparers did not identify themselves on returns and/or did not keep required records. That fact is of concern for several reasons. First, IRS cannot measure an individual preparer's performance over time and take any necessary actions unless it can identify and analyze the returns prepared by that individual. Second, IRS does not know why certain preparers do not identify themselves on returns and/or do not keep required records. Such preparers may be so motivated for a variety of reasons. Some simply may have overlooked or been unaware of the requirements; some may have been "too busy" or simply neglectful; others, however, may be preparing fraudulent returns and may intentionally be seeking to avoid IRS scrutiny. Third, unless IRS can detect and deter these problem preparers, some taxpayers may inadvertently be victimized by the preparers' noncompliance. Fourth, the extent of the problem is unknown due to limitations associated with IRS' compliance program.

With respect to the latter point, under current procedures, preparers who commit either of the aforementioned violations generally will not be caught and penalized unless IRS selects a

return they have prepared for examination. Even under that circumstance, IRS will not detect these preparers unless taxpayers respond to IRS' probing questions concerning how their returns were prepared. Further, IRS generally cannot detect recordkeeping violations unless a preparer accompanies a taxpayer during an examination and responds to IRS' probing questions about recordkeeping requirements. And, because IRS examines fewer than 2 percent of all returns filed, it cannot detect more than a small percentage of preparers who do not identify themselves on returns and/or do not keep required records.

As a result, IRS has no means of knowing the extent of the problem it faces, nor can it assess the effectiveness of its current compliance program. Additional information is needed to assess the extent of the problem and a reevaluation of the current compliance approach is warranted. In so doing, IRS may find that it needs to implement an aggressive compliance approach targeted specifically at paid preparers. If warranted, such an approach might include identifying preparer advertisements, visiting preparers' places of business, and analyzing copies of returns in their possession (or immediately assessing penalties for not having required lists or copies of returns).

## CONDUCT VIOLATIONS: IRS' ADMINISTRATION OF PENALTY PROVISIONS HAS BEEN UNEVEN

IRS has made some progress in dealing with the problem of preparers who commit disclosure and recordkeeping violations. On the other hand, whether IRS has made similar progress in dealing with another, more serious problem--negligent and/or dishonest preparers--is unknown. Such return preparers undermine the tax system because they tend to understate taxpayers' tax liabilities knowingly or through ignorance.

Although IRS' administration of conduct-related penalties has been uneven, its efforts have nonetheless demonstated that negligent and/or dishonest preparers still pose a threat to the tax system. To deal more effectively with these continuing problems, IRS needs to take steps to (1) further clarify guidelines pertaining to the penalty for negligent or intentional misconduct, (2) clarify the circumstances under which the willful misconduct penalty ought to be asserted, and (3) reevaluate its compliance approach with respect to preparers who endorse or negotiate taxpayers' refund checks.

## Further clarification of current guidelines would help assure consistency in administration of the penalty for negligent or intentional misconduct

On the basis of general guidelines issued by IRS headquarters, IRS examiners began asserting 1/ penalties against paid preparers for negligent or intentional misconduct in October 1977--10 months after the Tax Reform Act's penalty provisions went into effect. Almost immediately, preparers began complaining that examiners were asserting these penalties on an inconsistent basis. As a result, IRS reevaluated its guidelines and subsequently made several attempts to further clarify what exactly constitutes negligent or intentional misconduct. IRS' most recent efforts in this regard should help assure application of this penalty on a more consistent basis. However, IRS needs to take additional steps to (1) resolve persistent confusion over how examiners ought to take tax law complexity into account when making penalty assertion decisions and (2) ensure that needed information is included in case files.

### Examiners found it difficult to take into account return complexity and the frequency and materiality of errors

In 1977, IRS guidelines were quite general stating that preparers were guilty of negligent or intentional misconduct if they failed to exercise due diligence in properly applying tax rules and regulations. The guidelines provided that this penalty provision was to be applied in the same manner as penalties are applied against taxpayers preparing their own returns. Further, in determining whether to assert this penalty, IRS examiners were instructed to take into account the complexity of the return at issue and the frequency and materiality of errors made. However, those instructions were not supplemented with specific descriptions of what constitutes a complex issue; also lacking was specific criteria defining the terms frequency and materiality.

Beginning in 1978, several IRS districts recognized the need for more specific guidance and issued guidelines containing examples of negligent or intentional misconduct to help promote a consistent application of this preparer penalty by examiners.

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1/IRS uses two terms when describing penalty actions against preparers. The term "assertion" is used when an examiner decides that a penalty should be levied against a preparer. The term "assessment" is used when a service center bills the preparer for the penalty amount.

According to district examiners, the examples were useful but still were subject to differing interpretations. And, of course, the examples only were available in those districts where supplemental guidance had been developed. In any case, examiners continued asserting penalties against preparers for negligent or intentional misconduct. During calendar years 1977 through 1979, IRS assessed 8,176 penalties against preparers for negligent or intentional misconduct. And, during those years, individual preparers and preparer groups complained to IRS and to members of the Congress that the penalties were being applied in an inconsistent manner.

To determine more specifically why preparers felt that IRS was not assessing penalties on a consistent basis, we sent questionnaires to randomly selected preparers in two groupings--the general population of preparers and preparers who had been assessed penalties. The results from our questionnaires indicated that preparers were particularly concerned with two major problems. Specifically, preparers felt that IRS often did not take into account the complexity of issues on a return before assessing a penalty. Similarly, preparers felt that penalties were being assessed for isolated errors.

To evaluate the accuracy of preparers' views and the consistency of IRS' penalty assessments, we reviewed a randomly selected sample of 1,699 case files pertaining to penalties assessed for negligent or intentional misconduct by all IRS district offices during the period January 1977 through July 1980. The methodology we followed in selecting this random sample is discussed in detail on pages 40 and 41.

Of the 1,699 case files, only 13 contained any comments concerning the complexity of the tax issues involved. Therefore, we were unable to determine whether examiners considered the complexity of the issues but did not document the results or whether examiners simply did not consider the complexity of the issues at all. Regardless, the lack of documentation in case files means that IRS has no way to determine the extent to which examiners consider the complexity of issues on a return in reaching decisions on penalty assessments.

With respect to penalties being assessed for isolated errors, we sought to determine, for the same 1,699 cases, the number of errors associated with each penalty assessment. We were able to obtain that information from only 1,279 of the 1,699 case files; the remaining 420 case files did not contain specific data on the number of errors made. Regardless, we found that IRS

was in fact assessing penalties for single errors, 1/ as shown in the following table.

| Number of errors | Case files | |
|---|---|---|
| | Number | Percent |
| One | 506 | 40 |
| Two | 266 | 21 |
| Three | 216 | 17 |
| Four | 107 | 8 |
| Five or more | 140 | 11 |
| More than one but total number unclear | 44 | 3 |
| Total | 1,279 | 100 |

The following examples may illustrate why penalties for isolated errors sometimes seem inappropriate from the standpoint of certain preparers. In the first case, the preparer made one error on a return. In the second case, the preparer made several errors. Yet each preparer was assessed the same penalty despite the extreme difference in the degrees of negligence.

--An examiner proposed the $100 negligence penalty because the preparer had understated the taxpayer's tax liability by erroneously claiming an energy credit for insulation and windows on a newly constructed home. The examiner pointed out that, for the credit to be allowed, the residence to which the expenditures applied had to be substantially completed by April 20, 1977, which was not the case with this residence. The examiner did not comment on whether or not this was a complex code provision nor did the file contain information on the amount of the understated tax liability.

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1/In some instances, as part of a program action case, IRS assessed multiple penalties against a preparer for making the same or a similar error on many returns. In such instances, there is less cause for concern about the appropriateness of a penalty assessment for a single error on any one return. In calendar year 1981, 8,554, or 30 percent, of the 28,230 return preparer penalties assessed pertained to program action cases. As discussed on pages 23 to 25, however, we were unable to determine whether any individual file was part of a program action case.

--In contrast, another examiner proposed the $100 negligence penalty because the preparer (1) did not provide required data for a depreciation deduction on schedule C, (2) did not provide required data for a depreciation deduction on schedule F, (3) provided documentation during the examination which showed substantial discrepancies between the depreciation claimed and the amounts that should have been claimed, (4) carried forward an incorrect investment credit, (5) made significant errors in computing the taxpayer's original purchase price for a farm, and (6) did not include certain income on schedule F.

To determine local level viewpoints on the appropriateness of penalty assessments for single errors, we interviewed officials in four IRS district offices--Detroit, Fargo, Manhattan, and San Francisco. Officials from three of the four districts stated that penalties were and should be assessed for isolated errors when such errors are material in nature. Officials from the fourth district stated, however, that regardless of the materiality of any single error, penalties generally were not and should not be assessed for isolated errors.

With respect to a related issue, we sought to determine, to the extent feasible, whether examiners seemed to take dollar amounts involved into account when asserting penalties. We were able to obtain that information for only 908 of the 1,699 cases. As shown below, it appeared that examiners generally refrained from assessing penalties against preparers who understated a taxpayer's tax liability by $100 or less.

| Amount of understated tax liability | Case files | |
|---|---|---|
| | Number | Percent |
| $0 | 3 | 0.3 |
| $1 through $50 | 5 | 0.5 |
| $51 through $100 | 11 | 1.2 |
| $101 through $200 | 51 | 5.6 |
| $201 through $500 | 189 | 20.8 |
| $501 through $1,000 | 215 | 23.7 |
| $1,001 through $3,000 | 247 | 27.2 |
| More than $3,000 | 187 | 20.7 |
| Total | 908 | 100.0 |

As indicated by the above statistics, although examiners generally did not assert penalties for amounts of $100 or less, they seemed to consider amounts exceeding $200 to be material. The above statistics also indicate that examiners may have had some difficulty determining whether amounts of $101 to $200 were material.

To further assess the extent to which examiners took materiality into account, we sought to determine the dollar amounts of understated tax liabilities associated with penalty actions taken on the basis of single errors. As shown on page 14, our sample included 506 cases in which penalties were assessed for single errors. The following table shows, for 316 of those cases, the dollar amounts of understated tax liabilities. Information on dollar amounts involved in the remaining 190 cases was not included in the files.

| Amount of understated tax liability | Case files | |
|---|---|---|
| | Number | Percent |
| 0 | 2 | 0.7 |
| $1 through $50 | 1 | 0.2 |
| $51 through $100 | 6 | 2.0 |
| $101 through $200 | 24 | 7.7 |
| $201 through $500 | 82 | 26.0 |
| $501 through $1,000 | 70 | 22.2 |
| $1,001 through $3,000 | 72 | 22.7 |
| More than $3,000 | 59 | 18.5 |
| Total | 316 | 100.0 |

These statistics indicate that examiners rarely asserted penalties for understatements involving $100 or less when only a single error was involved. Again, however, some examiners did assert penalties for single errors when the amount involved was $200 or less. And, again, examiners clearly considered tax liability understatements of more than $200 to be material, even where a single error had been made.

Because preparers had complained about a lack of consistency in IRS penalty decisions, we also sought to evaluate the effectiveness of two specific IRS control mechanisms aimed at assuring quality and consistency. In this regard, we reviewed the 1,699 case files included in our sample to determine whether (1) required supervisory reviews had been made before penalties were assessed and (2) required quality control group reviews had been made before penalties were assessed. However, as discussed below, we were unable to judge the effectiveness of IRS' control mechanisms because most of the files lacked documentation with respect to the reviews.

Of the 1,699 cases in our sample, 855, or 50 percent, pertained to penalties asserted by district office examiners whose decisions were subject to supervisory review. Of the 855 case files, 634, or 74 percent, contained no evidence of supervisory review. Field examiner penalty actions generally were not subject to supervisory review during the period covered by our sample. However, per IRS requirements, all 1,699 case files should

have been reviewed by a quality control group composed of district examination division personnel. Yet 858, or 51 percent, of the 1,699 case files contained no indication that the required review had been made. Thus, we were unable to assess the utility of these two control mechanisms.

In light of these varied problems, IRS recognized the need to improve its administration of the penalty for negligent or intentional misconduct and took some corrective actions.

### Revised IRS guidelines provided examiners with some criteria on which to base decisions for the negligent misconduct penalty

Because preparers continued to complain to IRS and to the Congress about inconsistent administration of the penalty provisions, IRS took action in 1980 to remedy some of the more apparent problems. In January 1980, for example, IRS issued Revenue Ruling 80-28 which described three specific situations in which preparers would be penalized for negligent misconduct. In February 1980, IRS began requiring advance supervisory review of field examiners' penalty assessment proposals. Those reviews, already in effect for office examiners, were aimed at assuring the uniformity and accuracy of penalty assessments. In September 1980, IRS further supplemented existing guidance by issuing Revenue Procedure 80-40 and Revenue Rulings 80-262 through 80-266. Among other things, these rulings (1) reiterated that examiners were to take into account the complexity of the tax return in making penalty assessments and (2) noted that IRS would assess penalties against preparers for single errors if such errors were sufficiently obvious, flagrant, or caused material understatements of tax liabilities. In September 1980, IRS also provided guidance to examiners with respect to the materiality issue in the form of a specific dollar tolerance level.

Whether IRS' efforts to clarify negligent or intentional misconduct have had their desired effects remains unclear. Our sample covered the period January 1977 through July 1980. Thus, the 1980 revisions to IRS' guidelines had little effect on our overall results. We noted, however, that IRS assessed 9,377 penalties against preparers for negligent or intentional misconduct in calendar year 1980. During 1981, only 7,229 such penalties were assessed. These statistics could mean that preparers' performance improved. On the other hand, IRS' new guidelines may have had the effect of limiting the number of penalty assessments through establishment of quantitative criteria.

In any case, IRS' new guidelines, while helpful, could be clarified and expanded in two ways to better assure consistency

in penalty assessments. In this regard, although examiners have been instructed to take return complexity into account when making penalty decisions, they have not been afforded specific guidance on how to do so. IRS could do more to reduce uncertainty in this area. One means for doing so would involve expanding current guidelines and/or training materials to include case examples. Also, by requiring better documentation in case files, IRS could better evaluate the consistency of its penalty-related decisions.

## Inadequate guidelines have hampered administration of the penalty for willful misconduct

Like the situation with penalties for negligent or intentional misconduct, IRS' administration of the penalty for willful misconduct has been hampered by inadequate guidelines. Again, examiners have been required to make decisions as to whether penalties ought to be asserted by taking into account the complexity of returns and the frequency and materiality of errors but have been afforded only general guidance as to what constitutes willful misconduct. Moreover, IRS has made little effort to clarify guidelines relating to the $500 penalty for willful misconduct. As a result, preparers have continued to complain that IRS has assessed this penalty in an inconsistent fashion. The lack of specific guidelines, together with minimal documentation in case files, has limited IRS' ability to assess the effectiveness of its efforts to detect and deter preparers who willfully understate taxpayers' tax liabilities.

Beginning in late 1977, IRS examiners began asserting penalties against preparers for willful misconduct in accordance with general guidelines issued by IRS' national office. Basically, the guidelines stated that willful misconduct may be characterized as actions which are more serious in nature than mere negligence but short of criminal fraud. The guidelines made no distinction between intentional misconduct ($100 penalty) and willful misconduct ($500 penalty). Regardless, since 1977, IRS has annually assessed preparers an increasing number of willful misconduct penalties. During 1977 through 1981, IRS assessed 8,267 such penalties.

In response to these assessments, preparers and preparer groups have complained to IRS and to members of the Congress that IRS lacks specific criteria for determining willful misconduct and thus has been inconsistent in assessing this penalty. In responding to our questionnaire, 50 of 100 paid preparers, who had been assessed the penalty, indicated that IRS had little

or no basis for its assessment. Among other things, the preparers complained that IRS did not take into account the complexity of the returns prepared; they also stated that IRS assessed willful misconduct penalties for isolated errors.

To evaluate preparers' contentions and to determine the effectiveness of IRS' enforcement efforts, we analyzed a randomly selected nationwide sample of 260 willful misconduct penalty case files. The case files pertained to penalties assessed from October 1977 to July 1980. The specific methodology we followed in selecting this random sample is discussed on pages 40 and 41. We sought to determine whether and how, in asserting this penalty, examiners took into account return complexity and the frequency and materiality of errors. We also sought to determine whether required supervisory and quality control reviews were having their desired effects.

We were unable to determine whether examiners took return complexity into account in asserting willful misconduct penalties because none of the 260 case files contained comments on the complexity of the Internal Revenue Code sections involved.

With respect to the frequency of errors, we were able to obtain data from 118 of the 260 case files. The remaining 142 case files did not contain specific data on the number of errors made. As shown in the following table, we found that examiners sometimes asserted the willful misconduct penalty against preparers for single errors. 1/

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1/In some instances, as part of a program action case, IRS assessed multiple penalties against a preparer for making the same or a similar error on many returns. In such instances, there is less cause for concern about the appropriateness of a penalty assessment for a single error on any one return. In calendar year 1981, 8,554, or 30 percent, of the 28,230 return preparer penalties assessed pertained to program action cases. As discussed on pages 23 to 25, however, we were unable to determine whether any individual file was part of a program action case.

| Number of errors | Case files Number | Percent |
|---|---|---|
| One | 19 | 16.3 |
| Two | 22 | 18.3 |
| Three | 24 | 20.5 |
| Four | 18 | 15.6 |
| More than four | 30 | 25.1 |
| More than one but precise number of errors unknown | 5 | 4.2 |
| Total | 118 | 100.0 |

Further, because willful misconduct was defined by IRS as being more serious than negligent misconduct, it would seem reasonable to expect that examiners would apply differing interpretations to materiality in determining which penalty to assert. However, the following statistics for 102 of the 260 case files in our sample indicate that examiners seemed to apply the same basic materiality criteria for each penalty.

| Amount of understated tax liability | Case files Number | Percent |
|---|---|---|
| $0 | 0 | 0 |
| $1 through $ 50 | 0 | 0 |
| $51 through $ 100 | 3 | 2.9 |
| $101 through $ 200 | 7 | 6.8 |
| $201 through $ 500 | 23 | 22.5 |
| $501 through $ 1,000 | 32 | 31.4 |
| $1,001 through $ 3,000 | 25 | 24.6 |
| More than $ 3,000 | 12 | 11.8 |
| Total | 102 | 100.0 |

Similar to the situation with penalties asserted for negligent or intentional misconduct, examiners generally avoided asserting the willful misconduct penalty when the amount of understated tax liability was $100 or less. They were less hesitant to assert the penalty if the understatement was more than $100 but not more than $200. And, clearly, examiners considered understatements in excess of $200 to be material.

IRS, of course, may have been correct in assessing penalties for single errors and for varying amounts of understated tax liabilities. However, because its guidelines lack specificity and because case files lack documentation, neither we nor IRS can assess the appropriateness and consistency of these penalty

assessments. Most of the case files not only lacked information on complexity and the frequency and materiality of errors, but also lacked information on supervisory and quality control reviews. Of the 260 case files, only 32, or 12 percent, contained evidence of supervisory reviews. Similarly, only 72, or 28 percent, contained evidence that required quality control reviews had been conducted. Clearly, IRS needs better information on these important penalty assessments to assure the appropriateness, consistency, and effectiveness of decisions made by examiners.

In sum, IRS' administration of the willful misconduct penalty has been hampered by inadequate guidelines. And, because the guidelines are inadequate, it seems unlikely that IRS will soon be in a position to evaluate program effectiveness and to correct any deficiencies. Action is needed to (1) better define the circumstances under which the willful misconduct penalty ought to be asserted, (2) specify how examiners ought to take return complexity and the frequency and materiality of errors into account in asserting this penalty, and (3) improve documentation in case files pertaining to examiners' decisions and supervisory and quality control reviews.

## Inconsistent enforcement efforts limited effectiveness of penalty for refund check violations

Because many taxpayers had been victimized by unscrupulous preparers, the Congress authorized IRS to assess a $500 penalty against any preparer who endorsed or negotiated a taxpayer's refund check. IRS used its existing enforcement mechanisms to administer this penalty provision, with one exception. One district developed and used an innovative approach to detect violators. As a result, that district accounted for a majority of the refund check penalties assessed during 1980 and 1981. IRS' remaining 58 district offices have not detected as many preparers who endorsed or negotiated taxpayers' refund checks.

As previously discussed, IRS' basic approach to administering the refund check penalty provision involved asking taxpayers and/or preparers, during examinations, to specify which party had endorsed or negotiated the refund check. During 1977 through 1979, a 3-year period, IRS assessed 1,194 refund check penalties nationwide. In 1980, 3,166 such penalties were assessed. But, as shown below, that increase is largely attributable to the efforts of IRS' Central Region.

CALENDAR YEAR 1980

| Region | Returns filed Number (000,000) | Percent | Returns examined Number (000) | Percent | Refund check related penalties Assessed | Percent |
|---|---|---|---|---|---|---|
| North Atlantic | 19.6 | 14 | 334.8 | 15 | 8 | a/ 0 |
| Mid-Atlantic | 19.2 | 13 | 252.4 | 11 | 0 | 0 |
| Southeast | 20.9 | 15 | 343.4 | 16 | 680 | 22 |
| Central | 18.3 | 13 | 202.9 | 9 | 1,895 | 60 |
| Midwest | 19.9 | 14 | 269.0 | 12 | 349 | 11 |
| Southwest | 18.9 | 13 | 258.2 | 12 | 75 | 2 |
| Western | 25.7 | 18 | 544.4 | 25 | 159 | 5 |
| Total | 142.5 | 100 | 2,205.1 | 100 | 3,166 | 100 |

a/The actual percent is .25 percent.

The above statistics indicate that IRS' Central Region was the most active region during 1980 in terms of refund check penalties, accounting for 1,895 or 60 percent of IRS' assessments. IRS' North Atlantic Region accounted for only 8 assessments; its Mid Atlantic Region made no assessments that year. The latter two regions, which together accounted for 38.8 million returns filed and 587,000 returns examined in 1980, detected only 8 refund check violations in 1980.

We found that the extreme variance among regional statistics could be attributed to three main factors. First, each IRS district generally was left on its own to determine the desired level of activity with respect to these penalty assessments. IRS' national and regional offices established no specific goals with respect to the refund check negotiation penalty. Second, IRS' basic approach to administering this penalty provision limited the number of violators it could detect. As a general proposition, refund check violators could only be detected if returns they had prepared were selected for examination. Even under that circumstance, however, IRS could identify violators only if taxpayers and/or their accompanying preparers responded to probing questions. Third, one district office within IRS' Central Region--the Louisville district--developed and actively pursued an innovative compliance approach.

Although each of IRS' 10 service centers prepared listings of addresses to which more than one refund check had been sent, only one IRS district followed up on those lists during 1980. Louisville district examiners determined whether the addresses pertained to preparers and, if so, they visited selected preparers' places of business. The examiners asked these preparers

whether they had endorsed or negotiated refund checks for certain taxpayers. Often, preparers responded affirmatively and examiners then asserted the $500 penalty.

The district's basic approach was not complex but it did involve seeking out potential violators, rather than waiting for violators to accompany taxpayers to examinations. In 1980, the Louisville district accounted for 1,883, or 59 percent, of the 3,166 refund check penalties IRS assessed nationwide. In 1981, these efforts yielded similar results as the Louisville district again accounted for a disproportionate number of refund check penalties compared to all other IRS district offices. Specifically, in that year, Louisville accounted for 1,562, or 75 percent, of the 2,077 penalties IRS assessed for refund check violations.

We discussed this matter with various IRS officials. The officials stated that there is no reason to believe that there are more refund check violators in the Louisville district than there are elsewhere. In their view, the statistical differentials were in fact attributable almost entirely to the Louisville district's innovative enforcement approach.

Thus, on a national basis, IRS has not detected many refund check violators. As a result, taxpayers may still run a high risk of being victimized by unscrupulous preparers. Conversely, most unscrupulous preparers seem to run a low risk of being detected and penalized by IRS. Further, after 5 years of experience with the refund check penalty provision, IRS does not know the extent of the problem it faces with preparers who endorse or negotiate taxpayers' refund checks. Actions aimed at ensuring consistent application of this penalty are warranted. These actions should include a reevaluation of IRS' basic compliance approach along with development of more specific guidance on required district office activity levels.

## PROGRAM ACTION CASES: RECENT BUDGET CUTS HAVE LIMITED IRS' ABILITY TO DETECT AND DETER PROBLEM PREPARERS

As discussed above, IRS relied primarily on its existing enforcement structure to administer the preparer penalty provisions of the 1976 Tax Reform Act. That approach enabled IRS to identify many individual instances in which preparers committed disclosure, recordkeeping, or conduct violations. On the other hand, IRS also recognized the need to supplement its basic compliance approach with a special program aimed at detecting and

deterring preparers who consistently violate the law. Such preparers are of particular concern to IRS because their actions undermine the tax system. Further, occasional penalty assessments may not effectively deter those preparers whose financial gains from violations of the law greatly exceed penalty amounts assessed against them.

To deal with this segment of the population, IRS developed and implemented a special compliance program. Specifically, IRS sought to identify such preparers and to initiate what was referred to as "program action cases" against them. Through such cases, IRS sought to assess multiple penalties against preparers who committed multiple violations. Although IRS' approach to program action cases had some limitations, it did enable the Service to detect and deter some problem preparers. In January 1982, however, in an effort to reduce costs, IRS stopped keypunching certain preparer-related information in service center computers. As a result, identifying problem preparers became a much more difficult task. When implemented, however, a recent IRS decision to reinstitute a modified version of the keypunching operation should alleviate this problem.

Beginning in 1977, IRS designated an individual in each district office as the return preparer program coordinator. Among other things, coordinators maintained a card file on three kinds of preparer penalty actions--those under consideration, those asserted, and those completed. Coordinators were required to review the file on a monthly basis with a view toward identifying preparers who had been involved in several penalty actions. When such preparers were identified, coordinators requested service center computer listings of returns prepared by the subject individuals. The coordinators then analyzed the returns and could, with supervisory approval, recommend that a number of the returns be examined. Through these program action cases, IRS sought to achieve two objectives--to correct errors on returns filed and to assert multiple penalties against preparers who committed multiple violations.

Because detecting and deterring such preparers constitutes a very important aspect of the paid preparer compliance program, we wanted to evaluate IRS' efforts in that regard. However, we were unable to do so for two reasons. First, IRS maintained no centralized files on program action cases, and we therefore could not identify a universe from which to draw a sample. Second, IRS collected few statistics on program action case results as they pertained to specific paid preparers. Some statistics, however, were collected on an aggregate basis, and they shed some light on the utility of such cases as a compliance tool.

In calendar year 1981, for example, IRS initiated program action cases against 214 paid preparers. During that same year, 8,554 penalties were assessed in connection with program action

cases. Assuming that there is a direct link between targeted preparers and penalties assessed for calendar year 1981, 1/ these statistics work out to an average of about 40 penalties per preparer. According to IRS officials, it was not uncommon for 40 or more penalties to be assessed against a preparer in a given year. The officials further stated that, in some instances, penalties totaling thousands of dollars were assessed against individual preparers through program action cases.

On the surface then, it seems that IRS may have been achieving some success in detecting and deterring problem preparers via program action cases, at least in terms of preparers who committed multiple violations during a given tax year. However, due to a lack of management information, neither we nor IRS could determine the extent of that success. Clearly, there were limitations on the program. In particular, IRS relied on a manual card file system as a means for detecting preparers who had committed multiple violations. District coordinators had to search through three separate file sections each month in an effort to detect preparers suspected of committing multiple violations. The card file could not be used to identify problem preparers operating in more than one district. Further, the file was purged annually and, therefore, coordinators had little means through which to detect such preparers on a year-to-year basis.

Despite limitations, program action cases represented IRS' primary means for detecting and deterring preparers who committed multiple violations. In January 1982, however, due to budget cuts, IRS stopped keypunching preparer-related data from returns filed. As a result, district coordinators no longer could get service center listings of returns prepared by an individual preparer. This, in turn, made it much more difficult for district coordinators to develop program action cases. Recently, however, the Commissioner reconsidered the decision to eliminate the keypunching operation. If sufficient funds are available, the Commissioner plans to reinstitute a modified version of the keypunching operation in January 1983. According to IRS officials, the modified keypunching operation will facilitate development of program action cases in future years.

In any case, the decision to eliminate the preparer-related keypunching operation has made it more difficult for district offices to develop program action cases. Furthermore, as discussed below, it has also affected IRS' ability to collect and analyze needed management information on the return preparer compliance program.

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1/Some of these penalties may have been asserted against preparers targeted for program action cases in prior years.

## IRS NEEDS BETTER MANAGEMENT INFORMATION TO ASSESS THE EFFECTIVENESS OF ITS PAID PREPARER COMPLIANCE PROGRAM

When IRS decided to seek the legal authority to assess civil penalties against paid preparers, it believed that such an enforcement tool would provide an effective means for dealing with what was believed to be a small group of problem preparers. After 5 years of experience with those penalties, however, it appears that the problem preparer group was, and still may be, larger than originally anticipated. This raises a question as to whether the penalty provisions are having their desired effects.

Some industry representatives feel that the penalties have improved preparers' performance; others disagree. Similarly, IRS headquarters officials believe that the provisions are working as intended; however, some IRS field office officials do not agree with that assessment. Regardless, IRS has not collected the data needed to assess the effectiveness of its administration of the penalty provisions. In particular, IRS lacks data on preparers who commit multiple violations over the course of several years. Such data is needed to evaluate the utility of existing penalty provisions and the adequacy of IRS' existing enforcement approach. IRS' Internal Audit Division alerted top Service managers to the need for management information in a January 1981 report. However, due primarily to budget constraints, IRS has not sought to collect the needed information.

### Initial IRS estimates of the number of problem preparers were understated

For many years, IRS knew that some negligent and/or dishonest return preparers were undermining the tax system. However, until 1977, IRS had little means for collecting data on the extent of the problem. Enactment of the paid preparer penalty provisions changed that situation by affording IRS the means to identify returns prepared for a fee and to evaluate preparers' performance over time. Although IRS has not collected and analyzed all available information, it appears that the Service's pre-Tax Reform Act estimates of the extent of the problem were understated.

As early as 1971, IRS began studying methods for dealing with problem preparers. An IRS study group, which consulted interested IRS officials, representatives of 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. * * * To fill this gap we think we have devised some tools which the Service can use on a reasonable and selective basis * * *."

In 1975, IRS estimated that there were from 200,000 to 250,000 individuals involved in the return preparation business. And, of these, IRS estimated that only a few thousand were considered to be problem preparers.

In an effort to obtain better information on the extent of the problem, we sent a questionnaire to selected individuals who had prepared 20 or more returns for a fee in calendar year 1980. IRS used its computerized data base to identify that universe for us. The universe totaled 196,163 preparers. We sent questionnaires to a randomly selected nationwide sample of 434 of the 196,163 preparers. We received 356 responses. By projecting the results of our questionnaire over the universe, we estimate that about 42,400, or 22 percent, of the 196,163 preparers had been involved in an IRS penalty action during the period January 1977 through January 1981. We further estimate that 35,200 individual preparers were involved in disclosure and/or recordkeeping penalties and that 7,200 preparers were involved in penalties for misconduct.

Although IRS did not specifically quantify its estimate that there were "only a few thousand" problem preparers, it seems apparent that the Service did not expect to detect the volume of offenses actually identified during January 1977 through December 1981. In that period, IRS assessed over 232,000 penalties against paid preparers. Moreover, many preparers were assessed multiple penalties. And, IRS was able to detect this high volume of offenses despite limitations on its compliance program.

Taken together, these statistics indicate that the preparer problem was, and still may be, greater than IRS originally anticipated. Furthermore, because many preparers have been assessed multiple penalties, questions arise as to whether the penalty provisions are having their desired effect. In fact, as discussed below, there are differing views on the effectiveness of preparer penalties.

## Differing views on the effectiveness of preparer penalties

Some IRS personnel and some return preparers believe that the 1976 Tax Reform Act's penalty provisions have had the effect of improving preparers' performance. That view, however, is not

shared by other IRS personnel and other return preparers. Regardless, the data needed to support or refute either viewpoint has not been collected.

Certain IRS headquarters officials told us that they believe the penalty provisions have served as an effective deterrent against would-be violators. The officials cited the number of penalties assessed since the provisions went into effect as the primary basis for that belief. On the other hand, various IRS field office personnel have a differing viewpoint. In this regard, some IRS district office and service center managers and examiners told us that IRS has been most successful in identifying and penalizing those preparers who have sought to comply with the requirements of the law. They base this belief on the view that IRS has been able to easily detect and penalize preparers who at least partially identify themselves on returns. Conversely, they believe that IRS has been less successful in detecting preparers who do not identify themselves on returns and/or commit conduct violations.

We also obtained mixed views on the utility of the penalty provisions from return preparers. Our questionnaire results 1/ indicate that 56 percent of the preparers included in our nationwide random sample believed that the provisions have favorably impacted on the quality of returns prepared. But 21 percent felt that the provisions have had little or no impact. The remaining 23 percent did not make a judgment.

Further, in providing us with optional comments on questionnaire reponses 2/, many preparers stated that the provisions were having undesired effects and/or were being administered in an uneven fashion by IRS. For example, of 1,833 respondents

--222 said that preparers were being forced to take over IRS' examination function;

--115 said that IRS assessed penalties for isolated errors;

--108 said that IRS lacked sufficient evidence for many penalty assertions;

--105 believed that tax law complexity, not preparer incompetence, caused most of the errors on returns;

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1/These questionnaire results pertain to our randomly selected nationwide sample of return preparers in general.

2/These questionnaire results pertain to randomly selected samples of preparers in general and preparers who had been assessed penalties by IRS.

--101 felt that the penalties had raised the cost of doing business in the return preparation field, thus reducing the number of qualified tax return preparers in business;

--99 believed that IRS expected preparers to be more qualified than IRS employees;

--68 believed that IRS employees were confused over and inconsistent in applying the penalty provisions; and

--62 commented that the entire penalty program was worthless.

Thus, both IRS representatives and preparers have mixed views on the effects of the penalty provisions. IRS has collected some but not all the information needed to support or refute differing contentions about the program. However, the information which has been collected has not been analyzed. As a result, IRS does not know whether it has detected and deterred a sufficient number of preparers who have violated the law. In particular, IRS lacks sufficient data on preparers who commit multiple violations over the course of several years. Yet that data is crucial for determining whether preparer penalties have had a deterrent effect.

## IRS lacks management information on the effects of preparer penalties

The 1976 Tax Reform Act's penalty provisions were designed to provide IRS a means for dealing with incompetent and/or dishonest return preparers. After 5 years of experience with the provisions, however, IRS lacks information on whether the law has achieved its desired effect. Moreover, IRS does not know whether its compliance approach constitutes the most effective means for dealing with problem preparers. Better management information is needed to answer these key questions.

In January 1977, IRS began entering paid preparers' names and identification numbers into service center computers as part of its disclosure violation detection program. IRS thus collected data at its 10 service centers on the number of preparers in business, at least to the extent that preparers were willing to identify themselves on tax returns. However, IRS did not consolidate the data it had collected and thus has not developed key baseline information on the universe of preparers in business each year. Without that data, IRS has little basis for measuring the extent of any problem it has with groups of preparers. Moreover, beginning in January 1982, due to budget constraints, IRS stopped entering preparers' names and identification numbers into service

center computers. Elimination of that activity resulted in cost savings of $4.5 million, according to IRS estimates. As a result, however, IRS will find it difficult to identify the universe of preparers in business in future years.

Besides not identifying the universe of preparers in business during particular years, IRS also lacks information on preparers who consistently violate the law on a year-to-year basis. At its 10 service centers, IRS collected computerized information on disclosure-related penalty assessments, collections, and abatements. That data was used to identify trends in those categories and the trends formed the basis for managerial decisions. For example, in 1977, IRS' statistical analyses indicated that disclosure-related penalty abatement rates were high. Further analysis enabled IRS to determine that many preparers were unfamiliar with the then-new penalty provisions. This prompted IRS to begin an education program for preparers.

On the other hand, although IRS had collected data on disclosure violations, it did not use the computerized data to identify preparers who had committed multiple violations. Without such data, IRS has no way of determining whether there exists an intractable group of preparers who can be expected to continue violating disclosure requirements over the course of several years. That group would merit special IRS attention. Clearly, if such a group were identified, IRS would want to reevaluate both its compliance approach and the utility of existing penalties for disclosure violations.

Like the situation in service centers, district offices collected information on disclosure, recordkeeping, and conduct penalties. However, the information was collected primarily for case control purposes, rather than for management information purposes. Moreover, district offices relied on a manual card file system; no penalty-related data was keypunched into computers.

The file system used in the four districts we visited--Detroit, Fargo, Manhattan, and San Francisco--contained individual cards for each potential or actual penalty assertion against a preparer. The cards were retained in one of three separate file sections depending on whether the penalty action was pending, had been initiated, or had been initiated and closed. As previously discussed, by checking through these three separate file sections, an examiner could determine whether an individual preparer had committed multiple violations with respect to current year returns filed. However, in terms of management information with respect to preparers in general, the card file could not easily be used to develop useful data.

District offices did use the card file for generating limited management information on the total number of penalties assessed each quarter and the number of individual preparers involved in the assessments. However, little management information pertaining to preparers who had committed multiple violations was developed. This is because developing and updating such management information through card file analyses is a very costly and time-consuming task. Without that information though, IRS cannot evaluate the effectiveness of district office efforts to deal with preparers who violate disclosure and conduct requirements. And, again, IRS has no way of knowing whether it is dealing with an intractable group of preparers which can be expected to continue violating the law.

A similar problem exists with respect to management information comparing and combining data on service center and district penalty assertions. IRS needs to know whether service centers and districts are asserting different penalties against the same individuals. If that is the case, then IRS would want to pay particular attention to such preparers in future years. Otherwise, the preparers could continue exhibiting a pattern of errors over a period of time while being detected only in isolated instances. This overall lack of information on such preparers is perhaps one reason why IRS has made little use of its injunctive authority. Only five preparers were subjected to injunctions during 1977 through 1981.

IRS thus has not developed the data needed to fully assess the utility of preparer penalties. Neither does IRS know whether its compliance enforcement approach is appropriate. These findings are not new; IRS' Internal Audit Division brought them to the Service's attention in January 1981.

## IRS' Internal Audit Division already has cited the need for better management information on preparer penalties

In a January 1981 report, IRS' Internal Audit Division reported that the Service could improve its administration of the preparer penalty provisions by (1) establishing program goals and (2) adapting its management systems to gather information on the extent to which those goals are met. As of September 1982, however, IRS had not acted on the Internal Audit Division's recommendations.

In its January 1981 report, the Internal Audit Division stated the following:

--"The current program does not require analysis of results to identify the types and extent of compliance problems. There also has not been a determination as to what will be considered a satisfactory level of voluntary compliance within the preparer community. Without a starting point, a measurement criteria and an established goal, the Service cannot effectively appraise whether the Program is resulting in increased compliance.

We recommend that the Service identify the areas of greatest noncompliance, determine the level of compliance considered satisfactory and establish measurable program goals and objectives based on known compliance problems."

--"The lack of measurable goals and objectives has not enabled the Service to systematize the accumulation of information to help management evaluate the results of the program.

We recommend that the Service improve the feedback for managing and evaluating the Return Preparers Program by adapting current management information systems to provide complete and comprehensive data that will assist in measuring and evaluating the achievement of the program goals and objectives when they are established."

In response to the report, top IRS managers stated the following:

"Rather than establishing quantitative goals for preparer identification and resource application, the program is designed to identify and address the problem of incompetent, unscrupulous, or fraudulent preparers through existing return processing and examination procedures. The Assistant Commissioners believe that existing procedures provide an effective means for identifying suspect preparers, uniformly applying the preparer penalty provisions and ensuring a high degree of compliance with rules and regulations.

Compliance, however, will meet with Planning and Research, Statistics Division to analyze and consider the implications of previously accumulated Taxpayer

Compliance Measurement Program (TCMP) data. The Statistics Division will, also, be requested to participate in a study with Compliance to determine the feasibility of measuring preparer compliance."

In effect, through the above response, top IRS managers specified their belief that the preparer penalty program was working well. At the same time, however, they acknowledged that the data to support their belief was not available. The managers thus indicated that key Service personnel would meet to analyze and consider previously accumulated data on return preparers. They further stated that a study would be conducted to determine the feasibility of measuring paid preparer compliance levels. However, as of September 10, 1982, neither action had been taken.

Although much time has elapsed since the above actions were first proposed, there still exists a need for IRS to actually carry them out. One IRS official, who has responsibility for the Service's Taxpayer Compliance Measurement Program, told us that previously accumulated data probably would not be of much help in assessing paid preparer compliance levels. This is because IRS has not sought to collect much data on preparers or preparer penalties during past Taxpayer Compliance Measurement Program cycles. On the other hand, the official also noted that future Taxpayer Compliance Measurement Program cycles could in fact provide a vehicle for assessing compliance levels among paid preparers. The official noted, however, that such an effort would require extensive advance study, development of a scientific approach, and time-consuming implementation and analysis.

## CONCLUSIONS

The return preparer penalty provisions of the 1976 Tax Reform Act were designed to enable IRS to deal with incompetent and/or dishonest preparers. After 5 years of experience with the provisions, however, the overall effectiveness of the program is unknown. This is because, for a variety of reasons, IRS has not developed needed management information. As a result, the Congress and IRS have no real assurance that the legislative actions with respect to return preparers have achieved their desired effect.

Available statistics do indicate that IRS has been successful in getting an important segment of the preparer population--those who only partially identify themselves on tax returns they prepare--to more fully comply with disclosure requirements. On the other hand, it seems questionable whether IRS has been as successful in dealing with another segment of the preparer population--those who completely fail to identify themselves on returns they prepare. With respect to this population segment,

IRS' compliance approach limits its ability to detect such preparers. Yet this preparer group, whose size is unknown, is of great concern to IRS. When an individual prepares a return for a fee and does not so indicate that fact on the return, the individual's motives may be suspect. IRS needs to develop better information on the extent of the problem it faces in this regard and use that information to reevaluate its compliance approach.

The extent to which IRS has been successful in dealing with preparers who commit conduct violations also is unknown. Inadequate guidelines have hampered examiners' efforts to assert penalties for negligent or intentional misconduct. Although IRS has taken steps to improve its guidelines for these penalties, further improvements are needed. Inadequate guidelines also have hampered examiners' efforts to assert penalties for willful misconduct. IRS has not yet taken steps to improve those guidelines. Also, inconsistent enforcement efforts against preparers who negotiate taxpayers' refund checks have raised questions about the effectiveness of IRS' current compliance approach with respect to that particular problem.

Besides built in compliance program limitations and difficulties with guidelines, IRS has not collected or analyzed all of the data needed to assess program effectiveness. Thus, the extent to which IRS has been effective in detecting and deterring compliance problems among the entire population of preparers is unknown. Of particular significance is the fact that IRS lacks data on preparers who commit multiple violations over the course of several years. Such data is essential because preparers who consistently violate the law should be put out of business. Otherwise, they can continue preparing erroneous returns. Problems with respect to lack of data on program effectiveness were brought to top IRS managers' attention by the Service's Internal Audit Division in early 1981. However, due primarily to budget constraints, little action has been taken on the Internal Audit Division's recommendations.

Budget constraints also forced IRS to reevaluate recurring costs associated with the return preparer compliance program. As part of the Administration's Government-wide cost cutting effort, IRS determined that it could best absorb some budget cuts by eliminating the computer-supported service center portion of the preparer program. This has, however, reduced IRS' ability to develop program action cases because service center computer listings were essential to that program. Program action cases represented IRS' primary means for dealing with preparers who violated the law on a consistent basis. Elimination of the service center computer operation also has affected IRS' ability to develop needed management information on the preparer compliance program and reduced IRS' ability to detect partial disclosure violations.

The Commissioner, however, recently reconsidered the decision to eliminate the service center portion of the paid preparer compliance program. 1/ If sufficient funds are available, the Commissioner plans to implement a modified version of the program in January 1983. The revised program will be directed primarily at facilitating development of program action cases in future years. It is not, on the other hand, designed to generate extensive management information nor does IRS presently contemplate using the program as a means for detecting partial disclosure violations.

Clearly, IRS needs to reinstitute the computer-supported service center program which facilitates development of program action cases. Furthermore, there are some steps which IRS ought to take to resolve questions about the appropriateness of its compliance approaches, the consistency of penalty decisions, and the overall effectiveness of preparer penalties as compliance tools. With respect to the latter point, two independent studies, each with a different scope, have reached the same conclusion. That is, both the IRS Internal Audit Division report and our review have surfaced the need for better management information on IRS' return preparer compliance program. Actions IRS needs to take with respect to its program are discussed below.

## RECOMMENDATIONS TO THE COMMISSIONER OF INTERNAL REVENUE

Because problem preparers undermine the tax system, IRS needs to do all it can to detect and deter these individuals. To determine the extent of the preparer noncompliance problem, we recommend that the Commissioner identify and implement the least costly means of collecting needed management information on the preparer population and on preparer penalties. The Commissioner should ensure that the data collected includes information on preparers who commit multiple violations over the course of several years. Without basic management information, neither IRS nor the Congress will be able to assess the effectiveness of preparer penalties as compliance tools. In this regard, the Commissioner may wish to consider using the Service's Taxpayer Compliance Measurement Program as a means for collecting some of the needed data.

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1/In a draft of this report sent to IRS for comment, we proposed that the Commissioner reevaluate the decision to stop keypunching preparer-related data. However, when IRS informed us of the Commissioner's recent action on this matter, we deleted that proposal.

As part of the process of gathering and analyzing management information on the paid preparer noncompliance problem, we recommend that the Commissioner also reassess certain IRS compliance approaches and take corrective actions as appropriate. In this regard, the Commissioner should specifically (1) determine whether a sizeable group of preparers exists who are not identifying themselves on returns they prepare and have not been detected by IRS' current compliance program and (2) reevaluate the Service's current nationwide approach to detecting paid preparers who negotiate taxpayers' refund checks.

One possible means for assessing the extent of the problem with preparers who do not identify themselves on tax returns would involve locating preparers through their advertisements and then visiting their places of business with a view toward identifying returns they have prepared. IRS could then check the returns to see if the preparers identified themselves. If not, the returns could be examined to determine why the preparers had not identified themselves. Because the Louisville district already is using a similar approach with respect to preparers who negotiate taxpayers' refund checks, the Commissioner may want to include that district in any test that is made. Also, as one possible means for reevaluating the Service's compliance approach with respect to preparers who negotiate taxpayers' refund checks, the Commissioner may wish to test, in certain other regions and districts, the Louisville district's innovative approach for dealing with the problem. In this regard, the Louisville district has demonstrated that IRS' current national compliance approach to the problem may not be working as well as it should and that a more vigorous effort on IRS' part seems warranted. Whatever plan the Commissioner decides to pursue with respect to these two problem areas, it is essential that any tests be conducted in a sound methodological manner and in a sufficient number of locations so that decisions can be made on whether, and what, actions should be implemented nationwide.

Finally, to assure greater consistency in penalty assertion decisions, we recommend that the Commissioner:

--Publish guidelines better defining the circumstances under which the willful misconduct penalty ought to be asserted. By so doing, the Commissioner would better ensure consistency in the application of this penalty while also alerting preparers to situations in which they should expect to be penalized for this serious violation.

--Identify additional means through which to better ensure that examiners take tax law complexity into account when

making penalty assertion decisions. In this regard, the Commissioner may wish to discuss this issue with representatives of paid preparer groups with a view toward developing solutions to a continuing problem. One solution the Commissioner may wish to consider would be to revise and/or expand examiner training on this matter. Another solution the Commissioner may wish to consider would be to provide examiners with written examples of cases in which return complexity precluded penalty assertions as well as cases in which alleged return complexity did not constitute valid cause for preparers' errors.

--Specify that all penalty case files contain information on the type of penalty assessed, the basis for the penalty action, the dollar amounts involved especially in terms of understated tax liabilities, and the results of supervisory and quality control reviews. Without such information, IRS managers and internal auditors cannot fully evaluate the effectiveness of IRS' compliance program.

## AGENCY COMMENTS AND OUR EVALUATION

By letter dated September 11, 1982 (see app. II), the Commissioner of Internal Revenue stated that:

--It would be beneficial for IRS to have more information on preparer compliance levels and that the Service's Taxpayer Compliance Measurement Program may be a good vehicle for obtaining that information. However, because results from that program will not be available until mid-1985, the Service will evaluate the usefulness of an interim study aimed at collecting management information on returns where preparer penalties have been asserted. Thus, IRS plans to explore both long- and short-term approaches to developing needed management information on preparer penalties.

--IRS hopes to use its Taxpayer Compliance Measurement Program to determine whether a sizeable group of preparers exist who are not identifying themselves on returns they prepare and have not been detected by other compliance programs.

--The Service will review district procedures to ascertain whether the Louisville district's experience with refund check violations is indicative of a nationwide problem.

--IRS will seek to better define the circumstances under which the willful misconduct penalty ought to be asserted

by incorporating pertinent court cases in training material related to preparer penalties.

--IRS sees a need to give additional emphasis to the tax law complexity issue in its training material. This issue will be addressed in future revisions of training material related to preparer penalties.

--Despite existing Internal Revenue Manual requirements, it is possible that some case files may lack certain documentation. IRS therefore plans to reemphasize existing requirements to better ensure that case files contain sufficient documentation.

The actions proposed by the Commissioner are generally responsive to our recommendations. Over the long term, these actions should enable IRS to (1) determine the overall effectiveness of its paid preparer compliance program and (2) correct any identified deficiences.

Even so, we think that the Commissioner could better assure consistent application of the willful misconduct penalty by taking the action proposed one step further. We saw the need for better guidance for examiners and preparers regarding the circumstances in which this penalty should be imposed and recommended that IRS publish guidelines to this end. The Commissioner recognized in his comments that, other than the legislative history and Treasury regulations, there are no guidelines that specifically discuss this penalty. He agreed that examples of willful misconduct might be helpful in promoting a consistent application of the penalty but stated that fashioning an all-inclusive definition of the term "willfulness" would be a difficult task. This is because determining whether a preparer acted willfully is a factual question. Accordingly, he proposed to better define the circumstances under which the willful misconduct penalty ought to be asserted by incorporating pertinent court cases in training material related to preparer penalties. He made no mention, however, of further publicizing this information.

We agree with the Commissioner that it would be difficult to fashion an all-inclusive definition of "willfulness." In our view, however, the very fact that it is so difficult to define willfulness is reason enough for IRS to make a concerted effort to develop guidelines which discuss the complexities of the concept. The guidelines need not seek to "fashion an all-inclusive mechanical definition" of the term. Instead, they could seek to shed light on the factors that need to be taken into account when determining whether a preparer committed a willful misconduct violation. And several examples of circumstances in which IRS deemed that penalty appropriate, as well as examples in which IRS deemed the penalty inappropriate,

would be helpful. Making this information available through means other than training materials, as has already been done for the penalty pertaining to negligent misconduct, would provide examiners and preparers better guidance. This, in turn, would give IRS management greater assurance that the willful misconduct penalty will be more consistently applied.

Of broader concern, however, is the need for the Commissioner to take into account the expected status of IRS' taxpayer service program when developing a timetable for implementing corrective actions to the paid preparer program. The taxpayer service program involves answering questions; providing self-help or direct return preparation assistance to certain taxpayers; and otherwise assisting taxpayers over the telephone, at walk-in offices, and through correspondence. IRS' fiscal year 1983 budget request called for sharp cutbacks in these activities. Those budget cuts, if approved by the Congress, 1/ could have the effect of forcing many more taxpayers to seek assistance from paid preparers. The Commissioner should keep this possibility as well as the problem of increasing tax law complexity in mind when determining the timing of corrective actions related to IRS' paid preparer compliance program.

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1/As of December 14, 1982, IRS' fiscal year 1983 budget request had not been approved. Instead, IRS was operating under a continuing resolution. Thus, the question of whether IRS would in fact cut back on its taxpayer service activities in fiscal year 1983 was unresolved as of that date.

## CHAPTER 3

## OBJECTIVES, SCOPE, AND METHODOLOGY OF REVIEW

The Joint Committee on Taxation asked us to evaluate the effectiveness of IRS' tax return preparer program in achieving the goals intended by the Tax Reform Act of

--helping IRS to identify returns prepared by paid preparers,

--deterring preparers from engaging in negligent or fraudulent practices designed to understate taxpayers' tax liabilities, and

--prohibiting preparers from endorsing or negotiating taxpayers' refund checks.

We were also asked to examine IRS' administration of the program in general and specifically to see whether IRS uniformly applied penalties against preparers. Further, we were asked to obtain the opinions of tax return preparers on program effectiveness and IRS' administration.

To the extent possible and practical, we used standard statistical techniques in selecting samples of preparers and penalty cases while carrying out our audit work. Our samples were constructed to give us a 95 percent confidence level with an error rate of ± 5 percent.

We selected our preparer samples from two groups--preparers in general and preparers who had been subjected to penalties. To obtain the views of preparers in general on the utility of the Tax Reform Act's penalty provisions and the effectiveness of IRS' administration, we sent a questionnaire to a randomly selected sample of 434 individuals who had prepared 20 or more tax returns in calendar year 1980. We received 356 responses--an 84.8 percent response rate. This sample was drawn from an IRS-identified universe of 196,193 preparers.

To evaluate the appropriateness and effectiveness of IRS penalty assessments, we selected and analyzed a randomly selected sample of 3,348 district-initiated penalty assessments. Our sample was drawn from the universe of penalties assessed by district offices during the period January 1977 through July 1980. That universe totaled 16,369 cases and included penalties for disclosure, recordkeeping, and conduct violations. Of the 3,348 sample cases, IRS located 3,041. The following table shows how the 3,041 cases were distributed in terms of types of penalties.

| Type of penalty | Number of cases |
|---|---|
| Disclosure | 681 |
| Recordkeeping | 271 |
| Conduct: | |
| Negligent or intentional misconduct | 1,699 |
| Willful misconduct | 260 |
| Endorsement or negotiation of refund check | 45 |
| Multiple penalties | 82 |
| Unknown | 3 |
| Total | 3,041 |

Besides reviewing the 3,041 case files, we also sent a questionnaire to each preparer included in this sample. We wanted to determine whether preparers who had been penalized by IRS differed from preparers in general in their views on the utility of penalties and the effectiveness of IRS' administration. Because some preparers included in our sample had been assessed more than one penalty by IRS, the number of preparers involved did not total 3,041. In this regard, IRS maintains case files by penalty action and not by preparers' names. Thus, there were 2,127 preparers involved in the 3,041 penalty assessments. We sent a questionnaire to all 2,127 preparers and received 1,477 responses, a 69.4 percent response rate. Since a different portion of the eligible cases were selected from each IRS region, the responses were weighted, on the basis of the probability of selection, to obtain the national results.

In carrying out this review, we visited all 10 IRS service centers and 4 of IRS' 59 district offices. At the 10 service centers, we interviewed IRS officials as well as employees responsible for carrying out the penalty program. We also reviewed office memorandums, publications, computer listings of preparer actions, and account cards showing penalty assessments. At the four district offices--Detroit, Fargo, Manhattan, and San Francisco--we interviewed IRS officials and employees responsible for carrying out the penalty program. Included in interviews at each district were at least six field or office examiners, the employees responsible for initiating penalty actions. We reviewed available records which included copies of procedures, interoffice memorandums, publications, and reports on preparer penalty actions. In selecting district offices to visit, we took several factors into consideration including the need for geographical coverage, the size of district offices from an examination

function standpoint, and the fact that IRS' Internal Audit Division was concurrently analyzing penalty assessments in certain district offices.

We also interviewed IRS headquarters officials from the Office of the Chief Counsel, the Criminal Investigation Division, the Examination Division, the Individual Tax Division, the Internal Audit Division, the Returns Processing Division, the Statistics Division, and the Tax Systems Division. Preparer groups we talked to included the Association of Tax Consultants, the National Association of Enrolled Agents, H&R Block, Inc., the California Society of Certified Public Accountants, the Louisiana Society of Certified Public Accountants, and the Oregon Board of Tax Service Examiners.

APPENDIX I

## RETURN PREPARER

## PENALTIES AUTHORIZED

## BY THE TAX REFORM ACT OF 1976

| Section of code | Violation | Penalty type | Penalty amount per violation |
|---|---|---|---|
| 6694(a) | Understatement of taxpayer's tax liability because of negligent or intentional disregard of rules and regulations by preparer | Conduct | $100 |
| 6694(b) | Understatement of taxpayer's tax liability because of willful action of preparer | Conduct | $500 |
| 6695(a) | Failure of preparer to furnish copy of return to taxpayer | Record-keeeping | $ 25 |
| 6695(b) | Failure of preparer to sign return | Disclosure | $ 25 |
| 6695(c) | Failure of preparer to furnish identifying number on return | Disclosure | $ 25 |
| 6695(d) | Failure of preparer to maintain copies of returns prepared or maintain a listing of clients | Record-keeping | $ 50 |
| 6695(e) | Failure of person who employs a preparer to: | | |
| | (1) file required information return on employee, or | Record-keeping | $100 |
| | (2) provide all the information required on the return | Record-keeping | $ 5 |
| 6695(f) | Endorsing or negotiating a taxpayer's refund check | Conduct | $500 |

APPENDIX II

COMMISSIONER OF INTERNAL REVENUE

Washington, DC 20224

SEP 11 1982

Mr. William J. Anderson
Director, General Government Division
United States General Accounting Office
Washington, DC 20548

Dear Mr. Anderson:

Thank you for the opportunity to review your draft report entitled "Administering Commercial Return Preparer Penalties: IRS Has Made Progress But Further Improvements are Needed."

We are enclosing comments on your recommendations. As mentioned in your report, our own Internal Audit organization has also reviewed this area and, based on recommendations made in their January 1981 report, we have taken steps (some of which you noted) to improve the administration of return preparer provisions.

We believe it is important to note that return preparer penalty assessments reviewed by your study covered the period from January 1977 through July 1980. During this period, we recognized that we had problems with return preparer penalty assessments that had to be dealt with. We did so by revising Internal Revenue Manual instructions on a number of occasions. We also met with various professional organizations in drafting Revenue Procedure 80-40, 1980-2 C.B. 775 and Revenue Rulings 80-262 through 80-266, 1980-2 C.B. 375. All of these documents (which were published after July 1980) provide guidelines for asserting the preparer penalty for negligent disregard of rules and regulations. Since publication, we have not received any critical comments from the preparer industry.

We realize that there is a need for additional data that will allow us to more effectively monitor compliance of professional income tax return preparers. We will be exploring ways of doing this, perhaps as an addition to the next cycle of our Taxpayer Compliance Measurement Program (TCMP).

We hope that our comments will be helpful in preparing your final report.

With kind regards,

Sincerely,

Roscoe Egger

Department of the Treasury Internal Revenue Service

APPENDIX II

## RESPONSES TO THE RECOMMENDATIONS TO THE COMMISSIONER MADE IN THE DRAFT GAO REPORT ON THE RETURN PREPARERS PROGRAM

### Recommendation #1

Because problem preparers undermine the tax system, IRS needs to do all it can to detect and deter these individuals. To determine the extent of the preparer noncompliance problem, we recommend that the Commissioner identify and implement the least costly means of collecting needed management information on the preparer population and on preparer penalties. The Commissioner should ensure that the data collected includes information on preparers who commit multiple violations over the course of several years. Without basic management information, neither IRS nor the Congress will be able to assess the effectiveness of preparer penalties as compliance tools. In this regard, the Commissioner may wish to consider using the Service's Taxpayer Compliance Measurement Program as a means for collecting some of the needed data.

As part of the process of gathering and analyzing management information on the paid preparer noncompliance problem, we recommend that the Commissioner also reassess certain IRS compliance approaches and take corrective actions as appropriate. In this regard, the Commissioner should specifically (1) determine whether a sizeable group of preparers exists who are not identifying themselves on returns they prepare and have not been detected by IRS' current compliance program and (2) reevaluate the Service's current nationwide approach to detecting paid preparers who negotiate taxpayers' refund checks.

One possible means for assessing the extent of the problem with preparers who did not identify themselves on tax returns would involve locating preparers through their advertisements and then visiting their places of business with a view toward identifying returns they have prepared. IRS could then check the returns to see if the preparers identified themselves. If not, the returns could be examined to determine why the preparers had not identified themselves. Because the Louisville district already is using a similar approach with respect to preparers

who negotiate taxpayers' refund checks, the Commissioner may want to include that district in any test that is made. Also, as one possible means for reevaluating the Service's compliance approach with respect to preparers who negotiate taxpayers' refund checks, the Commissioner may wish to test, in certain other regions and districts, the Louisville district's innovative approach for dealing with the problem. In this regard, the Louisville district has demonstrated that IRS' current national compliance approach to the problem may not be working as well as it should and that a more vigorous effort on IRS' part seems warranted. Whatever plan the Commissioner decides to pursue with respect to these two problem areas, it is essential that any tests be conducted in a sound methodological manner and in a sufficient number of locations so that decisions can be made on whether, and what, actions should be implemented nationwide.

Comments:

The Service is aware that with the ever-increasing complexities in the Federal tax statutes, it is important to have the capability of identifying and dealing with paid return preparers whose conduct in representing their clients is improper. While a formal compliance program with stated numerical objectives has not been established and is not contemplated at this time, problem preparers are constantly being identified and monitored through other compliance programs. For example, through our DIF selection system, returns are selected for examination because of a high potential for error. By the examination of those returns in IRS local offices, patterns of improper conduct by preparers are identified and appropriate actions taken to deal with the problem. Even though we examine only a small fraction of the total returns filed, we can identify the abusive preparer.

Further, both revenue agents and tax auditors have local knowledge of the preparer industry. Through examinations of returns, they are aware of preparers in their respective communities that prepare returns with multiple adjustments which would give rise to the assertion of a return preparer penalty.

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As pointed out in the Service's own Internal Audit Report on the return preparer program issued in January 1981, it would be beneficial for the Service to have more information on the total number of preparers and, thereby, be able to estimate levels of compliance within the industry. We agree that the Taxpayer Compliance Measurement Program (TCMP) may be a good vehicle for collecting some information on all of the various types of preparer penalties. The first survey for which such data could be collected is the survey of 1982 individual returns filed in 1983, since an audit evaluation document (checksheet) will be developed shortly. The information from this survey will not be available until mid-1985 when production of the first output table is expected. Through the TCMP, the Service hopes to determine whether a sizeable group of preparers exists who are not identifying themselves on returns they prepare and have not been detected by other Compliance programs.

Although it may be possible to collect information on returns where preparer penalties have been asserted, such data may not be conceptually valid when we attempt to project them to the population of preparers. The Service will evaluate the usefulness of a study to produce such management information.

With regard to the Louisville District check negotiation project, the Service will review District procedures to ascertain whether a problem exists nationwide.

APPENDIX II



Recommendation #2

Finally, to assure greater consistency in penalty assertion decisions, we recommend that the Commissioner:

-- Publish guidelines better defining the circumstances under which the willful misconduct penalty ought to be asserted. By so doing, the Commissioner would better ensure consistency in the application of this penalty while also alerting preparers to situations in which they should expect to be penalized for this serious violation.

Comments:

Other than the legislative history and treasury regulations, there are no "guidelines" (i.e., Revenue Rulings, etc.) that specifically discuss Section 6694(b). This is due to the fact that the determination of whether a preparer's conduct was "willful" is a factual question. We believe it would be difficult, if not impossible, to fashion an all-inclusive, mechanical definition of "willfulness" that would be useful in determining whether a preparer's conduct falls within the purview of Section 6694(b). While examples of willful misconduct may be helpful in promoting a consistent application of the preparer penalty by examiners, the penalty is to be applied in light of all the facts and circumstances of each case, taking into account any and all mitigating factors. Thus, the term "willful," when employed in a civil context, connotes a voluntary, conscious, and intentional act.

The Service normally includes all relevant court cases in training material for all program areas. Therefore, as the return preparer segments of training material come up for review, we will incorporate pertinent court cases.

Recommendation #3

-- Identify additional means through which to better ensure that examiners take tax law complexity into account when making penalty assertion decisions. In this regard, the Commissioner may wish to discuss this issue with representatives of paid preparer groups with a view toward developing solutions to a continuing problem. One solution the Commissioner may wish to consider would be to revise and/or expand examiner training on this matter. Another solution the Commissioner may wish to consider would be to provide examiners with written examples of cases in which return complexity precluded penalty assertions as well as cases in which alleged return complexity did not constitute valid cause for preparers' errors.

Comments:

Currently, the Service position on return complexity is set forth in Rev. Proc. 80-40, 1980-2 C.B. 775, and in our instructions to field personnel. These instructions are at IRM 4297.2. In Section 4 of Rev. Proc. 80-40, the Service adopted the position that in determining whether the return preparer penalty should be asserted, all relevant facts and circumstances of each case should be taken into account. In making this determination, the nature of the error causing the understatement must be taken into account. Specifically, the Revenue Procedure requires that the examiner must decide:

> Was the provision that was misapplied or not discovered so complex (emphasis added), uncommon, or highly technical that a competent preparer of returns of the type at issue might reasonably be unaware or mistaken as to its applicability?

The Service does see the need to give additional emphasis to the issue of complexity in its training material. Therefore, this issue will be addressed in future revisions of training material that contain a segment on the return preparer penalty.

Recommendation #4

-- Specify that all penalty case files contain information on the type of penalty assessed, the basis for the penalty action, the dollar amounts involved especially in terms of understated tax liabilities, and the results of supervisory and quality control reviews. Without such information, IRS managers and internal auditors cannot fully evaluate the effectiveness of IRS' compliance program.

Comments:

The Service currently requires that examiners make certain notations in the case files. In a situation where penalties are not pursued, appropriate comments as to the extent of the review should be documented (IRM 4297.4(2)). If the examiner concludes that the penalty should be pursued, the examiner will complete two copies of Form 6459, Return Preparer Checksheet, and then discuss his/her findings with the group manager. If the group manager authorizes the opening of a penalty investigation, he/she will document such authorization by signing the bottom of the Form 6459. A copy of this form will be placed in both the preparer case file and the related income tax case. The preparer's position will be fairly and carefully considered and clearly reflected in the workpapers and on Form 5808, Return Preparer Penalty Follow-up. Appropriate copies of the income tax examination workpaper will be made a part of the return preparer case file. The file will also include copies of the unagreed or agreed income tax case, examination report, and a copy of the tax return (IRM 4297.4).

There are particular forms that must be filled out in the processing of an agreed or unagreed case. These forms require the signature of the group manager and all preparer cases must be identified with a Form 3198, Special Handling Notice, and marked "Mandatory Review." In addition, there is a specialized form required when assesssing the penalty which must indicate the type of penalty and the reason for assessment.

The Service recognizes that even with these provisions in the Internal Revenue Manual, it is possible that some case files may lack certain documentation. Therefore, the Service will reemphasize these Manual provisions.

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