

154031



United States
General Accounting Office
Washington, D.C. 20548

General Government Division

B-260155

April 14, 1995

The Honorable Margaret Milner Richardson
Commissioner of Internal Revenue

Dear Ms. Richardson:

This letter shares results from our study of the Internal Revenue Service's (IRS) oversight of both paid preparers of tax returns and software for preparing returns. We closed our study after some limited survey work because insufficient data were available for us to do enough analyses to fully evaluate the effectiveness of IRS' oversight of the preparers or software. We are providing the preliminary results we developed during our survey because we thought it may prove useful as IRS: (1) reviews recent proposals concerning IRS' oversight of paid preparers; (2) develops plans to collect new compliance data; and (3) considers ways to reach its goal of 90-percent tax compliance by 2001. Overseeing paid preparers and software is important because both can affect tax compliance either positively or negatively, depending on how well they work.

BACKGROUND

Anyone can be paid to prepare a tax return. Some paid preparers are attorneys, certified public accountants (CPA), or enrolled agents. These tax practitioners may represent clients before IRS but must qualify to do so. Attorneys and CPAs qualify on the basis of their professional status; enrolled agents qualify by passing an IRS test or by having worked at IRS. Other paid preparers include various types of commercial preparers. As unenrolled preparers, they are not qualified to practice before IRS. Regardless of the type of preparer, all returns are required to meet various standards, such as only including tax positions that have a realistic chance of being sustained on their merits.

Individuals who want assistance in filing tax returns without paying a preparer may use computer software. Three basic software options are available: (1) 1040PC software replaces the individual income tax return with a shorter version; (2) a transmitter authorized by IRS can use software to electronically file (ELF) tax returns; and (3) other tax software used in various commercial computer programs computes the tax liability on the basis of data entered into the program and prints the results onto a substitute Form 1040.

SUMMARY OF OUR RESULTS

Although paid preparers and tax software may affect tax compliance, IRS lacks some useful data on their compliance impacts. For example, IRS does not know the extent to which preparers as a whole or by component group caused noncompliance or improved compliance on the returns. Such distinctions could be important in deciding whether IRS should strengthen or weaken its oversight of a specific component group. IRS has similar decisions to make on tax software oversight. On one hand, IRS has established testing programs for ELF and 1040PC software. On the other hand, IRS has limited information on the extent to which taxpayers and preparers use software packages for substitute returns, or to which these packages generate accurate returns.

IRS DOES NOT KNOW THE IMPACT OF PAID PREPARERS ON TAX COMPLIANCE

Paid preparers did about half of the 1992 individual income tax returns.¹ These returns generally reflected higher income and were more complex, increasing the chances for noncompliance. IRS' most recent compliance data indicated that 1988 individual returns done by paid preparers had more noncompliance than all other returns.² IRS found noncompliance on about 55 percent of the returns done by paid preparers compared with about 40 percent on other returns; the average amount of change in tax liability on returns done by paid preparers was more than twice the average amount on other returns.

¹IRS data showed that paid preparers filed 56.1 million (49 percent) of these returns for 1992.

²IRS generated the compliance data by comprehensively auditing a random sample of individual tax returns under the Taxpayer Compliance Measurement Program (TCMP) for 1988. The next round of TCMP audits is slated to start in October 1995, focusing on 1994 tax returns.

The data did not show whether the noncompliance was caused by the preparers or was unintentional due to factors such as more complex tax provisions or inadequate information from clients. In addition, the data on noncompliant returns did not distinguish between tax practitioners and unenrolled preparers.

As preparers do more returns, the need to understand their impact on compliance will grow. In its next round of TCMP audits for 1994 returns, IRS plans to identify the reason for each item of noncompliance on the return by applying a code. One code will deal with reliance on the advice of a preparer. The remaining codes will cover various types of unintentional and intentional noncompliance but will not show whether preparers were involved. This new coding system represents a step forward from the methods used in TCMP audits for earlier tax years.

IRS' OVERSIGHT OF PAID PREPARERS DIFFERS

Knowing the impacts of paid preparers on compliance, particularly by type of paid preparer, can be important given the difference in IRS' oversight. IRS imposes more requirements and can impose more sanctions against practitioners than against unenrolled preparers.

For example, IRS can penalize preparers who violate those standards for preparing returns but needs an injunction from a U.S. District Court to bar them from preparing returns. Practitioners face more sanctions. In addition to imposing monetary penalties, IRS can suspend or disbar practitioners who violate certain standards from representing clients before IRS. IRS' focus on practitioners arises from their role in representing clients before IRS as well as in preparing returns. Lacking data on how these preparers affected compliance, we could not determine whether the difference in oversight was justified.

Recently, two proposals on IRS' oversight of paid preparers were made. First, in January 1995, the IRS Commissioner's Advisory Group recommended requiring unenrolled preparers to register with IRS and meet initial and continuing education requirements. The proposal also would subject unenrolled preparers to all other standards that apply to practitioners. Unenrolled preparers who violate ethical standards might be prohibited from preparing returns.³

³To implement the CAG proposal, IRS may require additional legislative authority.

Second, a September 1994 study by IRS' Brooklyn District recommended even more oversight and sanctions for paid preparers. The study proposed an annual check to see whether preparers filed their personal tax returns and paid their taxes. The study also proposed that the preparers who fail this check be suspended from doing returns or, if they are tax practitioners, from practicing before the IRS.

IRS DID NOT CHECK THE ACCURACY
OF MOST TAX PREPARATION SOFTWARE

Recent literature has discussed the growing use of tax software in preparing returns. Members of the preparer community have estimated that 80 percent or more of the paid preparers also used tax software. However, IRS knew little about the impact of any software on compliance.

For example, about 18 million of 116 million returns filed in 1994 used ELF and 1040PC software. IRS did not know how many of the remaining 98 million returns used software or whether the software produced accurate substitute returns. IRS asserted little oversight over the 239 developers (as of February 1995) of software for substitute returns. IRS checked all three software options' output for conformity to specifications but did more testing for the ELF and 1040PC software. IRS tested the ELF software for reliable data transmission and the 1040PC software for accuracy. This additional 1040PC testing of accuracy checked the math computations but not whether the 1040PC software consistently calculated the correct tax liability.

Recent articles have raised concerns about software accuracy and consistency in calculating tax liabilities. One evaluation of nine software packages uncovered a variance in tax liability for the same set of facts. Ranging from a \$310 refund to \$1,484 in additional tax owed, this variance purportedly resulted from how aggressively the software treated complex tax issues such as the depreciation deduction.⁴

While IRS has tested 1040PC software for accuracy, it is not clear how effective the testing has been. For example, some developers sold 1040PC software for the 1994 filing season before the software passed the tests. In addition, some developers continued to adjust the software during the filing season, which could introduce errors. Finally, IRS did not follow its policy on mailing back computer-generated returns that did not meet

⁴Theresa W. Cary, "Tax Shelters," ComputerLife (February 1995), pp. 99-103.

B-260155

format specifications. IRS officials said legal rulings on processing returns deterred IRS from following its policy.

IRS had no data on how often these practices allowed inaccurate 1040PC software to enter the market. As IRS modernizes its computer systems and expedites its processes, knowing the accuracy of returns prepared using any computer software could be important, particularly as IRS strives for 90-percent tax compliance by 2001.

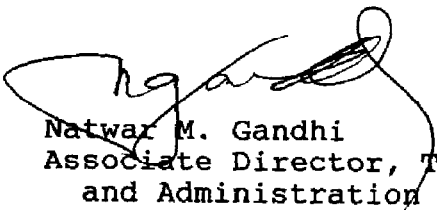
OBJECTIVES, SCOPE, AND METHODOLOGY

Our survey objectives were to determine how (1) IRS data could be used to profile paid preparers and the accuracy of returns they prepared, (2) IRS oversees paid preparers, and (3) IRS oversees software for preparing returns. To develop preliminary information for each objective in turn, we (1) analyzed IRS data and studies on returns done by preparers and on compliance on the returns; (2) interviewed IRS staff and analyzed IRS data, procedures, and sanctions associated with the oversight of preparers; and (3) analyzed IRS policies, guidance, and controls for the three software options, as well as interviewed responsible IRS officials, tax practitioners, and software developers, and reviewed articles on various types of software.

We did our work at IRS' National Office, North Atlantic Regional Office, Manhattan District Office, and Brookhaven Service Center between September 1994 and March 1995. We obtained oral comments from IRS' Director of Practice and other IRS program officials responsible for oversight of tax return preparers and tax return preparation software. They agreed that the information we are reporting is factual.

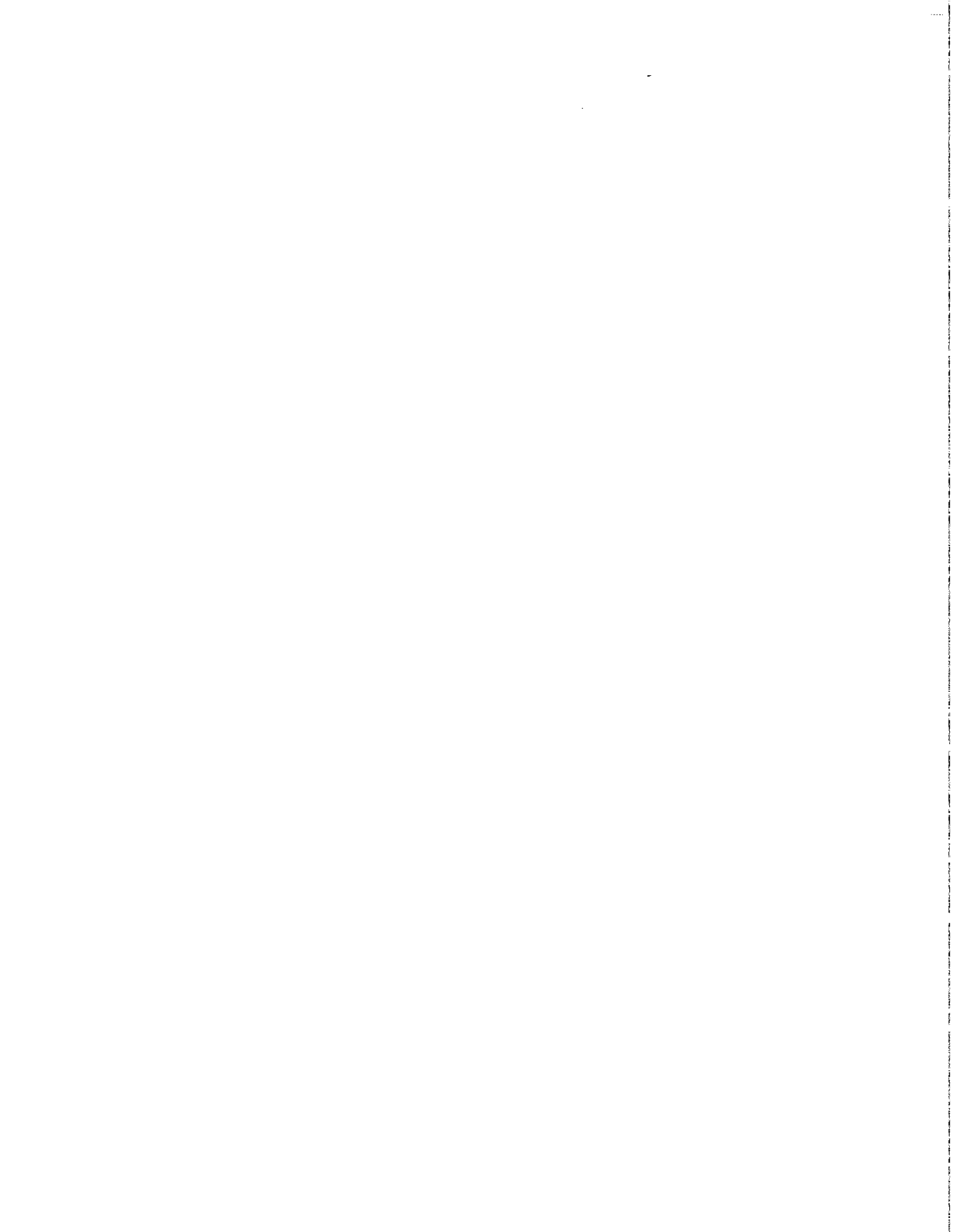
- - - - -
We will send copies of this letter to pertinent congressional committees, the Secretary of the Treasury, and other interested parties, as well as to others upon request. If you have any questions, please call me on (202) 512-9044.

Sincerely yours,



Natwar M. Gandhi
Associate Director, Tax Policy
and Administration Issues

(268653)



Ordering Information

The first copy of each GAO report and testimony is free. Additional copies are \$2 each. Orders should be sent to the following address, accompanied by a check or money order made out to the Superintendent of Documents, when necessary. Orders for 100 or more copies to be mailed to a single address are discounted 25 percent.

Orders by mail:

**U.S. General Accounting Office
P.O. Box 6015
Gaithersburg, MD 20884-6015**

or visit:

**Room 1100
700 4th St. NW (corner of 4th and G Sts. NW)
U.S. General Accounting Office
Washington, DC**

**Orders may also be placed by calling (202) 512-6000
or by using fax number (301) 258-4066, or TDD (301) 413-0006.**

Each day, GAO issues a list of newly available reports and testimony. To receive facsimile copies of the daily list or any list from the past 30 days, please call (301) 258-4097 using a touchtone phone. A recorded menu will provide information on how to obtain these lists.

**United States
General Accounting Office
Washington, D.C. 20548-0001**

**Bulk Mail
Postage & Fees Paid
GAO
Permit No. G100**

**Official Business
Penalty for Private Use \$300**

Address Correction Requested
