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TAX PREPARER REGULATION

Improving Tax Return Accuracy Depends on IRS's Use of New Requirements

Statement of James R. White, Director
Strategic Issues

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Highlights of [GAO-11-868T](#), a testimony before the Subcommittee on Oversight, Committee on Ways and Means, House of Representatives

Why GAO Did This Study

Paid preparers are a cornerstone of the U.S. tax system, as they prepare approximately 60 percent of all tax returns filed, and their actions have an enormous impact on the Internal Revenue Service's (IRS) ability to administer tax laws effectively. In previous work, GAO found that taxpayers were not always served well by their paid preparers, and GAO proposed stricter oversight of preparers. In 2010, IRS began implementing new requirements for paid preparers and believes that the requirements will increase taxpayers' compliance.

This testimony addresses (1) prior GAO work on paid preparer performance, (2) IRS's progress in implementing the new requirements, and (3) how IRS can use the requirements to improve taxpayer compliance. It is based on GAO's March 2011 report on IRS's implementation of the paid preparer requirements and other GAO reports related to paid preparers. Further, GAO identified additional steps IRS has taken to implement the requirements since the March report was issued. GAO discussed the new information with IRS officials, and they concurred with the findings.

View [GAO-11-868T](#) or key components. For more information, contact James R. White at (202) 512-9110 or whitej@gao.gov.

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TAX PREPARER REGULATION

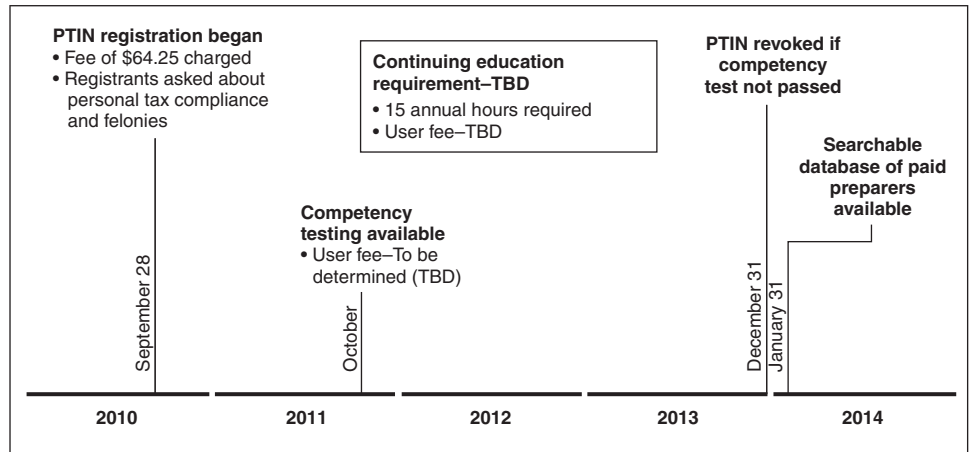
Improving Tax Return Accuracy Depends on IRS's Use of New Requirements

What GAO Found

As intermediaries between taxpayers and IRS, paid preparers can educate taxpayers about tax laws and prevent tax return errors and resulting IRS audits. However, GAO has found that paid preparers make errors. For example, in a 2006 report, GAO had tax returns prepared at 19 outlets of several commercial tax chains. All 19 returns had mistakes ranging from refund overclaims of nearly \$2,000 to underclaims of over \$1,700. In 2008, GAO reported that in Oregon, regulation of paid preparers corresponded with more accurate taxpayer returns.

To date, IRS has implemented a requirement that paid preparers obtain a preparer tax identification number (PTIN) and plans to implement competency testing and continuing education requirements. IRS also plans to require paid preparers to adhere to Department of the Treasury standards of practice. Initially, IRS plans to focus on educating paid preparers about the new requirements and not on penalizing them for noncompliance. However, it is developing and implementing strategies for ensuring paid preparers comply with the new requirements.

Proposed Timeline for IRS's Implementation of Paid Preparer Requirements



Source: IRS.

The extent to which the new paid preparer requirements will result in more accurate tax returns depends on IRS actions. In a March 2011 report, GAO recommended that IRS document a strategic framework for how it plans to leverage the requirements to improve taxpayer compliance. IRS agreed and is working on a plan. There are various ways that IRS can leverage the paid preparer requirements in order to provide better service to taxpayers and ultimately improve taxpayer compliance. For example, IRS management has discussed conducting research on which strategies are most effective for improving the quality of tax returns prepared by different types of paid preparers. Documenting this framework so it is transparent to paid preparers—who bear the burden of complying with the requirements—could assist with preparers' voluntary compliance by demonstrating the requirements' worth.

Chairman Boustany, Ranking Member Lewis, and Members of the Subcommittee:

I am pleased to be here to discuss the Internal Revenue Service's (IRS) implementation of new requirements for paid tax return preparers¹ and how those requirements may lead to improved taxpayer compliance. Paid preparers are a cornerstone of our tax system, as they prepare approximately 60 percent of all tax returns filed, and their actions have an enormous impact on IRS's ability to administer tax laws effectively. In previous work, which I will discuss, we found that taxpayers were not always well served by their paid preparers, and we proposed stricter oversight of preparers. In 2010, IRS began implementing new requirements for paid preparers, such as requiring competency tests, and has concluded that the requirements will increase tax compliance. Improved compliance would reduce the tax gap between what is owed in taxes and what is paid voluntarily and on time. IRS's most recent estimate for the gross tax gap was \$345 billion for 2001.² Increased paid preparer performance could also benefit taxpayers by reducing their likelihood of being audited by IRS and subjected to resulting penalties and interest.

My testimony today will cover (1) GAO work on paid preparer performance prior to IRS's implementation of the new requirements, (2) IRS's progress in implementing the new requirements, and (3) how IRS can use the requirements to improve taxpayer service and compliance. My testimony is based on our March 2011 report on IRS implementation of the paid preparer requirements and other reports

¹A tax return preparer is any person who prepares for compensation, or who employs one or more persons to prepare for compensation, all or a substantial portion of a tax return or claim for refund of tax. 26 U.S.C. § 7701(a)(36).

²IRS estimated that it would eventually collect about \$55 billion of the gross tax gap through late payments and IRS enforcement actions, leaving a net tax gap of around \$290 billion.

related to paid preparers.³ We also identified steps IRS has taken to implement the requirements since the March 2011 report was issued. We discussed the new information in this statement with IRS officials, and they concurred with our findings. Our work on the prior reports and this statement was conducted in accordance with generally accepted government auditing standards. Additional information on our scope and methodology is available in our published reports.

GAO's Prior Work Identified Issues with Paid Preparer Performance

Paid preparers play a critical role in helping taxpayers meet their tax obligations. As intermediaries between taxpayers and IRS, paid preparers educate taxpayers about tax laws, guidance that can prevent errors and unnecessary audits. However, in prior reports, we found that taxpayers were not always well served by their paid preparers.

- In a 2002 report, we found that as many as 2.2 million individual taxpayers were likely to have overpaid their taxes by as much as \$945 million because they took the standard deduction instead of itemizing their deductions. About 50 percent of these taxpayers used a paid preparer.⁴
- For a 2006 report, we had tax returns prepared for us at 19 outlets of several commercial tax return preparation chains scattered throughout a major metropolitan area.⁵ All 19 visits showed problems, and several of the preparers gave us incorrect tax advice. As shown in figure 1, only 2 of 19 tax returns showed a correct tax refund amount, and in both of those visits the paid preparer made mistakes that did not affect the final refund amount. While some errors had fairly small tax consequences, others had very large consequences. Incorrectly

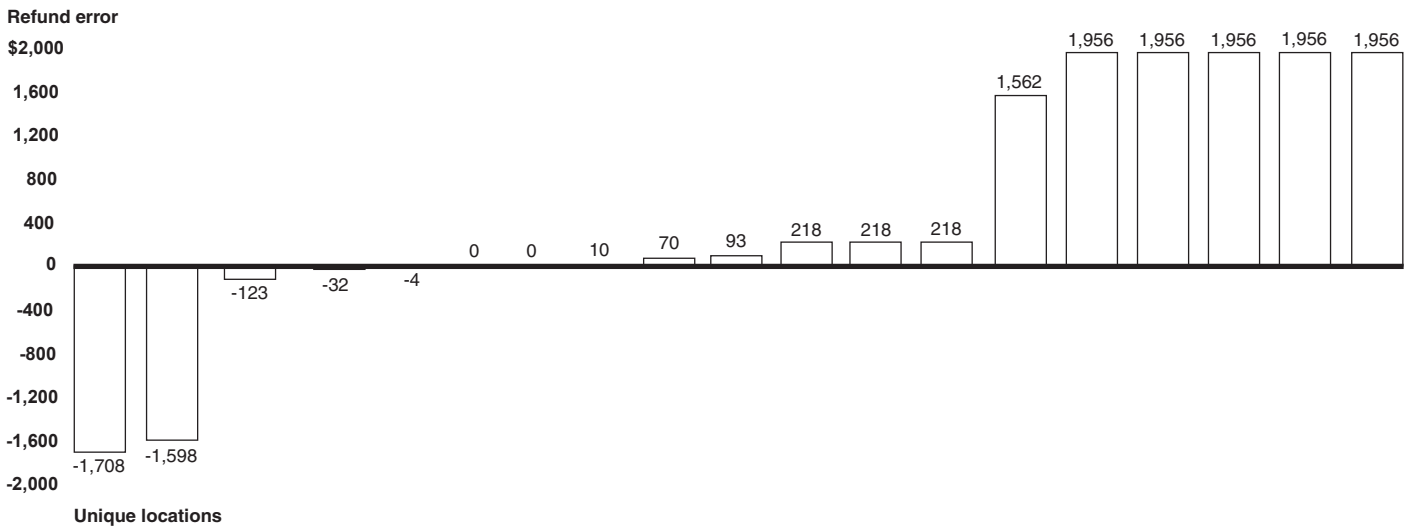
³GAO, *Tax Preparer Regulation: IRS Needs a Documented Framework to Achieve Goal of Improving Taxpayer Compliance*, [GAO-11-336](#) (Washington, D.C.: Mar. 31, 2011); *Tax Preparers: Oregon's Regulatory Regime May Lead to Improved Federal Tax Return Accuracy and Provides a Possible Model for National Regulation*, [GAO-08-781](#) (Washington, D.C.: Aug. 15, 2008); *Internal Revenue Service: Fiscal Year 2009 Budget Request and Interim Performance Results of IRS's 2008 Tax Filing Season*, [GAO-08-567](#) (Washington, D.C.: Mar. 13, 2008); *Paid Tax Return Preparers: In a Limited Study, Chain Preparers Made Serious Errors*, [GAO-06-563T](#) (Washington, D.C.: Apr. 4, 2006); and *Tax Deductions: Further Estimates of Taxpayers Who May Have Overpaid Federal Taxes by Not Itemizing*, [GAO-02-509](#) (Washington, D.C.: Mar. 29, 2002).

⁴[GAO-02-509](#).

⁵[GAO-06-563T](#).

reported refunds ranged from refunds overclaimed by nearly \$2,000 to underclaims of over \$1,700.

Figure 1: Refund Amounts over or under Correct Amount from GAO Paid Preparer Visits



Source: GAO.

Although few states regulate paid preparers, in a 2008 report we found that Oregon’s paid preparer regulatory regime may have led to more accurate federal tax returns.⁶ Based on this finding, we suggested Congress adopt a nationwide paid preparer regulatory regime similar to Oregon’s paid preparer regulatory regime if it judged that Oregon’s regulatory regime accounted for at least a modest portion of the higher federal tax return accuracy in the state at a favorable cost compared to potential benefits. In another 2008 report we recommended that IRS develop a plan to require a single identification number for paid preparers, including the feasibility of options, benefits and costs of those options, as

⁶GAO-08-781. Oregon requires paid preparers to complete qualifying education, pass a state-administered examination, and register to be certified as a Licensed Tax Preparer. Paid preparers must complete 30 hours of continuing education and reregister in each subsequent year. Oregon also requires that all preparers work under the supervision of a Licensed Tax Consultant, CPA, public accountant, or attorney. California, Maryland, and New York also regulate paid preparers but oversight in each state varies.

well as their usefulness for enforcement and research on paid preparer behavior.⁷

In June 2009, the Commissioner of Internal Revenue initiated a review of paid preparers to help IRS strengthen its partnerships with paid preparers and ensure that paid preparers adhere to applicable professional standards and follow tax laws. IRS recommended changes to the oversight of paid preparers in its December 2009 Return Preparer Review report.⁸ These recommended changes included:

- mandatory registration for paid preparers who are required to sign a federal tax return;
- competency testing and continuing education for paid preparers who are required to register with IRS and who are not attorneys, certified public accountants, or enrolled agents, who generally must complete continuing education requirements to retain their professional credentials; and
- holding all paid preparers to standards of practice under Department of the Treasury *Circular No. 230*,⁹ which governs the practice of practitioners before IRS,¹⁰ regardless of whether or not the preparers are required to sign a federal tax return.

IRS intends these new requirements to improve service to taxpayers, increase confidence in the tax system, and increase taxpayer compliance.

IRS Has a New Registration Requirement for Paid Preparers and Plans for Gradual Implementation

IRS has implemented a requirement that paid preparers obtain a preparer tax identification number (PTIN) if they prepare all or substantially all of a

⁷GAO-08-567.

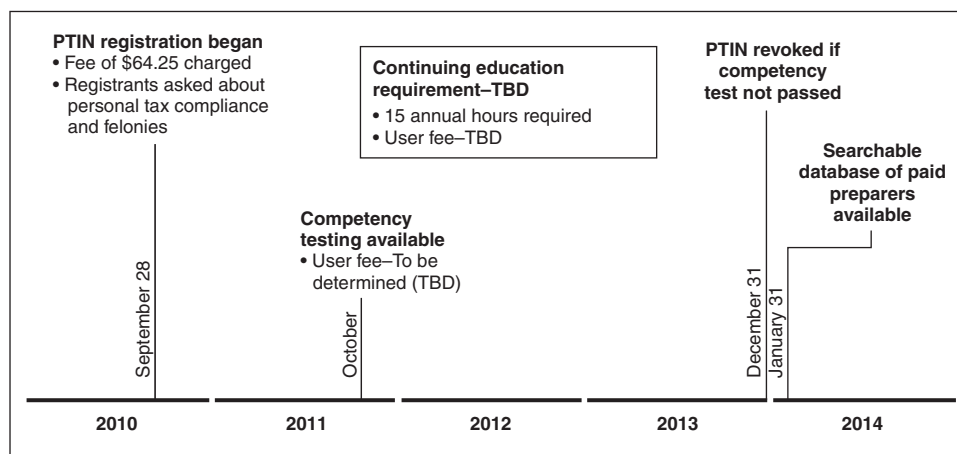
⁸IRS, *Return Preparer Review*, IRS Publication 4832 (December 2009).

⁹31 C.F.R. part 10.

¹⁰Practice before IRS encompasses all matters connected with a presentation to IRS relating to taxpayer's rights, privileges, or liabilities under tax laws, including preparing documents or filing documents with IRS. Practitioners are attorneys, certified public accountants, enrolled agents, enrolled actuaries, enrolled retirement plan agents, and on August 2, 2011, will include registered tax return preparers. 31 C.F.R. § 10.2(a).

tax return filed after December 31, 2010.¹¹ Figure 2 shows IRS's tentative schedule for implementing other new requirements, including competency testing and continuing education. In addition to those requirements, IRS will require all paid preparers to adhere to *Circular 230* standards of practice, revisions to which have been finalized and take effect on August 2, 2011.¹²

Figure 2: Proposed Timeline for IRS's Implementation of Paid Preparer Requirements



Source: IRS.

According to IRS, as of mid-July 2011, 717,000 paid preparers have registered for a PTIN. Paid preparers may register for a PTIN online or on paper via Form W-12, *IRS Paid Preparer Tax Identification Number (PTIN) Application*.¹³ When applying for a PTIN, paid preparers are asked, under penalty of perjury, to self-disclose if they are compliant with their

¹¹*Furnishing Identifying Number of Tax Return Preparer (Final Rule)*, 75 Fed. Reg. 60,309 (Sept. 30, 2010). In *IRS Notice 2011-6*, IRS has provided a list of forms for which a paid preparer will not be required to obtain a PTIN in order to prepare.

¹²*Regulations Governing Practice Before the Internal Revenue Service (Final Regulations)*, 76 Fed. Reg. 32,286 (June 3, 2011).

¹³The fee for PTIN registration is \$64.25. The IRS portion of the fee is \$50, with the remaining \$14.25 being a fee charged by the vendor that will establish and maintain the PTIN registration system. We determined that IRS set its portion of the user fee consistent with established criteria.

personal and business taxes. The IRS Return Preparer Office (RPO) Director said that IRS plans to initiate automated tax compliance checks on all paid preparers. IRS plans to limit the checks to whether the preparers have filed all federal tax returns and paid or entered into an agreement to pay federal tax debts. Paid preparers are also asked, under penalty of perjury, if they have been convicted of a felony in the past 10 years. The RPO Director said that IRS plans to begin the process of checking the accuracy of registrants' tax compliance and background information by late 2011 and that registrants who provide false information on their PTIN applications will have severely limited appeal rights if IRS proposes to deny them PTINs.

Circular 230 will require individuals to pass a competency test to become a registered tax return preparer. The competency test will cover individual income tax return issues only, and attorneys, certified public accountants, enrolled agents, certain supervised preparers, and individuals who do not prepare individual income tax returns and associated schedules and forms are not required to take the competency test. Paid preparers who have a valid PTIN before competency testing is available will have until 2013 to pass a competency test and complete the suitability check. Paid preparers who register for a PTIN after testing is available must pass a competency test before obtaining a PTIN. IRS plans for testing to be available beginning in October 2011 (see figure 2 above). Registered tax return preparers will be subject to suitability checks, which they may undergo either before taking or after passing the competency test. IRS plans to conduct these checks to determine whether the individuals have engaged in disreputable conduct. In addition, IRS plans to implement a continuing education requirement whereby paid preparers who are required to take the competency test will be required to take 15 hours of training annually—3 hours of federal tax law updates, 2 hours of ethics, and 10 hours of additional federal tax topics. The RPO Director said that IRS plans to approve continuing education providers rather than individual courses and audit a random sample of continuing education courses.

Initially, IRS plans to focus on educating paid preparers about the new requirements, and not on penalizing paid preparers for noncompliance, according to the RPO Director. In November 2010, IRS sent letters to 10,000 paid preparers to remind them of their responsibility to comply with requirements for paid preparers, including registering for a PTIN. In July 2011, IRS began sending letters to about 100,000 paid preparers who used identifying numbers other than a new PTIN on returns they prepared during the 2011 filing season. The letters explain the new

oversight program and inform preparers of how to obtain a new PTIN and where to get assistance. In addition, the RPO Director told us IRS is evaluating methods to identify individuals who prepare tax returns for others but do not sign the returns as paid preparers. IRS states that later this year it will send letters to taxpayers whose returns appear to have been prepared with assistance but do not include tax return preparer signatures. The letters will inform taxpayers how to file a complaint against preparers who failed to sign returns and explain how to choose legitimate tax preparers. IRS states that the goal of the letters is to protect taxpayers by ensuring that all paid federal tax return preparers are registered with IRS, sign tax returns they prepare, and use an identifying number when required to do so.

IRS's Plans for Leveraging the Paid Preparer Requirements Are Key to Improving Taxpayer Compliance

IRS can use the paid preparer requirements to help achieve its goal of leveraging the preparer community to increase taxpayer compliance; however, the extent to which the requirements will result in improved compliance depends on how IRS uses them. In our March 2011 report, we found that IRS had discussed but not documented a framework for how it plans to develop service and enforcement efforts that leverage the new paid preparer requirements to improve taxpayer compliance. Likewise it had not developed a framework for evaluating the effect of any planned service and enforcement efforts or the effect of the requirements themselves on improving taxpayer compliance. IRS began implementing the requirements before laying out strategies for how to leverage them and measure their impact in an effort to realize benefits sooner.

Without a documented framework to guide its overall effort, IRS may not adequately or effectively identify and collect key baseline data now, modify its strategies to improve outcomes, allocate its resources most effectively given competing priorities, or maximize paid preparers' compliance with the requirements. Furthermore, some members and officials from paid preparer associations stated that the requirements will be worthwhile only if they result in an improvement in taxpayer compliance. The impact of these requirements depends on the compliance of paid preparers who bear the burden of complying with the requirements. Demonstrating to paid preparers that IRS will evaluate whether the requirements improve service to taxpayers or taxpayers' compliance could improve preparers' voluntary compliance with the requirements. In our report, we recommended that IRS document a strategic framework showing how it intends to use the paid preparer requirements to improve taxpayer compliance and assess their effectiveness. IRS agreed with our recommendation and plans to

complete its strategic plan at the end of July 2011. IRS stated that the plan will detail the overall mission, vision, and goals to ensure return preparer oversight will ultimately achieve improved taxpayer compliance and tax administration.

There are various ways that IRS can leverage the paid preparer requirements to provide better service to taxpayers and ultimately improve taxpayer compliance. For example, according to the RPO Director, IRS plans to develop a comprehensive database containing information on paid preparers and the tax returns they prepare. IRS plans to use information from this database to test which strategies are most effective for improving the quality of tax returns prepared by different types of paid preparers.¹⁴ We have consistently stressed the importance of IRS's conducting compliance research such as this and using research results to identify areas of noncompliance, justify resource requests, and target scarce resources. In addition, given IRS's new strategy for modernizing the way it manages individual taxpayer accounts, IRS could conduct analyses of tax return information and data on paid preparers earlier in the filing season. This would allow IRS to reach out to paid preparers during the filing season to either correct widespread errors among paid preparers or to contact a paid preparer who repeatedly makes the same type of error on tax returns. IRS has also discussed how to measure the effect of the requirements themselves, for example, the effects that requiring continuing education and testing have on tax return accuracy.

Chairman Boustany, Ranking Member Lewis, and Members of the Subcommittee, this completes my prepared statement. I would be happy to respond to any questions you may have at this time.

For further information on this testimony, please contact James R. White at (202) 512-9110 or whitej@gao.gov. In addition, contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this statement. In addition to the individual named above,

¹⁴For more information on the management information system IRS will need to have in order to develop an enforcement strategy based on paid preparer data, see Treasury Inspector General for Tax Administration, *It Will Take Years to Implement the Return Preparer Program and to Realize Its Impact*, 2010-40-127 (Washington D.C.: Sept. 30, 2010).

Jeff Arkin, Assistant Director; Amy Bowser; Maya Chakko; Donna Miller; and Daniel Webb made key contributions to this report.

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