

GAO

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PAID TAX RETURN PREPARERS

In a Limited Study, Chain Preparers Made Serious Errors

Statement of Michael Brostek, Director
Strategic Issues





Highlights of [GAO-06-563T](#), a statement before the Committee on Finance, U.S. Senate

Why GAO Did This Study

Despite the importance of paid tax return preparers in helping taxpayers fulfill their obligations, little data exist on the quality of services they provide. Paid preparers include, for example, enrolled agents, who are approved by the Internal Revenue Service (IRS) once they pass an examination on tax matters or demonstrate past IRS employment experience, and unenrolled preparers, who include self-employed individuals and people employed by commercial tax preparation chains.

GAO was asked to determine (1) what the characteristics were of tax returns done by paid preparers, (2) what government regulation exists for paid preparers, and (3) what specific issues taxpayers might encounter in using paid preparers. To do its work, GAO analyzed IRS data, reviewed paid preparer regulatory requirements, and had tax returns prepared at 19 outlets of several tax preparation chains.

What GAO Recommends

GAO recommends that the Commissioner of Internal Revenue conduct necessary research to determine the extent to which paid preparers live up to their responsibility to file accurate and complete tax returns based on information they obtain from their customers.

www.gao.gov/cgi-bin/getrpt?GAO-06-563T.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Michael Brostek at (202) 512-9110 or brostekm@gao.gov.

PAID TAX RETURN PREPARERS

In a Limited Study, Chain Preparers Made Serious Errors

What GAO Found

Many taxpayers choose to pay others to prepare their tax returns rather than prepare their own returns. According to the most recent reliable data, about 56 percent of all the individual tax returns filed for tax year 2002 used a paid preparer, with higher paid preparer usage among taxpayers with more complicated returns such as those claiming the earned income credit (EIC).

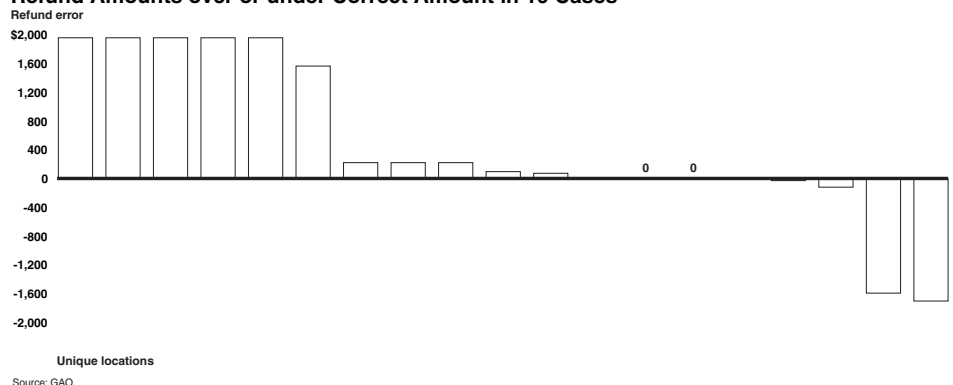
All paid preparers are subject to some IRS regulations and may be penalized if they fail to follow them. For example, all paid preparers must identify themselves on the returns they prepare and must not deliberately understate a taxpayer's tax liability. When the EIC is involved, paid preparers must also ask specific questions to determine a taxpayer's eligibility for the credit.

In GAO visits to commercial preparers, paid preparers often prepared returns that were incorrect, with tax consequences that were sometimes significant. Their work resulted in unwarranted extra refunds of up to almost \$2,000 in 5 instances, while in 2 cases they cost the taxpayer over \$1,500. Some of the most serious problems involved preparers

- not reporting business income in 10 of 19 cases;
- not asking about where a child lived or ignoring GAO's answer to the question and, therefore, claiming an ineligible child for the EIC in 5 out of the 10 applicable cases;
- failing to take the most advantageous postsecondary education tax benefit in 3 out of the 9 applicable cases; and
- failing to itemize deductions at all or failing to claim all available deductions in 7 out of the 9 applicable cases.

GAO discussed these findings with IRS and referred to it problems that were found. Had these problems been discovered by IRS on real returns, IRS officials said that many of the preparers would have been subject to penalties for such things as negligence and willful or reckless disregard of tax rules.

Refund Amounts over or under Correct Amount in 19 Cases



Mr. Chairman and Members of the Committee:

I appreciate the opportunity to testify on the services offered by paid tax return preparers. Every year tens of millions of taxpayers pay someone to prepare their tax returns. According to Internal Revenue Service (IRS) officials, several hundred thousand certified public accountants (CPA) and attorneys were authorized to practice before it as of March 2006, and there were about 41,000 active enrolled agents. Enrolled agents are approved by IRS once the agents pass an examination on tax matters or demonstrate past IRS employment experience. In 2003, the National Taxpayer Advocate said the number of unenrolled preparers—those not enrolled with IRS—ranged from 300,000 to 600,000. On the basis of scanning major preparation company Web sites, we know the major preparation companies have thousands of offices nationwide. Despite the importance of paid tax return preparers in helping taxpayers fulfill their obligations, little data exist on the quality of services they provide.

In most states, anyone can be a paid preparer regardless of education, training, or licensure. However, there are different types of preparers. Paid preparers who hold professional certification include CPAs and attorneys. CPAs and attorneys are licensed through state agencies, although licensure is not focused on their role as tax preparers. CPAs, attorneys, and enrolled agents are referred to collectively as practitioners. Other preparers are called unenrolled preparers. This population of preparers is very diverse, ranging from many of the individuals employed by commercial tax preparation companies to those who are self-employed. Some have extensive training and experience and others do not.

In 2003, we reported to this Committee that while many taxpayers who used paid preparers believed they benefited from doing so, some were poorly served. We said that the available evidence did not allow a precise estimate of the percentage of taxpayers affected, but none of it suggested that the percentage was large. We reported that preparer mistakes can cause taxpayers to over- or underpay their taxes, and that taxpayers may pay for certain services, such as short-term loans called Refund Anticipation Loans (RAL), without understanding their costs and benefits.¹ In an April 2003 hearing of this Committee, we testified that taxpayers can

¹GAO, *Tax Administration: Most Taxpayers Believe They Benefit from Paid Tax Preparers, but Oversight for IRS Is a Challenge*, [GAO-04-70](#) (Washington, D.C.: Oct. 31, 2003).

take common sense steps when choosing or working with a paid preparer, such as:

- when searching for a preparer, obtain recommendations from people you trust;
- check out your preparer's qualifications;
- make sure you understand the services you will be getting, how much they cost, and how they will benefit you;
- make sure your preparer understands your personal circumstances and reviews your official tax documents; and
- review your completed return before you sign it.²

Although taxpayers should take these common sense steps, IRS also notes on its Web site under "Tips for Choosing a Tax Preparer" that no matter who prepares a tax return, the taxpayer is legally responsible for all of the information on that tax return.

My statement today is based on recent work we have done at the request of the Committee. Our objectives were to determine (1) what the characteristics were of tax returns done by paid preparers, (2) what government regulation exists for paid tax return preparers, and (3) what specific issues taxpayers might encounter in using paid preparers.

In preparing this statement, we did the following work:

- We analyzed IRS's Statistics of Income (SOI) individual taxpayer database for tax year 2002, the most recent reliable data available, to determine the

²GAO, *Paid Tax Preparers: Most Taxpayers Believe They Benefit, but Some Are Poorly Served*, [GAO-03-610T](#) (Washington, D.C.: Apr. 1, 2003).

income levels of users of paid preparers and characteristics of the tax returns that these users filed.³

- We reviewed laws, regulations, and other guidance and interviewed IRS officials to determine regulatory requirements that apply to different types of paid preparers.
- We had tax returns prepared for us at 19 outlets of several commercial chain preparers scattered throughout a major metropolitan area. We chose a large metropolitan area in which several chain preparers were represented so that we could do our investigation in different sections of the area. Our staff posed as taxpayers and asked the paid preparers to prepare, but allow us to file, our federal tax returns under two scenarios. In one scenario, a plumber and his wife, with one of their children in college, derived almost all of their income from his job, some work on the side, and a mutual fund. They had enough deductions of various kinds to make it advantageous for them to itemize tax deductions using Schedule A. We had 9 returns prepared for this scenario. In the second scenario, a low-income single mother was a retail sales worker who had side income from babysitting. She had one child who lived with her and one who did not. We had 10 returns prepared for this scenario. In general, we used each scenario twice when visiting individual chain preparers but at different outlets. Our 19 site visits cannot be used to generalize our findings to the retail tax preparation community. We did not visit any law firms, CPA firms, or single-office tax return preparation businesses.

To arrive at correct returns for the two scenarios, our staff and staff from the Senate Committee on Finance and the Joint Committee on Taxation (JCT) completed the tax returns and agreed on (1) what should and should

³As part of this and other work we have done, we tested this SOI database by comparing record counts and selected totals in the files provided to us by IRS to published amounts, finding that the required data elements were sufficiently reliable for the purposes of our work. We used the 2002 database rather than the 2003 database that was the most recent available because IRS officials told us that some 2003 preparer information had been miscoded and would not be fixed until after we needed the information. Because the SOI individual file and the National Research Program files to be discussed later are created following a probability procedure based on random selections, each sample is only one of a large number of samples that might have been drawn. Since each sample could have provided different estimates, we express our confidence in the precision of our particular sample's results as a 95 percent confidence interval (e.g., plus or minus 5 percentage points). This is the interval that would contain the actual population value for 95 percent of the samples that could have been drawn. As a result, we are 95 percent confident that each of the confidence intervals in this statement will include the true values in the study population.

not be reported on the returns and (2) the correct refund amount for each scenario. For each of the 19 visits, we then compared the tax returns produced with the consensus mock returns. In doing its mock returns, JCT noted that it relied on the facts we provided and discussions in which we participated. JCT cautioned that a paid preparer might reach a reasonable conclusion different from JCT's on certain issues or on the basis of actual questions asked or answers given during a site visit. To minimize any potential for preparers to have legitimately different results from our returns, we trained our staff to answer preparers' questions consistently with the facts we used in preparing our mock returns. Although we are defining the mock returns as correct, we recognize that the final determination of the accuracy of a return is subject to IRS and court interpretation.

- We analyzed IRS's National Research Program (NRP) database to compare the compliance found on returns that used paid preparers and returns that did not.⁴

We did our work in February and March 2006 in accordance with generally accepted government auditing standards and the quality standards for investigations as set forth by the President's Council on Integrity and Efficiency.

My statement today will make the following points:

- Many taxpayers choose to pay others to prepare their tax returns rather than prepare their own returns. About 56 percent of about 130 million individual tax returns filed for tax year 2002 used a paid preparer, with higher paid preparer usage among taxpayers with more complicated returns, that is, those using the Form 1040 as opposed to the Form 1040EZ, those claiming itemized deductions and not the standard deduction, and those claiming the earned income credit (EIC).
- All paid preparers are subject to some IRS regulations and may be penalized if they fail to follow them. For example, all paid preparers must identify themselves on the returns they prepare and must not deliberately

⁴NRP is a detailed IRS study of taxpayer compliance for tax year 2001. As part of other work we have done or are doing, we tested the NRP database by interviewing knowledgeable agency officials, finding that the required data elements were sufficiently reliable for the purposes of our work. See the earlier footnote on the SOI file for a discussion of NRP confidence intervals.

understate a taxpayer's tax liability. When the EIC is involved, paid preparers must also ask specific questions to determine a taxpayer's eligibility for the credit. Lawyers, certified public accountants, and certain tax professionals are also subject to additional requirements.

- In our site visits, paid preparers often prepared returns that were incorrect, with tax consequences that were sometimes significant. Their work resulted in unwarranted extra refunds of up to almost \$2,000 in 5 instances, while in 2 cases they cost the taxpayer over \$1,500. Some of the most serious problems involved preparers
 - not reporting side income in 10 of 19 cases;
 - not asking about where a child lived or ignoring our answer to the question and claiming an ineligible child for the EIC in 5 out of the 10 applicable cases;
 - failing to take the most advantageous postsecondary education tax benefit in 3 out of the 9 applicable cases; and
 - failing to itemize deductions at all or failing to claim all available deductions in 7 out of the 9 applicable cases.

We discussed these issues with IRS. Had these problems been discovered by IRS on real returns, IRS officials said that many of the preparers would have been subject to penalties for such things as negligence and willful or reckless disregard of tax rules. We have referred matters we encountered to IRS so that any appropriate follow-up actions can be taken.

More than Half of Taxpayers Used a Paid Preparer, but Use Varied by Tax Return Complexity and Often Involved Larger Refunds

As shown in table 1, according to SOI data, somewhat over half of the approximately 130 million individual tax returns filed for tax year 2002 were done by a paid preparer. This filing breakdown was true for all income levels we analyzed, although the income level exceeding \$100,000 had the highest percentage—64 percent.⁵ As not all paid preparers provide preparer information on returns they prepare, the percentages of returns that actually were prepared by another person for pay is probably somewhat higher.

⁵All percentage estimates from the SOI files have margins of error of plus or minus 5 percentage points or less, unless otherwise noted. All numerical estimates other than percentages have margins of error of plus or minus 5 percent or less of the value of those numerical estimates, unless otherwise noted.

Table 1: Estimated Percentage of Individual Taxpayers' Returns Prepared by a Paid Preparer for Tax Year 2002, by Adjusted Gross Income Level

Adjusted gross income level	Estimate (percent)
\$0–20,000	53
20,001–40,000	56
40,001–60,000	57
60,001–80,000	58
80,001–100,000	55
Over 100,000	64
All adjusted gross income levels	56

Source: GAO analysis of IRS SOI data.

As table 2 shows, this consistency of use did not hold for other groupings of individual tax returns prepared by paid preparers. Use of paid preparers differed among different types of returns, taxpayers of different filing statuses, filers taking different types of deductions, and claimants and nonclaimants of the earned income tax credit. According to the breakdown in table 2, one-third of taxpayers filing the simplest individual tax form—the Form 1040EZ—used a paid preparer for tax year 2002, and two-thirds of a low-income working group—those claiming the EIC—paid someone to prepare their tax returns.

Table 2: Estimated Percentage of Individual Taxpayers Using a Paid Preparer for Tax Year 2002, by Various Groupings

Grouping and subgrouping	Estimate (percent)
Type of return	
Form 1040EZ	33
Form 1040A	50
Form 1040	64
Filing status	
Single	48
Married filing jointly	61
Head of household	65
Type of deductions	
Itemized	62
Standard	52
Earned income credit	
Claimed	67
Not claimed	54

Source: GAO analysis of IRS SOI data.

Table 3 shows that whether taxpayers prepared their own returns or paid a preparer, their tax returns showed a median of hundreds of dollars in tax refunds for tax year 2002.⁶ However, overall and at the four lowest income categories, those using paid preparers had a higher median at statistically significant levels.

Table 3: Estimated Median Tax Year 2002 Refunds on Returns Filed by Individual Taxpayers Using Paid Preparers and Those Preparing Their Own Returns

Income level	Using a paid preparer	Preparing own return
\$0–20,000	\$751	\$365
20,001–40,000	1,324	846
40,001–60,000	1,436	1,224
60,001–80,000	1,611	1,359
All adjusted gross income groups	1,118	674

Source: GAO analysis of IRS SOI data.

⁶The median is the middle value in a distribution, with an equal number of values above it and below it.

At the \$0–20,000 income level, a major part of the reason why refunds are so different for those who used paid preparers versus those who prepared their own returns appears to be the EIC. As table 4 shows, those who claimed the EIC and used a paid preparer had tax returns showing a median more than \$900 higher in refunds than those who claimed the EIC and prepared their own returns.

Table 4: Estimated Median Tax Year 2002 Refunds on Returns Filed by Low-income Individual Taxpayers Using Paid Preparers and Those Preparing Their Own Returns, by Whether They Claimed the EIC

Taxpayer category	Using a paid preparer	Preparing own return
All taxpayers	\$751	\$365
Taxpayers claiming the EIC	2,675	1,754 ^a
Taxpayers not claiming the EIC	367	273

Source: GAO analysis of IRS SOI data.

^aThe 95 percent confidence interval surrounding this estimate ranges from \$1,596 to \$1,944.

Regulation of Tax Preparers Varies by Type of Preparer

Different types of paid preparers are governed by different regulations. All are subject to Internal Revenue Code (IRC) penalties, and all paid preparers who choose to file electronically are subject to IRS Electronic Return Originator (ERO) rules. However, only paid preparers who choose to represent taxpayers before IRS are governed by IRS Circular No. 230 regulations.⁷ In addition, California and Oregon have their own regulations that apply to all paid preparers. Table 5 summarizes how different types of paid preparers are covered by different regulations.

⁷Department of the Treasury, Circular No. 230, *Regulations Governing the Practice of Attorneys, Certified Public Accountants, Enrolled Agents, Enrolled Actuaries, and Appraisers before the Internal Revenue Service* (Washington, D.C.: June 20, 2005).

Table 5: Summary of Paid Preparer Regulation

Regulation	Preparers covered		Description of regulation
	Practitioners	Unenrolled preparers	
IRC penalties	X	X	Address such areas as fraud, negligence, due diligence, and unauthorized disclosure
ERO rules	X	X	Apply to all entities in IRS's e-file program and their principals and responsible officials and include application requirements and rules for participating in electronic filing
Circular 230	X		Applies to CPAs, attorneys, and enrolled agents and governs duties and restrictions, sanctions, and disciplinary proceedings
State regulations	X		Contain licensing and usually continuing education requirements for CPAs and attorneys with only California and Oregon having these requirements for unenrolled tax preparers

Source: GAO.

Some Regulations Apply to All Paid Preparers

All paid preparers are subject to IRC penalties and the regulations that implement them. According to the Internal Revenue Manual, penalties are IRS's key tools against noncompliant preparers. Table 6 lists civil penalties that apply specifically to preparers and some of the criminal penalties (sections 7206, 7207, and 7216) that apply to paid preparers.

Table 6: Internal Revenue Code Penalties

Code section	Description	Penalty
6694(a)	Understatement of taxpayer's liability due to an unrealistic position	\$250 per return
6694(b)	Understatement of taxpayer's liability due to willful or reckless conduct	\$1,000 per return
6695(a)	Failure to provide copy of return to taxpayer	\$50 per failure
6695(b)	Failure to sign return	\$50 per failure
6695(c)	Failure to furnish identifying number	\$50 per failure
6695(d)	Failure to retain a copy or list of returns filed	\$50 per failure
6695(e)	Failure of employers to file correct information on each tax preparer employed	\$50 per failure

Code section	Description	Penalty
6695(f)	Negotiation of taxpayer's refund check	\$500 per check
6695(g)	Failure to be diligent in determining earned income tax credit eligibility	\$100 per failure
6701	Aiding and abetting understatement of tax liability	\$1,000
6713	Improper disclosure or use of return information	\$250 per disclosure, up to a maximum of \$10,000
7206	Willful preparation of a false or fraudulent return or other document	Up to \$100,000, 3 years imprisonment, or both
7207	Knowingly providing fraudulent returns or other documents to IRS	Up to \$10,000, 1 year imprisonment, or both
7216	Knowingly or recklessly disclosing or using return information	Up to \$1,000, 1 year imprisonment, or both
7407	Authority to enjoin income tax preparers	

Source: Internal Revenue Code.

Some civil penalties for preparers who engage in improper conduct are found in IRC sections 6694 and 6701. These include a \$1,000 per return penalty if the understatement of the taxpayer's liability was due to the preparer's willful attempt to understate liability or reckless or intentional disregard for the rules. They also include a \$1,000 penalty on preparers who help taxpayers understate their liability. In addition, they include a \$250 per return penalty if the preparer knew or reasonably should have known that the understatement of a taxpayer's liability was due to a position that had no realistic possibility of being sustained.

IRC section 6695 contains many identification penalties that apply to preparers. For instance, a preparer must sign the return after it is completed but before the taxpayer signs it and provide the taxpayer a copy of the return. The preparer must also put his or her social security number or other number issued by IRS on the return. The penalty for failing to meet these requirements is \$50 per failure but cannot annually exceed \$25,000 per person for each type of failure. Most penalties in this section are not to be assessed if the preparer shows that the violation was due to reasonable cause or not due to willful neglect. All penalties in this section can be assessed in conjunction with other penalties.

IRC section 6695 includes requirements specific to the EIC. It requires paid preparers to take certain actions in determining the taxpayer's eligibility for the EIC and the amount of EIC claimed. For instance, preparers are

required to complete an eligibility checklist to determine if a child is a “qualifying child” by meeting residency, age, and relationship requirements. Of particular importance in our investigation, a qualifying child must have lived with the taxpayer for over half of the year.

Preparers are also subject to criminal sanctions arising from improper conduct. Civil and criminal penalties can be imposed for the same violation. Preparers who help taxpayers prepare false or fraudulent returns may be liable and could receive a prison term and a fine of up to \$100,000.

Other penalties, both civil and criminal, protect taxpayers from paid preparers improperly disclosing the information they provide for their tax return. Section 6713 imposes a civil penalty on preparers who improperly use or disclose taxpayer information. Section 7216 imposes a criminal penalty on preparers who knowingly or recklessly disclose or use return information.

IRS’s Small Business/Self Employed Division has responsibility for assessing and collecting monetary penalties against any paid preparers who do not comply with civil tax laws when filing returns. Under section 7407, IRS may also bring a civil action in District Court to seek an injunction prohibiting preparers from preparing taxes. IRS’s Criminal Investigation Division investigates paid preparers suspected of violating criminal tax laws. In fiscal year 2005, Criminal Investigation conducted 248 investigations under its Return Preparer Program, with 140 of these resulting in recommended prosecutions.

Additional Regulations Apply Only to Some Paid Preparers

Some IRS rules and regulations apply only to paid preparers in certain circumstances. For example, ERO rules apply to preparers who are EROs—entities that IRS has approved to file electronic returns. EROs may or may not be preparers. ERO rules also apply to ERO principals and responsible officials. Circular 230 regulations apply to enrolled agents, attorneys, and CPAs.

IRS has broad authority to monitor and sanction any paid preparer who is authorized to file tax returns electronically. To participate in the IRS e-file program, applicants must pass an IRS suitability check that may include a background check, a credit history check, a tax compliance check, and a check for prior e-file noncompliance. An IRS official told us that although some EROs do not provide preparation services, most do.

IRS monitors EROs to ensure compliance with revenue procedures and publications that govern IRS's e-file program. For instance, according to an IRS official, IRS continues to see if program participants are suitable to participate. It also suggests that EROs verify the identity and taxpayer identification number of taxpayers to protect the e-file program from fraud and abuse. Violation of provisions in either a revenue procedure or an IRS publication could lead to sanctions. IRS sanctions range from a letter of reprimand for a relatively minor infraction to expulsion from the e-file program for more severe infractions. According to IRS, in 2005 it conducted 1,104 monitoring visits for the e-file program resulting in 322 sanctions or proposed sanctions.

Circular 230 imposes standards on enrolled agents, attorneys, and CPAs. According to the Circular, in general, only practitioners may represent taxpayers before IRS; however, unenrolled preparers may represent taxpayers in certain situations.⁸ An attorney or CPA may represent taxpayers before IRS by filing a written declaration with IRS that he or she is licensed as either an attorney or a CPA. Under Circular 230, tax preparers who are not attorneys or CPAs but who wish to have the unrestricted privilege of representing taxpayers must be approved as enrolled agents with IRS. Enrolled agent applicants must either pass an examination on tax matters or have past IRS employment experience. They are also required to meet continuing education requirements.

Circular 230 describes the standards of conduct that practitioners must follow to maintain the right to represent taxpayers before IRS. There are generally three categories of misconduct covered under Circular 230: (1) misconduct while representing a taxpayer, (2) misconduct while preparing a taxpayer's return, and (3) misconduct not directly involving IRS representation. In terms of the second category—tax preparation—one standard is the realistic possibility standard. This standard restricts practitioners from signing tax returns if the position does not have a realistic possibility of being sustained by IRS. In addition, practitioners are required to advise taxpayers of any noncompliance issue or omission from tax returns submitted to IRS, advise taxpayers of the consequences of this noncompliance or omission, and exercise due diligence to ensure

⁸Unenrolled preparers may only represent those taxpayers before IRS whose returns they prepared and only during examination of the return. When unenrolled preparers represent taxpayers before IRS, they are governed by IRS Revenue Procedure 81-38, which contains standards of conduct similar to those in Circular 230, including the need for due diligence in preparing tax returns.

accuracy in preparing tax returns. Practitioners are also prohibited from charging contingent fees, that is, fees based on whether the return will avoid challenge from IRS, for some services including preparation of an original tax return. Finally, practitioners are prohibited from making fraudulent, coercive, or deceptive advertising statements.

IRS's Office of Professional Responsibility (OPR) administers the rules set forth in Circular 230. OPR may censure, suspend, or disbar any practitioner from practice before IRS if the practitioner violates any Circular 230 regulation, is shown to be incompetent or disreputable, or misleads or threatens a client with intent to defraud. OPR receives complaints from taxpayers and IRS employees regarding tax preparers. The American Jobs Creation Act of 2004⁹ added the authority to impose a monetary penalty on a practitioner who violates Circular 230, and an employer or firm if it knew, or should have known, of the misconduct. The act also added violations of Circular 230 to the list of misconduct that can lead to an injunction. In fiscal year 2005, OPR investigated 719 practitioners, resulting in 320 sanctions.

In the section on diligence as to accuracy in Circular 230, a practitioner will have been "presumed to have exercised due diligence for purposes of this section if the practitioner relies on the work product of another person and the practitioner used reasonable care in engaging, supervising, training, and evaluating the person, taking proper account of the nature of the relationship between the practitioner and the person."¹⁰ According to an IRS official, "another person" includes an unenrolled preparer, and enrolled agents are responsible for ensuring that unenrolled preparers working for them do high quality work. According to the official, if there were a problem with an unenrolled preparer's work, IRS could take action against the employing enrolled agent.¹¹

State Regulation of Paid Preparers Focuses on Licensed Practitioners

Although all states have licensing requirements for CPAs and attorneys, only two states have licensing requirements for unenrolled preparers. California and Oregon both require unenrolled paid preparers to register

⁹Pub. Law No. 108-357, Oct. 22, 2004.

¹⁰Circular No. 230.

¹¹In our 19 site visits that will be described later, we do not know if any of the paid preparers we saw were enrolled agents or working for enrolled agents.

with state agencies and meet continuing education requirements. California requires that paid preparers pass a 60-hour approved course and obtain a tax preparer bond to become registered. California also requires 20 hours of continuing education annually. In Oregon, tax preparers must be at least 18 years old, have a high school degree or equivalent, complete 80 hours of income tax law education, and pass a tax preparer examination. Oregon also requires 30 hours of continuing education annually. While Oregon requires enrolled agents to register, enrolled agents must meet far fewer registration requirements than unenrolled preparers must.

In addition to state licensing requirements, tax practitioners often belong to professional organizations such as the American Institute of Certified Public Accountants, the American Bar Association, or the National Association of Enrolled Agents. These organizations impose general standards of conduct on the actions of their members, including those who prepare tax returns.

Taxpayers Using Paid Preparers May Receive Incorrectly Completed Tax Returns

Taxpayers relying on paid preparers to provide them with accurate, complete, and fully compliant tax returns may not get what they pay for. Tax returns prepared for us in the course of our investigation often varied widely from what we determined the returns should and should not include, sometimes with significant consequences. Many of the problems we identified put preparers, taxpayers, or both at risk of IRS enforcement actions. The National Research Program's review of 2001 tax returns also found many errors on returns prepared by paid preparers, and some of those errors were more frequent on paid prepared returns than on self-prepared returns.

All of the Tax Return Preparer Visits We Conducted Produced Errors, Some with Substantial Consequences

All 19 of our visits to tax return preparers affiliated with chains showed problems. Nearly all of the returns prepared for us were incorrect to some degree, and several of the preparers gave us very bad tax advice, particularly when it came to reporting non-W-2 business income. Only 2 of 19 tax returns showed the correct 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 reported refunds ranged from refunds overclaimed by nearly \$2,000 to underclaims of over \$1,700.

Figures 1 and 2 below show how the tax return preparers we visited completed key lines on the 1040 form, and explanations of some of these

lines follow the figures. Also, appendix I has descriptions of selected visits we made to paid preparers, describing two example visits with fewer issues and two with serious compliance problems.

Form **1040** Department of the Treasury—Internal Revenue Service
U.S. Individual Income Tax Return 2005 (99) IRS Use Only—Do not write or staple in this space.

Label
 (See instructions on page 16.)
 Use the IRS label. Otherwise, please print or type.

Presidential Election Campaign Check here if you, or your spouse if filing jointly, want \$3 to go to this fund (see page 16) ☐ You ☐ Spouse

Filing Status
 Check only one box.
 1 ☐ Single
 2 ☐ Married filing jointly (even if only one had income)
 3 ☐ Married filing separately. Enter spouse's SSN above and full name here. ☐ Qualifying widow(er) with dependent child (see page 17)
 4 ☐ Head of household (with qualifying person). (See page 1.) If the qualifying person is a child but not your dependent, enter this child's name here. ☐ Qualifying widow(er) with dependent child (see page 17)

Exemptions
 6a ☐ Yourself. If someone can claim you as a dependent, do not check box 6a
 b ☐ Spouse
 c **Dependents:**
 (1) First name Last name (2) Dependent's social security number (3) Dependent's relationship to you (4) If qualifying child for child tax credit (see page 19)
 If more than four dependents, see page 19.
 d Total number of exemptions claimed

Income
 Attach Form(s) W-2 here. Also attach Forms W-2g and 1099-R if tax was withheld.
 If you did not get a W-2, see page 22.
 Enclose, but do not attach, any payment. Also, please use Form 1040-V.

Adjusted Gross Income

7 Wages, salaries, tips, etc. Attach Form(s) W-2
 8a Taxable interest. Attach Schedule B if required
 b Tax-exempt interest. Do not include on line 8a
 9a Ordinary dividends. Attach Schedule B if required
 b Qualified dividends (see page 23)
 10 Taxable refunds, credits, or offsets of state and local income taxes (see page 23)
 11 Alimony received
 12 Business income or (loss). Attach Schedule C or C-EZ
 13 Capital gain or (loss). Attach Schedule D if required. If not required, check here ☐
 14 Other gains or (losses). Attach Form 4797
 15a IRA distributions 15b Taxable amount (see page 25)
 16a Pensions and annuities 16b Taxable amount (see page 25)
 17 Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E
 18 Farm income or (loss). Attach Schedule F
 19 Unemployment compensation
 20a Social security benefits 20b Taxable amount (see page 27)
 21 Other income. List type and amount (see page 29)
 22 Add the amounts in the far right column for lines 7 through 21. This is your total income

23 Educator expenses (see page 29)
 24 Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ
 25 Health savings account deduction. Attach Form 8889
 26 Moving expenses. Attach Form 3903
 27 One-half of self-employment tax. Attach Schedule SE
 28 Self-employed SEP, SIMPLE, and qualified plans
 29 Self-employed health insurance deduction (see page 30)
 30 Penalty on early withdrawal of savings
 31a Alimony paid b Recipient's SSN
 32 IRA deduction (see page 31)
 33 Student loan interest deduction (see page 33)
 34 Tuition and fees deduction (see page 34)
 35 Domestic production activities deduction. Attach Form 8903
 36 Add lines 23 through 31a and 32 through 35
 37 Subtract line 36 from line 22. This is your adjusted gross income

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see page 78. Form 1040 (2005)

Line 6d: 12 of 19 returns reported correct number of exemptions; 7 returns reported too many exemptions.

Line 7: All returns included correct amount of W-2 income.

Line 10: 11 of 19 returns included state tax refunds correctly; 8 returns reported state tax refunds incorrectly.

Line 12: 9 of 19 returns included non-W-2 business income; 10 returns did not.

Page 16

Figure 2: Summary of How Paid Preparers Completed Selected Lines on the IRS Form 1040 (page 2)

Form 1040 (2005) Page 2

Tax and Credits

38 Amount from line 37 (adjusted gross income) 38

39a Check ☐ You were born before January 2, 1941, ☐ Blind, ☐ Total boxes checked 39a

☐ Spouse was born before January 2, 1941, ☐ Blind, ☐ checked 39a

b If your spouse itemizes on a separate return or you were a dual-status alien, see page 35 and check here 39b

40 Itemized deductions (from Schedule A) or your standard deduction (see left margin) 40

41 Subtract line 40 from line 38 41

42 If line 38 is over \$109,475, or you provided housing to a person displaced by Hurricane Katrina, see page 37. Otherwise, multiply \$3,200 by the total number of exemptions claimed on line 6d

43 Taxable income. Subtract line 42 from line 41. If line 42 is more than line 41, enter -0- 42

44 Tax (see page 37). Check if any tax is from: a ☐ Form(s) 8814 b ☐ Form 4972 43

45 Alternative minimum tax (see page 39). Attach Form 6251 44

46 Add lines 44 and 45 45

47 Foreign tax credit. Attach Form 1116 if required 46

48 Credit for child and dependent care expenses. Attach Form 2441 47

49 Credit for the elderly or the disabled. Attach Schedule R 48

50 Education credits. Attach Form 8863 49

51 Retirement savings contributions credit. Attach Form 8880 50

52 Child tax credit (see page 41). Attach Form 8901 if required 51

53 Adoption credit. Attach Form 8839 52

54 Credits from: a ☐ Form 8396 b ☐ Form 8859 53

55 Other credits. Check applicable box(es): a ☐ Form 3800 b ☐ Form 8801 c ☐ Form 8802 54

56 Add lines 47 through 55. These are your total credits 55

57 Subtract line 56 from line 46. If line 56 is more than line 46, enter -0- 56

Other Taxes

58 Self-employment tax. Attach Schedule SE 57

59 Social security and Medicare tax on tip income not reported to employer. Attach Form 4137 58

60 Additional tax on IRAs, other qualified retirement plans, etc. Attach Form 5329 if required 59

61 Advance earned income credit payments from Form(s) W-2 60

62 Household employment taxes. Attach Schedule H 61

63 Add lines 57 through 62. This is your total tax 62

Payments

64 Federal income tax withheld from Forms W-2 and 1099 64

65 2005 estimated tax payments and amount applied from 2004 return 65

66a Earned income credit (EIC) 66a

b Nonrefundable combat pay election 66b

67 Excess social security and tier 1 RRTA tax withheld (see page 59) 67

68 Additional child tax credit. Attach Form 8812 68

69 Amount paid with request for extension to file (see page 59) 69

70 Payments from: a ☐ Form 2439 b ☐ Form 4136 c ☐ Form 8885 70

71 Add lines 64, 65, 66a, and 67 through 70. These are your total payments 71

Refund

72 If line 71 is more than line 63, subtract line 63 from line 71. This is the amount you overpaid 72

73a Amount of line 72 you want refunded to you 73a

b Routing number 73b

c Type: ☐ Checking ☐ Savings 73c

d Account number 73d

74 Amount of line 72 you want applied to your 2006 estimated tax 74

Amount You Owe

75 Amount you owe. Subtract line 71 from line 63. For details on how to pay, see page 60 75

76 Estimated tax penalty (see page 60) 76

Third Party Designee

Do you want to allow another person to discuss this return with the IRS (see page 61)? ☐ Yes. Complete the following. ☐ No

Designee's name Phone no. () Personal identification number (PIN)

Sign Here

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Your signature Date Your occupation Daytime phone number ()

Spouse's signature. If a joint return, both must sign. Date Spouse's occupation

Paid Preparer's Use Only

Preparer's signature Date Check box: ☐ self-employed Preparer's SSN or PTIN

Firm's name (or yours if self-employed), address, and ZIP code EIN () Phone no. ()

Form 1040 (2005)

Printed on recycled paper

Line 40: 7 of 9 returns included itemized deductions; 2 of 9 returns that should have included itemized deductions had standard deduction instead.

Line 47: 1 of 9 returns correctly included foreign tax credit; 8 returns did not.

Line 50: 6 of 9 returns included Hope credit, but 3 of these improperly included cost of books in expenses. 3 of 9 claimed either the Lifetime Learning credit or the tuition and fees deduction, which were far less advantageous for the taxpayer.

Line 66a: 5 of 10 EIC claims correctly claimed 1 child; 5 EIC claims were for 2 children.

Line 73a: 2 of 19 refund amounts were correctly stated. 5 refunds were understated and 12 were overstated.

14 of 19 returns were properly signed by the preparer. 1 return did not include any preparer information. 4 others were missing either a preparer name or an identifying number.

Source: GAO.

Identifying information. Taxpayer names and social security numbers were correctly entered on all but one of our returns, with one preparer

entering a wrong middle initial. Some preparers asked for this information orally, and some asked us to complete information worksheets.

Filing status. All of our prepared tax returns showed the correct filing status for the two different scenarios we used. The plumber's return always correctly indicated married filing jointly, and the sales worker's return always indicated her filing status as head of household.

Exemptions. Exemption information entered on the returns prepared for us included some mistakes. All 9 of the plumber's returns listed the correct number of exemptions. However, the plumber's daughter was listed with a different last name on 1 return. Also, both of the plumber's children were listed with first and middle names on another return, despite the 1040 form clearly calling for dependents' first and last names.

Of the 10 sales worker returns prepared for us, 7 incorrectly indicated both children lived with the taxpayer in 2005. When asked where her children lived, our staff always said that one lived with her and the other with the child's grandmother throughout 2005. However, this question was not always asked. In general, incorrectly reporting the number of dependent children may have implications for other lines on a tax return, specifically the dollar amount of personal exemptions on line 42, the child tax credit reported on line 52, and the additional child tax credit on Form 8812 and line 68.

Wages and investment income. Most income documented by third-party reporting forms (Forms W-2 or 1099) was included on our returns correctly, but not in every case. Wages shown on forms W-2 were correctly listed on line 7 (see fig. 1) of all 19 of the tax returns prepared for us in our investigation. Similarly, tax-exempt interest (line 8a) and qualified dividends (line 9b) were listed on a Form 1099 from a mutual fund and were entered correctly on all 9 of the plumber's returns. However, the same Form 1099 included ordinary dividends, but 1 preparer entered the wrong amount on line 9a. Also, the mutual fund Form 1099 listed capital gains, but 2 returns did not include capital gains income on line 13.

State tax refunds. State tax refunds were also shown on Forms 1099 given to the paid preparers we visited, but 8 out of 19 preparers handled

them incorrectly.¹² In the plumber scenario, the state tax refund should have been reported as income (line 10) on this year's return, but this was not done on 5 of the 9 returns prepared for him. The sales worker did not itemize deductions for 2004, so her state tax refund was not supposed to be reported as income this time. However, 2 of 10 preparers included her state tax refund on line 10, and a third preparer listed the state tax refund amount from the state Form 1099 as unemployment compensation on line 19.

Business income. Reporting "side income"—income from casual self-employment arrangements—was very problematic in many of our visits to paid preparers. Both of our taxpayer scenarios included self-employment income, and we told the preparer that we had such income whenever we were asked. Also, if the preparer did not ask about non-W-2 business income, we still told the preparer that we had such income before the end of the visit. Despite being told of the side income in every case, 2 out of 9 plumber return preparers and 8 out of 10 sales worker return preparers did not report the income as required.¹³

Even in cases where the side income was reported, several paid preparers gave us incorrect information. Several advised us that reporting such income was our decision because IRS would not know of it unless we reported it. One preparer told our investigator posing as a sales worker that she did not have to report the income unless it was over \$3,200. Another said that her income could not be reported because she did not have the names and the social security numbers of the children she watched. On the other hand, the discussion of side income with the paid preparers (when a discussion took place) often, to the sales worker's potential benefit, included detailed probing by the preparer to identify expenses to offset the income we described.

¹²According to IRS publication 525, a state tax refund generally must be reported as income if the taxpayer deducted the tax in an earlier year. The plumber scenario included that he itemized deductions, including state income taxes paid, in the prior year and the sales worker scenario included that she did not itemize deductions the prior year. There are some qualifications to the reporting requirement in the IRS publication, but questions asked by paid preparers (if any) either did not address them or led to answers that would cause the refund to be included as income.

¹³Our taxpayers' returns should have included either a Schedule C-EZ, Net Profit from Business, or a Schedule C, Profit or Loss from Business. In both scenarios, the income also required a Schedule SE for self-employment taxes.

The amount of business income we built into our scenarios, and that preparers often did not include on the tax returns that they prepared, was not unusual for wage-earning taxpayers who underreported business income for tax year 2001. According to data taken from IRS's recent NRP efforts, for tax year 2001, about 37 percent of taxpayers with wages and business income who underreported their business income did so by amounts of up to \$1,500, and about 65 percent underreported their business income by up to \$5,000.¹⁴

Deductions. Only 2 of 9 of the plumber's returns reported the correct amount of itemized deductions (line 40). Returns done by 2 preparers claimed the standard deduction, even though it was about \$4,000 less than the total amount of itemized deductions we included in the scenario. Five other preparers itemized deductions for the plumber, but made other mistakes. These errors changed the amount of the plumber's refund, although sometimes by fairly small amounts. One preparer, however, missed deductions for property taxes worth about \$4,000, meaning that the claimed refund was hundreds of dollars lower than it should have been. On the other hand, all 10 of the sales worker returns claimed the standard deduction, which was to the taxpayer's advantage in these cases because she had very few deductions to itemize. In 2002, we reported that as many as 2 million taxpayers failed to minimize their taxes by failing to itemize their deductions and that about half of these taxpayers had returns prepared by another person.¹⁵

Foreign tax credit. The plumber's Form 1099 from his mutual fund showed a small amount of foreign taxes paid, but only 1 of the 9 preparers we visited claimed the foreign tax credit (line 47) for which the taxpayer was eligible.

Child-care expenses. The sales worker had child-care expenses, but none of the 10 preparers we visited included the credit for child- and dependent-care expenses (line 48) for which she was eligible. Some preparers told her that she could not claim the credit because she did not

¹⁴Taxpayers with wage income who underreported their business income by amounts ranging from \$1,500 to \$5,000 accounted for only a relatively small amount—about \$5.8 billion—of the approximately \$53.6 billion underreported as business income by all wage earners with business income.

¹⁵GAO, *Tax Deductions: Further Estimates of Taxpayers Who May Have Overpaid Federal Taxes by Not Itemizing*, [GAO-02-509](#) (Washington, D.C.: Mar. 29, 2002).

have the social security number of her child-care provider. This information was incorrect. The instructions for Form 2441 state that a taxpayer who attempts to collect the social security number of his or her child-care provider but is unsuccessful can report that fact on Form 2441 and still claim the credit.¹⁶

Education credits. In the plumber scenario, one of the taxpayer's children was a college student in the second year of postsecondary education, but 6 of 9 paid preparers made some sort of error in determining the line 50 education credit—either improperly including items in expenses, not claiming the credit most advantageous to the taxpayer, or both. The expenses and the year in school made the Hope education credit far more advantageous to the taxpayer than either the tuition and fees deduction (line 23) or the Lifetime Learning credit. Of the 9 plumber's returns, 6 included the Hope credit, but 3 of the 6 preparers involved improperly included books among the expenses, increasing the credit by about \$100 above what it should have been. One preparer included the tuition and fees deduction instead of the Hope credit and 2 others claimed the Lifetime Learning credit, reducing the taxpayer's refund by hundreds of dollars. In 2005, we reported that many tax returns, including many prepared by paid preparers, made such suboptimal choices among the three postsecondary education tax preferences.¹⁷

Earned income credit. The EIC on line 66a was another area where paid preparers made very significant mistakes. Of the 10 returns prepared for the sales worker, 5 reported two children on Schedule EIC, Earned Income Credit, instead of the one child who lived with the taxpayer in 2005 and was eligible for the EIC. IRS has estimated that incorrectly claimed children are the largest category of errors for the EIC, accounting for about \$3 billion of the estimated \$8.5 billion to \$9.9 billion in EIC overclaims in tax year 1999. IRS regulations require that paid preparers ask a series of questions to determine eligibility for the EIC, including whether children lived with the taxpayer in the United States for more

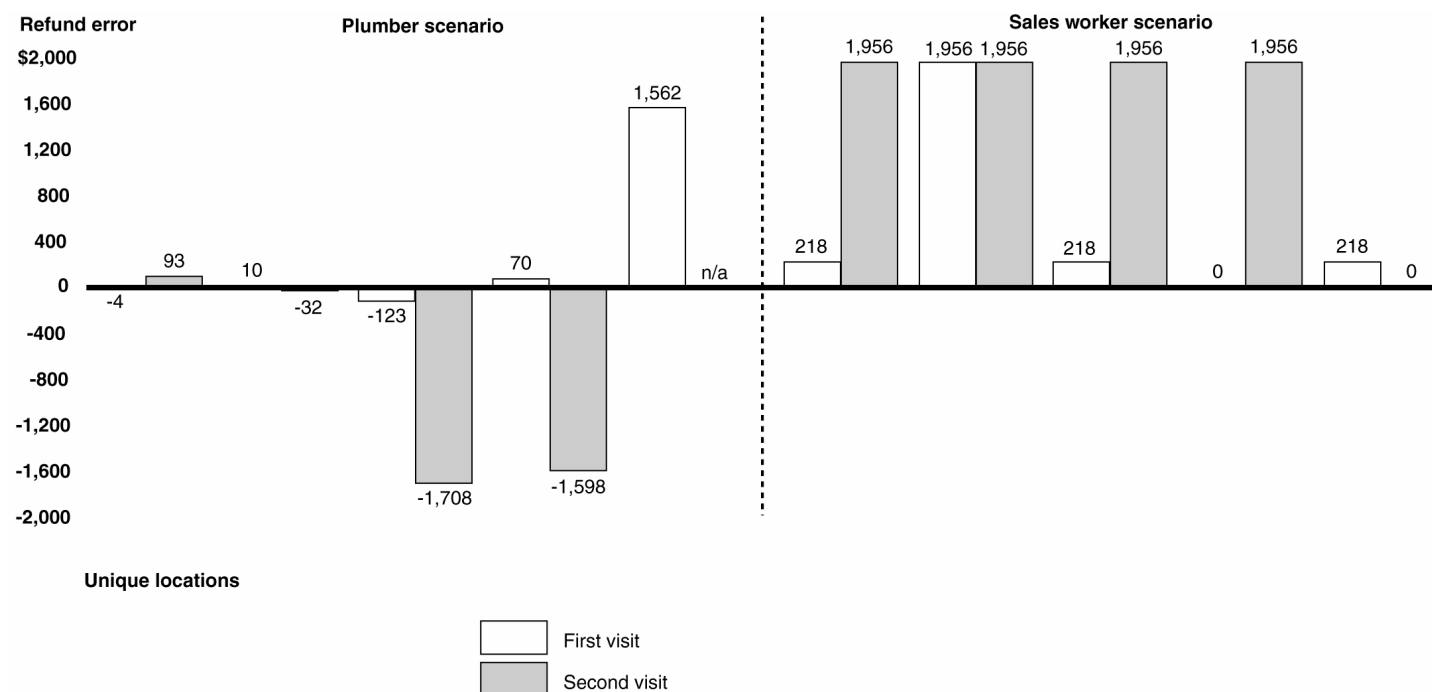
¹⁶It is possible that some preparers understood the rules for reporting the credit. Other preparer mistakes, such as not reporting side income or claiming the wrong number of exemptions, had the effect of eliminating the sales worker's tax liability. Because the credit for child- and dependent-care expenses is not refundable, not claiming it in cases where the taxpayer's tax liability was reduced to 0 may not have been a mistake in its own right.

¹⁷GAO, *Student Aid and Postsecondary Tax Preferences: Limited Research Exists on Effectiveness of Tools to Assist Students and Families through Title IV Student Aid and Tax Preferences*, [GAO-05-684](#) (Washington, D.C.: July 29, 2005).

than half of the year. We were posing as a fairly unsophisticated taxpayer who was unaware of EIC eligibility rules, so we did not volunteer that one of our children did not live with us in 2005. Whenever we were asked if our children lived with us, however, we said that one did and one did not. Only 1 preparer asked all of the required questions. Three preparers asked about the names, dates of birth, and social security numbers of the two children but never asked where the children lived in 2005. Three preparers gave us a worksheet to complete that asked most but not all of the required questions, but 2 of these preparers still entered two children when we wrote down that one child did not live with the sales worker at all during the year. In 1 of these cases, another employee reviewed the return.

Refunds. As a result of the errors described above, some claimed refunds on line 73a on our 19 returns were either substantially higher or lower than they should have been. Figure 3 shows the deviation from the correct refund amount under our two scenarios. The pairs of bars shown in the figure indicate returns prepared by employees affiliated with the same chain. As shown in the figure, refunds reported for the plumber were incorrect in all 9 cases—sometimes by only small amounts, but at other times by substantial sums. Refunds reported for the sales worker were correct in 2 cases and overstated in the other 8 cases. The paid preparers that arrived at the refund amount that was \$218 too high ignored the sales worker’s side income but reported the correct number of children living with her when calculating the EIC. The preparers who arrived at overclaimed refunds of \$1,956 did not include the side income and reported two children for EIC purposes.

Figure 3: Refund Amounts over or under Correct Amount



Source: GAO.

The 19 paid preparers we visited arrived at the correct refund amount only twice. On 5 returns, all for the plumber, they understated our refund amount by a total of \$3,465. On 12 returns (4 for the plumber and 8 for the sales worker) they overstated the refund by a total of \$12,169—a total of \$1,735 in overstated refunds for the plumber and \$10,434 for the sales worker.

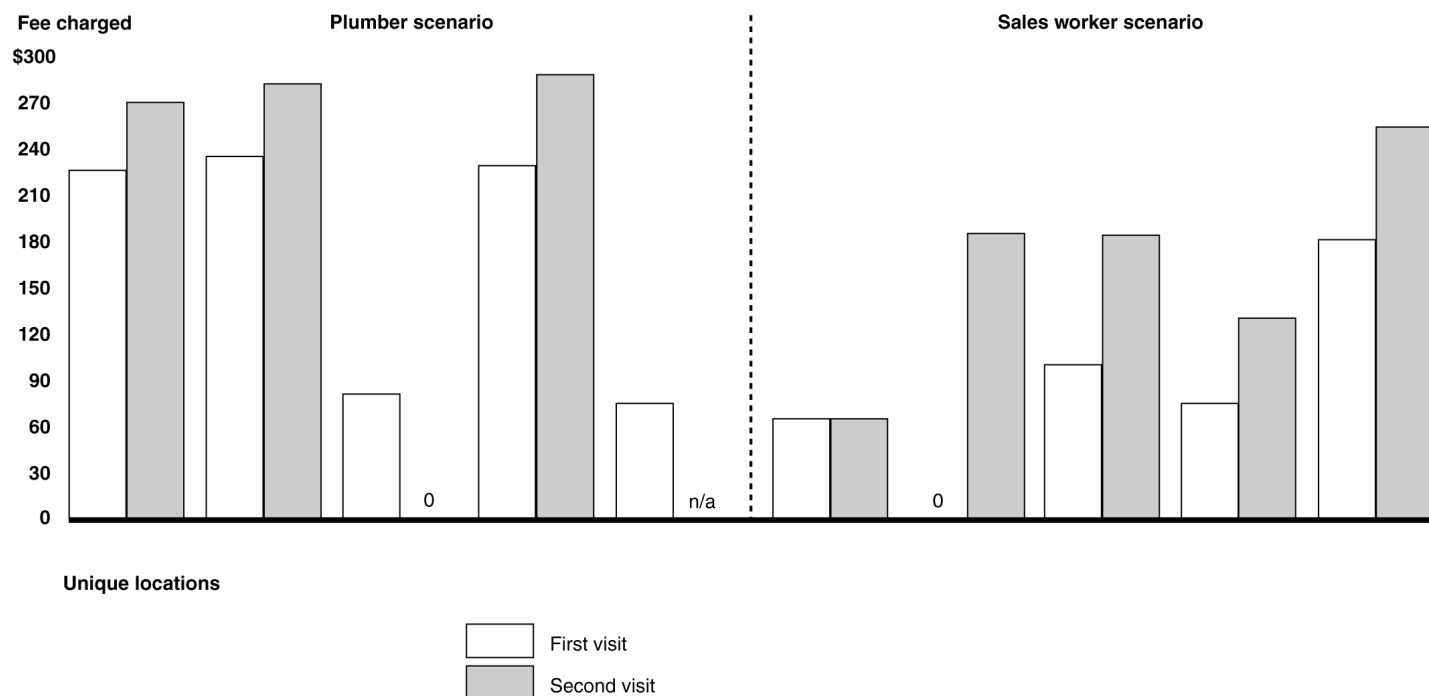
Preparer’s identifying information. In addition to various computational errors, some preparers also did not include identifying information required on the 1040 forms they completed. IRS regulations require that paid preparers include a signature or typed name, a social security number or “PTIN” (an IRS-issued unique identifier for paid preparers), and the name and employer identification number of their employer. Four of our 19 returns had no preparer signature and 2 had no preparer social security number or PTIN. All but 1 return prepared for us included a company name and employer identification number; that return was missing all identifying information.

Preparer services and fees. Most paid preparers we visited offered services besides the federal tax returns we requested. Some preparers offered to prepare the state tax return for us. In a few cases the preparer gave us completed state tax returns along with the federal return and did not indicate that there was an additional charge. Whenever asked, we said we only wanted a federal tax return. Electronic filing was always an option. One preparer proceeded to electronically file our return, even after we said we wanted to mail in a paper return. In this case, the preparer did not ask us to provide a personal identification number or ask us directly to sign a form authorizing the electronic filing, as required by IRS regulations.

We were also usually offered ways to get our refunds more quickly than waiting for a check mailed from IRS. Some of these options involved RALs—short-term loans made to taxpayers and paid off with tax refunds—and others involved direct deposit alternatives. In some cases, what were clearly RALs were not described as loans but as “options” or “bank products.” One preparer gave us a RAL application to sign at the start of the visit without explaining what it was we were being asked to sign. Another preparer told us the size of the refund we could receive in 12 to 48 hours but did not give us the amount we would receive if we were willing to wait for a check from IRS, did not identify the faster refund as a loan, and did not explain that the amount we would receive was reduced by the amount of the fee associated with the option. In this case, the fee for the RAL was between about \$470 and about \$570, after subtracting the amount charged to prepare the return. With a refund amount of about \$5,000 and assuming a 10-day wait for the refund, this means that the annual percentage rate for the loan was between about 380 percent and about 470 percent.

The fees charged in our 19 visits varied widely, sometimes between offices affiliated with the same chain, and were sometimes significantly larger or smaller than the original estimate we were given. In both the plumber and the sales worker scenarios, we received 1 set of returns at no cost, and another paid preparer reduced the fee for the sales worker without explaining why. Figure 4 shows the fees charged by each of the 19 paid preparers we visited. The pairs of bars in figure 4 represent the fees charged by offices of the same chain for the same scenario. In only 1 of the 9 cases where the same firm prepared the same tax return were we charged the same amount. In some cases, the preparer stressed that one advantage of purchasing a RAL or paying the fees to arrange for direct deposit of the refund would mean that the cost of the visit would come out of the refund and that we would not have to pay any money on the day of the visit.

Figure 4: Fees Charged for Tax Preparation Services



Source: GAO.

One of the common sense steps we mentioned earlier when choosing or working with a paid preparer is to make sure you understand how much the services you are getting cost. For this reason, we asked for an estimate of fees at the start of every paid preparer transaction. Eight preparers either did not provide an estimate or gave an estimate with the qualifier that the fee would depend on the forms required. In the other 11 cases, we were quoted a fee or a range that did not depend on a variety of forms, and in 9 of those the fee we were ultimately charged was within the quoted range, within \$30 of the fee quoted, or less than the estimate. Some preparers provided a detailed receipt showing the forms that were prepared, but some receipts only showed the final fee. None of the more detailed receipts, however, included specific costs for individual forms.

Many Problems on Our Tax Returns Could Risk IRS Enforcement Actions against the Paid Preparer, the Taxpayer, or Both

According to IRS officials, paid preparers and taxpayers risk enforcement action by filing a tax return that includes the types of misstatements or omissions that we have described. According to the officials, although IRS seldom has clear evidence about what transpires between a preparer and a taxpayer, if IRS were to uncover problems with the preparation of real tax returns similar to several that we found, the preparers would be subject to civil sanctions.

Several penalties would be applicable depending on the facts and circumstances of each situation. IRS officials said that if the preparers had been preparing tax returns to be actually filed, many of them would have been subject to civil penalties for such things as negligence and willful or reckless conduct. For example, as stated earlier in our testimony, if a paid preparer encourages a taxpayer not to report or to erroneously report transactions on his or her tax return, resulting in a tax-due understatement or refund overstatement, the preparer could be assessed penalties of up to \$1,000 for willful or reckless disregard of tax rules and regulations.¹⁸ In both of our scenarios, information provided to preparers included self-employment income that the preparer did not encourage reporting. According to IRS officials, the preparer is clearly responsible for properly reporting all income, including the self-employment income in these scenarios, on a taxpayer's return. They added that although preparers are not required to audit taxpayers to uncover unreported income, they must make reasonable inquiries to correctly report income.

IRS officials also said that civil penalties would be applicable to other issues we encountered, depending on the facts and circumstances. Preparers who did not ask all the EIC due diligence questions would be subject to the penalty for the failure to be diligent in determining EIC eligibility. Similarly, preparers who improperly included hundreds of dollars of books in the education credit taken would be subject to a penalty for negligence.

IRS officials we spoke with, who included representatives of Criminal Investigation, said that although the dollar amounts of errors made by the practitioners might not result in prosecutions, criminal sanctions such as willful preparation of a false or fraudulent return might apply.

¹⁸ IRC sections 6694(a) and (b).

In addition to paying the tax due after correcting the return and any related late payment interest, the taxpayer may also be assessed a penalty, depending on the facts and circumstances of each situation, according to IRS officials. For example, if taxpayers substantially understate income, overstate deductions, or provide other incorrect information resulting in decreased tax or improperly high refunds, they may be assessed an accuracy-related penalty. The penalty could be assessed for any failure to comply with the tax laws, including the failure to report self-employment income.¹⁹

Because the returns we had prepared were not real returns and were not filed, penalties would not apply. However, we have referred matters we encountered to IRS so that any appropriate follow-up actions can be taken.

The National Research Program Found Errors on Returns Prepared by Paid Preparers

IRS's tax year 2001 NRP data also indicate that tax returns prepared by paid preparers contained a significant level of errors. As shown in table 7, IRS audits of returns prepared by a paid preparer showed a higher error rate—56 percent—than audits of returns prepared by the taxpayer—47 percent.²⁰ Errors in this context changed either the tax due or the amount to be refunded. A similar statistically significant relationship existed for all income groups of \$80,000 and below that we studied. Of course, as noted before, it is important to remember that tax preparers are used more often on some more complicated returns than on some simpler ones, although we were unable to gauge the full extent to which this might be true. Also, the fact that errors were made on a return done by a paid preparer does not necessarily mean the errors were the preparer's fault; the taxpayer may be to blame. The preparer must depend on the information provided by the taxpayer.

¹⁹IRC section 6662(b).

²⁰All percentage estimates from the NRP files have margins of error of plus or minus 5 percentage points or less, unless otherwise noted. All numerical estimates other than percentages have margins of error of plus or minus 5 percent or less of the value of those numerical estimates, unless otherwise noted.

Table 7: Estimated Percentage of NRP-audited Tax Year 2001 Individual Returns with Errors

Type of return	Estimate (percent)
Prepared by a paid preparer	56
Prepared by the taxpayer	47
All returns	52

Source: GAO analysis of IRS NRP data.

The different error rates for paid preparer and self-prepared returns translated into different amounts that taxpayers owed IRS after audit. For instance, as shown in table 8, taxpayers using a paid preparer owed a median of \$363 to IRS after audit, compared with a median of \$185 for taxpayers preparing their own returns. This type of disparity in taxes owed existed for every income level we studied except for the \$40,001–60,000 and \$60,001–80,000 ranges in which the differences were not statistically significant.

Table 8: Estimated Median Additional Taxes Owed on NRP-audited Tax Year 2001 Individual Returns^a

Type of return	Estimate	Lower bound	Upper bound
Prepared by a paid preparer	\$363	\$338	\$397
Prepared by the taxpayer	185	164	210
All returns	279	262	300

Source: GAO analysis of IRS NRP data.

^aThe 95 percent confidence intervals surrounding the estimates range from the lower bounds to the upper bounds.

Table 9 shows some specific Form 1040 line items for which the NRP paid preparer and self-prepared error rates differed from each other in a statistically significant way. We also found problems with these line items in our visits to paid preparers. For example, NRP audits revealed that, for the Form 1040 line showing the amount of standard deduction or itemized deductions taken, about 23 percent of self-prepared individual returns had errors, compared with about 31 percent of returns done by paid preparers. Paid preparer and self-prepared error rates did not differ from each other in a statistically significant way for business income and education credits line items, other line items for which we had found problems.

Table 9: Estimated Percentages of NRP-audited Tax Year 2001 Individual Returns Containing Specific Line Items with Errors on Those Line Items

Form 1040 line item	Self-prepared returns (percent)	Returns done by a paid preparer (percent)
Deductions	23	31
Foreign tax credit	16	6
Earned income credit	45	53
Refund	48	57

Source: GAO analysis of IRS NRP data.

Concluding Observations

Our limited review and the problems we found do not permit observations about the quality of the work of paid tax preparers in general. Undoubtedly, many paid preparers do their best to provide their clients with tax returns that are both fully compliant with the tax law and cause them to neither overpay nor underpay their federal income taxes. Furthermore, as we observed in 2003, it is easy to understand how the complexity of the tax code brings many taxpayers to conclude that they should turn to a paid preparer.

As we also observed in 2003, however, our tax system depends on taxpayers accurately completing and filing their returns. With their important role in helping taxpayers meet their obligations, paid preparers become a critical quality-control checkpoint for the tax system. Where we saw serious problems in our few visits, these same preparers may make similar mistakes on the genuine tax returns they complete this year. Their mistakes and misstatements may also ripple even further through the system as the taxpayers they serve may come to believe that, for example, non-W-2 business income does not have to be reported, and they may even spread that misinformation among their friends and neighbors. In light of the importance of paid preparers in our tax system today, knowing if what we found is the exception or the rule in the paid tax preparation services industry is critical. With better information about the extent of problems, IRS can better target its limited enforcement and education resources.

Finally, our observation in 2003 that taxpayers who choose to use paid preparers need to be wise consumers is even more important today in light of our most recent findings. As IRS notes on its Web site under “Tips for Choosing a Tax Preparer,” no matter who prepares a tax return, the taxpayer is legally responsible for all of the information on that tax return.

We discussed our findings and observations with senior IRS officials, and they generally agreed with our message.

Recommendation for Executive Action

We recommend that the Commissioner of Internal Revenue conduct necessary research to determine the extent to which paid preparers live up to their responsibility to file accurate and complete tax returns based on information they obtain from their customers. In conducting this research, the Commissioner should consider whether the methodology we used would provide IRS with a more complete understanding of paid preparers' performance.

Mr. Chairman, this concludes my prepared statement. I would be happy to respond to any questions you or other Members of the Committee may have at this time.

Contacts and Acknowledgments

For further information on this testimony, please contact Michael Brostek at (202) 512-9110 or brostekm@gao.gov. David Lewis, Assistant Director; Mario Artesiano; Paul Desaulniers; Danielle Free; Leon Green; George Guttman; Christine Hodakievic; Lindsey Houston; Shirley Jones; Jason Kelly; Lawrence Korb; Barbara Lewis; John Mingus; Karen O'Connor; and Cheryl Peterson made key contributions to this testimony.

Appendix I: Paid Preparer Visit Examples

None of our 19 visits to paid preparers were problem-free, but some had relatively minor issues while others had more serious problems. The following are descriptions of selected visits we made to paid preparers. For each scenario, we provide one example of a visit that had fewer compliance issues than most of our visits under the same scenario, and one example that had more serious problems than most.

Example of a Plumber Visit with Minor Issues

During this site visit, the paid preparer asked various questions and prepared a return with few problems. For example, presumably to determine the taxability of a state income tax refund, the preparer asked about the previous year's itemized deductions and their amount. The preparer also asked about which year the college-age child was in schooling and whether the tuition in question had been paid in 2005, questions needed to determine the applicability of the Hope education credit. While the preparer did not ask about side income, when the taxpayer volunteered that he had non-W-2 income, the preparer included it on the return without discussing whether to either change it or not report it. The preparer also probed for expenses to offset it.

The refund on the completed tax return was only \$4 below the correct amount. The difference was due to the preparer (1) overclaiming the amount of personal property tax paid by including nondeductible fees and (2) not taking the credit for foreign taxes paid. The preparer also listed noncash charitable donations as cash donations, though this did not affect the amount of the refund.

The cost of the visit to the paid preparer was about \$100 more than the amount originally quoted. However, at the start of the visit, the preparer had said that the actual amount would depend on the number of forms used. One of the forms used was the Schedule B, Interest and Ordinary Dividends. While this form might have been used to capture information the taxpayer provided, it did not need to be filed with IRS, since the income amounts were less than the minimums requiring the form. The paid preparer did not offer other services such as a Refund Anticipation Loan (RAL) to the taxpayer.

Example of a Plumber Visit with Serious Problems

Costly issues for the taxpayer during this site visit were the paid preparer's failure to itemize deductions and the preparer's decision to claim the tuition and fees deduction instead of the Hope education credit. The preparer did not itemize the deductions despite the fact that the taxpayer showed the preparer the documents supporting itemization. The preparer

even asked questions about medical expenses and charitable contributions. The preparer also asked about whether there were any nonreimbursed employee expenses and about whether the college-age child was a full-time student.

On another issue, when discussing the taxpayer's side income, the preparer wondered if the taxpayer had reported it the previous year, which he had. The preparer suggested also reporting it this time so as not to arouse suspicion, but at a much lower amount than the taxpayer identified. The taxpayer declined the offer, and the preparer ultimately included the correct amount. The preparer did not provide the taxpayer with a completed Schedule C-EZ or a Schedule SE, although information from both was reported on the form 1040. In addition, the preparer did not include the state tax refund as income.

When asked about the tax return's price at the beginning of the session, the preparer could not give an exact estimate but instead provided a range. However, the preparer ended up not charging the taxpayer at all since the refund involved was so small. In fact, the refund was about \$1,700 smaller than the correct amount.

Example of a Retail Sales Worker Visit with Fewer Serious Issues than Most We Encountered

This example is 1 of the 2 retail sales worker returns in which the refund computed by the paid preparer was the same amount we computed. The preparer reported the correct number of children for EIC purposes and asked most of the due diligence EIC questions. Although the preparer claimed the wrong number of children as exemptions, that did not affect the final refund amount. Although the preparer did not ask directly about side income, the preparer included it when we offered the information. The price charged was the same as the price quoted, and the preparer pointed out that a RAL was in fact a loan. The preparer did not, however, sign the tax return or provide any other preparer information on it.

Example of a Retail Sales Worker Visit with Several Serious Problems

In this example, the paid preparer's return resulted in the tax return showing a refund of almost \$2,000 more than the correct amount. The return did not include the side income even though the preparer asked about anything else that should be considered and the taxpayer mentioned it. The preparer said the taxpayer would need records of income and expense to be able to report the income. The return included two children as qualifying for the EIC and the additional child tax credit even though only one lived with the taxpayer. The preparer appeared to go through an on-screen EIC checklist but did not ask the taxpayer the questions. The

papers taken away from the preparer included an EIC worksheet with the answers completed by the preparer, some of them incorrect.

There were also other issues with the return prepared. First, it did not include child-care expenses as the taxpayer was told the expenses would have to exceed \$7,300 to be claimed. Second, it incorrectly included the state tax refund as income because the preparer said the amount was for unemployment compensation. Third, the return did not include the preparer's social security number although it did show his name.

The preparer offered a RAL that would have been available in an hour at a cost of about \$400.

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