

PREPARING YOUR TAXES: HOW COSTLY IS IT?

HEARING
BEFORE THE
COMMITTEE ON FINANCE
UNITED STATES SENATE
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PREPARING YOUR TAXES: HOW COSTLY IS IT?

TUESDAY, APRIL 4, 2006

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:15 a.m., in room SD-215, Dirksen Senate Office Building, Hon. Charles E. Grassley (chairman of the committee) presiding.

Also present: Senators Thomas, Bunning, Baucus, Wyden, and Schumer.

OPENING STATEMENT OF HON. CHARLES E. GRASSLEY, A U.S. SENATOR FROM IOWA, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. I am sure you are well-aware of the fact that we had a vote. I am going to put a longer statement in the record. Hopefully I have shortened it some on my own volition.

[The prepared statement of Senator Grassley appears in the appendix.]

The CHAIRMAN. Today's hearing will examine the current state of tax preparation, electronic filing services, looking at how States are succeeding in the area of electronic filing, with 20 States offering direct Internet filing.

State electronic filing has consistently grown at a faster rate than what we do at the Federal level, with five States exceeding what we do at the Federal level. With so many people using preparers who are paid and electronic filing, we need to ensure that these preparation methods are helpful and user-friendly.

The feedback that we are receiving is that the tax preparation system is breaking down, so we will look today at some bad practices that seem to be systemic, calling for action on the part of this committee, I believe.

Given the complexity of our current system, taxpayers should be entitled to a tax preparation method that they can rely upon. Today, more than 60 percent of all returns are completed by paid preparers, annually preparing more than 78 million returns.

While I believe that a large majority of tax return preparers are honest, highly educated individuals who serve the community well in providing sound financial advice, we are also getting reports from various sources that an increasing minority is doing a disservice to the American public, some through bad advice, some through incompetence, and some through taking advantage through unscrupulous means towards the taxpayer.

Adequate training within the paid preparer community is essential. The IRS needs to impose penalties against the unscrupulous.

Today, it seems like any old Joe can hang up a shingle and prepare income tax returns, because there are no requirements of competence.

It is incredible that we have legal requirements for someone to qualify as a barber to cut your hair, and yet there are no requirements for someone preparing your taxes.

The vast majority of Americans want to do the right thing and pay their taxes. Americans have a right to expect that when they hire a tax preparer they are going to get honest, straightforward advice.

One of our witnesses, Mr. Brostek, will testify about the experience of GAO in reviewing the practices of tax preparers on an undercover basis. The results of that investigation are very troubling.

For those taxpayers who can prepare their own returns, they should be able to do so electronically, without cost, to achieve that goal. Congress allowed the IRS to establish the Free File program in 2002. The Taxpayer Advocate will comment on their findings on that aspect of it.

Here is some of what we know from our internal staff review. For the year 2004 tax year, the Free File Alliance offered free filing services to everyone, without restriction.

For the 2005 tax year, the new Free File agreement signed by IRS restricted the availability of Free File by placing income restrictions on the program, and so, not surprisingly, the IRS statistics show that the use of the program has decreased by more than 21 percent.

Also, taxpayers are being inundated with additional charges from private preparers that may accrue and the sale of ancillary services such as fees for State return preparation and filing, resetting passwords, printing and mailing services, professional tax return review, audit protection, live chat help, telephone technical support, and per-question fees for consultation with tax professionals. These are things that I am unfamiliar with, with the very complicated return that I have as a farmer and as a public official.

Taxpayers entitled to a refund from the government receive offers then for anticipation loans, having fees deducted from their refunds, offers to get their refunds by cashier's check, pre-paid Visa cards, and retail gift cards. It sounds like a commercial enterprise.

Meanwhile, we have H&R Block, the Nation's largest tax preparer, being charged with breaching fiduciary duties to customers. So those are the issues before us, and we will be exploring those issues in anticipation of Senator Baucus and I having legislation in this area.

Senator Baucus?

**OPENING STATEMENT OF HON. MAX BAUCUS,
A U.S. SENATOR FROM MONTANA**

Senator BAUCUS. Thank you, Mr. Chairman. T.S. Eliot wrote, "April is the cruelest month." Many consider doing their taxes to be the cruelest part of all.

Filling out burdensome income tax forms is so stressful that most Americans pay someone to do it for them. Taxpayers are willing to spend hundreds of dollars to make sure that their taxes are done right.

Most taxpayers want to do the right thing. I think that is very true. Most Americans, red-blooded Americans, want to do the right thing. They do not like paying their taxes, but they feel it is their duty to pay their taxes and it is their duty to pay their taxes the right way, no more than they have to, but pay the taxes that they feel they legally owe and should pay.

I feel very strongly that most Americans feel that way, and I think that is sort of the bedrock that we should all keep in mind as we are trying to figure out how best to make the system even more efficient. They are willing to trust a paid preparer, many times, often a complete stranger, with their most intimate financial information to do just that.

Every year, paid preparers serve as a link between 80 million taxpayers and the IRS. This year, another 10 million taxpayers bought tax software to file on their home computers. That is a big influence on our tax system. The state of the tax preparation industry is a warning signal for the health of our Nation's voluntary tax system. It is like a canary in a coal mine. Regrettably, the canary is dying.

Today we will hear the serious symptoms of an ailing system. Over the last several weeks, GAO undercover investigators visited the offices of five national tax preparation chains. Using simple tax scenarios, they tested how paid preparers treat their customers, and the Nation. The results were shocking.

The preparers failed at their most important task: only 10 percent of their returns were prepared correctly. Frequently, preparers did not ask enough questions to know if they were getting the right answers. Many preparers were eager to probe for additional deductions or credits, but many did not report cash income.

Many preparers ignored the answers that the undercover investigators gave them; they used answers of their own. They made up their own facts, and they made up their own tax laws.

Several refunds were \$2,000 more than they should have been. Many preparers seemed to be more interested in coming up with a big refund than they were in getting it right. They were acting not for their client's benefit, but for their own. The bigger the refund, the more preparers can sell products like refund anticipation loans or audit insurance.

Many preparers quoted fees that were substantially less than what they ended up charging. Many preparers levied extra charges for unnecessary forms, refund anticipation checks, or products like debit cards. Charges like these raise the cost of filing considerably.

Today we are also going to learn that the IRS's Free File program is not always so free. The Free File program is a partnership between the IRS and private preparers. That is what it is.

Taxpayers that use the program encounter hidden costs and bait-and-switch offers to buy upgrades or products like refund anticipation loans. These loans make taxpayers have to pay for borrowing their own money.

In sum, many tax preparers perpetuate a cruel hoax on taxpayers and the Treasury alike, and the Treasury has not done all they can to avoid this cruel result.

I want to acknowledge that there are many hardworking, well-qualified, and competent professionals in the tax business. I am

proud that my home State of Montana boasts some of the more rigorous industry standards in the country. These professionals must meet stringent training, they must have experience, and continuing education requirements to practice. These are not the preparers about whom we are talking today.

But we cannot stick our heads in the sand. We cannot pretend that problems do not exist. Instead, we should listen carefully to our witnesses and find solutions that will mend what is broken.

Last year, I co-sponsored S. 832, the Taxpayer Protection Assistance Act of 2005, along with my colleague Senator Bingaman—whom I think is the primary sponsor—the Chairman, Senator Grassley, Senator Schumer, Senator Smith, and Senators Akaka and Pryor. It goes right to the heart of many of these problems.

It requires paid preparers to meet minimal training and competency standards before they can hang out their shingle. It makes it easier for the IRS to discipline bad preparers. It helps to protect taxpayers from unexpected or excessive charges. It requires disclosing the cost of refund anticipation loans.

We should make it easy to comply with the tax law. So, maybe it is time to really strongly consider making electronic filing available at no cost to all taxpayers.

Just a few weeks ago, everyone received a package of forms and instructions in the mail, or they could have gone to their local library to get them. Recently, the forms have become available through the IRS website. All the forms and instructions are free.

So why do we force taxpayers to pay a preparer or buy software to file electronically? Why? Taxpayers do not have to go to a bookstore and buy forms to file a paper return. They should not have to pay to file an electronic one, either.

Today's hearing highlights tough issues that affect all of us. I want to thank all the witnesses for agreeing to appear before the committee. I look forward to your testimony.

As Simon and Garfunkel sang, "April, come she will." And today, until we reform the tax code, we are fated annually to confront onerous forms to meet April's deadline.

Let us ensure that the work of tax preparers does not add to April's cruelty. Let us ensure that the bad apples among them do not continue to play a cruel hoax on the Nation's finances. Let us look forward to a better spring after we do.

The CHAIRMAN. Thank you, Senator Baucus.

Now we have Michael Brostek, who is with the Government Accountability Office. He is accompanied by a team that includes Paul Desaulniers, and we also have Christine Hodakievic with him. We have Mr. Bert DuMars, Director of Electronic Tax Administration, IRS; Nina Olson, National Taxpayer Advocate of the Taxpayer Advocate Service, IRS; Mr. Robert Weinberger, member of the Free File Alliance; Mr. Francis Degen, president of the National Association of Enrolled Agents; and, lastly, Mr. Harley Duncan, executive director of the Federation of Tax Administrators.

So we will go in that order. Then if you folks have a longer statement than the 5 minutes that have been allotted, it will be put in the record.

Also, as a reminder, because of so many votes and committee meetings this morning, if members cannot come, you will probably

get some questions in writing from those of us who are there, and for sure from people who are not here.

So, we would appreciate it if those questions from members would be in in 48 hours, and then an answer maybe in a couple of weeks from you folks.

So we will start with Mr. Brostek.

STATEMENT OF MICHAEL BROSTEK, DIRECTOR, STRATEGIC ISSUES TEAM, U.S. GOVERNMENT ACCOUNTABILITY OFFICE, WASHINGTON, DC; ACCOMPANIED BY PAUL R. DESAULNIERS AND CHRISTINE A. HODAKIEVIC, SPECIAL AGENTS, U.S. GOVERNMENT ACCOUNTABILITY OFFICE, WASHINGTON, DC

Mr. BROSTEK. Good morning, Mr. Chairman, Senator Baucus, and members of the committee. My colleagues and I are pleased to participate in the committee's hearing today.

As requested, my statement will focus on who uses paid return preparers, how preparers are regulated, and the experiences our investigators had when they had tax returns prepared by 19 offices of five major commercial preparer chains.

Paid preparers play a critical quality control role in the tax system. Given the complexity of our tax laws and the desire of taxpayers to avoid audits, about 56 percent of the 130 million tax returns prepared in 2002 were professionally prepared.

The use of paid preparers was fairly evenly distributed across income levels, and, in general, taxpayers with more complex returns used preparers the most.

Paid preparers all operate under some common regulatory requirements, but regulations also vary based on the characteristics of the paid preparers, such as whether they are approved to represent taxpayers before IRS.

Certain regulatory requirements define practices that all preparers must follow. Some of these requirements have associated civil penalties. For instance, preparers must not understate a taxpayer's liability due to willful or reckless disregard of the tax laws.

Preparers must also provide taxpayers a copy of the return, sign the return, and provide an identifying number. In addition, preparers must ask a series of questions provided by IRS in determining whether taxpayers are eligible to claim the Earned Income Credit.

Finally, certain actions on the part of paid preparers could result in criminal penalties. Among these are willful preparation of a false or fraudulent return or other document, and knowingly providing fraudulent returns or documents to IRS.

We used two scenarios to gain a better understanding of how preparers actually perform. In one scenario, a plumber and his wife had wage income, mutual fund investment income, and cash income from some side jobs. One of their two children was in college.

In the other scenario, a sales clerk had two children; one lived with her all year and one lived all year with the grandmother. The sales clerk also had some cash income from baby-sitting.

In constructing the scenarios, we attempted to avoid complex rules. We had nine plumber returns prepared, and 10 for the sales clerk. With one exception, each scenario was done in two outlets of the same firm.

At the beginning of the session with a paid preparer, we ask preparers about likely charges. Ultimately, the preparers charges varied highly, even within the same firms for the same returns, as shown on page 25 of my statement and on the board to my left.

Only one firm charged us the same fee at two separate outlets for the same return. In 11 cases, the final cost was close to the preparer's initial estimate, or less. We went to five different preparer chains, and for each one we went to two of their outlets for each scenario, so the white and the gray represent two different visits for the same scenario to the same preparer. We grouped the bars together so you can see that there was a variation in the fees charged for the same return.

Moving on, as is summarized on pages 16 and 17 of my statement and on the boards that are being put up, of 10 key lines on the return, all of the preparers were correct in only one case, that is recording the wage income from the forms W-2 for our taxpayers. The preparers made a wide range of errors on the other lines, but I will highlight four.

First, 10 preparers failed to record our taxpayer's side income. Failure to report cash income is one of the largest contributors to the tax gap for individual taxpayers.

Second, 5 of the 10 preparers reported two qualifying children for the Earned Income Credit when only one qualified. The EIC has long been plagued by a high non-compliance rate, and qualifying child errors are the largest portion of non-compliance for EIC.

Third, in two cases where itemizing deductions would have benefited our plumber, the preparer took the standard deduction instead. In 2002, we estimated that about 2 million tax returns had this error; half involved paid preparers. In total, the taxpayers may have overpaid by \$1 billion.

Fourth, in three plumber returns, the preparer did not take the Hope education credit, thereby costing our taxpayer hundreds of dollars.

In 2005, we reported that hundreds of thousands of taxpayers did not claim the education benefit that was best for them, and half of those used a paid preparer.

As shown on page 23 of my statement and on the board being put up, the errors that preparers made on our returns resulted in refunds that were substantially higher or lower than they should have been in 8 of the 19 cases.

In some cases, errors that could have resulted in substantially erroneous refunds did not, only because the preparer made an offsetting, equally significant error. In total, our taxpayers would have received refunds overstated by over \$12,000, and understated refunds totaling about \$3,500.

That the preparers' errors were significant is underscored by the potential penalties that could apply, as is shown on the board being put up and on pages 9 and 10 of my statement.

IRS officials said that they seldom have clear evidence regarding a preparer's conduct, but if the conduct we observed was found for real tax returns, several penalties would apply.

For example, for not reporting the cash income of our taxpayers, the preparers could be fined up to \$1,000 for willful or reckless dis-

regard of tax rules and regulations, or perhaps the \$1,000 penalty for aiding and abetting understatement of tax liability.

For not asking the required EIC due diligence questions, the preparers would be subject to a \$100 penalty. For improperly including the cost of books when claiming the Hope credit, which was a material error, in IRS officials' view, the preparers could be subject to a negligence penalty.

And although prosecutors might not accept the case due to the dollar amount involved, failing to report cash income might even be subject to a criminal penalty for willful preparation of a false or fraudulent return. The penalty carries a fine of up to \$100,000, imprisonment up to 3 years, or both.

Undoubtedly, many paid preparers do their best to provide clients with returns that are accurate in all regards. However, the problems that we experienced with paid preparers suggest that taxpayers need to exercise caution.

Taxpayers are ultimately liable for the accuracy of their returns, and the poor performance of a preparer can result in taxpayers being audited, having to pay taxes plus interest, and possibly even penalties. From the tax administration perspective, our results are troubling.

Preparers play a vital role. A preparer who performs poorly may do so throughout the filing season with many, many clients. When a preparer provides bad advice to a taxpayer, such as that cash income need not be reported, the taxpayer may well tell family and friends, adversely affecting their compliance as well.

Our work is, however, anecdotal. We went to 19 locations in one metropolitan area. However, if taxpayers rarely make serious errors, it is odd that we would have found so many in the cases that we did.

Given the key role of paid preparers, we are recommending that IRS study whether the poor performance we found is an aberration or a more common problem. Further, we have referred the matters we encountered to IRS for follow-up as may be appropriate.

This concludes my statement. My colleagues and I would be happy to answer questions.

[The prepared statement of Mr. Brostek appears in the appendix.]

The CHAIRMAN. For the benefit of the other people, we gave 8 minutes or a little longer to GAO because they were reporting on their investigation. So if there is unequal treatment, I just wanted to explain that we said that they should take more time.

Mr. DuMars?

STATEMENT OF BERT DuMARS, DIRECTOR, ELECTRONIC TAX ADMINISTRATION, INTERNAL REVENUE SERVICE, WASHINGTON, DC

Mr. DUMARS. Thank you. Good morning, Mr. Chairman, Ranking Member Baucus, and members of the Senate Committee on Finance. My name is Bert DuMars, and I am the Director of Electronic Tax Administration for the Internal Revenue Service. It is my pleasure to be with you this morning to discuss, from an electronic perspective, return preparation options for taxpayers.

My written statement has been submitted for the record, and in my oral remarks I would like to address two key points.

First, I want to update you on the status of our overall tax administration efforts. We have made enormous progress in ETA, spurred on partially by the IRS Restructuring and Reform Act of 1998, and the ambitious targets established in that law.

The IRS expects to process almost 135 million individual tax returns in 2006, and we anticipate a continued growth in the number of those that are e-filed. This year marks the 20th anniversary of e-filing, and each year we have made steady and sustained progress. We are continuing that progress in this current filing season.

Through March 26, 68.5 percent of the individual returns that have been filed have been e-filed. But electronic tax administration is more than individual e-filing. Currently, over 96 percent of all information returns are e-filed as well.

More than 240,000 corporations have already e-filed their returns to us in this filing season. We are continually expanding requirements that corporations and large tax-exempt entities take advantage of e-filing.

We are also making good use of our award-winning website, *irs.gov*, which allows taxpayers to get answers to many of their questions at their convenience utilizing their home computer. We have had over 90 million visits to our website thus far in 2006.

A robust ETA program will reduce time spent by taxpayers dealing with the IRS. It will reduce the number of phone calls, thus freeing up our compliance employees to focus on real compliance issues rather than just retrieving or correcting information.

The second issue that I wish to address is the Free File program. In November of 2001, OMB's Quicksilver Task Force established 24 e-government initiatives as part of the President's management agenda. One initiative instructed the IRS to provide free on-line tax return preparation and filing services to taxpayers.

As we began to implement this initiative, it was our judgment, subsequently supported by various amendments, legislative proposals, and Congressional directives that IRS should stay out of the tax software preparation business. Thus, we began negotiating with private software providers, and out of that was born the Free File Alliance.

The original agreement called for free filing to be made available to 60 percent, or 78 million individual taxpayers. That agreement expired in 2005 and, as such, had to be renegotiated with the private companies.

One of the prime concerns in the negotiations, particularly among some of the smaller companies, was the fact that, in 2005, many Free File providers had expanded their offerings to all taxpayers. While this was good for taxpayers, it posed a threat to the continued existence of the Free File Alliance.

While it was IRS's objective to make Free File available to as many taxpayers as possible, ultimately the negotiations ended with a program to cover anyone with an adjusted gross income of less than \$50,000, or 70 percent of all taxpayers. This means that it was made available to 93 million taxpayers, or 70 percent.

This represents a significant improvement over the previous agreement. I know there has been some concern with the ability of Free File providers to sell ancillary services to taxpayers.

The one area where we have some information on these services is refund anticipation loans. Only 0.6 percent of the taxpayers utilizing Free File have utilized a RAL, and that number is actually going down. As of today, it is 0.59 percent, so it is shrinking.

In fact, half of the Free File vendors do not even offer refund anticipation loans; actually, it is more than half, 11 of 20 do not.

This 0.6 percent is the lowest rate of any electronic filing. The highest rate is for those electronic returns filed by tax preparers. Twenty percent of those returns involve a RAL.

Thank you, Mr. Chairman. I will be happy to respond to any questions.

The CHAIRMAN. Thank you.

[The prepared statement of Mr. DuMars appears in the appendix.]

The CHAIRMAN. Ms. Olson?

**STATEMENT OF NINA E. OLSON, NATIONAL TAXPAYER
ADVOCATE, TAXPAYER ADVOCATE SERVICE, WASHINGTON, DC**

Ms. OLSON. Mr. Chairman, Senator Baucus, and members of the committee, for most Americans the annual rite of preparing and filing their tax returns represents their most significant contact with the U.S. Government. The importance of making this process run smoothly, therefore, cannot be overstated. More than 60 percent of American taxpayers pay preparers to prepare their returns, and GAO's findings today underscore the significant problems that exist in the tax preparation industry.

In my 2002 annual report to Congress, I proposed a plan for the IRS to register, test, and certify unenrolled Federal income tax preparers.

It is remarkable to me that, in the United States today, an insurance agent cannot sell insurance without a license, a contractor cannot build without a license, and a hair stylist cannot touch a lock on a person's head without a license, yet anyone can prepare a tax return for a fee with no training, no licensing, and no oversight required.

In the 108th Congress, the Senate passed my proposal to regulate unenrolled preparers as part of the Tax Administration Good Government Act. The proposal was introduced again in this Congress as part of S. 832, and I am pleased that the Chairman and Ranking Member of the Senate Finance Committee are again cosponsors.

I encourage Congress to pass this common-sense legislation. As I recommended in my 2003 report to Congress, I also encouraged Congress to enact a more stringent compliance and penalty regime to deter reckless disregard of the rules or negligence by paid preparers.

Of course, these proposals would help only the 60 percent of taxpayers who use return preparers. We also need to do more to help taxpayers who self-prepare their returns.

Four years ago, the IRS and the software industry created the Free File program to make e-filing more accessible to taxpayers.

Unfortunately, the Free File program has done little to increase the number of taxpayers who e-file their returns. This year, it appears that roughly 135 million individual taxpayers will file income tax returns, yet only about 4 million taxpayers, or 3 percent, will use Free File.

Partly in request to a response from the staff of this committee, I asked several tax attorneys in my office to test four fact patterns on each of the 20 Free File sites.

We designed each of our examples to test tax provisions that were common to various segments of the taxpayer population. We tested scenarios involving Katrina relief provisions, self-employment and depreciation provisions, the application of the Alternative Minimum Tax, and the recently enacted Uniform Definition of a Qualifying Child.

Here are some of the results we found. Only 7 of the 20 Free File sites calculated the correct tax in the Katrina relief scenario; 12 sites did not apply the special casualty loss tax benefits available to Hurricane Katrina victims, causing users to overpay their taxes.

Nine sites did not increase the lifetime learning credit for eligible education expenses for individuals affected by Hurricane Katrina, as authorized by the Gulf Opportunity Zone Act of 2005, again causing users to over-pay their taxes.

Schedule C, the sole proprietorship schedule, was not supported by several sites. Some of these sites did not warn taxpayers sufficiently prior to data entry into the program. Other sites did not support the section 179 depreciation deduction. At least two sites did not support more than four dependents. I do not know what happened to the other children you might have had in that calculation.

At least three sites omitted the Alternative Minimum Tax calculation, thus understating the tax due. These taxpayers can expect to hear from the IRS.

Cross-marketing of ancillary products and services is common on many of the sites, despite their being accessed from *irs.gov*, the official IRS website. For example, one well-known software product charges taxpayers who want to prepare and file their State returns \$19.95, and then offers to deduct that fee directly from their refund if they pay an additional processing fee of \$29.95, for a total cost of \$49.90.

Several of the sites offered bank products as a method to receive tax refunds; others charged a fee per question for answers to tax law inquiries, and did not mention that this service is free if the taxpayer called the IRS.

The results of our testing demonstrate that Free File is not an easy service for taxpayers to navigate, and it can even result in inaccurate returns. As currently structured, Free File amounts to a wild, wild west of differing eligibility requirements, differing capabilities, and differing availability of, and fees for, add-on products.

Where do we go from here? Considering the poor performance of many of the Free File sites, the tiny fraction of taxpayers who use them, concerns about exploitative cross-marketing of other products, the appearance that the IRS is endorsing the Free File products, and taxpayer concerns about the confidentiality of their tax data, there is little justification to continue with Free File and

every justification for the IRS to develop a tax preparation template and to provide free filing for all taxpayers, just as it does for paper filers. The IRS template and direct filing portal should be simple, accurate, and confidential.

The issues I have discussed in my testimony make clear that the role of tax preparation is central to effective tax administration. As the tax administrator, the IRS should do more to oversee more closely those persons and entities that provide tax preparation services and to provide a high-quality, free vehicle for paper and electronic return preparation and filing. Thank you.

The CHAIRMAN. Thank you, Ms. Olson.

[The prepared statement of Ms. Olson appears in the appendix.]

The CHAIRMAN. Mr. Weinberger?

**STATEMENT OF ROBERT A. WEINBERGER,
MEMBER, FREE FILE ALLIANCE, LLC**

Mr. WEINBERGER. Thank you, Mr. Chairman and members of the committee.

The landscape of tax return preparation has evolved significantly since enactment of the IRS Restructuring and Reform Act in 1998.

First, electronic tax preparation and filing have become commonplace. Over 80 percent of returns are now prepared on a computer, and over 50 percent are now e-filed. Do-it-yourself tax preparation assisted by software is growing, up 17 percent this year alone. But the majority of e-filed returns still come from paid and volunteer return preparers.

At H&R Block, 95 percent of tax returns prepared in our offices this year so far were e-filed. While steady progress is being made, we join with others in suggesting that Congress consider extending the 80 percent e-file goal set for 2007 to 2011 to maintain focus on e-filing.

One innovative e-filing channel is the Free File Alliance. Over 14 million returns, including 3 million this year, have been e-filed through this public/private partnership, which includes 20 companies. Taxpayers have saved more than \$42 million through donated services, and the IRS has saved far more.

This year, 70 percent, or 93 million, low- and moderate-income tax filers with adjusted gross incomes of \$50,000 or less are eligible for free Federal income tax preparation and on-line filing using the same products offered commercially, not stripped down versions. Free File standards exceed government regulatory requirements.

Free File is a positive example of government/industry partnership in the public interest. Second, Americans are increasingly turning to professionals for tax assistance.

About 60 percent of all taxpayers use a paid return preparer. Their reasons include complexity, convenience, and counseling. Good tax return preparers help us navigate a complex tax system and ease the burden and anxiety that most Americans feel at tax time.

Increasingly, there is recognition that tax time is an opportunity for an annual financial check-up. Since nearly 80 percent of taxpayers receive refunds averaging \$2,100, it is both a teachable moment and an opportunity to save for a family's key financial goals of college, home ownership, and retirement.

We also use the opportunity to alert our low-income clients to their eligibility for a variety of under-utilized government benefits outside the tax code, including Children's Health Insurance, food stamps, and prescription drug discounts.

Our fees vary by location. They are based on the forms used and the work done, not on a client's income or the size of his refund. They can be as low as \$24 for the simplest 1040-EZ. This year they average \$154 for a Federal, State, and any local return needed.

A third change over the last decade is the growing need for meaningful minimum quality standards. Thirty years ago, with a much simpler tax code, Henry Block testified and proposed IRS registration of all tax return preparers. We renew that call today, and go further.

We believe IRS certification of paid return preparers, which would require validation of tax knowledge, background checks, and continuing tax education, would benefit the public. This could be accomplished through enactment of section 4 of S. 832, co-sponsored by Chairman Grassley, Ranking Member Baucus, and other members of the committee.

It would require testing for technical knowledge, competence and ethics, continuing education, and stiffer penalties for misconduct. The new program would complement existing laws covering tax return preparation, and extensive rules covering practitioners who represent taxpayers before the IRS and those who originate electronic returns.

Because some 80 million taxpayers get help from over a million tax practitioners in a compact, 10- or 11-week period, adequate staffing is critically important for effective enforcement.

High-quality tax returns depend on practitioner training and education, especially given frequent changes in the tax code. The average H&R Block tax return preparer has over 225 hours of training, and nearly half have 5 or more years of experience. Over 5,000 are enrolled agents or CPAs. Minimum requirements include a basic 66-hour tax course, with equal amounts of homework and a passing grade.

For re-hiring, at least 24 hours of continuing education are required yearly. We offer 59 advanced courses. Our tax professionals are also trained on systems, products, policies, and procedures, which require an additional 20 to 35 hours in class.

We follow a strict code of business conduct, and our electronic return originators require IRS approval, which may include background checks and tax compliance verification.

Our tax pros work with state-of-the-art software that checks calculations, theory, and accuracy. Approximately 10,000 diagnostics help flag items to review and will not let the user file unless identified errors are corrected. We also utilize a second review by another professional for many tax returns.

With a complex tax code and 16 million returns prepared in our offices by over 100,000 return preparers, occasional errors are possible. However, we believe our error rate at that volume level is small as compared to competitors or other professions. For all clients, we stand behind the quality of our work and guarantee that we will pay any interest or penalties if we err.

Mr. Chairman, while the tax landscape continues to change, some things remain constant. Our training and compliance culture remains strong. We assist our clients in determining their correct tax liability to pay precisely what they owe, no more and no less.

And for over a half century, H&R Block has built its reputation as a trusted tax and financial advisor to middle America. Our best practices and code of ethics reflect longstanding commitments to integrity and professionalism, which we renewed today. Thank you.

The CHAIRMAN. Thank you, Mr. Weinberger.

[The prepared statement of Mr. Weinberger appears in the appendix.]

The CHAIRMAN. Now, Mr. Degen?

STATEMENT OF FRANCIS X. DEGEN, E.A., PRESIDENT, NATIONAL ASSOCIATION OF ENROLLED AGENTS, WASHINGTON, DC

Mr. DEGEN. Thank you, Mr. Chairman. Thank you for asking the National Association of Enrolled Agents to testify before you today. We are the premiere organization representing the interests of 46,000 enrolled agents across the country.

Enrolled agents are the only practitioners in whom the IRS directly attests to competency and ethical behavior.

I would like to suggest how our system of voluntary compliance is threatened by unlicensed return preparers who, in many instances, we have found to be unscrupulous or incompetent, and, unfortunately, in far too many cases, both unscrupulous and incompetent.

To help remedy this disturbing situation, NAEA urges members of this committee to take action by reporting out Senator Bingaman's bill, S. 832, the Taxpayer Protection and Assistance Act of 2005.

For EAs, who abide by the highest levels of ethical and competency standards in order to live up to the requirements set by Federal regulation, the competitive disadvantages of the situation are stark. Time and time again when our members are surveyed, they relate instances of what we call "preparer shopping" during the tax season.

Indeed, some taxpayers gather up their tax documents and walk out because someone right down the street has guaranteed them a minimum refund, \$1,000, \$3,000, or even more. Or the taxpayer wants the preparer to help them incorrectly report expenses or income from rental property, or not report under-the-table income. The list goes on and on.

As I have stated before at the Committee on Ways and Means, people drive in excess of the speed limit until they notice the cop. Then they all observe the speed limit for a while. But when the cop leaves the beat, speeds begin to creep back up. Mr. Chairman, it has been too long since the tax cop has been out circulating the neighborhood is his black-and-white.

While it is easy to focus only on fraud, one must not forget that preparer incompetence probably causes as much heartache. We all know that the tax code is quite complicated. Unfortunately, too many preparers today fail to attain adequate training and edu-

cation and do not make the investment in time and money to keep up with the constantly changing tax code.

Mr. Chairman, it is important to place negligence and incompetence on an equal footing with intentional fraud when attempting to understand the magnitude of the non-compliance program among unregulated preparers. Parenthetically, I think we have heard some testimony about that today.

NAEA strongly endorses the concept of regulating all paid return preparers, requiring an initial test for competency, background checks, annual minimum continuing education requirements, and compliance with the current Circular 230 ethical standards.

Additionally, the Office of Professional Responsibility needs adequate resources to both enforce the rules and promote all preparers covered by Circular 230.

After many months of working with the practitioner community, Senator Bingaman, in concert with both you, Mr. Chairman, and Senator Baucus and Senator Schumer, has developed thoughtful legislation that addresses most of these elements.

NAEA has endorsed this legislation as the most comprehensive road map to address the problem of unregulated preparer non-compliance. We would urge the committee to report out this piece of legislation as soon as possible.

Mr. Chairman, before I close I would like to take one minute to talk about e-services. The e-services product is one of the best and most useful IRS has launched in recent memory for the practitioner community. NAEA remains troubled that the Agency continues to predicate e-service access on participation in the e-filing program.

Clearly, meeting the congressionally mandated 80 percent e-file participation rate is important to the Agency. At the same time, using the e-services program to incent e-filing participation without regard to the specialized services of the practitioner's best position to use it—enrolled agents, attorneys, certified public accountants—is distressing to NAEA members and appears to run counter to the Service's commitment to customer service.

The Service's refusal to open e-services to all Circular 230 practitioners opens the Agency to a criticism I have heard often, namely, while the IRS has in place a framework that prescribes competency and ethics and holds EAs, attorneys, and CPAs to a higher standard, the Agency consistently fails to support its licensed practitioners, fails to distinguish between licensed and unlicensed practitioners, and fails to promote anything except e-filing.

In closing, Mr. Chairman, we unconditionally endorse Senator Bingaman's bill and stand ready to work with you in passing it expeditiously.

As I have said previously while testifying before Congress, most taxpayers would be astounded to find that, while their barber or their manicurist is licensed, their tax preparer may not be.

Comparing the down side of a bad haircut to that of an incorrect tax return, it is time to establish Federal standards to ensure basic competence and ethical behavior. I thank you, and will take any questions that you have.

[The prepared statement of Mr. Degen appears in the appendix.]
The CHAIRMAN. Mr. Duncan?

**STATEMENT OF HARLEY DUNCAN, EXECUTIVE DIRECTOR,
FEDERATION OF TAX ADMINISTRATORS, WASHINGTON, DC**

Mr. DUNCAN. Thank you, Mr. Chairman, members of the committee. We appreciate the opportunity to present to you the viewpoint of State tax agencies on the issues before this committee.

What I would like to do is to give you a snapshot of State electronic filing practices and experience, and then address a few selected issues that are before this committee.

In terms of State electronic filing practices and experience, our States began electronic filing in 1990. At the present time, each of the 41 States and the District of Columbia that has a broad-based State income tax provides at least one avenue for the electronic filing of State income tax returns.

The bulk of those programs operate in a joint Federal/State program where either the practitioner or the individual, if they use third-party software, can file both the State and the Federal return in a single transmission, and the State information is later made available to the State tax agency.

In addition to those traditional practitioner and on-line programs, we have a group of States, 21 States, that provide a direct Internet filing option, where a taxpayer may, at no charge, interact with a State website to file his/her State tax return. We also have 10 States that still operate a tele-file program.

State electronic filing has been growing at a rate of about 25 percent per year through 2004. It slowed to 15 percent last year and is running at about 7.7 percent through March 17 of this year. In 2005, there were 50 million State electronic returns filed.

In terms of the proportion of State returns, some States exceed 60 percent of all their returns received electronically, including Minnesota and Iowa, and nine others have in excess of 50 percent of their returns received electronically, I might add, including Montana.

The mix of electronic returns in 2005 was 75 percent from practitioners, 18 percent using third party on-line software, 4 percent direct Internet filing, and 3 percent through the tele-file programs.

With respect to direct Internet filing programs where a taxpayer may, at no charge, interact with the State website to file his/her State return, I would note that we have no position as to whether a State should do it or should not do it. Rather, they should have the choice to evaluate their circumstances and determine whether they would like to.

There are 21 States that now have these filing programs in 2006. In 2005, they generated about 2 million returns. In several States, direct Internet-filed returns exceeded 15 percent of all electronic returns, particularly in some of the longer-standing programs, such as in Pennsylvania, Delaware, and New Mexico.

It has been suggested by some that the direct Internet filing programs are an inappropriate form of competition with the private sector and represent a conflict of interest on the part of State tax agencies. I think for our part, the State tax agencies that offer it see it differently.

They view it as an extension of their obligation to provide tax forms and information to the taxpayer that enable them to complete their obligations. They see it as an additional electronic serv-

ice that they are providing, one of several that they provide, whether it is electronic payments, account maintenance, on-line help, and the like.

They see it as simply a matter of moving their business in the same direction that all other businesses are moving, and in a way that people expect to interact with business and their government.

If a direct program is considered for the Federal Government, there are at least several issues that would need to be considered, not the least of which is the complexity of the Federal return. State Internet filing sites can eliminate a good bit of that complexity because of their reliance on a starting point of Federal adjusted gross income and not considering the calculations behind that.

A word on Free File. Selected members of the Free File Alliance offer free services in the 21 States that do not operate a direct Internet filing program. There are generally two to four vendors that have chosen to offer services to some taxpayers in those States.

While the States are appreciative of these efforts, there is a concern among the States that complete information on whether a taxpayer qualifies for a free State return is not easily available to the taxpayer when they begin the free filing of the Federal return.

Under the current system, one has to go back and forth between a practitioner's site and the IRS site to get that. We would argue that complete information on who qualifies for State and Federal returns should be available on *irs.gov*.

The last point I would make, Mr. Chairman, is about electronic filing mandates. There are 12 States that have those, they have proven useful in increasing electronic filing, and there is some experience at the States that would be helpful to the Federal Government if you were interested. Thank you very much.

[The prepared statement of Mr. Duncan appears in the appendix.]

The CHAIRMAN. We thank all of you very much for your testimony. We will have 5-minute rounds. I will probably have a couple rounds of questions I will want to ask.

I will start with you, Mr. Brostek. Your agency uncovered some things that can result in fines against tax preparers. You had things come up like improper claims for child-related benefits, some preparers failing to properly include their identifying information and signing the returns as required by statute. I think you said that you are going to take steps of turning this over to the IRS for IRS follow-up.

Mr. BROSTEK. Yes, we already did.

The CHAIRMAN. All right. You have done that. And so whatever is done will be the IRS following up with that. All right.

Then maybe to you and your investigators, Paul and Christine, whoever wants to answer it. The percentage of paid preparers who failed to include cash income on the returns, of course, is a very disappointing finding that you had.

Taxpayers need to ensure that they provide their preparers with correct information to properly calculate the tax liability. But responsibility also falls on the preparer to perform an income and expense probe to make sure that everything is considered.

The preparer is also responsible for correctly reflecting the tax treatment of the income and expense items, which is, after all, why they were hired in the first place. If cash income is left off the returns more often than it is included, one has to wonder what the circumstances were surrounding that omission.

It seems to me the only way this could occur is if the income was intentionally left off the return, or that the taxpayer and the preparer failed to properly communicate with each other about the income.

So I would like to ask the three of you to tell me a little bit about the circumstances under which you discussed the income with the preparers and what the reaction to the income was.

How about you, Ms. Hodakievic. Would you be able to help us in regard to that?

Ms. HODAKIEVIC. Yes, Mr. Chairman. For consistency and to give the preparers every opportunity to complete a correct return, if we had not been prompted to provide the information by the preparer, in every case we had not been asked up front, we brought it to the attention of the preparer that we had this side income. In my case, it was from baby-sitting, in the amount of about \$20 a week.

Each preparer responded to that information differently. In one case, I had a preparer simply stare at me and then ignore the information and continue preparing my return by answering the questions for me that he was prompted to by his computer.

On another occasion, I had a preparer tell me outright, "it's best not to report that." Then on another occasion, I had a preparer tell me that since the amount was below \$3,200, there was no requirement to report that income.

The CHAIRMAN. One thing that bothers me about the Government Accountability Office testimony is that, out of all the nine preparers that Paul visited in his plumber scenario, no two reached the same tax liability. In fact, out of all 19 visits, I am told that only twice was the correct tax liability achieved, and one of those times was only because the investigator told the preparer to re-do the return to properly reflect the income and the child-related benefits.

Didn't any of the preparers, Paul, that you went to perform a quality review? Didn't they respond properly to what you were saying, or were they trying to be very evasive?

Mr. DESAULNIERS. Well, of the nine preparers that I visited, one of them did a review, had a supervisor review it, and I had to come back and pick up the return the next day. But they are reviewing the information that was entered into the form, not the information that was taken from me. So, if the person did not report side income, for instance, there is no way that the reviewer would have of knowing that.

The CHAIRMAN. Senator Baucus?

Senator BAUCUS. Thank you, Mr. Chairman. I would like to follow up. This is astounding, frankly. I mean, what was it, only 10 percent were prepared correctly? Is that basically what the Agency came up with?

Mr. BROSTEK. Well, we ended up with two that came up with the right refund, but they did not necessarily prepare the return correctly. They made offsetting errors in some cases.

Senator BAUCUS. So what percent of the returns were prepared correctly?

Mr. BROSTEK. None.

Senator BAUCUS. None. Is that right? None?

Mr. BROSTEK. That is true.

Senator BAUCUS. None. Out of how many? Nineteen? Is that correct?

Mr. BROSTEK. Correct.

Senator BAUCUS. Nineteen. None were prepared correctly out of 19.

How did you choose these preparers?

Mr. BROSTEK. Well, we selected one metropolitan area where we understood that there were many of the nationwide chains located. Within that metropolitan area, we went to places all over the area, in large part so we would not be seen going into one store, and then across the street into the next one. So we were, throughout the metropolitan area, going to at least two of the same chain with the same scenario.

Senator BAUCUS. All right. And your returns were fairly ordinary, or were they complicated?

Mr. BROSTEK. Well, we think they were fairly ordinary. We attempted to avoid really complex rules. In the cases where the preparers made some of the more significant errors, in my judgment, the rule was not difficult to follow at all.

For the Earned Income Credit, your child has to live with you more than half the year. Whenever we were asked, and in fact, we would even write down on a piece of paper, one of these children did not live with us at all during the year, yet the preparer would record the child as living with us.

Senator BAUCUS. Now, your impression, just being objective about this. Why were no returns prepared correctly? To what degree is it incompetence and to what degree is it intentional?

Mr. BROSTEK. We do not really know entirely.

Senator BAUCUS. Just your gut guess. I mean, you got a feel when you walked in there.

Mr. BROSTEK. Let Paul give you an idea.

Senator BAUCUS. Paul, yes, if you could. Just your honest assessment of what you saw, and why.

Mr. DESAULNIERS. Right. Many of them were confident that they knew what they were doing.

Senator BAUCUS. They were confident.

Mr. DESAULNIERS. Confident.

Senator BAUCUS. Competent?

Mr. DESAULNIERS. No, I did not say that. Confident.

Senator BAUCUS. Confident, with an "F."

Mr. DESAULNIERS. With an "F." They were confident as they took the information from me. And some of them were, it appeared, knowledgeable, but there were also a few that—myself, I am not that familiar with preparing taxes, and I quickly discovered that they were asking me questions that they should already have known I was not entitled to.

For instance, child care. Once they found out that my wife did not work, there should not be any more questions, but they contin-

ued to ask questions as if they were going to take a deduction for child care.

Senator BAUCUS. Did you run into situations where there should have been side income, side cash that should have been reported?

Mr. DESAULNIERS. Yes. In each instance, they either asked me or I offered to them that I had side income. Four of the nine people that I met with recommended that I not report the income.

Senator BAUCUS. Was that a recommendation in the sense that you do not have to, or that maybe you should if you can maybe get away with it?

Mr. DESAULNIERS. Right.

Senator BAUCUS. Which was it?

Mr. DESAULNIERS. That it was unnecessary to report it. I would say two of them said it was unnecessary, the others said you do not need to report it.

Senator BAUCUS. All right.

Mr. DESAULNIERS. Some said, there is no law requiring me to report it, and other ones said it was my choice, but they would recommend that it not be reported.

Senator BAUCUS. So some of it was incompetence. Was it all incompetence or was there also some ulterior motive, do you think?

Mr. DESAULNIERS. Well, I would have to think that they would know that side income should be reported.

Senator BAUCUS. That is pretty common knowledge, is it not?

Mr. DESAULNIERS. I do not prepare taxes, but I would think it would have to be reported.

Senator BAUCUS. Yes.

Ms. HODAKIEVIC, your impression as to what is going on here. How much is incompetence and how much is more than incompetence? That is, how much is failure to prepare returns accurately?

Ms. HODAKIEVIC. In terms of the failure to report the side income, I believe in a couple cases it may have been due to their desire to expedite the process. It was easier and faster to complete the tax return by not going back and then once again including the income.

In other cases, from their responses, I can only assume it is incompetence, given the information that I provided and the reasons they said not to include the income. I failed to mention earlier, in one of the scenarios, a tax preparer asked me if I had the Social Security information for the persons who had paid me for baby-sitting.

And when I told them that I did not, they told me I was not able to report that income because I needed their Social Security numbers to be able to do so. So from what I know now, and after seeing the returns that they had prepared, a large percent was incompetence there.

Senator BAUCUS. I will have more questions. My time has expired.

The CHAIRMAN. Senator Wyden, then Senator Bunning.

Senator WYDEN. Thank you, Mr. Chairman.

Ms. Olson, your annual report to Congress recommends as one of the core principles for tax reform that "the tax laws should be simple enough so that taxpayers can prepare their own returns

without professional help, simple enough so that taxpayers can compute their liabilities on a single form, and simple enough so that IRS telephone assistants can fully and accurately answer taxpayers' questions."

Now, I have introduced S. 1927, the Fair Flat Tax Act, that does exactly what your core principles call for. In fact, my legislation includes a 1-page, 30-line 1040 form. I filled it out myself for my own return in a half an hour.

Recently, the folks at *Money* magazine took my proposal, and the fellow called back and said he did his, using my form, in 15 minutes. Would you not agree that having the kind of simplified tax system we would have under my legislation would achieve your core principles for tax reform?

Ms. OLSON. Well, sir, I would have to agree that any form that you are able to fill out in that amount of time would meet my core principles. In saying that, I stay scrupulously clear of any issues of tax policy and setting rates and things like that.

Senator WYDEN. With respect to your views and Mr. Brostek's, if the tax code were reformed along the lines Ms. Olson recommends so that people could fill it out on one piece of paper, something my bill does—others have offered the same thing—would it not be possible for taxpayers to save a significant amount of time and a substantial amount of money compared to what is happening today? For you, Ms. Olson, and you, Mr. Brostek.

Ms. OLSON. Yes. Even if people insisted on going to preparers, as they do for the simplest returns, it would eliminate some of the mistakes, one would hope, that we are hearing about today.

Senator WYDEN. Mr. Brostek?

Mr. BROSTEK. Yes. I would agree that if we were able to have a much simpler form, it should decrease the amount of record keeping that people need to do, the amount of time they need to spend to complete the return, and would likely reduce the number of people who go to pay someone to do their return.

Senator WYDEN. Would it not be correct that a simplified system could save taxpayers billions of dollars and hundreds of millions of hours of time? I base this on the comments made by Mr. Rossotti, who served on the President's commission.

The new Tax Foundation report has figures that are substantially higher than Mr. Rossotti's. The new report says that the \$265.1 billion tax compliance cost is greater than the revenue of Wal-Mart, the largest company in America.

So would the proposal that I am advocating and the core principles that you are talking about, Ms. Olson, not save taxpayers billions of dollars and hundreds of millions of hours of time?

Ms. OLSON. Yes, sir. And it would also save the IRS, and that would, in return, save taxpayers millions of dollars, at least.

Senator WYDEN. Mr. Brostek?

Mr. BROSTEK. I think that is a reasonable conclusion, that it would save both the taxpayers and IRS.

Senator WYDEN. One of the most alarming parts of the new study by the Tax Foundation indicates that the cost of tax compliance ranged from 14 to 16 cents per dollar of tax collected during the 1990s, but in 2002, the cost of compliance soared to almost 22

cents per dollar of tax collected, and it has stayed between 22 and 24 cents per dollar collected in the past 3 years.

So the cost per dollar of tax collected is about 50 percent higher than it was 10 years ago. For you, Ms. Olson, and you, Mr. Brostek, why have the costs of tax compliance soared just in the last couple of years?

Ms. OLSON. Well, let us just look at the education provisions. The number of education provisions that we have has soared, and taxpayers have to keep records for that and they have to spend time figuring out which one is the right one for them. You multiply that by many of the other provisions that we have in the code today.

Mr. BROSTEK. I do not know precisely why the costs would have been going up recently. We did do some work last year, reporting on the number of tax expenditures, special provisions in the code that reduce people's taxes. Those have risen steadily since 1974. They have risen in the last couple of years at a steeper rate. The tax provisions affect individuals far more than corporations.

Most of these tax expenditures affect individual taxpayers, and thus, all of the 130-plus million people who are paying taxes have to take those into account, in some sense, generally, when they are doing their returns.

Senator WYDEN. My time is up. But I think this alone, Mr. Chairman and colleagues, ought to be a wake-up call for bipartisan tax reform. The fact that the cost of tax compliance has soared just since the year 2000 makes the case, in my view, for us getting to work on a bipartisan basis. The Chairman knows that I am interested in pursuing my bill. I think there are a variety of other approaches that would make sense as well.

But if Ronald Reagan, Bill Bradley, Dan Rostenkowski and Bob Packwood could get it done in 1986, I think 20 years later we can do it again. I look forward to talking to these able people at the witness table about that, and you and Senator Bunning as well. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Bunning?

Senator BUNNING. Thank you, Mr. Chairman.

Twelve years ago in the Ways and Means Committee, we did something similar. We handed out 25 tax returns with exactly—exactly—the same set of circumstances. And guess what? We got 25 different results on the tax liability on those returns. This is 1994, 1995—somewhere in there—when we did it. Now it is even more complicated because we have added new and changing things to the tax code.

And we talked about doing exactly what my good colleague from Oregon said, simplifying the tax code, making a flat tax, or sales tax, or whatever, and no one could come to a conclusion at that time.

So I am going to ask the GAO, I was particularly troubled that side income was often not reported, despite the preparers being told that side income existed. I realize that this requires some speculation on their part, but did the investigators get the feeling that it was a preparer mistake or did they feel that the preparer was deliberately under-reporting the income?

Mr. DESAULNIERS. In one case, I had a preparer that I told about side income, and her response was to wave her hands and tell me, no, you do not want to report that.

Senator BUNNING. Not knowing the law that it has to be reported.

Mr. DESAULNIERS. I do not think it was a question of her not knowing the law. I think she was trying to—

Senator BUNNING. Hurry you through the process?

Mr. DESAULNIERS. No. I think she was trying to increase my refund.

Senator BUNNING. All right.

Mr. Weinberger, you said that your company pays penalties and interest for your customers if there was a mistake in their return. How often has your company been called on to do that?

Mr. WEINBERGER. I do not have the data, but I would be happy to try to get it.

Senator BUNNING. Would you please furnish that for us?

[The information appears in the appendix.]

Senator BUNNING. Do you know what percentage of your customers get audited by the IRS?

Mr. WEINBERGER. No, because they would not necessarily all call it to our attention. But generally the audit rates are 1 percent or less throughout the tax system.

Senator BUNNING. Mr. Degen, can you explain for us what types of qualifications enrolled agents must have?

Mr. DEGEN. Well, Senator, in order to become an enrolled agent, if this answers your question, there are two paths that you can take. One path is to have worked for the Internal Revenue Service for 5 years in a capacity that interprets the Internal Revenue Code, typically a revenue agent or a revenue officer.

Senator BUNNING. Someone with a green shade who sits and audits your return?

Mr. DEGEN. Right. Exactly.

Senator BUNNING. All right.

Mr. DEGEN. And the second way is for an individual such as myself, who did not work for the Internal Revenue Service, to pass what is called the Special Enrollment Examination. This, up to the current time, has been a 2-day, 11-hour examination which basically tests your knowledge of the Internal Revenue Code.

What it allows you to do is to represent taxpayers in dealing before the IRS. So you can represent taxpayers in examination, in collections, and at the appeals level. The intent of the exam is to make sure that you are proficient so that when you deal with the IRS you can ably serve your clients.

Senator BUNNING. And it is your recommendation in your written testimony that all paid return preparers should be regulated.

Mr. DEGEN. Yes.

Senator BUNNING. Is that correct?

Mr. DEGEN. Yes. I am not advocating that they all become enrolled agents. I think that is a far step right now. But, yes.

Senator BUNNING. But anybody you pay should be regulated.

Mr. DEGEN. Anyone you pay. Right. There needs to be oversight. I think that is the key to it. We have a system in place already in the Office of Professional Responsibility. They do oversight, but

only on enrolled agents, certified public accountants, and attorneys. Basically, what we would propose is that oversight be expanded, and let them look at all tax preparers and regulate them.

Senator BUNNING. Mr. Weinberger, would you like to comment on that recommendation?

Mr. WEINBERGER. Well, we do favor testing and certification. Whether the program would be administered under Circular 230 by that office or administered elsewhere, for example, joined to the Administration of Electronic Return Originators, as the IRS increasingly moves to electronic filing, is something I think needs to yet be determined.

But the thing to point out, I think, also with respect to enrolled agents, is their credential primarily relates to representing taxpayers before the IRS, and 99 percent of taxpayers do not have post-filing disputes with the IRS. So while they are qualified—

Senator BUNNING. Do you feel that is because they are so well represented, or do you feel that the IRS just does not have the manpower to audit that many returns?

Mr. WEINBERGER. Maybe a combination, but certainly the latter is the case.

Senator BUNNING. All right. Thank you. My time has expired.

The CHAIRMAN. Thank you very much, Senator Bunning.

I am going to turn to Ms. Olson. There has been a lot of press lately regarding the disclosure of taxpayer information. The IRS released proposed regulations under section 7216 that many privacy advocates fear will open the door for the sale of tax information by preparers. The IRS's goal in rewriting the regulation was actually to tighten the disclosure rules and update them for today's electronic age.

As Taxpayer Advocate, I would like to have your perspective on the proposed regulation and your position on what is a correct solution.

Ms. OLSON. All right. First of all, the world is wide open right now for the disclosure and sale of taxpayer information by the preparer. Under current regulations, there is no hindrance to disclosure of that information being disclosed to third parties, sold to third parties, and those third parties can re-disclose that information to anyone.

It was precisely that wide-open nature that drove me to want the current regulations to be revised so that taxpayers had to be specifically told that that might happen, that that could possibly happen, and that they had to understand that before they consented, and that there would be a limit on the period of time in which any consent the taxpayers gave would run. Under the current regulations, it is, again, wide open. That consent stands for ever, and ever, and ever, and ever, and ever.

So I think the regulations did a very good job in trying to tamp down and control some of what I consider the very wide-open provisions of the current regulations. Having said that, I think if I had had my druthers, I would have probably eliminated the disclosure language entirely, because I think that that is so wide open.

I would have limited taxpayer consent to use, and maybe some very limited disclosure, only in the context of tax return purposes, in connection with tax return preparation, so that we did not get

people disclosing it to used car salesmen and all these other uses that we are seeing, but that it serves some tax administration purposes. So, I think that is where I would have gone if we had to go back to the drawing board, or actually, frankly, if you wanted to review 7216 statutorily.

The CHAIRMAN. Thank you very much.

I am going to move on to Mr. DuMars. It is my understanding that you are very supportive of the status quo in terms of electronic filing. So as a committee, we are interested in getting your view on direct Internet filing at the Federal level.

Does the IRS support Direct I-File or the development of electronic portals? Do you believe that Direct I-File is a service that should be provided by the government to the taxpayer? Assuming that I-File is desirable, what are the key issues that Congress should keep in mind in drafting the enabling legislation?

Mr. DUMARS. Well, I think that the Free File program actually works very well, and it works very well at a very low cost. Literally, in my organization we only have a very minimal number of full-time employees who actually have to manage it. To consider something at a much broader development is going to be very expensive, very time-consuming, and probably require significant resources and investment.

The other thing that has occurred, and I think this is something from what happened over the last couple of years, is the guidance from the Senate and the Congress on this, especially when we were in the negotiations, the amendment that occurred right at the end of the last two weeks of the negotiations with this current agreement pretty clearly stated that we were to work with the industry and comply with the Free File Alliance agreement that we came up with.

So, those are some of the things that, when we looked at what would be the right way, and then also going back to RRA 1998, where it states that we should be working with industry to come up with a solution in the space—those are the things we looked at with regards to this.

The other thing just to think about when you are looking at what solutions might we consider, one advantage of the Free File Alliance is there are 20 members of that alliance currently today, and that actually will fluctuate over time as new companies come on board, and so on.

That actually provides a lot of innovation and development in this space, especially with, as many people have said here, the complexity of the tax code.

One thing we have to realize with Free File or any type of an electronic software package, is what it is doing is hiding the forms from the taxpayer. It is doing that to try to simplify it, to make it easier for them to understand their obligation. So, those are the things that we kind of take into consideration as we look at this.

I would be concerned about a one-size-fits-all type solution that we would come up with and how that would actually meet the needs of a taxpayer versus the 20 solutions that we have today, where they get very specific on the taxpayer needs.

The CHAIRMAN. All right.

Senator Baucus, then Senator Bunning.

Senator BAUCUS. Mr. DuMars, I do not quite understand this. A person can deal directly with his or her paper return. Kitchen table. Fill out the return. I have done this. Kitchen table. Fill out the tax return and just send it in.

Yet, I cannot do that electronically today. Why? What is the difference? Why do I have to deal with a preparer if I file electronically, and do not have to deal with a preparer if I file a paper return? What is the difference?

Mr. DUMARS. I think it is kind of having this understanding of how the system has actually been developed. Remember, this is the 20th year of e-file, so we are sitting on a system that is literally 20 years old, that was developed for bringing in batch processing of returns in bulk from the different organizations that deliver those returns. It was not designed specifically for a direct interface on a one-to-one basis. That requires significant enhancements.

Senator BAUCUS. No. I am sorry. You are not answering my question. My question is, what theoretical difference is there? I do not care what has happened historically. What theoretical difference is there between my filing a paper return directly with IRS, fill it out, envelope, address it, put my stamp on it, mail it in?

Mr. DUMARS. So you are talking, from a process perspective.

Senator BAUCUS. Yes. Why should I, from a process perspective, not be able to do that?

Mr. DUMARS. All right.

Senator BAUCUS. Why can I not just go on the computer, access the IRS site, and IRS sends back to me my return electronically. It is all electronic, on my computer screen. IRS then asks certain questions, which prompts my responses. I just fill it out and just send it in directly. Push a button, "return," and off it goes to IRS, just like I send my paper return in. What is the difference? Should there be a difference?

Mr. DUMARS. Should there be a difference?

Senator BAUCUS. Let me ask more precisely. Why should I not be able to file directly an electronic return, just as I am now able to file directly a paper return?

Mr. DUMARS. So are you asking the question from a policy perspective or technological perspective?

Senator BAUCUS. Either one.

Mr. DUMARS. Either one. From a policy perspective, it has been made clear to my—

Senator BAUCUS. No. I am not going down that road.

Mr. DUMARS. All right. All right.

Senator BAUCUS. I will get to that later.

Mr. DUMARS. All right.

Senator BAUCUS. I am going directly just from a technical concern or from a philosophical point of view.

Mr. DUMARS. All right.

Senator BAUCUS. From a policy point of view. Forget legislation. Assume there is no legislation on this issue whatsoever. Let us assume you have made no agreement with the Free File Alliance. Put that all aside for a moment, just starting fresh.

Mr. DUMARS. All right. From a technological perspective.

Senator BAUCUS. Yes.

Mr. DUMARS. It would require significant investment and significant development to make a system like that work. You have to understand, with today's environment, we actually have processes where the returns go to a software preparer, and even in the preparer's space, it goes to the same place.

Then they batch them up and they send them to us in large bulk. If we were to take them directly, we would have to have the capability of taking millions of returns in a day directly through an interface.

We would actually have to go through significant amounts of development to make that occur. Just from a purely technological perspective, it would require significant investment.

If you look at how much investment, the software industry today just does it for their small slices of this market. You would probably have to multiply that at a much higher level just for us to do it as well. It would require a large investment.

Senator BAUCUS. Has IRS done a study on this to determine what it would cost, what it would be?

Mr. DUMARS. I do not think we have done one in a while.

Senator BAUCUS. Any reason why you have not?

Mr. DUMARS. I think at this point because of the current system, the current way we are set up. I think, if this is something you want us to look at, this is something we could look at.

Senator BAUCUS. Some States do this.

Mr. DUMARS. At a significantly lower volume than what we would have to deal with.

Senator BAUCUS. All right. We will take it up later, that is, how you go about doing all this.

Here is my problem. I think, honestly, most preparers are preparers for one reason: they want to make money. Nobody is a preparer altruistically, out of the goodness of his heart. It just does not work that way, I do not think. That is the only way they make money.

So many preparers charge so many additional fees, so many different services ancillary to preparing a return, and I have to think they do that because they want to make money.

For example, one preparer in the Free File Alliance urges taxpayers to go out and drum up more business for the preparer and you get \$20, \$40 per return. It is a business. It is to get more business.

Then there are the anticipation loans charging usurious rates. I have heard rates up to 150 percent, 200 percent. Then there is the question of tax return information going to someone else, to a banker, for example, a credit card company, whatnot, all done by preparers.

I have to think—and I will let Mr. Weinberger address this—that the primary reason anybody is a preparer is to earn some income for the preparer or for the company. That is why they are there.

I doubt seriously whether any preparer would do this, again, totally altruistically, out of the goodness of his heart, and lose money as a consequence. By definition, they would have to lose money, because time is money, by taking the time with a taxpayer where that time could be spent elsewhere.

Mr. Weinberger, is it not true that H&R Block likes to earn income?

Mr. WEINBERGER. It is, Senator. But I would also point out that the seasonal tax return preparers whom we hire are often retirees or housewives. It is probably hard to get rich preparing tax returns in that environment.

I think a lot of those individuals derive considerable psychic benefit from helping their fellow citizens comply with their tax responsibilities, and from the gratification they get in seeing people improve their financial circumstances as a result of the advice that they gave.

Senator BAUCUS. So, you pay preparers. That is a cost to the company, to pay preparers. What do you get out of that? What income do you get? What income does H&R Block receive in the preparation business?

Mr. WEINBERGER. Well, we derive income from the fees that are paid.

Senator BAUCUS. Correct. Fees paid. Now, what about the whole list? GAO has this whole list of side fees that are charged. Are you saying GAO is incorrect in their analysis?

Mr. WEINBERGER. Well, I have not read the GAO report, so I cannot comment. But we do offer additional products and services, as a convenience to our customer and as a profit-making enterprise for the company. No one is required to take any of those products unless he or she feels that it might—

Senator BAUCUS. Right. But there is a person in my office who went through one of the preparers in the Free File Alliance. What happened? Well, she went through it. Midway through, for an additional \$25, you can get an upgrade. She did not want an upgrade, she just wanted a return. It was blocked. She could not get anywhere because she did not want to pay \$25 additional for an upgrade.

There are so many additional fees in the fine print at large here, and it is just bothersome. It feels like people are getting taken for a ride, often, when they try to fill these out.

Mr. WEINBERGER. Well, Senator, in the Free File Alliance, it is a bedrock principle that a citizen should be able to file a Federal income tax return without any cost, without any charge, and the service cannot be conditioned on purchasing any other product or service. The opportunities may exist, but there is no requirement that anyone take those products or services.

Senator BAUCUS. It just intuitively, at a gut level, bothers me that a person cannot deal directly with IRS, but has to go through a middleman. Has to, if you file an electronic return. Has to. I have no choice.

If I want to file electronically, I have to go through a middle person. It just seems wrong to me that I cannot just go directly to the IRS website if I want to—I am not required to, but if I want to—and file a return directly.

I just think that too often, to be honest about it, the tax preparation business does not want the IRS to offer true free tax filing because the tax preparation business wants to make money. That is the honest answer here.

There may be a technical reason, but the real reason is, the industry goes to the IRS and says, no, we want to sign a contract with you prohibiting taxpayers from filing directly, and the real reason is, most people sign contracts because they want their business to make something out of it. That just bothers me, personally.

The CHAIRMAN. Senator Bunning?

Senator BUNNING. Thank you, Mr. Chairman.

Mr. DuMars, you indicated in your written testimony that returns filed through Free File are down nearly 21 percent, while overall the number of returns filed electronically are up about 2 percent. Do you attribute this situation entirely to the changed income limitations on Free File or do you think there are other factors contributing to this trend?

Mr. DUMARS. I think there are additional factors.

Senator BUNNING. For instance?

Mr. DUMARS. For instance, last year when Free File launched in January, we had front-page articles about the Free File program. Particularly, there was one in *USA Today*, right on the front page. You could not buy that coverage. That was the most outstanding coverage. We had a bump in millions of returns to the program because of that.

This year, the best story we have gotten of any stories has been a page 3 "Business Section" story, usually just a couple of paragraphs. It is a big difference between a front-page *USA Today* story, which then ripples out throughout the Nation, to just having it on page 3.

The problem is, it is becoming an old story. This is the fourth year of the program. There is no new news, other than there was some limitation. The limitation probably has some contribution to that, but really, all the publicity we got last year really drove it up significantly more than we expected.

Senator BUNNING. You also indicated that reaching the goal of 80 percent of returns filed electronically by 2007 will not be attained. What does the IRS project that the percentage will likely be in 2007?

Mr. DUMARS. I do not have the exact numbers, but we are probably going to be closing in on 60 percent. We will get closer to that by 2007.

Senator BUNNING. Rather than 80.

Mr. DUMARS. Rather than 80, on individual returns.

Senator BUNNING. Is there anything that is slowing down the ability to reach the 80-percent goal, or do you think it was just set too high to begin with?

Mr. DUMARS. I think at the time the goal was set, it was actually a good thing to set it as high as it was, because I think it helped drive us in that direction. I think to set very ambitious goals is actually positive for us, and it makes us focus and drive that way. We are continuing to try to do everything we can to get as high as possible by 2007 on the individual returns.

We are also pushing as hard as we can on the business returns as well. Actually, I think we are seeing their pent-up demand. We just did not have the software out and available until the last couple of years. So, actually, those two sides of it are moving about as well as we could expect.

Senator BUNNING. When do you think we will reach 80 percent?

Mr. DUMARS. The projections are showing somewhere in the 2010 to 2011 time frame. But it is hard to know.

Senator BUNNING. So you are suggesting we move the time frame?

Mr. DUMARS. I would not do it just yet. Let us keep pushing. Let us keep pushing as hard as possible.

Senator BUNNING. But it is easier to do it up front than it is in a crisis situation where you cannot get to the goal, and all of a sudden you say, oh, my God, we are not going to make it, you have to change it.

Mr. DUMARS. Yes. I do like the pressure, though.

Senator BUNNING. Yes. Well, maybe this group up here at this table does not.

Mr. DUMARS. All right.

Senator BUNNING. We have enough pressure on other things. For instance, immigration.

Mr. Weinberger, you indicated that the do-it-yourself tax preparation with software is growing quite a bit, but that the majority of e-filers returns are completed by paid and volunteer return preparers. Can you give us an idea of what types of taxpayers choose one versus the other?

Mr. WEINBERGER. Well, often it is taxpayers who have more complicated returns who seek a return preparer, although in some cases it may be a 1040-A filer who takes the Earned Income Tax Credit. The Taxpayer Advocate, in numerous reports, has pointed out that that highly beneficial program is also a very complex program to administer.

Senator BUNNING. Are there demographic groups that would tend to use the do-it-yourself software, while other groups tend to use paid preparers?

Mr. WEINBERGER. Yes. I think there are studies on that, but I am not conversant with them.

Senator BUNNING. Is your firm?

Mr. WEINBERGER. Yes. I would be happy to provide that.

Senator BUNNING. Can you furnish that information to us?

Mr. WEINBERGER. Yes, sir.

[The information appears in the appendix.]

Senator BUNNING. That is all the time I have, Mr. Chairman.

The CHAIRMAN. Thank you. I just have a couple of questions to ask.

I am going to go to Mr. Weinberger. The tax software preparation industry continues to lobby actively against permitting the IRS to develop an Internet portal and means by which American taxpayers could file their returns electronically without using software developed by the industry.

At this point, it seems that the industry should be sufficiently mature in its development that it would focus on value-added services. It also seems that the Federal Government should regard the offering of direct Internet filing just as States do, and as you have heard Senator Baucus refer to.

For the purpose of this discussion, I would like to set aside the notion of return-free filing and focus your responses exclusively upon direct Internet filing.

Do you view the IRS's development of a portal in which taxpayers could merely use fillable forms and blank screens, including basic computational calculators for common, but difficult issues like the Earned Income Credit, AMT, and taxation of Social Security benefits as a conflict of interest or inappropriate competition to the private sector?

Does your response change if the system is more interactive, not simply fillable forms? Do you have any recommendations on how the government could partner with the private sector on these initiatives?

Mr. WEINBERGER. Well, that is a complex question with lots of parts. Let me take a few of them. I do not know that the tax software industry has weighed in against a direct filing portal. As Mr. DuMars has testified, there are a number of technical issues embedded in the way in which, historically, the IRS has developed its systems.

I think there was also a GAO report, in about 1997, as I recall, about a cyber-file program that the IRS was exploring at the time that found significant security issues related to the program. I think possibly for that, or cost reasons, the exploration was pulled back.

As a private-sector company, we prefer not to have competition from the Federal Government in terms of the Federal Government preparing tax returns for individuals, and we do feel that there can be a conflict of interest in terms of how a return is prepared in gray areas. That is why many tax clients come to a paid preparer, for counsel, and also to have someone on their side in terms of dealing with the government.

Those are issues that have to be weighed carefully by Congress in the balance in terms of both cost, in terms of policy, in terms of whether the preparation of a tax return is a core governmental function.

Mr. DuMars has testified that the administration view is that it is not a core governmental function, but certainly I would view enforcement of the tax code and collection of taxes as a core governmental function.

So, there is a distinction in terms of what the government can do best and what the private sector can do best. Through the last 10 presidents, beginning with President Eisenhower, it has been the policy of the U.S. Government not to compete with its citizens, except in those instances where the private sector cannot perform the function well.

That was embedded in OMB Circular A-76 and was an important factor, I think, in the government's willingness to agree with the private sector to form this unusual private/public partnership, which is the Free File Alliance.

The CHAIRMAN. All right.

My last question is for Mr. DuMars. If we would decide that it would be appropriate to develop a means of electronic filing via the IRS at the Federal level, do you think it would be possible to develop a partnership with the States?

What issues should be considered to ensure that taxpayers would be able to undertake a coordinated filing effort at the Federal and State level, especially given that the States are so far out ahead

of the Federal Government? I think we have 21 States providing some form of direct electronic filing for their constituents.

Mr. DUMARS. I think the one thing to know on the State issues is we have been making progress, actually working with the Free File Alliance, on adding more State capabilities over time.

That is one of the things we do after each filing season: we review that process, try to work on that and see what we can do to bring them in to work with the Free File Alliance and make it available through the Alliance membership. Today, there are three members who offer free State returns. We are looking at possibly others in the future.

The one thing that the Free File Alliance has been open to is meeting with the States directly to work on solving that problem, which is very much a lower-cost solution, something we can put in place relatively quickly.

The one thing I think we need to consider is, what are the trade-offs we would have to make in investments on our back-end processing versus something like this where this is going to be a very expensive endeavor? I think that is the one thing.

We still have a lot of work and there are a lot of challenges in our back-end processing, and we see some of those challenges every day during the filing season. Where do we go with our modernization program, especially around e-file itself?

We have gone into the business returns. We need to move into the individual space. That is going to require significant investment, and that is going to provide a lot of benefit to taxpayers once it is done. So, those are the issues that worry me; what do we take away from to do something like this? That is the thing I think we need to consider.

The CHAIRMAN. Senator Baucus, do you have another question?

Senator BAUCUS. I am just curious. Do corporations file electronically today directly with the IRS?

Mr. DUMARS. Some do.

Senator BAUCUS. Can you characterize which do?

Mr. DUMARS. The very largest, typically the top 50 of the very large corporations. Actually, some have developed their own software, for instance, and they will submit in the very largest returns that we receive directly.

Senator BAUCUS. Can a corporation, if it wants to, file directly?

Mr. DUMARS. By developing their own software?

Senator BAUCUS. Yes. Let us go to the other end. Let us say that I am a closely-held corporation, a Sub S corporation. Can I go directly to *irs.gov* and file directly?

Mr. DUMARS. Not to *irs.gov*. What they have done is, the ones who are doing it have purchased software, and then with that software they have asked for direct access. Those are also very large corporations. Or they have developed their own software and they have worked with us to develop a link into us. It does not go through *irs.gov*, it goes through our registry user portal, or e-services area.

Senator BAUCUS. Right. But say I am a corporation. Do I have to hire a preparer if I file electronically?

Mr. DUMARS. Do you have to hire—

Senator BAUCUS. Do I have to go through a preparer? Today, as an individual, filing an individual return, I have to go through a preparer if I am going to file electronically.

Mr. DUMARS. Or buy a software package.

Senator BAUCUS. Or buy a software package.

Mr. DUMARS. Right. The vast majority of large corporations will buy a software package. They use a “preparer,” which is usually a major CPA firm. Then there are a few that want to be able to file directly using either the software they spent a significant investment to build themselves, or software that they spent a significant investment to purchase.

Senator BAUCUS. But corporations may file directly with *irs.gov*.

Mr. DUMARS. Right, under this process.

Senator BAUCUS. Although individuals cannot.

Mr. DUMARS. Right. This is the back-end processing part I was speaking about. This is the newest part of our modernized e-file program for the business returns.

Senator BAUCUS. So, Mr. Weinberger, what is the theoretical difference between corporations versus individuals and whether or not IRS is competing with the private sector, or whether there is a bias against the taxpayer? On the one hand, corporations can file directly, individuals cannot.

Your response, I took it, was generally in the context of, preparers should not compete with Uncle Sam. Second, preparers are really in the business to help the taxpayer. Preparers are on the taxpayers’ side against the government. Those are the two basic answers you gave. So my question is to what degree those two basic answers also apply to corporate returns.

Mr. WEINBERGER. Well, I am not familiar enough, I think, with the corporate return filing setting. I would point out, though, the IRS derives considerable benefit from competitive market forces and the private software industry creating innovative products and being at the cutting edge technologically in terms of what they are producing, and finding new ways to assist taxpayers in easing the burden of tax filing. I think that has some considerable advantages over a one-size-fits-all model, which also has some considerable security risks.

Senator BAUCUS. Well, let us just probe that a little bit. If I buy Turbo Tax, for example, that is kind of a one-size-fits-all. Turbo Tax markets to a lot of different individuals.

Why can the IRS not then contract out with software companies, software development companies, to develop—put out for competitive bid, different developers have different products, different ways of doing things.

IRS could then select the best, or a series of several, for example, and still that enables me as a taxpayer to file directly with the IRS if I want to. I just do not like paying all these additional fees, frankly. I do not like all the stuff I have to go through as a taxpayer when I deal with a preparer. I want to just deal directly.

So why should the government not take advantage of the free enterprise creative juices of the software development industry and purchase software so that IRS can then set up a website where I can file?

Mr. WEINBERGER. Well, if the government picked a winner, so to speak, in that competition and made it a sole-source provider and the rest of the software industry withered, the government would lose the competitive pressures which lead to innovation.

Senator BAUCUS. Well, wait a minute. That is not a fair answer. You are assuming in your answer by saying if you sole-source there would be a lock on it. Look at the defense industry. The defense industry wants to spread out a little bit so there is not a lock, for good reasons. Why would the same not apply here? I am talking about DoD.

Mr. WEINBERGER. Yes. In terms of your hypothetical, I was making an assumption, and that was that the government would select one software company to be its provider.

Senator BAUCUS. Or several, I said.

Mr. WEINBERGER. In that model, I think it would reduce innovation, but it would preserve some element of it.

Senator BAUCUS. All right.

Now, again, my favorite example of a paper return. Does your reason for preparers apply equally to paper returns as it does to electronic filing? Your answer, or your response was, well, to be on the side of the taxpayer. Are you saying, therefore, I should not be able to file a paper return directly, that I should have to go through a preparer? Are you saying that?

Mr. WEINBERGER. No.

Senator BAUCUS. Then why should I have to go through a preparer to file electronically?

Mr. WEINBERGER. That is the current IRS rule.

Senator BAUCUS. No, no. I am asking the policy reason. What is the policy reason?

Mr. WEINBERGER. Policy reason? There is no policy reason. I think that you could very well have the government permit direct filing. I think that there are a number of technical issues and security issues related to it, and cost issues.

Senator BAUCUS. But from a policy perspective, you see no difference?

Mr. WEINBERGER. No.

Senator BAUCUS. Thank you.

Mr. WEINBERGER. But I may think of one. [Laughter.]

Senator BAUCUS. You may. I suspect you will.

Mr. WEINBERGER. All right.

Senator BAUCUS. And you can raise your hand if you come up with one. [Laughter.]

Mr. DuMars, just briefly, if I might.

The CHAIRMAN. Go ahead.

Senator BAUCUS. Thank you.

My question is, what is the IRS doing about the problem that GAO just reported? I mean, that sounds pretty dramatic.

Mr. DUMARS. And it is a very large problem, one that we are very concerned about. But it is one we have to look into. We will definitely take their information and we definitely will research this.

But what are the trade-offs we have to make to go after this versus the other jobs that everyone wants us to do, and what are

the costs and what is the resource allocation we are going to need to actually do that?

Senator BAUCUS. Are you telling us that you may not be doing anything about all of this because it is a resource question?

Mr. DUMARS. No.

Senator BAUCUS. Well, that is kind of how it sounded.

Mr. DUMARS. Sorry. That is not what I meant. We are looking at this. We constantly have programs to look at this. However, how much more resource do we have available to go after it in the broader sense that maybe you are considering versus other things you want us to go after in a very broad sense as well, around compliance and around these areas?

We do look at them through different programs that we have, through our CI group and through other groups within IRS. But as I say, it is something we need to research a lot on what just occurred and find out more about it.

Senator BAUCUS. How many preparer penalties did the IRS assert last year?

Mr. DUMARS. I have no knowledge of this.

Senator BAUCUS. Could you provide that for the committee, please?

Mr. DUMARS. Yes, we could.

Senator BAUCUS. How many disciplinary actions did the IRS Office of Professional Responsibility take last year?

Mr. DUMARS. I will have to get that from them as well.

Senator BAUCUS. All right. And any relevant additional information would be helpful as well.

[The information appears in the appendix.]

Senator BAUCUS. Do you want to raise your hand, Mr. Weinberger? [Laughter.]

Mr. WEINBERGER. I would be happy to provide something, Senator.

Senator BAUCUS. All right.

[The information appears in the appendix.]

Senator BAUCUS. I am through, Mr. Chairman.

The CHAIRMAN. All right.

Senator BAUCUS. Although I might say that I am a little bit concerned about all of this, as I know you are, too.

The CHAIRMAN. I would think, in addition to your question that Mr. DuMars answered about what the IRS is doing, now it is too late to do it for this year, but for next year, maybe around January 1, or when you get into tax season, they should make public some of the information that the Government Accountability Office found.

They found that not one single tax return was filed the same, or accurately. Then we have these instances in which people say certain income does not have to be reported.

If we know that tax preparers are giving that information out, the IRS knows it, it seems to me the IRS would put out as many press releases as you can and get as many public service announcements as you can saying, taxpayer, for your own interests, you ought to be concerned about these things. And do not let somebody pull the wool over your eyes.

You are paying them to give you the information, make sure you get it, so the government can at least be notifying people that there are real problems like this out here, and they are pretty deep-seated based upon what we have heard today.

In addition to that, I do not generally make a summation at the end of a hearing, but I would like to say a couple of things.

First of all, we have had some eye-opening testimony today. Clearly, there is much that can be done to make life easier for our taxpayers. I just suggested one thing that the IRS might do a year from now.

We need to take steps to ensure that, when a taxpayer uses a preparer, they can trust that that preparer be a knowledgeable professional who is going to do the right thing and put the interests of the taxpayer first. That preparer needs to be of the mind that it is his duty to make sure that the taxpayer pays the right amount of money, not one penny more, not one penny less.

Now, we have heard discussions also about taxpayer privacy. This is an issue that Senator Baucus and I hear a lot about. I am concerned about trends suggesting that tax preparers are interested in selling taxpayer information to make a fast buck rather than as proprietary information that should be held in confidence by a trusted advisor. It seems that we need to change the focus of paid preparers from selling to advising.

Further, it is my hope that, in consultation with Senator Baucus and other members of the committee, that we can look to the near future for a time to reconsider the Good Government legislation that has been referred to.

We have developed this to address many of the issues discussed today. We should take some time to incorporate into that legislation new issues considered in the hearing today, including the impropriety of peace-of-mind audit insurance and the development of additional means of electronic filing.

The IRS needs to have an aggressive game plan to increase electronic filing in the near future. We really need to consider whether to have the IRS provide a basic means of electronic filing should be seen as an extension of its obligations to the taxpayer to provide them with forms and instruction.

The tax code, of course, is complex enough without making it harder for working families. We should continue to look at how we can partner with the private sector and the IRS to make this happen.

There should be plenty of room for the software industry to continue to provide value-added services, and I think you have heard Senator Baucus speak very eloquently on that very point.

Finally, on an issue directed toward the IRS, and hoping to get Ms. Olson's help on something that we did not discuss today, I hope you will take back a message that my patience is wearing thin on the issue of offers-and-compromise and effective tax administration.

I have asked the Secretary and the Commissioner for a response to this matter. It is important to my constituents, many of them hit by the incentive stock option AMT.

Now, I happen to know that you share my concerns on this and have been fighting a good fight in this area. However, I have heard

nothing from Treasury in response to that request, and I am not pleased with what appears to be the thinking, that, rather than responding to that question, Treasury hopes that this will go away, I believe. I see no reason why the IRS cannot put a pilot program together in this area and see what the reaction is from practitioners and taxpayers rather than just simply doing nothing for fear of some unknown.

Do you have anything you want to say in closing?

Senator BAUCUS. Yes. Thank you, Mr. Chairman. I think this has been a very instructive hearing. I thank the GAO. I mean, you have done a great job. I take my hat off to all of you at GAO. You work hard and you perform a real public service. You are trusted. You are truly nonpartisan.

It is one of the few anchors around here that we can rely on for getting good, solid, honest, objective analysis on various problems, and I personally just thank you very, very much. I think I speak for all of the Congress, and probably most of the American people, in saying that.

Mr. BROSTEK. Thank you very much.

Senator BAUCUS. You bet. I just urge you, you have our trust, so obviously go the extra mile to keep it. We rely on you a lot, and just thank you very, very much.

Second, Mr. Chairman, you referred to the Good Government bill, which I think is good legislation. I thank Senator Bingaman for introducing it; you and I are both co-sponsors of that legislation. I think it is good, and we should follow up with it.

I also, frankly, think that we should outlaw insurance on tax preparation. I mean, if taxpayers rely upon tax preparers, why should tax preparers then sell insurance? I think that is wrong. It just does not make much sense to me. People should not have to pay extra.

I also hope that the IRS follows up with information that they are gleaning from this hearing, but also information that GAO is giving to them, because there has to be adequate enforcement here. I have full confidence that the IRS will take this very seriously and enforce the law.

I also think, Mr. Chairman, that the IRS could keep this committee apprised of actions that it takes against preparers, based to some degree on information that has come out of this hearing, but just generally. I mean, Mr. DuMars said he would send some information to us. I look forward—I know you do, too—to that information.

It is important in the individual context, this hearing, but it is also important in the larger context. We have about a \$340 billion a year tax gap. That is, income taxes that people owe, legally are due, but are not paying. It is huge.

It is \$340 billion every year. About half of that is on the individual side, about \$170 billion of income taxes that individuals owe, are legally owed, and are not paying.

This preparation business is part of the problem. I mean, the degree to which the preparers are encouraging people to not report cash income, to overstate deductions, to get bigger refunds back, et cetera, contributes to the tax gap. Therefore, it undermines public confidence. It is also a tax on other Americans who are being fair.

I think most preparers do a good job. That is my personal experience, and I think we should remember that. But there are too many preparers who are not doing a good job, way too many. I just urge the industry to really clean up its act or it is going to suffer even greater consequences.

The tax gap, too, is important on a world agenda. The greater the tax gap, the greater the need to borrow money from overseas to finance the government's necessary services. Who is buying our treasuries to finance government services? China, Japan, lots of other countries.

So, preparers could provide a real service here to individual Americans who want to pay their taxes, not more than they have to, but pay what they should, but also helping to close down the tax gap. It is not easy to close the tax gap.

There are lots of reasons why we have it. But this is one way, among many, many, that will help contribute to closing down the tax gap, if the preparing industry just does a better job than it has thus far. I know they will try, and I hope they are successful.

Thank you, Mr. Chairman.

The CHAIRMAN. Yes. Let me thank each of you for your testimony and being patient through 2 hours of hearing. We appreciate it very much. Thank you very much.

The hearing is adjourned.

[Whereupon, at 12:13 p.m., the hearing was concluded.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD



Committee On Finance

Max Baucus, Ranking Member

**Opening Statement of U.S. Senator Max Baucus (D-Mont.)
Preparing Your Taxes: How Costly Is It?
Hearing Before the Senate Finance Committee**

T.S. Eliot wrote: "April is the cruelest month." And many would consider doing their taxes to be the cruelest part of all.

Filling out burdensome income tax forms is so stressful that most Americans pay someone to do it for them. Taxpayers are willing to spend hundreds of dollars to make sure that their taxes are done right.

Most taxpayers want to do the right thing. They are willing to trust a paid preparer — often a complete stranger — with their most intimate financial information, to do just that.

Every year, paid preparers serve as the link between 80 million taxpayers and the IRS. And this year, another ten million taxpayers bought tax software to file from their home computers.

That's a big influence on our tax system. The state of the tax preparation industry is a warning signal for the health of our nation's voluntary tax system. It's like a canary in a coal mine.

I am sorry to report that the canary is dying.

Today, we will hear the serious symptoms of an ailing system.

Over the last several weeks, GAO undercover investigators visited the offices of 5 national tax preparation chains. Using simple tax scenarios, they tested how paid preparers treat their customers and the Nation.

The results were shocking.

--2 more--

The preparers failed at their most important task. Only ten percent of their returns were prepared correctly. Frequently, preparers did not ask enough questions to know if they were getting the right answers. Many preparers were eager to probe for additional deductions or credits. But many did not report cash income. Many preparers ignored the answers that the undercover investigators gave them. They used answers of their own.

They made up their own facts. And they made up their own tax laws.

Several refunds were \$2,000 more than they should have been. Many preparers seemed to be more interested in coming up with a big refund than they were in getting it right.

They were acting not for the client's benefit, but for their own. The bigger the refund, the more that preparers can sell products like refund anticipation loans or audit insurance.

Many preparers quoted fees that were substantially less than what they ended up charging. Many preparers levied extra charges for unnecessary forms, refund anticipation checks, or products like debit cards. Charges like these raise the cost of filing considerably.

Today, we are also going to learn that the IRS's Free File Program is not always so free. The Free File Program is a partnership between IRS and private preparers. Taxpayers who use the program encounter hidden costs and bait-and-switch offers to buy upgrades or products like refund anticipation loans. These loans make taxpayers have to pay for borrowing their own money.

In sum, many tax preparers perpetrated a cruel hoax on taxpayers and Treasury alike. And the Treasury has not done all that it can to avoid this cruel result.

I want to acknowledge that there are many hard-working, well-qualified, and competent professionals in the tax business. I am proud that my home state of Montana boasts some of the most rigorous industry standards in the country. These professionals must meet stringent training, experience, and continuing education requirements to practice.

These are not the preparers about whom we are talking today.

But we cannot stick our heads in the sand. We cannot pretend that problems do not exist. Instead, we should listen carefully to our witnesses today and then find solutions that will mend what's broken.

Last year, I introduced S. 832, "The Taxpayer Protection and Assistance Act of 2005" together with my Colleagues, Senators Grassley, Bingaman, Schumer, Smith, Akaka, and Pryor. It goes right to the heart of many of these problems.

--1 more--

It requires paid preparers to meet minimal training and competency standards before they can hang out their shingle. It makes it easier for the IRS to discipline bad preparers. It helps to protect taxpayers from unexpected or excessive charges. It requires disclosing the cost of refund anticipation loans.

We should make it easy to comply with the tax law. Maybe it's time to consider making electronic filing available at no cost for all taxpayers.

Just a few years ago, everyone received a package of forms and instructions in the mail. Or, they could go to their local library to get them. Recently, the forms have become available through the IRS website. All of the forms and instructions are free.

So, why do we force taxpayers to pay a preparer or buy software to file electronically?

Taxpayers don't have to go to a bookstore and buy the forms to file a paper return. And they should not have to pay to file an electronic one, either.

Today's hearing highlights tough issues that affect all of us. I want to thank all of the witnesses for agreeing to appear before the Committee today. I look forward to your testimony.

As Simon and Garfunkel sang, "April, come she will." And until we reform the tax code, we are fated annually to confront onerous forms to meet April's deadline.

Let us ensure that the work of tax preparers does not add to April's cruelty. Let us ensure that the bad apples among them do not continue to play a cruel joke on the Nation's finances. And let us look forward to a better spring, after we do.

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United States Government Accountability Office

GAO

Testimony
Before the Committee on Finance,
U.S. Senate

For Release on Delivery
Expected at 10:00 a.m. EDT
Tuesday, April 4, 2006

PAID TAX RETURN PREPARERS

In a Limited Study, Chain Preparers Made Serious Errors

Statement of Michael Brostek, Director
Strategic Issues



April 4, 2006



Highlights of GAO-06-563T, a statement before the Committee on Finance, U.S. Senate

PAID TAX RETURN PREPARERS

In a Limited Study, Chain Preparers Made Serious Errors

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/gettrpt?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.

What GAO Found

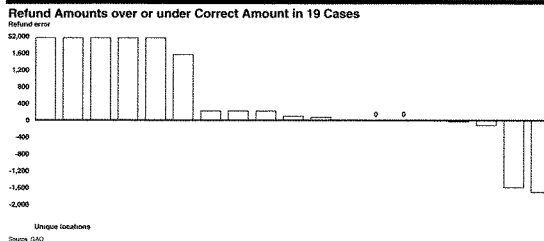
Many taxpayers choose to pay others to prepare their tax returns rather than prepare their own returns. According to the most recent reliable data, about 56 percent of all the individual tax returns filed for tax year 2002 used a paid preparer, with higher paid preparer usage among taxpayers with more 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.



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.³

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

³GAO, *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 SUI 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 SUI 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*
Taxpayers not claiming the EIC	367	273

Source: GAO analysis of IRS SOI data.

*The 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.⁹ 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

⁹Unenrolled 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.

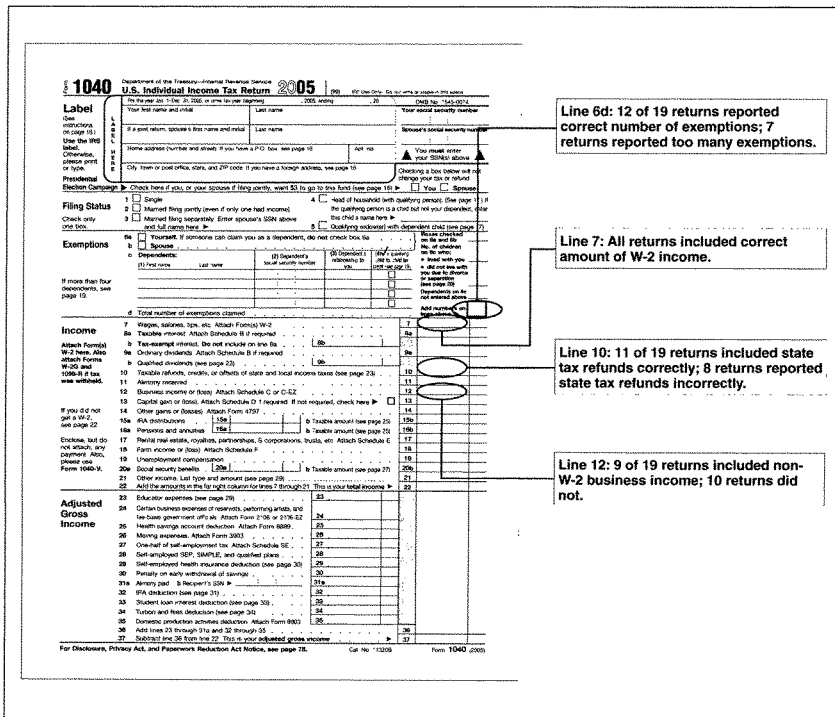
All of the Tax Return Preparer Visits We Conducted Produced Errors, Some with Substantial Consequences

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

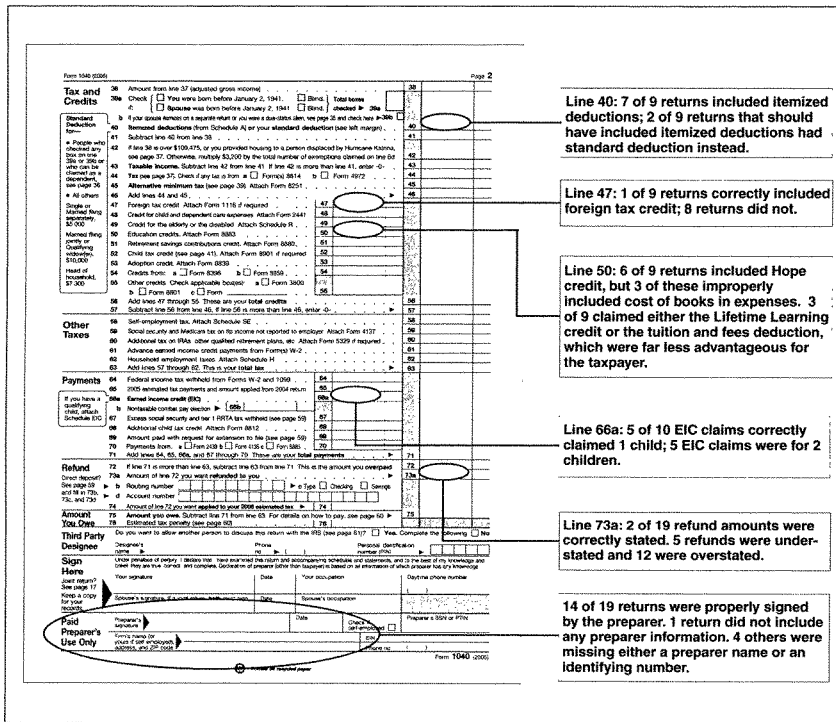
lines follow the figures. Also, appendix I has descriptions of selected visits we made to paid preparers, describing two example visits with fewer issues and two with serious compliance problems.

Figure 1: Summary of How Paid Preparers Completed Selected Lines on the IRS Form 1040 (page 1)



Source: GAO.

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



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

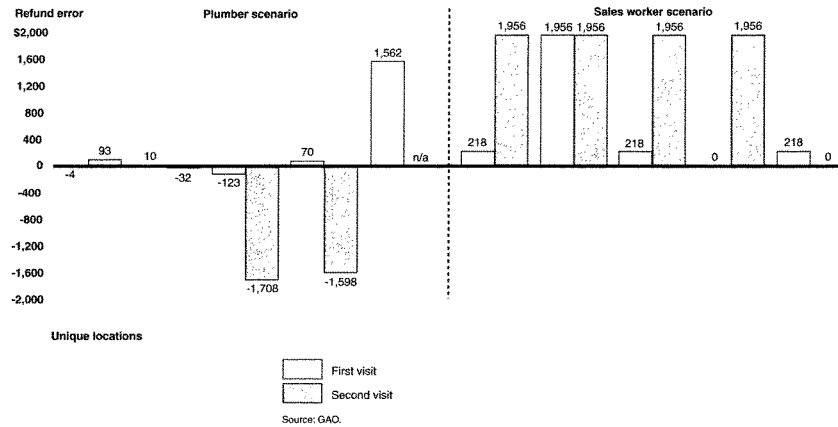
¹⁶It is possible that some preparers understood the rules for reporting the credit. Other preparer mistakes, such as not reporting side income or claiming the wrong number of exemptions, had the effect of eliminating the sales worker's tax liability. Because the credit for child- and dependent-care expenses 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



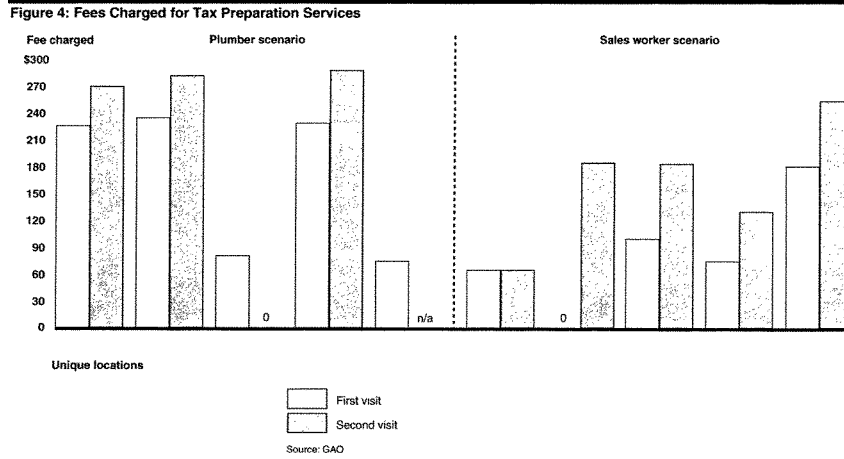
The 19 paid preparers we visited arrived at the correct refund amount only twice. On 5 returns, all for the plumber, they understated our refund amount by a total of \$3,465. On 12 returns (4 for the plumber and 8 for the sales worker) they overstated the refund by a total of \$12,169—a total of \$1,735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



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.

¹⁸IRC 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*

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.

*The 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.

Michael Brostek Answers to Questions for the Record from Senator Baucus
(Questions dated April 6, 2006)

1. Do taxpayers have a right to file tax returns for free, whether they are paper or electronic?
2. Do you think taxpayers should have to pay a preparer, buy software or go through a middleman to file their returns electronically when they can file a paper return directly and for free? Taxpayers don't have to go to a bookstore to buy paper forms to file their returns through the mail. Why should electronic filing be so different from paper filing?
3. Should the IRS offer direct, free e-filing through its website? Are there any policy reasons why the IRS should not offer direct and free electronic filing to taxpayers?

Decisions about how the federal government should permit or require citizens to file tax returns should be informed by careful analysis of costs, benefits and other trade-offs. At the request of this Committee, GAO is studying issues related to electronic filing and ways to address those issues. The results of this work should help support Congressional decision making in this area.

4. Free File doesn't seem to be doing a good job of serving the purposes for which it was designed. At its peak in 2005, only 5 million taxpayers out of 133 million used it. What do you think should be done to make it easier for taxpayers who want to prepare and file their returns on their own for free to be able to do so?
5. Would it be a good idea to open up Free File to everyone until IRS has its own system in place?

In an amended agreement with IRS that took effect this year, the Free File Alliance set a \$50,000 income limitation on taxpayer participation. This limit was absent last year and reduced the number of taxpayers eligible to participate in the program. As of March 19, 2006, IRS processed about 2.9 million free file returns, which is a decrease of 23 percent from the same period last year. Opening the program up to more taxpayers will require reaching a new agreement with the members of the Free File Alliance and may impact the number of firms electing to participate. The work GAO is doing related to electronic filing also should help Congressional decision makers consider the future of Free File.

6. Could the IRS and the states use electronic filing to work together to help people pay their taxes? How might that work? Are there any obstacles that might make such a partnership difficult? What are they?

State-level electronic filing mandates on certain classes of paid preparers already impact federal tax return electronic filing in the absence of formal agreements. In the 12 states that mandate electronic filing for certain classes of preparers, federal return electronic filing rates are higher than in similar states without mandates. It is possible that coordination between the states and IRS may further increase federal electronic filing. As noted previously, GAO is currently studying issues related to electronic filing and ways to address those issues.

7. An argument has been raised that the IRS would incur substantial costs to develop software if it were to offer direct and free electronic filing. What are the pros and cons of the IRS developing its own software compared to contracting with outside parties to provide the software?

The work GAO has underway examining electronic filing barriers and other issues should help both IRS and Congressional decision makers evaluate the trade-offs involved in expanding electronic filing capabilities.

8. Please comment on the pros and cons of an IRS mandate that individual taxpayers must file their returns electronically. Include in your comments consideration of whether a mandate would apply to all individuals, or certain types of taxpayers.

State mandates on certain classes of paid preparers for electronic filing have increased both state and federal electronic filing rates in those states. However, these programs typically include opt-out provisions for taxpayers who prefer to file by mail. A more stringent mandate at the federal level would likely increase electronic filing, but it would also come with added burdens that should be factored into the decision to impose the mandate. Last November, GAO recommended that IRS develop better information about the costs to tax practitioners and taxpayers of mandatory electronic filing of tax returns for certain categories of tax practitioners.¹

¹ GAO, *Tax Administration: IRS Improved Some Filing Season Services, but Long-term Goals Would Help Manage Strategic Trade-offs*, GAO-06-51 (Washington, D.C. Nov. 14, 2005).

9. What can Congress do to remedy the problems highlighted at the hearing?

To identify legislative changes that will address the problem of poor quality and noncompliant tax return preparation, it is important that Congress first have a better understanding of both the scope of the problem and its root causes. Our work shows that problems exist, but not how widespread those problems may be or their source. One positive step in the near term would be for the Senate Finance Committee to continue its oversight in this area and ensure that IRS pursues the research that we recommended at the April 4 hearing.

10. What can Treasury and the IRS do to remedy the problems highlighted at the hearing?

As stated in the answer to question 9, to identify changes necessary to address the problem of poor quality and noncompliant tax return preparation, it is important that Treasury and IRS first understand the scope of the problem and its causes. With more information, Treasury and IRS will be in a better position to identify and pursue any necessary changes.

11. What can the preparers and software communities do to remedy these problems?

Our work did not examine what the preparer companies do to ensure quality work by their employees, though our findings suggest breakdowns in such things as hiring practices, training, and quality assurance procedures. Given the significance of the problems shown in our limited review, it may be prudent for the tax preparation chains to examine whether their procedures are adequate to ensure consistent, high quality service to the taxpayers who seek their assistance.

**Written Comments of Francis X. Degen, EA
President National Association of Enrolled Agents
before the Senate Finance Committee
April 4, 2006**

Thank you, Mr. Chairman, Ranking Member Baucus, and members of the Committee on Finance, for asking the National Association of Enrolled Agents to testify before you today on tax return preparation. NAEA is the premier organization representing the interests of the 46,000 enrolled agents across the country. Enrolled agents are the only practitioners in whom the IRS directly attests to competency and ethical behavior. Our organization works to increase the professionalism of our members and the integrity of the tax administration system.

Background

It is a taxpayer's responsibility to file a complete and accurate tax return, as well as to remit taxes due on a timely basis. As you understand, this civic responsibility is not trivial. For a number of reasons, of which tax code complexity and fear of the IRS are two of the more common, taxpayers are increasingly turning to paid preparers for assistance in determining their tax obligations.

At the same time, most taxpayers do not realize that in forty-nine states tax preparers are not required to be licensed. As an enrolled agent, I represent far too many of these taxpayers when the IRS catches up with them after the fact. These non-compliant returns, prepared by unlicensed preparers, generally come in two flavors: the blatantly fraudulent and the merely inaccurate due to gross incompetence. From the taxpayer's perspective, the outcome is identical: tough enforcement actions by the government.

Legislators care about return fraud and incompetence because they undermine the integrity of our voluntary tax system, create resentment in those who file honest tax returns, and contribute to the \$300 billion plus gross tax gap. We share those concerns. Further, as federally licensed practitioners, EAs find themselves at a disadvantage when competing in the marketplace against the unscrupulous and find that these bad actors sully the reputation of all licensed tax professionals.

In our testimony today, I would like to present a picture of the problems presented to the tax system by unlicensed return preparers, who in many instances we have found to be unscrupulous or incompetent, and unfortunately in far too many cases both unscrupulous and incompetent. To help remedy this disturbing situation, NAEA urges members of this committee to take action by reporting out Senator Bingaman's bill, S. 832, The Taxpayer Protection and Assistance Act of 2005. I would also like to touch upon an e-filing/e-services concern held commonly by Circular 230 practitioners.

The Problem

While most of the focus for the IRS and policymakers over the last few years has been on large-dollar compliance areas such as corporate tax shelters and non-profit behavior, NAEA members have observed disturbing trends in the world of return preparation for ordinary taxpayers, almost always involving unlicensed preparers.

NAEA is not alone in acknowledging this problem. In her 2003 and 2004 annual reports, National Taxpayer Advocate Nina Olson recommended the establishment of a federal program to regulate unenrolled tax preparers. More pointedly, she noted in her 2003 report that over 55 percent of the 130 million individual taxpayers hired a return preparer. The majority of those preparers did not possess a legitimate license demonstrating competency or ethical standards. The result is startling: Ms. Olson noted that at least 57 percent of EITC earned income overclaims were attributable to returns prepared by unlicensed paid preparers, resulting in billions of dollars in lost revenue to the government.

For our members and all preparers who abide by the highest levels of ethical and competency standards in order to live up to the requirements set by federal regulations, the competitive disadvantages of this situation are stark. Time and time again, when our members are surveyed they relate instances of what we call "preparer shopping" during every tax season. Indeed some taxpayers gather up their tax documents and walk out because someone right down the street has guaranteed them a minimum refund amount: \$1,000, \$3,000, or even higher. Or the taxpayer wants the preparer to help him or her create phony business or unreimbursed employee business expenses, incorrectly report expenses or income from rental property, or not report "under-the-table" income. The list goes on and on.

Many of our members are aware of specific preparers in their neighborhoods who specialize year-in and year-out in ripping off the Treasury. Many have even complained to the IRS; but because of the lack of resources, the agency appears to focus on practitioners currently regulated under Circular 230. Last year, one of our members commented, "People drive in excess of the speed limit until they notice the cop; then they all observe the speed limit for a while, but when the cop leaves the beat, speeds begin to creep back up." Mr. Chairman, it has been too long since the tax cop has been out circling the neighborhood in his black and white.

While it is easy to focus on fraud, one must not forget that preparer incompetence probably causes as much heartache. We all know the tax code is too complicated. Unfortunately, too many preparers who are open for business today fail to attain adequate training and education or do not make the investment in time and money to keep up with the constantly changing tax code. Mr. Chairman, it is important to place negligence and incompetence on an equal footing with intentional fraud when attempting to understand the magnitude of the non compliance problem among unregulated preparers.

What can be done?

Mr. Chairman, we all acknowledge that the tax code is exceedingly complex. Dramatically simplifying the code would likely reduce some incidences of

noncompliance. However, absent significant simplification, we must deal with the situation as it currently exists.

NAEA strongly endorses the concept of regulating **all** paid return preparers, requiring an initial test for competency, background checks, annual minimum continuing education requirements, and compliance with the current Circular 230 ethical standards. Additionally, the Office of Professional Responsibility needs adequate resources to both enforce the rules and promote all preparers covered by Circular 230.

After many months of working with the practitioner community Senator Bingaman, in concert with the chairman and ranking member of this committee, has developed thoughtful legislation addressing most of these elements. NAEA has endorsed this legislation as the most comprehensive roadmap to address the problem of unregulated preparer noncompliance. We would urge the committee to report out this important piece of legislation as soon as possible because it:

A. Contributes significantly to taxpayer access to competent and ethical tax preparation services.

The legislation requires all paid preparers to pass an IRS initial competency examination testing understanding of basic individual income tax laws and ethical standards. Further, paid preparers would be required to complete annual continuing education and be subject to the ethical standards of Circular 230. These changes would contribute significantly to the use of qualified and ethical individuals preparing returns.

B. Builds on the existing regulatory framework and consolidates enforcement under one entity.

Rather than constructing a parallel regulatory framework and enforcement entity for different groups of paid preparers, the legislation consolidates all persons preparing returns (EAs, lawyers, CPAs, as well as other paid preparers) under the current regulations (Circular 230) and the existing Office of Professional Responsibility. In other words, there would be one ethical code, one set of coordinated exams that would allow for advancement within the profession, and standardized continuing education requirements all administrated under the current regulatory system.

In addition to being cost effective, this consolidation would ensure uniformity of standards and enforcement across all preparers.

C. Ensures adequate resources for administration, promotion, and, most importantly, enforcement.

The legislation would allow OPR to retain all registration fees for administration of the program, including policing all practitioners and preparers under its jurisdiction. Most importantly, the authorization to retain these fees ensures that the office would have adequate resources to investigate and penalize unlicensed individuals. This would go a long way toward discouraging taxpayers from shopping for the “best deal” among preparers and will help shut down many EITC mills across the country.

Additionally, the bill authorizes OPR to retain penalties administered under the program for promotion of all Circular 230 preparers to the general public. This will assist the public in understanding the importance of paying only licensed individuals for tax preparation and will assist the public in understanding the difference between the various groups allowed to do paid preparation.

D. Strikes a correct balance for creating a new tax practice credential.

The legislation recognizes the ramifications of creating a new credential in the world of tax administration. Currently, the general public is presented with three options for individuals who are authorized to practice before the IRS: EAs, lawyers, and CPAs. Circular 230 is very specific as to how these individuals may advertise and generally present themselves to the public. A new credential implying a higher level of authority and competency than merely preparing basic individual tax returns will cause confusion and undermine the general intent of the legislation.

For example, since the passage of the IRS Restructuring and Reform Act, there has been a great deal of confusion as to the credentials and *bona fides* of Electronic Return Originators or EROs. The IRS has issued signage denoting official endorsement of individuals qualifying as EROs, as well as financed a public awareness campaign in support of the program. Anecdotal evidence (the appearance of billboards and bus stop signage) in poorer neighborhoods claiming a government stamp of approval demonstrates the danger of putting out to the public confusing titles or credentials that overstate competency.

Additionally, state regulators would be very leery if not outright hostile toward the creation of a new credential in the accounting/tax preparation marketplace. States regulate the use of credentials and many list a litany of titles (e.g., certified tax consultant, chartered accountant, registered accountant) and abbreviations likely or intended to be confused with CPA that may not be used. After years of conflict, the majority of state boards of accountancy have accepted that a person recognized by IRS as being enrolled may use the enrolled agent name and EA abbreviation. Creating nomenclature that might overstate its intended mission is likely to re-ignite this battle, and at the very least potentially counter the underlying intent of the legislation. Once again, Senator Bingaman's bill strikes the right balance.

e-Filing and e-Services

The e-services product is one of the best and most useful IRS has launched in recent memory. At its heart, e-services is a tool that significantly improves the timeliness and quality of taxpayer representation while at the same time saving IRS thousands of man hours annually. What once took weeks or even months to resolve now can often be handled during one office visit by a distressed taxpayer.

NAEA echoes the Taxpayer Advocate's concerns with respect to the program and remains troubled that the agency continues to predicate e-services access on participation in the e-filing program. The fact remains that many Circular 230 practitioners focus their practices **solely** on representation and therefore cannot meet **any** e-services e-filing prerequisite. While some of those who file current-year returns may on rare occasion have use for it, those who provide representation services find it phenomenally useful.

The Service's refusal to open e-services to all Circular 230 practitioners opens the agency to a criticism I have heard often, namely that while the agency has in place a framework prescribing competency and ethics and holding EAs, attorneys, and CPAs to a higher standard (i.e., Circular 230), the agency consistently fails to support its licensed practitioners.

The IRS web page for e-services illustrates this issue. It states, “e-Services is not available to the general public. Only approved IRS business partners, such as e-filing tax professionals and payers, are eligible to participate in e-services.” Adding insult to injury, the site also defines an eligible tax professional as one who is an active participant in the IRS e-file program and e-files five or more accepted individual or business returns in a season. As a result, to the unschooled eye it appears that IRS believes tax professionalism is defined by filing five electronic returns and NOT by the EA license the IRS itself grants or by the licenses granted by state boards of accountancy or state bars.

Clearly, meeting the congressionally-mandated 80 percent e-file participation rate is important for the agency. At the same time, using the e-services program to “incent” e-filing participation without regard to the specialized services of the practitioners it licenses itself (EAs) and the other licenses over which it has most control (attorneys and CPAs) is distressing to NAEA members and appears to be at loggerheads with the Service’s commitment to customer service.

Enrolled agents believe excluding enrolled practitioners—particularly those who specialize in representation—from e-services participation compromises good taxpayer service and falsely creates a nexus between two unrelated products. We hope the agency revisits this policy decision and works posthaste to bring all Circular 230 practitioners into the e-services fold.

Closing

In closing Mr. Chairman, we unconditionally endorse Senator Bingaman’s bill and stand ready to work with you in passing it expeditiously. As I have said previously while testifying before Congress, most people would be astounded to find that while their barber or manicurist is licensed, their preparer may not be. Comparing the downside of a bad hair cut to an incorrect tax return, it is time to establish federal standards to ensure basic competency and ethical behavior.

Whether due to the complexity of the Internal Revenue Code or due to a healthy fear of the IRS—or simply for convenience—a majority of taxpayers do seek professional assistance in filing their tax returns. It stands to reason that an ethical and competent tax preparer is a taxpayer’s best and lowest cost insurance against IRS problems and the Service’s best and lowest cost assurance of return compliance.

The **National Association of Enrolled Agents (NAEA)** is the professional society representing enrolled agents (EAs), which number some 46,000 nationwide. Its 11,000 members are licensed by the U.S. Department of the Treasury to represent taxpayers before all administrative levels of the IRS, including examination, collection, and appeals functions.

While the EA license was created in 1884 and has a long and storied past, today’s EAs are the only tax professionals tested by IRS on their knowledge of tax law and regulations. EAs provide tax preparation, representation, tax planning, and other financial services to millions of individual and business taxpayers. EAs adhere to a code of ethics and professional conduct and are required by IRS to take Continuing Professional Education. Like attorneys and CPAs, EAs are governed by Treasury Circular 230 in their practice before the IRS.

Since its founding in 1972, NAEA has been the enrolled agents’ primary advocate before Congress and the IRS. NAEA has affiliates and chapters in forty-two states. For additional information about NAEA, please go to our website at www.naea.org.

**Questions for the Record From Mr. Francis Degen
April 4, 2006**

From Senator Grassley:

Mr. Degen, you have testified today about instances of “preparer shopping” in which taxpayers walk out of one preparer’s shop because another preparer offered them a bigger refund.

Well, I don’t blame the taxpayer for doing that *if* the bigger refund is based on an honest tax return. But if the return is blatantly fraudulent or inaccurate because of the gross incompetence of the preparer, that is a much different story. Taxpayers and return preparers both have obligations to prepare and file accurate tax returns. Deceptive practices violate the public trust and interfere with the obligation of American taxpayers to honestly and voluntarily pay their correct tax liability. It undermines the integrity of our whole tax system.

As you know, we have a bill currently pending, S. 832. This bill has been referred to in the past as the “Good Government Bill.” Mr. Degen, you are the president of the National Association of Enrolled Agents. Enrolled agents represent a group of practitioners that are currently regulated in terms of competency and ethical behavior. What do you think we in Congress can do to help improve the professionalism of the tax preparation industry in order to help the average taxpayer who may need the assistance of a paid preparer? What additional reforms should be included in the Good Government Bill (S. 832)?

Response to Senator Grassley

As you know, the National Association of Enrolled Agents supports S. 832 as the best means of ensuring that the public has access to competent, ethical return preparers. The bill would require all paid preparers to pass a basic competency test, have a clean ethical slate, abide by standards of conduct, and maintain tax law knowledge through continuing education. We believe that the bill strikes the right balance: ensuring the public’s access to professional preparation services while not overly burdening unenrolled preparers. Also—and this is critical—the legislation would ensure that the Office of Professional Responsibility would have adequate resources to enforce the legislation and go after the bad players. Without this self-funding, many of the worst preparers will simply go underground.

We have proposed a number of small amendments that will make technical changes to the bill and, additionally, will ensure against loopholes allowing the unscrupulous to avoid the requirements of the legislation.

From Senator Hatch:

1) Mr. Degen, you mentioned your support for Senator Bingaman's bill dealing with regulating tax return preparers. Are there provisions the Finance Committee should also consider that are not in the Bingaman bill?

Response: We believe that S. 832 is the best means of ensuring that the public has access to competent, ethical return preparers. The bill would require all paid preparers to pass a basic competency test, have a clean ethical slate, abide by standards of conduct and maintain tax law knowledge through continuing education. We believe that the bill strikes the right balance: ensuring the public's access to professional preparation services while not overly burdening unenrolled preparers. Also, very importantly, the legislation would ensure that the Office of Professional Responsibility would have adequate resources to enforce the legislation and go after the bad players. We have proposed a number of small amendments that will make technical changes to the bill and ensure against loopholes allowing the unscrupulous to avoid the requirements of the legislation.

2) I have received several complaints from constituents about the effects and additional costs to them of the Bingaman bill. What do I tell a competent, experienced tax preparer in Utah who does not believe he should have to go through the extra hassle and expenses of complying with new requirements?

Response: A competent and ethical return preparer who has years of professional experience and already goes through the necessary continuing education to keep up with the constantly changing tax code should not fear either the requirements or costs of complying with S. 832. The new exam will cover basic returns only, and any competent, professional Utahn should have no problem passing this exam. The additional registration fee to obtain this important new professional credential will be more than offset by the requirements of the bill that the IRS promote all licensed preparers. We believe it will be a win for both preparers—who won't have to compete with shady, fly-by-night competitors—and taxpayers.

3) What, in your view, are the three most important incremental simplification changes Congress should make this year to make the tax code more friendly to taxpayers?

Response: Congress should start with a permanent solution to the Alternative Minimum Tax. If Congress wants to keep the AMT as a backstop to ensure that taxpayers pay some minimum rate of tax, then it should apply only to the highest income classes. Additionally, we would recommend that the IRS review its current information requirements for Schedule D transactions. The new requirements are incredibly time-consuming with very little corresponding return for compliance. Finally, NAEA would respectfully request that Congress review and possibly reconsider the new rules on the uniform definition of "dependent."

From Senator Baucus:

- 1) Do taxpayers have a right to file tax returns for free, whether they are paper or electronic?
- 2) Do you think that taxpayers should have to pay a preparer, buy software or go through a middleman to file their returns electronically when they can file a paper return directly and for free? Taxpayers don't have to go to a bookstore to buy paper forms to file their returns through the mail. Why should electronic filing be so different from paper filing?
- 3) Should the IRS offer direct, free e-filing through its website? Are there any policy reasons why the IRS should not offer direct and free electronic filing to taxpayers?
- 4) Free File doesn't seem to be doing a good job of serving the purposes for which it was designed. At its peak in 2005, only 5 million taxpayers out of 133 million used it. What do you think should be done to make it easier for taxpayers who want to prepare and file their returns on their own for free to be able to do so?
- 5) Would it be a good idea to open up Free File to everyone until IRS has its own system in place?
- 6) Could the IRS and the states use electronic filing to work together to help people pay their taxes? How might that work? Are there any obstacles that might make such a partnership difficult? What are they?
- 7) An argument has been raised that the IRS would incur substantial costs to develop software if it were to offer direct and free electronic filing. What are the pros and cons of the IRS developing its own software compared to contracting with outside parties to provide the software?

Response to Questions 1 through 7

It is important to note up front that NAEA has always opposed Free File because of its potential for conflicts of interest and unfair sales practices.

NAEA would support the ability of taxpayers to electronically transmit their returns for free, but would not support the IRS getting into the business of preparing anything but the most basic returns. This distinction is important to consider as Congress moves ahead with any policy changes in this area. Free File has blurred this distinction between free electronic transmission and return preparation because the companies participating in the program provided free tax return preparation and electronic transmission in exchange for making a profit from ancillary services. While free transmission—either directly using personal tax software, through a practitioner, or on the internet—is a relatively simple technology issue for the IRS, having the IRS get into the business of actually preparing returns would be a more difficult proposition and raise a number of troubling issues. Such

a move would require the IRS in a sense to represent the taxpayer, which would raise issues of liability and independence.

NAEA would not oppose a plan enabling IRS to receive returns directly from a taxpayer's personal computer or from the taxpayer's paid preparers. Additionally, NAEA could envision a system where taxpayers could upload a copy of their return through the IRS internet site and that such a program could check for basic math errors. We would not support the agency essentially attaching tax preparation software to their internet site for the use by the public.

8) Please comment on the pros and cons of an IRS mandate that individual taxpayers must file their tax returns electronically. Include in your comments consideration of whether a mandate would apply to all individuals, or certain types of taxpayers.

Response to Question 8

We believe that the IRS can best reach the goals established under the IRS Restructuring and Reform Act of 1998 by continuing to partner with practitioners and through promotion and outreach to taxpayers. Also, IRS would likely see increases in electronic filing if the transmission of returns was free to tax return filers.

9) What can Congress do to remedy the problems highlighted at the hearing?

10) What can Treasury and the IRS do to remedy the problems highlighted at the hearing?

11) What can the preparer and software communities do to remedy these problems?

Response to Questions 9 through 11

We believe that S. 832 is the best means of ensuring that the public has access to competent, ethical return preparers. The bill would require all paid preparers to pass a basic competency test, have a clean ethical slate, abide by standards of conduct and maintain their knowledge of the law through continuing education. We believe that the bill strikes the right balance: ensuring the public's access to professional preparation services while not overly burdening unenrolled preparers. Also, very important, the legislation would ensure that the Office of Professional Responsibility would have adequate resources to enforce the legislation and go after the bad players.

12) The GAO investigation revealed that many of the returns prepared by tax preparations firms are not correct. Investigators thought some preparers lacked basic tax law skills. They also observed that the preparers failed to ask necessary questions to make sure all income was being reported or that earned income credit was accurate.

- a. Describe the oversight of preparers.
- b. How often is their work reviewed?
- c. What is done with preparers who consistently make mistakes?

13) How can you improve quality control so firms or groups like yours are not contributing to our \$350 billion annual tax gap?

Response to Questions 12 and 13

Not applicable to NAEA.

14) Please provide examples of training materials used to instruct new employees or members.

15) Please provide informational literature provided to prospective or new employees or members that describes the criteria they must meet in order to be hired, remain employed or become a member.

16) How many years of tax preparation experience does an average tax preparer or member have?

Response to Questions 14 through 16

Under Circular 230, enrolled agents must pass a detailed 2-day exam covering all areas of tax return preparation and ethics, undergo 24 hours of continuing education annually, and comply with the highest ethical standards. While NAEA represents enrolled agents of varying levels of experience, 58 percent of our members have more than 10 years of experience.

17) What percentage of your preparers/members are attorneys, CPAs or enrolled agents or none of the above (specify by category)?

Response to Question 17

NAEA is the only professional association which represents only enrolled agents. All of our members are enrolled agents.

18) Are preparers at the tax preparation chains considered to be employees? How are they paid, e.g., by the hour, number of returns prepared, fees generated, etc.?

Response to Question 18

Not applicable to NAEA.

19) Do you think it is important that the preparers/members comply with all tax laws concerning their own tax affairs?

Response to Question 19

In a word, yes. Enrolled agents not filing tax returns are subject to disbarment under Circular 230, and the most recent proposed changes to Circular 230 would set stringent standards on filing and payment compliance.

20) What processes do you have in place to ensure your preparers/members are compliant?

Response to Question 20

Not applicable to NAEA.

21) What do you do about those who are NOT compliant?

Response to Question 21

NAEA undertakes disciplinary proceedings against members who are not in good standing with the Office of Professional Responsibility.

22) Please respond to the following questions about preparer use or disclosure of tax return information.

a. Why is it so important for a tax preparation firm to be able to use or disclose tax return information?

b. When used within the firm, what is done with it? Describe processes and procedures to analyze data and how it is used within an affiliated firm. What protections are in place to ensure the tax return information is not inadvertently disclosed beyond the scope of the taxpayer's consent?

c. What happens to information once it is disclosed to a third party? Are there any limitations imposed on the third party by the preparer disclosing the information? How is the taxpayer protected from identity theft or other misuse of their most personal data?

d. Do you think that taxpayers realize what is happening with their tax return information? Do you think they would provide consent if they understood what happens to it?

Response to Question 22

Generally, NAEA supports the IRS-proposed regulation of section 7216 as a balanced approach to the issue of disclosing and using taxpayer information. The important distinction is informed consent.

23) What percentage of industry income is from preparing tax returns, the use of tax return information, the disclosure of tax return information, and income from the sale of non-tax products?

- 24) Does the impact on the bottom line influence the industry's position on the IRS section 7216 proposed regulations?
- 25) When taxpayers input information on the Free File Alliance vendor websites, are "cookies" created that are then used or disclosed by the vendors to solicit business for non-tax products?
- 26) Is information on the input screens (before the return is filed) considered to be tax return information by these vendors?
- 27) Do taxpayers have a right to know what it is going to cost them to have their tax return prepared *before* they get started?
- 28) Why is it so common for the actual fee to be so much more than the quoted fee?
- 29) Explain how the fees are set to have a tax return prepared. Is there a fee schedule? How often do the actual fees differ from the scheduled fees? How much leeway does the individual preparer have to change the price?
- 30) Are taxpayers charged for forms they don't need? For example, if the computer generates a Schedule B for interest income, but the amount is below the threshold to require the form, will the customer be charged?
- 31) What kind of oversight exists to monitor the prices that each preparer charges to make sure they are fair?
- 32) In recent years, there has been a big increase of non-tax products like RALs, IRAs and debit cards being sold by tax preparers. Explain how these are in the best interest of the consumer when usurious rates, high fees and low returns are common.
- 33) Is industry opposition to a direct IRS electronic filing portal triggered in part by the potential loss of income from selling non-tax products?

Response to Questions 23 through 33

Not applicable to NAEA.

- 34) We've heard a lot about the burdens on taxpayers as a result of using paid preparers. What are the "benefits"—why should a taxpayer go to a paid preparer?

Response to Question 34

Circular 230 practitioners—enrolled agents, certified public accountants, and attorneys—provide cost-effective tax return preparing with the highest level of accuracy and ethical consideration. Not all taxpayers need or desire the services of enrolled preparers. But many taxpayers want the advice and protection of hiring a licensed professional to ensure

the filing of an accurate return which complies with all aspects of the Internal Revenue Code.

35) Are these benefits unique to a paid preparer?

Response to Question 35

We believe these benefits are unique to enrolled preparers.

36) Mr. Weinberger, your written testimony refers to Free File as a “winner.” How can you call a program with all of the flaws we heard about at the hearing, and that only 4% of taxpayers have used so far this year, a “winner?”

37) Mr. Weinberger, you stated that H&R Block has training, ethics and oversight processes and procedures in place to promote quality and accuracy. The GAO investigation found significant problems among paid preparers working for national tax preparation chains. How diligently does H&R Block practice its processes and procedures? Describe the extent of corporate governance to ensure that they are followed.

Response to Questions 36 and 37

Not applicable to NAEA.

**WRITTEN TESTIMONY OF
BERT DUMARS
DIRECTOR, ELECTRONIC TAX ADMINISTRATION
INTERNAL REVENUE SERVICE
BEFORE
SENATE COMMITTEE ON FINANCE
ON
RETURN PREPARATION OPTIONS FOR TAXPAYERS
APRIL 4, 2006**

Good morning Mr. Chairman, ranking Member Baucus and members of the Senate Committee on Finance. My name is Bert Dumars and I am the Director of Electronic Tax Administration (ETA) for the Internal Revenue Service. It is my pleasure to be with you this morning to discuss, from an electronic perspective, return preparation options for taxpayers.

However, before discussing the specifics of our electronic filing program and the Free File Alliance, I would like to briefly update you on the status of this filing season.

2006 Filing Season

We expect to process almost 135 million individual tax returns in 2006, and we anticipate a continued growth in the number of those that are e-filed. In the 2005 filing season, over 50 percent of all individual income tax returns were e-filed. Encouraging e-filing is good for both the taxpayer and for the IRS. Taxpayers who use e-file can generally have their tax refund deposited directly into their bank account in two weeks or less. That is about half the time it takes us to process a paper return. The error rate for returns e-filed is significantly less than for paper returns. This includes taxpayer errors when they are preparing their return, as well as IRS data entry errors once the paper return is processed by the IRS. Reduced error rates increases IRS efficiency and saves taxpayers from unnecessary correspondence with IRS.

We have updated our web site, IRS.gov, to make it easier for taxpayers to get answers to many of their tax questions. The web site:

- Allows a taxpayer to determine whether he or she qualifies for the Earned Income Tax Credit (EITC);
- Assists the taxpayer in determining whether he or she is subject to the Alternative Minimum Tax (AMT);
- Allows 70 percent of taxpayers the option of filing their tax returns at no cost through the FreeFile program;
- Assists hurricane victims with information on many of the changes in the tax laws that are designed to help them along with a toll free number for victims to get their questions answered: and

- Allows a taxpayer, who is receiving a refund once a return is filed, to track its progress via the “Where’s My Refund?” feature on the site.

As of March 24, we have received over 73 million returns, a very slight decline over the same period as last year. However, we have seen an over two percent increase in the number of returns filed electronically. As of March 24, 50.3 million were filed electronically.

While returns filed through FreeFile are down nearly 21 percent, overall returns filed via home computers are up 17.2 percent.

Background on E-Filing

The IRS began the e-file program in 1986 as a pilot project in three cities: Cincinnati, Ohio, Phoenix, Ariz., and Raleigh-Durham, N.C. That year, there were 25,000 tax returns filed electronically. The e-file program expanded nationwide in 1990 and 4.2 million tax returns were filed. IRS e-file has undergone tremendous growth each year.

It received a major boost in 1998 with the enactment of the IRS Restructuring and Reform Act (RRA), which set forth the mandate that at least 80 percent of all tax and information returns be filed electronically by 2007. This ambitious goal set the stage for an aggressive campaign to expand significantly our electronic outreach to taxpayers. A robust ETA program will reduce time spent by taxpayers dealing with the IRS. It will reduce the number of phone calls we have to answer and because of these two factors we will free up our compliance employees to focus on real compliance issues, rather than just retrieving or correcting information.

We believe the internet has become our primary vehicle for delivering service information to taxpayers. Please note that I said primary and not exclusive. We recognize that we will likely always have a percentage of taxpayers that we need to serve through either direct personal service or over the telephone, but we hope to continually drive that number down, while at the same time improving the levels of service and taxpayer satisfaction. This will not only save us time and resources, but also will provide a valuable service to taxpayers. They can get answers to their questions at their home, at their convenience, rather than visiting a walk-in site.

Our e-Strategy for Growth outlines our plans to reduce taxpayer burden and continuously grow the e-file program. Key strategies include:

- Make electronic filing, payment and communication so simple, inexpensive, and trusted that taxpayers will prefer them to calling and mailing.
- Substantially increase taxpayer access to electronic filing, payment, and communication products and services.
- Aggressively protect transaction integrity and internal processing accuracy.
- Deliver the highest quality products and services as promised.

- Partner with states and other governmental entities to maximize opportunities to reduce burden for our common customer base.
- Encourage private sector innovation and competition.

To achieve these strategic goals, we will continue to develop and implement e-file marketing strategies, expand the use of electronic signatures, and enhance our web site services for practitioners, taxpayers and stakeholders. Ultimately, our goal is to offer all taxpayers and their representatives the ability to conduct nearly all of their interactions with the IRS electronically.

Thus far, we have achieved enormous success. Over 95 percent of information returns are filed electronically or through magnetic media. For Tax Year (TY) 2003, 51 percent of individual returns and 18 percent of business returns were filed electronically. While we will not meet the statutory goal of 80 percent by 2007, we are seeing steady growth. We continue to focus on increasing the number of individual taxpayers who e-file their tax return. In 2005 (Tax Year 2004), we received 52 percent of individual returns electronically, which represents an increase of 8.3 million over the previous year. We are making steady, sustainable progress in individual e-filing as the chart below illustrates:

Calendar Year	# of Electronic Returns
2005	68,476,000
2004	61,428,268
2003	52,869,010
2002	46,836,082
2001	40,206,823
2000	35,402,150
1999	29,329,540
1998	24,580,300
1997	19,135,670
1996	14,968,400

We have also made considerable progress in terms of e-filing corporate returns. Effective for the FY 2005 tax year, large corporate taxpayers (those with over \$50 million in assets) that file at least 250 returns of any kind annually must e-file.

E-file has been available to corporations on a voluntary basis since 2004. In 2005, more than 200,000 corporations voluntarily filed their corporate income tax returns electronically, including about 1,200 corporations with assets exceeding \$10 million. As of March 26, 2006 more than 240,000 corporations filed their corporate income tax returns electronically. Tax-exempt organizations with \$100 million in assets that file at least 250 information returns a year also are required to file electronically this year.

For tax years ending on or after Dec. 31, 2006, the electronic filing requirement will be expanded to include the tax year 2006 returns of corporations and tax-exempt

organizations with \$10 million or more in total assets who file 250 or more returns a year. In addition, private foundations and charitable trusts will be required to electronically file Form 990-PF, regardless of their asset size if they file 250 or more returns a year. As of March 26, 2006, the IRS has received more than 1,400 electronically filed information returns from tax exempt organizations.

I encourage Congress to pass the Administration's proposal to expand the Secretary's authority to require electronic filing from businesses and exempt organizations to help us continue to expand electronic filing.

Free File

Free File's roots can be found in the President's FY 2002 Management Agenda. It contained five Government-wide initiatives, one of which was to expand electronic government. The overarching goal was to "champion citizen-centered electronic government that will result in major improvements in the federal government's value to the citizen."

Subsequently, in November 2001, OMB's Quicksilver Task Force established 24 e-government initiatives as part of the President's Management Agenda. These initiatives were designed to improve government-to-government, government-to-business, and government-to-citizen electronic capabilities.

One initiative instructed the IRS to provide free online tax return preparation and filing services to taxpayers. In accordance with this OMB directive, the IRS began working in partnership with the tax software industry to develop a solution. Two principles guided its development: no one should be forced to pay extra to file his or her return and the IRS should not get into the software business.

The IRS believes that private industry, given its established expertise and experience in the field of electronic tax preparation, has a proven track record in providing the best technology and services available. Rather than entering the tax software business, IRS' partnership with private industry: (1) provides taxpayers with high quality services by using the existing private sector expertise; (2) maximizes consumer choice; (3) promotes competition within the marketplace; and (4) meets these objectives at the least cost to taxpayers.

On October 30, 2002, the IRS and the Free File Alliance, LLC, signed an agreement that created a public-private partnership to provide free services to the majority of taxpayers. The Free File Alliance, LLC, is a private-sector consortium of tax preparation software companies. The original agreement was for three years with a series of two year renewal options. The primary candidates for Free File were those taxpayers who prepare their own taxes and still file paper returns.

While membership in the Alliance may change from time to time, all members must meet certain IRS standards. Specifically, we must approve each member's proprietary tax

preparation software. In addition, each member must obtain third party privacy and security certification. Finally, all Alliance members must adhere to all Federal laws regarding taxpayer privacy.

Each Free File Alliance member was allowed to set taxpayer eligibility requirements for its program. Generally, eligibility was based on such factors as age, adjusted gross income, state residency, eligibility to file a Form 1040EZ or for the Earned Income Tax Credit. But, as a whole, under the original agreement, the Alliance was required to provide free services to at least 60 percent or 78 million of the nation's individual taxpayers. In addition, all active armed forces, federal reservist and National Guard personnel were eligible to free file through a separate program operated by the military.

While the IRS did not support or endorse any Free File Alliance company or product offered, it did provide a listing of the Alliance members via the Free File web page, which is hosted on IRS.gov. Companies were allowed to offer ancillary services to taxpayers for a fee, but the taxpayer was under no obligation to purchase any of those services as a condition of getting their Federal tax return prepared free of charge.

The intent of the Free File program was to reduce the burden on individual taxpayers, make tax preparation easier and expand the benefits of electronic filing to a majority of Americans. In the 2003 filing season, 2.8 million taxpayers took advantage of Free File. This number rose to 3.4 million in 2004. In 2005, the number increased to over 5 million.

The 2005 number may be a bit of an aberration in that many of the companies in the Alliance opted to lift qualification restrictions on taxpayers thus allowing any taxpayer, regardless of income, to utilize Free File. This started as some companies sought a competitive advantage by expanding their base and ended with many of the companies' offering free return preparation services to anyone.

While this was good for taxpayers in general, it posed a serious threat to the survival of the Alliance and was a prime topic of discussion when the contract was up for renewal at the end of last year. Many of the companies could not continue in the Free File Alliance unless it returned to offering the free service to low and moderate income individuals. The loss of these companies would have jeopardized the continued existence of the Alliance.

Renewal of Free File

It is important to remember that IRS' philosophy in developing Free File is that it would be a partnership between the Service and private tax preparation software providers.

Tax preparation is not an inherently governmental activity. Long before electronic filing became available, taxpayers used private sector companies to prepare and file their tax returns. Taxpayers today have the option of using third-party preparers or purchasing commercially available software and preparing the return themselves. In some cases, it

may be to the taxpayer's advantage to use a third party, particularly in complex situations that are subject to interpretation.

In terms of electronic filing, our partnership with private industry gives taxpayers high quality services, maximizes consumer choices, and promotes competition within the marketplace.

As we prepared for negotiations to extend the Free File agreement in 2005, the IRS took the position that Free File should be available to as many taxpayers as possible. The Alliance position was that Free File should only be available to low and moderate income taxpayers.

As is the case in most negotiations, we compromised and agreed that Free File would be offered to 70 percent of taxpayers, or anyone with an AGI of \$50,000 or less in 2005. This covers approximately 93 million of the 133 million taxpayers expected to file. This is an improvement over our earlier agreement which only guaranteed coverage of 60 percent or availability to 78 million taxpayers. The active armed forces, federal reservist and National Guard personnel continue to be eligible to free file under their own program.

The 70 percent taxpayer coverage is a national number. In many states the coverage rate is much higher. In Iowa for example, 71 percent of the taxpayers are eligible for Free File. In Montana, 78 percent of the taxpayers can Free File. In more affluent areas, the number of taxpayers eligible will be lower dependent on AGI.

In 2006, three Free File Alliance members are offering state filing for free. Seven members are offering to file F4868, Extension of Time to File Individual return. As of the end of February, 653 extension forms had been filed. In addition, there are two companies offering free packages in Spanish.

While the number of taxpayers taking advantage of Free File in 2006 will likely be less than in 2005, we are unable at this time to fully explain the decline. Certainly the fact that it is not available to everyone is one factor, but there likely are other factors as well.

A year ago, the Free File program was benefited greatly by a major article on the front page of *USA Today*. Immediately following that article, there was a tremendous surge of positive publicity as well as a surge in Free File usage by taxpayers. We have not been the beneficiary of similar publicity this year and to the extent we have received coverage much of it has focused on the taxpayers that Free File does not cover.

Ancillary Services

One of the major concerns that many critics of the Free File program have had has been the ability of the Alliance members to use Free File to market other services to taxpayers. These include the filing of state tax refunds and the offering of refund anticipation loans (RALs). We make it clear to taxpayers that the IRS does not endorse any of these

products or services nor is the completion of their tax return at no cost conditioned on the purchase of any product or service.

We generally do not know what if any fee services taxpayers actually use from the Free File vendors. The one service that we do have data on is refund anticipation loans (RALs). RALs are designed to provide the taxpayer an immediate refund in the form of a consumer loan. Often the costs incurred with the RAL are disproportionate to the amount of the refund, especially considering that a taxpayer that files electronically will get the refund from the IRS in about two weeks. Unfortunately, it is often low income taxpayers, the ones that can least afford it, who choose RALs.

What we are seeing from our Free File data thus far in this regard is encouraging. Only 0.6 percent of the taxpayers utilizing Free File have utilized a RAL. In fact, half of the Free File vendors do not even offer refund anticipation loans.

This 0.6 percent RAL participation for Free File is the lowest of any of our electronic filing groups. Other online filers have a 0.8 percent participation rate. The rate for online returns done by paid tax preparers is the highest. Approximately 20 percent of the preparer returns submitted electronically include a RAL.

Conclusions

Mr. Chairman, in summary, I would like to emphasize the following points:

- We are making tremendous progress in electronic tax administration. Our web site is an award winning site that gives taxpayers access to virtually everything they need to get their questions answered, determine their eligibility for things like the earned income tax credit and even file their returns.
- Currently, total e-file volume is up by 1.3 million returns. Online filing shows an increase of 2 million over last year and practitioner e-file is ahead of last years count by 1.9 million.
- We are also making progress on e-filing of corporate and tax exempt returns as e-filing is mandated for the largest companies and the largest tax exempt groups.
- The Free File program serves the twin objectives of keeping the IRS out of the tax preparation business and offers 70 percent of all taxpayers the ability to have their returns done at no cost,
- The Free File program has the lowest rate of RALs of any online filing group. Only 0.6 percent of Free File filers have utilized a RAL.

Thank you Mr. Chairman and I will be happy to respond to any questions that you may have.

**Questions for the Record
Chairman Grassley
Senate Finance Committee
Tax Return Preparation Options for Taxpayers
Questions for Bert DuMars**

From Senator Hatch:

- 1. Mr. DuMars, I received an email from one of my constituents, who lives in Kaysville, Utah. He asked me the following: "I need to find out why the IRS is charging money to electronically file taxes. If I send in a paper copy of my taxes, the IRS has to pay somebody to open the envelope and process all that paper. I would assume that the government would be happy to rid itself of the paper monster and would be happy to save the money it pays people to deal with the paper. However, for the privilege of filing my taxes online, which makes it easier for the IRS, produces no paper, and costs the IRS much less because they don't have to deal with paper, I must pay \$29.95. It doesn't make any sense." What can I tell this constituent?**

The IRS does not charge taxpayers to electronically file their taxes. To the contrary, we offer our Free File service which gives taxpayers access to online tax preparation software to prepare and e-file their federal income tax returns for free. We offer this free service in partnership with a group of tax software companies, known as the Free File Alliance. It is available to taxpayers with an adjusted gross income (AGI) of \$50,000 or less. This covers an estimated 93 million taxpayers or 70 percent of all filers. Taxpayers can access these services through www.irs.gov. Last year, over 5 million taxpayers took advantage of this free filing service to prepare and e-file their federal tax returns.

Those taxpayers with an AGI in excess of \$50,000 have other opportunities to electronically file for free. Individual tax software companies, including some Alliance members, offer unrestricted free services on their own web sites.

- 2. Mr. DuMars, I understand why the IRS should not be in the tax return preparation business. But please clarify something for me. If I buy a computer tax return preparation program, do I need to pay for electronic filing in addition to the cost of the program? In other**

words, is there a charge for electronic filing if I do not qualify for or use the Free File system?

There is no single business model or fee schedule for Authorized IRS e-file Providers who sell tax preparation software over-the-counter or provide their product and services online. For example, a company may choose to:

- offer both tax preparation software and e-file at no cost;
- offer free tax preparation software and charge a separate fee to e-file;
- charge a fee for tax preparation software and e-file at no cost; or
- charge a fee for both tax preparation software and e-file.

These are all business decision made by private companies. As indicated in the response to Question 1, if a taxpayer that is ineligible for Free File wishes to file electronically at no charge, there are several other options available to him or her.

3. What is the marginal cost of processing a paper return vs. an electronic return?

The marginal cost (labor only) of processing a paper return is \$2.65 vs. \$.28 per electronic return.

From Senator Baucus:

1. Do taxpayers have a right to file tax returns for free, whether they are paper or electronic?

It is the goal of the IRS to make it as easy as possible for taxpayers to file their income tax return. This includes not only the ease with which the return can be prepared, but also the costs associated with preparing and filing the tax returns. Unfortunately, the major obstacle in terms of both cost and ease of preparation is the inherent complexity of the tax code. Currently, 60 percent of all taxpayers choose paid preparers to file their returns. Two-thirds of all paper filers use computer programs to prepare their returns, presumably because the software helps guide them through the intricacies of the law. This means that in 2005, of the 130 million returns that were filed, only 20 million (15%) paper returns were not preparer- or computer-assisted. In short, taxpayers are experiencing inherent "costs" in filing their tax returns, but those costs are related more directly to the complexity of our tax laws and not to the method in which the return is filed.

2. Do you think that taxpayers should have to pay a preparer, buy software or go through a middleman to file their returns

electronically when they can file a paper return directly and for free? Taxpayers don't have to go to a bookstore to buy paper forms to file their returns through the mail. Why should electronic filing be so different from paper filing?

As indicated in the response to Question 3, the costs that many taxpayers face in filing their returns are more directly related to the costs of preparation not filing. These preparation costs are directly related to the complexity of the tax code as evidenced by the fact that so many taxpayers use paid preparers or purchase software even if they are going to paper file.

Those taxpayers that file paper returns without the aid of computer software must research their tax issues on line, in publications or through tax services, a considerable investment of time and effort.

3. Should the IRS offer direct, free e-filing through its website? Are there any policy reasons why the IRS should not offer direct and free electronic filing to taxpayers?

Beginning in 2003, we offered on the IRS web site, IRS.gov, a Free File program which was the result of a public-private partnership between the IRS and the Free File Alliance, a group of private tax software providers.

All of the major tax preparation software packages offer electronic filing as an option. For those that do not wish to pay for tax preparation or electronic filing, there are free online preparation and filing programs that any taxpayer can use.

To date, this combination of the Free File Alliance and options provided by other private sector vendors provide the best solution to the problem of ensuring taxpayers receive the most high quality free options for e-filing.

As with any partnership, the terms on which services are offered are subject to negotiations. It has been IRS' long standing position that Free File should be made available to as many taxpayers as possible. However, the Free File Alliance sees this as a program designed to benefit low income taxpayers. In addition, many Free File Alliance companies are participating in the program primarily because they see this as a way to keep IRS out of the tax preparation business.

The highest level of coverage that the Alliance was willing to agree to was 70 percent of all taxpayers. However, the IRS was able to obtain significant concessions on issues such as refund anticipation loans.

- 4. Free File doesn't seem to be doing a good job of serving the purposes for which it was designed. At its peak in 2005, only 5 million taxpayers out of 133 million used it. What do you think should be done to make it easier for taxpayers who want to prepare and file their returns on their own for free to be able to do so?**

Further research is necessary to gain a better understanding of taxpayer usage, satisfaction, and the attitudinal behavior towards Free File. This information is necessary in order to enhance program features and to develop effective marketing and communication strategies. While one would not expect that everyone that is eligible would take advantage of Free File, the fact that less than 5 percent of those eligible actually use it is a question on which we need to focus some attention.

- 5. Would it be a good idea to open up Free File to everyone until IRS has its own system in place?**

Opening Free File to everyone pending the development of an IRS system poses two immediate problems. First, such an action would be in violation of the current Free File agreement. That agreement, negotiated and agreed upon between the IRS and the Alliance, guaranteed coverage to 70 percent of the individual taxpayer population and extended the public-private partnership for an additional four-year period. The IRS also agreed to not accept or post any offer by an Alliance member which exceeds the stated limitations in the agreement amendment. The agreement can be terminated if the Agency provides written notice at least 24 months in advance to the Alliance terminating the partnership.

The second problem is that paying for an IRS developed system would be expensive and would divert scarce resources from other priorities.

- 6. Could the IRS and the states use electronic filing to work together to help people pay their taxes? How might that work? Are there any obstacles that might make such a partnership difficult? What are they?**

IRS, in cooperation with the Federation of Tax Administrators (FTA), is developing a pilot test for the collection of federal and state tax payments through the same Internet site. Initially in late 2006, IRS will be accepting withholding tax deposits for any Illinois business that chooses to participate. While IRS is developing the systems, security and other requirements for this pilot, they are working with several additional states to include their requirements.

The concept involves a single personal identification number (PIN) and password, issued by the federal government, that will enable any

employer to log onto www.eftps.gov and enter their tax payment amount in the same detail done today for the federal government and the respective state(s). If there are multiple state payments to be made at the same time, these can be accomplished in the same Internet session.

The payment transaction related to the state(s) will be electronically transmitted to the state agency for debiting of the taxpayer's bank account and crediting the states' account. Neither state money nor state data will be available to the federal government since we will use state-of-the-art technology to segregate this data from the federal payment data. However, the history of the transactions (including the state payment "authorization") will be available on-line through the Electronic Federal Tax Payment System (EFTPS). Should a payment reject (for whatever reason) at the taxpayer's bank, only the state will know and they will be responsible to such exception processing.

Some of the challenges that are presented by such a partnership with the states include: variable taxpayer identifying numbers, different payment due dates, different holidays, different terminology for the same tax types, etc. We are working diligently with the Financial Management Service (FMS), all the states, their payment processors, their banks, the FTA and others to make this happen.

7. An argument has been raised that the IRS would incur substantial costs to develop software if it were to offer direct and free electronic filing. What are the pros and cons of the IRS developing its own software compared to contracting with outside parties to provide the software?

IRS's core competencies are the administration and enforcement of the nation's tax laws. Developing software for income tax preparation and e-filing would represent a significant departure from those core competencies.

Because of the complexity of the tax code, it would be extremely difficult to develop a software package designed to meet the needs of all taxpayers. In the end it might be too much to tackle for those taxpayers that have a simple return, while those with more complex returns are likely to continue to seek out paid preparers. Currently private software providers can deal with this problem by targeting market segments for their products.

Finally, taxpayers are likely to have an inherent distrust for any system the IRS might devise. They may feel that the IRS software will not allow them to take advantage of every deduction or credit to which they are entitled.

8. Please comment on the pros and cons of an IRS mandate that individual taxpayers must file their tax returns electronically. Include in your comments consideration of whether a mandate would apply to all individuals, or certain types of taxpayers.

The Administration has not proposed a general e-file mandate for individual taxpayers. IRS is using other approaches rather than individual mandates that lessen the chance for burden on specific taxpayers.

The first is the model used in most states that mandate individual e-file. States require preparers that prepare some threshold level, usually 50 or 100 returns, to file their customers' returns electronically. This model recognizes that preparers need to invest in equipment and software and become vested in the e-file process, and the threshold establishes a level that makes that possible. The benefits to the government should outweigh the individual interest in this case because e-file meets all taxpayer reporting needs. However, most states do permit individual taxpayers to opt-out of e-file if they wish.

The second model would be to mandate all preparers and taxpayers that use software to prepare returns to e-file as well. This is consistent with RRA 98 (§2001(b)(1)) which set as a goal that all returns prepared electronically should be filed electronically as well. Taxpayers and preparers have much greater access to computers, software and internet resources than they did in 1998.

9. What can Congress do to remedy the problems highlighted at the hearing?

The best thing that Congress can do to address the problems raised at the hearing is to simplify the tax code so that individual taxpayers can prepare their own returns. This would address the need for paid preparers as well as for sophisticated software and reduce significantly the annual costs of tax preparation as well as the risks associated with a having non-qualified preparers do tax returns. In addition, the ability to create a simplified electronic filing system would be greatly enhanced allowing virtually all taxpayers to file their returns electronically.

Currently, the Service is facing conflicting pressures in Congress. Some members are urging that we develop our own electronic system with our own software. Others, including a majority of the Senate last October, believe that we need to continue with a public-private partnership such as the Free File program.

Congress can also fully fund the IRS's FY 2007 budget request and enact the five legislative proposals offered by the President to reduce the tax gap. One of those proposals would require paid tax preparers to sign all tax returns that they prepare, not just income tax returns.

10. What can Treasury and the IRS do to remedy the problems highlighted at the hearing?

There are two major steps that Treasury and the IRS can take to remedy the problems highlighted at the hearing. First, we need to explore ways to improve the Free File program and develop creative ways to promote the program to eligible taxpayers. After each filing season, the IRS meets with the Free File Alliance to discuss how the program can be improved. Those meetings have resulted in continued improvement on the quality of the program and what IRS knows about the taxpayers who take advantage of Free File. For example, this year, for the first time, we were able to add a marker that will identify the taxpayers who utilize Free File. We have the ability to do customer satisfaction surveys which will help us continue to improve the program. Another improvement in this year's program is the restrictive requirements relative to refund anticipation loans (RAL). As a result many companies in the Alliance do not even offer RALs as part of Free File and overall less than half of one percent of all Free File taxpayers received a RAL.

When necessary, we can meet with the Alliance during the filing season to correct problems that are identified. When Senators Grassley and Baucus recently identified several questionable ancillary issues associated with Free File, the IRS met with the Alliance and was able to immediately remedy some of the most egregious problems.

The second step the IRS and Treasury can take is to increase examinations of paid tax preparers. As indicated in Question 9, Congress can assist us in this regard by fully funding the IRS FY 2007 budget and adopting the President's five legislative proposals, one of which is to require paid preparers to sign all the returns that they prepare on behalf of a taxpayer and not just income tax returns.

11. What can the preparer and software communities do to remedy these problems?

The software community needs to be prepared to meet market demands. For example, 35-40 million people are preparing their returns utilizing computer software but are printing out paper copies and mailing them to the IRS. A major reason for this is that these taxpayers resent having to pay to file the returns electronically. The software community needs to look at ways to reduce or eliminate the costs associated with electronic

filing so that more taxpayers can derive the full benefits with electronic filing.

The preparer community needs to do a better job of monitoring itself and insuring that anyone preparing returns for a fee meets minimum standards for tax preparation.

12. Why did the IRS agree to a non-compete clause with the Free File consortium? Why would the IRS tie its own hands?

The Free File Alliance is a coalition of tax preparation software manufacturers. The public-private partnership stemmed from the government's desire to provide some free tax preparation and electronic filing services to taxpayers and the industry's concern about the government creating its own tax preparation software program. The Alliance agreed to provide free tax preparation software and free e-filing to 70 percent of all taxpayers. In return, the IRS agreed to stay out of the tax preparation software business during the term of the agreement.

Under the agreement amendment, the IRS may terminate the partnership with the Alliance without cause, such termination to be effective 24 months after the date of written notice of such termination being sent to the Alliance.

13. If Free File is an effective product, why did only 5 million people out of 133 million use it last year, with a 20% drop this year?

We are unable at this time to fully explain the decline. The fact that it is not available to everyone is certainly one factor, but there likely are other factors as well.

A year ago, the Free File program was benefited greatly by a major article on the front page of *USA Today*. Immediately following that article, there was a tremendous surge of positive publicity as well as a surge in Free File usage by taxpayers. We have not been the beneficiary of similar publicity this year and to the extent we have received coverage much of it has focused on the taxpayers that Free File does not cover.

14. Why, when the rate of use grew last year by 50% when the income restrictions were lifted, did IRS agree to reinstate those limits in the latest agreement?

Last year was the final year of the original 3-year agreement between the IRS and the Alliance which was set to expire on October 30, 2005. As we prepared for negotiations to extend the Free File agreement, the IRS took the position that Free File should be available to as many taxpayers as

possible. The Alliance position was that Free File should only be available to low and moderate income taxpayers.

As is the case in most negotiations, we compromised and agreed that Free File would be offered to 70 percent of taxpayers, or anyone with an AGI of \$50,000 or less in 2005. This covers approximately 93 million of the 133 million taxpayers expected to file. This is an improvement over our earlier agreement which only guaranteed coverage of 60 percent or availability to 78 million taxpayers.

While opening up Free File to all taxpayers was good for the IRS and for taxpayers in general, it could pose a threat to the survival of the Alliance. Many of the companies report that they would not continue in the Free File Alliance unless it returned to offering the free service to low and moderate income individuals. The loss of these companies could have jeopardized the continued existence of the free tax preparation and e-filing services that the Alliance guaranteed to provide to over two-thirds of the taxpayer population.

15. Do you think the new contract restrictions and the confusing inconsistencies in the program are contributing to this year's sharp decline?

See response to Question 13.

16. The Free File program is accessed through the IRS website. This implies the IRS endorses the services and the products offered through those websites – no matter how many disclaimers there are. How can you defend some of the things going on inside these websites? Do you think this is the best service the IRS can provide for low to middle income taxpayers?

The IRS.gov intercepting page (or site exit disclaimer page) that a visitor sees after they click on any of the Free File Alliance provider links is shown below.

The screenshot shows the IRS website header with the logo and navigation links. Below the header is a search bar and a menu with categories: INDIVIDUALS, BUSINESSES, CHARITIES & NON-PROFITS, GOVERNMENT ENTITIES, TAX PROFESSIONALS, RETIREMENT PLANS COMMUNITY, and TAX EXEMPT BOND COMMUNITY. The main content area features a sidebar with 'IRS Resources' including Compliance & Enforcement, Contact My Local Office, e-file, Forms and Publications, Frequently Asked Questions, News, Taxpayer Advocacy, and Where To File. The main text contains a disclaimer: 'Please note that by clicking on this link, you will leave the IRS web site and enter a privately owned web site created, operated and maintained by a private business. The information that this private business collects and maintains as a result of your visit to its web site may differ from the information that the IRS collects and maintains. (please see the IRS web site privacy and security notice for privacy protections IRS provides to web site visitors). By linking to this private business, the IRS is not endorsing its products, services, or privacy or security policies. We recommend you review the business's information collection policy or terms and conditions to fully understand what information is collected by this private business.' Below the text are two buttons: 'Leave IRS Site' and 'Return to Previous Page'. The footer contains links for Accessibility, FirstGov.gov, Freedom of Information Act, Important Links, IRS Privacy Policy, and U.S. Treasury.

The IRS has historically used site exit disclaimers for external links provided within IRS.gov. The current IRS site exit disclaimer clearly states that "... by clicking on this link, you will leave the IRS web site and enter a privately owned web site created, operated and maintained by a private business." It also clearly states that "By linking to this private business, the IRS is not endorsing its products, services, or privacy or security policies."

It should also be noted that the use of site exit disclaimers adhere to OMB Memorandum 05-04, Policies for Federal Agency Public Websites¹ (dated December 17, 2004), and is considered a best practice included in the Recommended Policies and Guidelines for Federal Public Websites Final Report (dated June 9, 2004) of the Interagency Committee on Government Information (ICGI).²

The ICGI Committee recommendation included:

- Federal public websites *must* disclaim responsibility for the content and privacy policies used by non-federal government websites.
- Federal public websites may notify visitors that they are leaving the website by identifying the destination website in the link text or

¹ <http://www.whitehouse.gov/omb/memoranda/fy2005/m05-04.pdf>

² <http://www.cio.gov/documents/ICGI/ICGI-June9report.pdf>, page 9.

description itself or by inserting an intercepting page that displays the notification, after the user selects the link.

One of the major concerns that many critics of the Free File program have had has been the ability of the Alliance members to use Free File to market other services to taxpayers. These include the filing of state tax returns and the offering of refund anticipation loans (RALs). We make it clear to taxpayers that the IRS does not endorse any of these products or services nor is the completion of their tax return at no cost conditioned on the purchase of any product or service.

What we are seeing from our Free File data thus far in this regard is encouraging. Less than 0.5 percent of the taxpayers utilizing Free File have utilized a RAL. In fact, half of the Free File vendors do not even offer refund anticipation loans.

This 0.6 percent RAL participation for Free File is the lowest of any of our electronic filing groups. Other online filers have a 0.8 percent participation rate. The rate for online returns done by paid tax preparers is the highest. Approximately 20 percent of the preparer returns submitted electronically include a RAL.

In addition, some companies participating in Free File provide awareness and information about products and services of beneficial value to taxpayers. For example, H&R Block testified, on April 4 to the Committee, that they use the opportunity to alert low-income clients to their eligibility for a variety of government benefits that can improve their family's finances, including children's health insurance, food stamps, and prescription drug discounts.³

Finally, if issues, such as certain offerings associated with the free filing of the tax return, are identified, IRS will meet with the Free File Alliance and attempt to resolve those immediately.

17. How much oversight of the Free File vendor programs does the IRS do? How do you monitor accuracy, availability of forms, and products being marketed? How many violations have you found, and what do you do when you find one?

Ensuring the integrity of the Free File program is extremely important. Participants in the Free File program are Authorized IRS e-file Providers that must adhere to IRS Revenue Procedure 2005-60. Acceptance into the IRS e-file program entails completing and submitting an IRS e-file

³ <http://finance.senate.gov/hearings/testimony/2005test/040406RWtest.pdf> , page 2.

application and undergoing an annual suitability check by IRS. Suitability checks may include a:

- Criminal background check;
- Credit history check;
- Tax compliance check to ensure that all required returns are filed and paid, and to identify fraud and preparer penalties; and,
- Check for prior non-compliance with IRS e-file requirements.

In addition, Authorized IRS e-file Providers that are software developers and transmitters undergo software and/or communications testing with IRS before acceptance into the program. The purpose of testing is to ensure, prior to live processing that:

- Participants transmit in the correct format and meet the IRS electronic filing specifications;
- Returns have few validation or math errors;
- Required fields will post to the IRS Master File; and
- Participants understand the mechanics of IRS e-file.

To ensure participating companies adhere to the terms and standards of the Free File agreement and Memorandum of Understanding (MOU) between the IRS and the Alliance, the Alliance members' web sites and tax software programs are reviewed prior to launch. Companies are required to supply the IRS with a link to their free file web site before the site is expected to go live. All sites are examined by IRS personnel and a contractor for the Free File Alliance before they are posted onto the IRS.gov web site.

A checklist template ensures consistency among reviewers. As part of the review, we note the type and cost of ancillary products and services offered from the sites. We also review to ensure that the companies clearly disclose the forms and schedules that their software program supports and the limitations from their landing page as required in the MOU.

We monitor the progress of the companies as well as the content posted on their landing pages during the filing season to ensure that the companies haven't modified their offerings. The companies are required to alert the IRS and the Free File Alliance Executive Director of any material changes made to their web sites.

Other requirements for Free File participation include attaining third party privacy and security certification, and complying with all federal rules and regulations on taxpayer privacy for paying and free customers. These rules prohibit use of tax return data for purposes not specifically authorized by the taxpayer (e.g., 26 U.S.C. §7216). Beginning in Calendar Year 2006, the participating members must meet a minimum

level of performance standard and conduct an annual penetration and vulnerability assessment prior to the start of the 2007 filing season.

While we did not identify any violations of the agreement or MOU during the 2006 filing season, we worked with the Alliance to resolve the issues raised by the Senate Finance staff. In the event a violation is reported or identified, it is our policy to notify the Free File Executive Director and the Alliance member requiring an immediate remedy to the violation. A company's failure to comply may result in the delisting from the Free File web site.

18. Why does the Free File program have to be so confusing? Why can't all the vendors have the same rules and the same forms?

All Free File participating companies adhere to the IRS e-file rules and program oversight as explained above.

The agreement enables Alliance members to customize offers to taxpayers most suited for their software and ensures that Alliance members remain competitive and innovative in the software industry. Individual company offers may target specific taxpayer segments focusing on geographic areas, age, military status, or income levels.

The IRS e-file program guidelines do not require Authorized IRS e-file Providers to offer every available tax form in their products. Authorized IRS e-file Providers must, however, disclose the form limitations in their products. In addition to the IRS e-file program guidelines, the following requirement is contained in the MOU:

4.5 Disclosure of Forms and Schedules and Limitations.

4.5.1 Members will disclose Members' schedules and forms on Members' Free File Landing Pages; and

4.5.2 Each Member and/or New Market Entrant will disclose any limitations in the forms and schedules that are likely to be needed to support Members and/or New Market Entrant's free offerings. This disclosure shall take place on Members' and/or New Market Entrants' Free File Landing Pages (or such page must have a clear link to such disclosures directly from this page). Representative examples of limitations required to be disclosed include, but are not limited to, the inability to support more than one W-2, and/or the lack of a form necessary to prepare a return that is likely to be based on the offer. Limitations in forms and schedules do not include any form that is not routinely required, e.g., the separate forms required for taxpayers with foreign income, unless a Member's offering is particularly orientated around such forms.

19. The IRS Oversight Board already has said the IRS won't hit the Congressional goal of 80% electronic filing by 2007. Why not? What aggressive steps is IRS taking to get as close as it can to 80%? When will the IRS hit the 80% goal?

Significant challenges remain in transitioning from a paper-based environment to an electronic-based environment and in meeting the congressional goal to have 80 percent of all returns filed electronically by 2007. Our e-strategy for growth outlines our plans to reduce taxpayer burden and meet the Congress' goal. Key strategies include:

- Make electronic filing, payment and communication so simple, inexpensive, and trusted that taxpayers will prefer them to calling and mailing.
- Substantially increase taxpayer access to electronic filing, payment, and communication products and services.
- Aggressively protect transaction integrity and internal processing accuracy.
- Deliver the highest quality products and services as promised.
- Partner with states and other governmental entities to maximize opportunities to reduce burden for our common customer base.
- Encourage private sector innovation and competition.

To achieve these strategic goals, we will continue to develop and implement e-file marketing strategies, expand the use of electronic signatures, and enhance our website services for both practitioners and taxpayers. Ultimately, our goal is to offer all taxpayers and their representatives the ability to conduct nearly all of their interactions with the IRS electronically.

Recognizing that Congress originally set a statutory goal of receiving 80 percent of all tax and information returns electronically by 2007, the IRS has focused on increasing the number of individual taxpayers who e-file their tax return. In 2005 (Tax Year 2004), we received 52 percent of individual returns electronically, which represents an increase of 8.3 million over the previous year. We are making steady, sustainable progress toward that goal. As of May 20, 2006, of the 125.4 million individual returns filed, nearly 57 percent were received electronically.

20. What efforts did IRS take this year to encourage former Telefilers to use Free File?

On the Free File Landing page, we included verbiage about TeleFile no longer being available and that taxpayers who used the telephone service in the past may qualify for Free File. In the Communication Plan and Fact Sheet that was shared with our internal and external stakeholders, we

listed Free File as one of the alternatives to TeleFile in our key messages. We sent a post card to all previous year Telefilers alerting them of the discontinuance of TeleFile and informing them of their available options, which included Free File. Additionally, we encouraged the use of Free File and other alternatives to former Telefilers via recorded voice scripts, press testimonies, news articles, Servicewide Electronic Research Program (SERP) Alerts, the IRS Digital Daily and the IRS and Electronic Tax Administration (ETA) websites.

21. What marketing and outreach efforts has IRS taken this year to encourage all taxpayers to use Free File or to e-file?

As part of the marketing campaign this year, IRS introduced Electronic IRS to increase awareness of all electronic products and services available at IRS.gov.

Electronic IRS brings all IRS electronic products and services under one strong identifier for easy access and availability online. To launch our campaign externally and internally we did the following:

- January 12th
 - Press Release issued
 - Electronic IRS live on Home Page and text page
 - Intranet Notebook live
- January 17th
 - E-media campaign began to tax preparers

This year we heavily focused on public education efforts with messages on e-file and Free File which included:

- January 30th
 - Satellite Media Tour= 3 hours, 13 live interviews, 22 total interviews, 238 airings, reached almost 2.5 million people
- March 30th
 - Satellite Media Tour= 3 hours, 6 live interviews, 17 total interviews, 17 airings, reached 300,000 people (busy news period – Jill Carroll, etc.)
- April 11th
 - 3 hours, 9 live interviews, 16 total interviews, 691 airings, reached 41.6 million people. In addition, 6 business web sites picked up the generic interview and placed it on their sites--- visited by more than 107 million.

22. Provide a breakdown of the electronic filing percentages for each category of return, e.g., individual, corporate, exempt, flow-through, information, etc.

2005 Calendar Year			
Major Categories	Percent Electronic	Major Categories	Percent Electronic
Individual	51.8	Employment	18.9
Information	96.3*	Exempt Organization	.6
Fiduciary	36.5	Government Entities	0
Partnership	6.6	Political Organizations	0
Corporation	3.4	Excise	0
Estate & Gift	0		

* This information return figure includes both e-filed returns and those filed on machine readable magnetic media.

23. Why can IRS mandate that large corporations must e-file? Should corporations be treated differently than individuals?

The IRS Code (26 USC Section 6011(e)) authorizes the Secretary to prescribe regulations providing the standards for determining which returns must be filed on magnetic media or in other machine-readable form. Section 6011(e)(1) indicates that the Secretary may not require returns of any tax imposed by subtitle A on individuals, estates and trusts to be other than on paper forms supplied by the Secretary. Section 6011(e)(2) provides that the Secretary may not require any person to file returns on magnetic media unless the person is required to file at least 250 returns during the calendar year.

Section 6011(e)(2)(B) requires that the Secretary, prior to issuing regulations requiring these entities to file returns on magnetic media, take into account (among other relevant factors) the ability of the taxpayer to comply at reasonable cost with the requirements of the regulations. The term magnetic media includes any magnetic media permitted under applicable regulations, revenue procedures, or publications, including electronic filing. Recognizing the benefits of electronic filing, Congress enacted section 2001(a) of the IRS Restructuring and Reform Act of 1998, Public Law 105-206, 112 Stat. 727, which states that the policy of Congress is to promote paperless filing, with a long-range goal of providing for the filing of at least 80 percent of all Federal and information returns in electronic format by 2007.

In February 2004, the IRS introduced Modernized e-File, a new electronic filing system for corporations required to file Form 1120 or Form 1120S and organizations required to file Form 990. During the development of Modernized e-File, the IRS worked closely with taxpayers and tax professionals to ensure that the new electronic filing system would satisfy their needs. Modernized e-File alleviates the burden of filing massive

paper returns, which may be up to 50,000 pages in length. Electronically filed returns are processed upon receipt and, shortly thereafter, an IRS acknowledgment message is generated to inform taxpayers or tax professionals that the return has been accepted or rejected. Error messages for rejected returns identify the reasons the return was rejected and make it easier for the taxpayer or tax professional to correct the errors. Modernized e-File streamlines electronic filing by eliminating the need for paper documents to be mailed to the IRS and enables taxpayers to attach forms and schedules, along with other documents, to the return in Portable Document Format (PDF).

IRS has been very judicious in applying its regulatory authority. IRS has not administratively mandated through regulations e-filing for any taxpayer segment without first having Modernized e-File in place. It has only mandated e-filing by corporations and exempt organizations with assets in excess of \$10 million dollars, except that there is no asset threshold for private foundations or section 4947(a) (1) trusts.

- 24. Please respond to the following questions concerning the IRS's ability to offer direct and free electronic filing for individuals.**
- a) Does the technology exist for IRS to do this – is it possible?**
 - b) How much money would it cost?**
 - c) How much more staff would you need?**
 - d) What other challenges would there be?**
 - e) When would be the earliest IRS could have a system in place?**

While technology probably exists or could be developed that would allow the IRS to offer direct and free electronic filing for individuals, we are unable to respond to your other specific questions. A study would have to be conducted to include such factors as to whether or not it would be cost effective to purchase vs. build the software, determining the impact to internal and external stakeholders and systems, IRS front end and back end processing, security, potential lawsuits if an error is discovered in software computations, volume and system capacity issues, resources, etc. This list is not meant to be all inclusive.

- 25. IRS reports show that electronic filing is up by a modest 3% this year. What is the IRS going to do to jump start e-file growth?**

Extension Campaign

- We are working on a campaign to reach the approximately 9,000,000 extension filers this year to make them aware that e-file and Free File are available for the extension and to file their return. Typically, e-file numbers drop significantly after the tax filing deadline-April 17.

- Objectives:
 - To increase awareness for e-filing extensions
 - To correct a perception that extensions cannot be e-filed
 - To continue e-filing volume beyond April 17th
- As part of the campaign we launched an Radio Media Tour on April 11
 - 3 hours, 9 live interviews, 16 total interviews, 691 airings, reached 41.6 million people. In addition, 6 business web sites picked up the generic interview and placed it on their sites--- visited by more than 107 million.

26. How does IRS shape its policy about electronic filing? What is the plan for this year, in two years, in five years? Do you have any studies underway or in the planning stages? What action is the IRS taking to make sure it will be ready to meet the e-filing needs of American taxpayers in the future?

IRS e-file policy has been and still is all about steady, incremental, permanent growth. Rather than develop attention-getting promotions that might artificially boost e-file participation then recede, IRS has worked with both taxpayers and the tax industry to convert them permanently to e-file. The IRS goal is that once taxpayers e-file, they never go back to paper. This approach has yielded consistent steady growth with no backsliding such that an estimated 55% of individuals will e-file in 2006.

Going forward, IRS recognizes that it must improve the quality of its e-file offerings to keep pace with taxpayer and private sector expectations. IRS e-file for individuals is using 20 year old programming and technology. It has been updated to include encryption. The future is continued development of Modernized e-File, now available only for Forms 1120 and 990. This modernization effort is critical to both returns processing and compliance since both are substantially improved with the new technology. The software industry will be able to create powerful new tax packages to serve more taxpayers better. This will lead to further conversions of taxpayers to e-file. IRS will devote more resources to e-file processing as paper return processing lessens.

27. Mr. DuMars has made public comments that support restrictions on Free File. For example, an Associated Press article on Sunday, January 22, 2006 contained the following quotation: "It had started looking like Free File was going to destroy the industry".

See response to Question 28.

28. Why should IRS policy about electronic filing be influenced by private industry?

The intent of the Free File program was to reduce the burden on individual taxpayers, make tax preparation easier and expand the benefits of electronic filing to a majority of Americans. In the 2003 filing season, 2.8 million taxpayers took advantage of Free File. This number rose to 3.5 million in 2004. In 2005, the number increased to over 5 million.

The 2005 number may be a bit of an aberration in that many of the companies in the Alliance opted to lift qualification restrictions on taxpayers thus allowing any taxpayer, regardless of income, to utilize Free File. This started as some companies sought a competitive advantage by expanding their base and ended with many of the companies' offering free return preparation services to anyone.

While opening up Free File to all taxpayers was positive for taxpayers and the IRS, it actually posed a potential threat to the survival of the Alliance. Many of the companies report that they could not continue in the Free File Alliance unless it returned to offering the free service to low and moderate income individuals. The loss of these companies could have jeopardized the continued existence of the free tax preparation and e-filing services that the Alliance guaranteed to provide to more than a majority of the taxpayer population.

29. It costs the IRS much more to process a paper return than an electronic one. Why are you more concerned about the bottom line of the tax preparation and software industry than you are the bottom line of the IRS?

The goal of the IRS is to convert as many taxpayers as possible to e-file as quickly as possible. This will have the greatest benefit to the IRS bottom line. Part of the strategy to do that is the Free File program, which as explained earlier is a public-private partnership that provides free tax preparation and electronic filing to 70 percent of all taxpayers. Absent that partnership, the taxpayers that utilized the Free File system last year and those that may utilize it in the future may not file electronically. So, the Free File program greatly benefits the IRS' bottom line.

Determining which taxpayers would be covered by Free File was the result of a negotiation. In the end, the IRS thought it was better for both taxpayers and its own bottom line that 70 percent have access to this free service versus offering the service to no one.

30. The hearing established there is a problem with a substantial number of paid preparers.

a) Is the IRS aware of the extent of the problem?

The IRS currently has a robust program to address problems caused by preparers who are negligent or encourage out-right fraud. We are aware of the need to address these preparers and prepare appropriate sanctions while also ensuring that the majority of competent preparers are not adversely impacted by our compliance efforts. Examination field resources dedicated to the Return Preparer Program have increased significantly over the past few years.

b) What is the IRS doing about the problem?

Examination field resources dedicated to the Return Preparer Program have increased significantly over the past few years. The IRS has a number of programs that address this problem including:

Program Action Case

When a preparer's misconduct appears to be pervasive and not isolated to a single taxpayer, a Program Action Case (PAC) is initiated. Generally, we begin the PAC by examining a sample of client returns to determine if a pattern of non-compliance exists. For those preparers for whom we find widespread evidence of material errors, that demonstrate intentional misconduct or clear incompetence, we apply penalties under IRC Section 6694 and/or IRC Section 6695. If appropriate, we will examine additional client returns beyond the initial sample. These cases may also lead to injunctions under IRC Section 7407 (Action to enjoin income tax return preparers).

IRS e-File Monitoring Program

Our SB/SE Division has responsibility for monitoring e-file providers and removing those who are noncompliant with the guidelines set forth in Revenue Procedure 2005-60 and Publication 1345, *Handbook for IRS e-file Providers of Individual Income Tax Returns*. We generally accomplish this monitoring through visits to the e-file Providers' establishments.

Violations result in a range of sanctions from a warning which is issued for minor violations up to an expulsion from the program. Program removal is instituted against a provider who has been through complete injunctive action or when the Office of Appeals has deemed an individual or firm is no longer eligible to practice before the IRS.

EITC Due Diligence Visits

The purpose of the EITC Due Diligence program is to review paid return preparer compliance with the EITC due diligence requirements under IRC Section 6695(g). Since many EITC preparers also are electronic return originators (EROs), we often conduct combined Due Diligence/ERO visits.

Examiners have the full suite of sanctions available to them from both the due diligence and e-file monitoring provisions including due diligence

penalties under Section 6695(g) and e-file monitoring sanctions ranging from warnings to expulsion from the e-file program.

Examiners also use the visits as a means of detecting fraudulent activities that result in fraud referrals and non-compliance that results in recommendations for Program Action Cases (PACs).

c) How many preparer penalties did the IRS assert last year?

During every field and office examination, examiners determine if return preparer violations exist. If evidence exists that a preparer is at fault in filing an erroneous return or there are indications of misconduct, consideration is given to asserting a preparer penalty under Section 6694 (Understatement of Taxpayer's Liability by Income Tax Return Preparer) and/or Section 6695 (Other Assessable Penalties With Respect to the Preparation of Income Tax Returns for Other Persons).

Due to the manner in which we post penalty information to our system, we are unable to provide a meaningful number of preparer penalties asserted. For assessment purposes, multiple assessments of an identical penalty against the same preparer in the same tax period must be consolidated and posted as a single assessment. For example, an examiner may determine that a return preparer acted recklessly in the preparation of ten tax returns. Pursuant to Section 6694, we penalize the preparer \$1000 per return. In addition, we determine the same preparer failed to sign three returns, failed to furnish copies to four taxpayers, and failed to be diligent in determining eligibility for earned income tax credit on one return. Pursuant to Section 6695, we penalize the preparer \$50 each for the first seven failures and \$100 for the last failure. Hence, although this case involves eighteen penalties, our system reflects only three penalty assertions – one for \$10,000, the second for \$350, and the third for \$100.

d) How many disciplinary actions did the IRS Office of Professional Responsibility take last year?

In fiscal year 2005, the IRS Office of Professional Responsibility issued 49 Suspensions and Disbarments, 37 Reprimands, and 223 Expedited Suspensions.

e) Do you think the IRS enforcement of paid preparers is commensurate with the extent of the problem?

While more can always be done, we have aggressively pursued those paid preparers who are negligent or encourage out-right fraud. Our recent efforts to focus additional attention on developing preparer penalty cases is reflected by the fact that at the end of the first quarter of FY 2006, we had over 500 Program Action Cases (PACs) in process, compared to just over 100 PACs in process during this same period in FY 2005. The Office

of Professional Responsibility (OPR) also has increased the number of expedited suspensions. In addition, the OPR has significantly increased its staff and has proposed additional amendments to Circular 230 that will enhance its ability to deal with practitioner behaviors that have a high impact on tax administration. The proposed changes include open proceedings, which will help to educate tax professionals about their obligations under the Circular and to deter improper conduct. Other proposals would reinforce existing provisions on diligence, conflicts of interest, contingent fees and compliance with tax obligations.

31. Does the IRS provide software to the VITA sites to prepare tax returns?

Yes. The IRS provides all VITA sites with specific software for use at the site. The software that is used is TaxWise.

32. Does the IRS develop the software provided by the IRS to VITA sites? If not, what is the source of this software?

No, the IRS does not develop the software it provides to VITA sites. Instead, the IRS purchases a commercial product. Currently, the IRS has a contract with Universal Tax Systems to provide TaxWise software for use by the volunteer sites.

33. Would this software be adaptable for use on the IRS website so everyone could e-file directly with the IRS for free? If not, why not?

No, the TaxWise software is not adaptable for use on the IRS website so that everyone could e-file directly with the IRS for free. The software is designed for use by individuals who have received training on use of the software. IRS requires all VITA volunteers to pass an online test before they are allowed to work in a VITA center. As a result, the software the IRS currently provides to VITA sites is not intended for individual usage. Rather, it is a professional product requiring an ERO (Electronic Return Originator) and use of an EFIN (Electronic Filing Identification Number).

34. When taxpayers input information on the Free File Alliance vendor websites, are "cookies" created that are then used or disclosed by the vendors to solicit business for non-tax products?

We do not track whether companies incorporate the use of "cookies" on their web sites. The companies are required to acquire third party security and privacy certifications which are applicable for the period the company is actively listed on the IRS web site. The privacy certification process requires the company to post their company's privacy policy on its landing

page. The privacy policy discloses to visitors the company's policy regarding its use of "cookies", if any.

The companies are required to comply with all federal rules and regulations on taxpayer privacy for paying and free customers (e.g., 26 U.S.C. §7216). These rules prohibit use of tax return data for purposes not specifically authorized by the taxpayer.

35. Is information on the input screens (before the return is filed) considered to be tax return information by these vendors?

Yes. IRC §7216 and the regulations promulgated thereunder define tax return information as all information provided to paid tax return preparers "...in connection with the preparation of a tax return..." (Regulations at 301.7216-1(b)(3)) to be tax return information. Tax return preparers include anyone who assists in the preparation of the return including for example, preparers, clerks, electronic return originators, transmitters and software vendors that obtain access to taxpayer information. The Free File Agreement acknowledges the application of §7216 to Free File participants even though there is no compensation involved. Knowing or reckless disclosure or use of this information without the consent of the taxpayer is a misdemeanor punishable by a fine up to \$1,000 or imprisonment for up to one year.

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**Statement of the
Federation of Tax Administrators
Before the
Committee on Finance
U.S. Senate**

Preparing Your Taxes: How Costly Is It?

April 4, 2006

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**Statement of
Federation of Tax Administrators
Before the
Committee on Finance
U.S. Senate
April 4, 2006**

Mr. Chairman and Members of the Committee:

My name is Harley Duncan. I am the Executive Director of the Federation of Tax Administrators. The Federation is an association of the principal tax administration agencies in each of the 50 states, the District of Columbia and New York City. We have been actively involved over the past 15 years in promoting electronic filing at the state level through such activities as coordinating IRS and state activities in the FedState electronic filing program, developing standards and promoting consistency among state approaches to electronic filing and encouraging the sharing of 'best practices' among the states. Thank you for the opportunity to appear before you today to present information on the experience of states in the electronic filing of individual income tax returns. The testimony will first review the scope of electronic filing programs across the states and the experience of states in the area. I will then turn to several issues I was asked by the Committee staff to address, including electronic filing mandates, Free File Alliance, and direct Internet filing programs in the states.

Individual Income Tax Electronic Filing in the States

Each of the forty-one states with a broad-based income tax and the District of Columbia provide one or more avenues for the electronic filing of individual income tax returns. Available avenues for electronic filing include:

- **Practitioner programs** – Each state has a program for the filing of electronic returns by practitioners on behalf of their clients. Thirty-seven states¹ are part of the joint FedState electronic filing program in which both the federal and state returns are filed in a single transaction between the practitioner and the IRS. The IRS then segregates the state return

¹ Throughout the testimony, the District of Columbia is referred to as a "state" since its electronic filing programs operate exactly like those in the states

information and makes it available for downloading by the state. The other five states – California, Illinois², Maine, Massachusetts and Minnesota – receive their returns directly from the practitioners (in a separate transmission) rather than participating in the FedState program.

- **Online Filing programs** – Each state also has a program for the electronic filing of returns filed by individual taxpayers using personal computers and approved commercial software that are routed through IRS-approved Electronic Return Originators. As with practitioner returns, these returns flow to the states through IRS except in those states with direct practitioner-filing programs in which case the online returns are filed directly with the state.
- **Telefile programs** – In 2006, ten states operate an independent Telefile program where the individual taxpayer enters his/her return information using a touch-tone telephone. These states include Colorado, Connecticut, Iowa, Kansas, Massachusetts, Nebraska, New Jersey, Ohio, Pennsylvania and Wisconsin.³
- **Direct Internet Filing (I-file) programs** – Twenty-one states are operating a direct I-file program in 2006. These programs allow individual taxpayers file their state income tax returns directly with the state through a state-developed and administered Web site. The number of such programs has remained relatively constant over the last several years.⁴
- **Bar code programs** – These programs involve computer-produced returns (either by individuals or practitioners) that are filed on paper, but where the return data is also captured and printed in a 2-dimensional bar code capable of being read quickly and accurately by either hand-held or high speed scanners. While not as efficient from a

² Illinois both participates in the FedState program and receives returns directly from practitioners. The bulk of the Illinois returns are received directly.

³ The number of states with Telefile programs has dropped significantly in recent years. In 2002, for example, twenty-seven states had a Telefile program, including seven states that participated in a joint FedState Telefile program in which both federal and state returns were filed in a single call. The FedState Telefile program was, of course, discontinued when the IRS discontinued its overall Telefile program. As with the IRS, states commonly cite the cost of the Telefile program, the relatively low volume of returns received through Telefile and the availability of electronic alternatives for Telefile taxpayers as reasons for discontinuing the program.

⁴ States with I-file programs this year include California, Colorado, Connecticut, Delaware, D.C., Hawaii, Illinois, Indiana, Kansas, Louisiana, Maine, Maryland, Nebraska, New Jersey, New Mexico, Ohio, Pennsylvania, South Carolina, Utah, Virginia and Wisconsin. Arkansas, Missouri and Iowa discontinued their I-file programs in 2005.

processing standpoint as electronic returns, bar code returns substantially reduce the resources required for income tax return data capture for states. In 2006, twenty-three states have such a program in place.⁵

Growth in Electronic Filing

The IRS electronic filing program was inaugurated in 1986, and the first FedState joint e-file program was piloted in South Carolina just four years later. E-file volumes have grown steadily as both the federal and state programs have gained visibility, more states have joined the program, additional filing options (particularly Telefile and Online filing from home computers) and greater familiarity among taxpayers with electronic business applications have broadened the market of potential e-file taxpayers. As shown in Table 1, the number of federal e-file returns reached a total of 68.5 million in 2005, about 2.8 times the 1998 level. The volume of state e-filed returns has nearly quintupled over the same period, reaching a level of about 50 million in 2005.

Table 1: Selected Federal and State Electronic Filing Statistics

Electronic Returns	1998	1999	2000	2001	2002	2003	2004	2005
Federal (Millions)	24.6	29.4	35.4	40.2	46.9	52.9	61.4	68.5
State (Millions)	10.1	14.3	18.1	23.8	29.4	35.5	43.3	49.8
Percentage Growth								
Federal		19.5%	20.5%	13.6%	19.2%	14.5%	18.0%	11.5%
State		48.3%	30.1%	34.4%	28.3%	24.3%	25.1%	14.9%
E-file - Percent of Total								
Federal	19.7%	23.1%	27.3%	30.9%	36.0%	40.6%	46.8%	51.6%
State	12.0%	16.6%	19.5%	23.5%	28.7%	34.2%	41.6%	47.5%

Source: FTA compilation based on state and federal data.

State electronic filing has consistently grown at a faster rate than federal electronic filing as shown in the table. The volume has grown at roughly a 25-30 percent annual rate from 2000-2004, while federal volumes increased at about a 15-20 percent rate, allowing the state programs to close the gap with IRS somewhat. In 2005, the number of state electronic returns averaged 93 percent of the federal electronic returns (for those states with an income tax), up from about 70

⁵ Alabama, Arizona, Colorado, Delaware, Georgia, Idaho, Illinois, Indiana, Kentucky, Louisiana, Maryland, Massachusetts, Michigan, Missouri, New Jersey, New Mexico, New York, North Dakota, Oklahoma, Oregon, Rhode Island, Utah, and Virginia.

percent in 2000. In five states – Kansas, Massachusetts, Ohio, New Mexico and Delaware – the number of state electronic returns exceeded the number of federal electronic returns filed from that state.⁶ As should be expected, the growth at both the state and federal level has begun to slow, a trend that has become more pronounced in 2006. (See below.)

The real question about the growing volume of electronic returns is the extent to which e-filing is reducing the volume of paper income tax returns and enabling tax administration agencies to become more efficient in the processing of returns and providing taxpayer service.⁷ As shown in Table 1, 47.5 percent of all state income tax returns were received electronically (in one form or another) in 2005. In 2000, only 20 percent of the returns were filed electronically; the comparable figure in 2004 was 42 percent. As shown in Chart 1 (attached), eleven states received more than one half of their returns electronically, and two – Iowa and Minnesota – received more than 60 percent electronically. Four of the five states with the highest proportion of electronic to total returns have an electronic filing mandate in place. [See later discussion.] Other factors that seem to influence a higher proportion of electronic filing are the number of options for electronic filing that a state offers. These do not explain all the differences across states, and some of the disparate results must be attributed to the nature of the taxpaying population and the complexity of their tax affairs.⁸

Distribution of Returns by Type

Returns filed through practitioners represented about 35.5 percent of all state returns and about 75 percent of all state electronic returns in 2005. Taken together, returns filed electronically by individuals using individual computers (i.e., using commercial software or online filing programs

⁶ See Federation of Tax Administrators Briefing Paper, “2005 Electronic Filing Season Results: A Review of State and Federal Data,” December 2005 for more detail. The document is available at www.taxadmin.org. The use of independent Telefile and I-file programs as well as a category of returns known as “state only” returns filed by practitioners enable a state to exceed the federal total.

⁷ E-filing improves tax agency efficiency by eliminating the handling, opening, assembly and data capture associated with paper returns. In addition, electronic returns are mathematically accurate, and errors that often occur during data entry are eliminated. This allows the returns to be processed with little or no intervention, thus allowing the agency to focus more quickly on the service and enforcement aspects of tax administration.

⁸ For example, some states that offer only practitioner and online filing (e.g., Idaho, Montana and Iowa) received 50 percent or more of their returns electronically while others that offer multiple options (e.g., New Jersey, Maryland and Illinois) were toward the lower end of all states.

and direct I-file programs) totaled 10.7 million returns or over 20 percent of all electronic state returns. Telefile returns have gradually declined over the last five years, reaching less than 2 percent of all returns in 2005.⁹

Type of Return	Return Count	Percent of Total
Paper	46,010,721	43.9%
Bar Code	8,997,975	8.6%
Practitioner E-file	37,228,806	35.5%
Online E-file	8,723,794	8.3%
Direct I-file	1,943,564	1.9%
Telefile	1,905,466	1.8%
	104,810,326	100.0%

Source: FTA compilation based on IRS and state data.

2006 Filing Season

Table 3 below presents information on the 2006 income tax filing season gained from a survey of 37 states. The data reflect returns received through March 17, 2006.

Type of Return	Return Count	Percent Change from 2005
Paper	11,349,937	-11.1%
Bar Code	2,490,270	7.5%
Practitioner and Online	31,595,549	9.7%
Direct I-File	1,388,428	11.7%
Telefile	640,671	-46.0%
Total Returns	47,464,855	3.0%

Source: FTA compilation based on state-provided data from 37 states.

⁹ Electronic transaction processing is also hitting the "payment" side of the ledger. Data from 26 states indicates that in 2005, over 17.5 million income tax refunds were paid through direct deposit transactions instead of paper checks. This represents 36 percent of the 49.3 million refunds paid in these states. Direct deposit eliminates the postage, envelope, printing and handling costs associated with paper checks as well as getting the refund in the hands of the taxpayer more quickly.

Key points about the 2006 season that can be drawn from the data include:

- The rate of growth in electronic filing is slowing. For all types of electronic returns, the growth rate from 2005 is 7.7 percent, in part due to the fact that the number of Telefile returns has dropped by nearly half. Even so, other forms of state electronic filing are up by only 10 percent, compared to 15 percent in 2005 and over 20 percent in the years prior to that.¹⁰ This is not necessarily unexpected, given the maturation of the programs and the fact that most early filers are already electronic filers. Still, it suggests a leveling of e-file numbers unless other action is taken.
- The discontinuation of the federal Telefile program has had a pronounced effect on those states that maintain independent Telefile programs, suggesting that taxpayers tend not to differentiate well between federal and state tax obligations. Most of the independent state Telefile programs are down by about 40 percent or more this year, compared to a 'natural' drop of about 15-20 percent in the last several years.¹¹
- Individuals filing from their individual computers (using third party software or sites or state-provided sites) are leading the way in 2006. IRS reports that Online Filing is growing at about three times the rate of practitioner-filed returns, and state data show Direct I-file returns are increasing more rapidly than practitioner-filed returns.
- Electronic filing mandates are having some influence on the growth in electronic returns in 2006. Through March 17, New York and Connecticut, each of which is implementing a mandate for the first time in 2006, had growth rates of 30 percent and 20 percent, respectively. Vermont is the only state without a new mandate that is growing at a 20 percent rate, and many states are in the single-digit range. About 25 percent of the total increase in electronic state returns are coming from Connecticut and New York; together, they accounted for only 7 percent of all state electronic returns in 2005.

¹⁰ By comparison, total electronic filing at the federal level is up 2 percent due to the elimination of the federal Telefile program. Excluding Telefile, federal e-filing is up 8 percent. See IRS News Release IR-2006-047, March 22, 2006.

¹¹ The reaction to the discontinuation of Telefile deserves observation. Minnesota discontinued its Telefile program in 2005. Of the 79,000 Telefile taxpayers in the prior year, 57 percent filed on paper in 2005. [Communication from Minnesota Department of Revenue, March 31, 2006.]

Direct Internet Filing Programs

As noted, twenty-one states now have an electronic filing program in which most or all taxpayers may file their state income tax return directly with the states tax agency without charge using a state (or contractor) developed and maintained secure Web-based application. In 2005, about 2 million returns were filed using these I-file programs. This amounts to about 4 percent of all electronic state returns, but in some states (e.g., Delaware, Maine, New Mexico and Pennsylvania) I-file returns account for over 15 percent of all computer-filed returns. The volume of I-file returns has more than doubled since in the last three years as the applications have improved and individuals have become more accustomed to conducting business electronically over the Internet.

State I-file programs have been criticized by some as constituting a form of inappropriate government-financed competition with private sector tax software and service providers and as representing a conflict of interest in that the tax administration agency to be in charge of the software that determines the liability of the taxpayer. For their part, states see the offering of an I-filing application as an extension of their obligation to provide forms and instructions to taxpayers and of their normal taxpayer service functions. States are moving aggressively on a number of fronts to use the Internet and electronic technologies to improve taxpayer service and reduce their operating costs (e.g., electronic payments, online account access, electronic forms and instructions). The I-file programs are an extension of this approach and consistent with the direction that state government as a whole and the private sector are taking in terms of interacting with their “customers.” States also believe that even with their I-file applications, there is a major and important role for private sector interests to offer tax software with a number of value-added features such as online support, integration with accounting packages, information report downloads, integration with federal filing software and the like. In short, states see the I-file programs as aimed at a segment of the taxpaying population that is comfortable with computers and electronic commerce and does not require a paid preparer or commercial software to complete his/her state income tax obligations.

If consideration is given to a direct Internet filing program for federal income tax returns, there are at least three issues that would need to be addressed.

- **Complexity.** In drawing on the state I-file experience, it must be recognized that state income taxes (and return filing) are inherently less complex than the federal income tax and thus easier to deal with in an online environment. Nearly every state income tax is based on the federal income tax base, and the bulk of the entries and calculations on a state income tax returns involve only areas of deviations from numbers calculated for federal purposes. All state I-file applications presume prior completion of a federal return and begin with federally computed numbers. The applications and rules need to accommodate these types of returns is immeasurably simpler than the application that would be required to accommodate a full-blown application that could deal with all types of federal returns and schedules. Limiting the types of returns and schedules for which any federal I-file application could be utilized, much as is done on the 1040EZ, 1040A or the Telefile application, would reduce these complexity challenges.
- **Security.** It goes without saying that security of the application and the data provided in a federal I-file application must be a paramount concern. Any breach of security or other lapse that caused a loss of taxpayer confidence in the system would have ramifications throughout the system.
- **Scalability.** It would seem that a significant challenge for any federal system would be to be scaled appropriately so as to have the capacity to handle the “April 15” crush that would most likely be experienced. Currently, that crush of taxpayers is spread among many individual preparers and some number of software firms. A single federal application, if widely available and used, would seemingly require considerable peak load capacity. A failure that shut taxpayers out of the ability to timely file their returns would reverberate throughout the system. Again, this risk could be mitigated in part by limiting the types of returns for which the application could be used and possibly considering an extended due date for such returns.

Free File Alliance

As you know, the IRS is working with a consortium of private sector software providers called the Free File Alliance (FFA) to provide a no-cost electronic filing application for federal individual income taxes. Some members of the Free File Alliance also provide free Web-based

return preparation and electronic filing services to selected groups of taxpayers in certain states.¹² Generally speaking, each of the 21 states that does not have a direct I-file program has from 2-4 members of the FFA that offer free services to some taxpayers in the states. Those states with Free File programs appreciate the support they have received from members of the Alliance.

As the Free File Alliance program has unfolded, however, states that are participating have become concerned that there is a significant potential for taxpayers to become confused during the free file process and end up in a situation in which they are confronted with being required to pay to file a state return electronically when they thought the return would be free. The concern of the states is that such taxpayers will turn to a paper filing (or in the worst case, not file at all.) The potential taxpayer confusion stems from three sources:

- Beginning in 2005 and continuing in 2006, the criteria for eligible taxpayers that are set by some Alliance members are more expansive at the federal level than they are at the state level. This has been ameliorated somewhat in 2006 with the more restrictive federal criteria, but a difference still exists for one or more providers in each state.
- Complete, clear information on who qualifies for a free state return is not as accessible as states believe it should be. Again, this situation is improved in 2006, as the IRS and the Alliance have been more conscientious about insuring that each provider make their eligibility and pricing information available. Unfortunately, however, the information is required under the FFA Agreement to be only on the “landing page” of the FFA member. This means that to “comparison shop,” a taxpayer must begin on IRS.gov, go to the FFA member landing page, back to IRS.gov, to the FFA member page and so on through the list of 20-some providers – not all of whom offer free state filing. This serious information gap could be closed by a requirement that complete offer information be made available in the “More Details” box that works off the IRS.gov site.
- Certain of the state free filing offers require that the taxpayer must begin the state filing process from the state tax agency’s Web site in order to qualify for the free state filing. This is counter-intuitive to the way in which state returns are prepared (i.e, federal first,

¹² Each member of the Alliance individually determines the taxpayers to whom it will offer free filing and those states in which it will offer the service. None of the Alliance members offers free filing services in any of the states that maintain their own direct I-file application.

then state), and we fear leads to taxpayers not being able to take advantage of a free filing opportunity for which they may have qualified.

In short, there are several features of the Free File Alliance effort that states believe are making it a less than optimal part of the overall effort to increase electronic filing at the state level. This is not meant to suggest that any one is being deceptive or trying to “hide the pea” in this effort. There is little doubt that some part of any taxpayer’s confusion is attributable to a lack of careful reading and comprehension and a lack of differentiating between state and federal tax obligations. It is meant to suggest, however, that if the FFA remains a part of the electronic filing effort that greater consideration needs to be given to the state interests in the program and to making it a federal-state program much like most of the other components of electronic filing.

Electronic Filing Mandates

The IRS Electronic Tax Administration Advisory Committee has on two occasions recommended that the federal government adopt a provision that would require certain tax preparers to file the returns they prepare electronically as a way to increase the electronic filing of federal income tax returns.¹³ The states have experience in this area that may be instructive to the Committee as it considers this matter.

There are twelve states that currently have an individual income tax filing mandate in place. They are Alabama, California, Connecticut, Massachusetts, Michigan, Minnesota, New Jersey, New York, Oklahoma, Utah, Virginia and Wisconsin.¹⁴ The mandates generally require each preparer that in the previous year filed in excess of some threshold number of returns to file all returns he/she prepares in the following year by electronic means. The threshold commonly starts at about 200-250 returns and phases down over 2-4 years to 50-100 returns being the demarcation point between those required to file electronically and those not.

¹³ IRS Electronic Tax Administration Advisory Committee, Annual Report to Congress, Publication 3415, June 2005. Available at < <http://www.irs.gov/pub/irs-pdf/p3415.pdf>>.

¹⁴ See Federation of Tax Administrators, Electronic Filing Mandates: Lessons Learned, June 2005, for a more complete description. Available at www.taxadmin.org. Note that these states account for 38 percent of the total U.S. population and slightly less than 50 percent of the population living in income tax states.

Implementation of mandates has increased the level of electronic filing at the state level.¹⁵ As noted earlier, four of the five states with the highest proportion of returns received electronically have a mandate in place. In addition, in each of 2004-2006, states that were first implementing a mandate in that year experienced a higher rate of electronic filing growth than did the remaining states. On average, mandate states grew at a 25-50 percent faster rate.¹⁶ Finally, IRS research indicates that implementation of state mandates generated an additional 2.5 million federal electronic returns in 2004.¹⁷

State experience in the design and implementation of income tax filing mandates yields the following “lessons learned” that should be relevant to the federal arena.

- The mandate should have a phase-in period, bringing in smaller volume preparers as implementation proceeds.
- There should be a ‘hardship exception’ that allows a preparer that is not capable of converting to electronic filing to be exempted from the requirement on a temporary basis.
- The mandate should allow a taxpayer to “opt out” and choose not to have the return filed electronically.
- Tax administrators consider it important to have penalties for non-complying preparers. The penalties should be applied judiciously, primarily in cases where a preparer is not acting in good faith.
- Certain low-volume forms should be excluded from the mandate to avoid costly programming for a minimal number of returns.
- It is difficult to underestimate the lead time necessary for implementation and the requirements imposed on the tax administration agency to communicate with preparers and software developers.

¹⁵ This should not be unexpected. At least one survey indicates that the primary determinant of why people file electronically and why they do not is that they leave the choice of filing to their preparer. See Deborah W. Thomas, Tracy S. Manly, and Christina M. Ritsema, “Initiatives for Increasing E-Filing: Taxpayer Attitudes Reveal What Works,” Tax Notes, July 12, 2004, pp. 191-196.

¹⁶ FTA calculations based on data submitted by the states.

¹⁷ McMillian, Howard. “State e-File Impact on Federal e-file.” Wage and Investment Research Group 1, Internal Revenue Service, 2004.

- Providing an enhanced set of services to preparers engaged in electronic filing can ease acceptance of the mandate.

Bar Code Returns

As noted, about one-half of the income tax states use a bar code program in which a two dimensional bar code is printed on returns that are produced using a computer (either by a preparer or by an individual), but are filed on paper. The bar code enables all the information on the return to be captured quickly and accurately with a simple hand-held scanner or a high-speed scanning and imaging machine. Scanning the bar code is considerably more efficient than manual data entry and even more efficient than high-speed imaging with optical character recognition. It also eliminates the errors and “re-work” associated with those forms of data capture. States estimate that bar codes can reduce the time and effort involved in processing paper returns by 50-90 percent, depending on other features of the state processing system.¹⁸ In 2005, states received about 9 million paper returns with a bar code; this is about 16 percent of all paper returns. In states that make aggressive use of bar codes (e.g., Alabama, Delaware, Indiana, Missouri, and North Dakota), over 40 percent of paper returns have a bar code, and in Massachusetts (which mandates that nearly all computer-produced returns either be filed electronically or have a bar code) over 70 percent of the returns have a bar code.

States recognize that bar coded returns are not as efficient as electronic returns. They see bar codes, however, as a bridge technology that provides significant efficiencies while continuing to try to migrate taxpayers to electronic filing. Bar codes can also help capture efficiencies from taxpayers that consider costs associated with electronic filing to be a barrier. Moreover, processing bar code returns has not required major investments by states. States have also worked with the software developer community to develop standards for bar code printing to minimize costs to developers. Adopting bar code technology at this point may not be appropriate for the IRS and the “1040 family” of returns. The utility of bar codes for tax administration, however, should not be underestimated and may be applicable to other return types (e.g., fiduciary returns, pass-through entities, non-profits or excise tax.)

¹⁸ Indiana, the state that pioneered bar coded returns, estimates that a bar code is \$.70 per return less costly to process than a paper return, while an electronic return saves \$1.039 per return compared to paper.

California ReadyReturn Program

In 2005, California adopted a pilot program to reduce (or virtually eliminate) the income tax filing burden for certain taxpayers. Under the ReadyReturn program, the tax administration agency (California Franchise Tax Board (FTB)) prepares a “pro forma” return for the taxpayer based on information reported to it through other wage and tax reporting channels. The return is then sent to the taxpayer with instructions; the taxpayer may file the pro forma return without change (either on paper or through a special Web site), file the pro forma return with changes or ignore the pro forma return and to file through normal processes. The ReadyReturn program is necessarily limited to a fairly narrow set of taxpayers that have only wage income, have only one employer, use a standard deduction, have no dependents and claim no credits.

California targeted 50,000 taxpayers in their pilot program. About 10,000 taxpayers (22 percent of those invited) chose to file using the ReadyReturn. Most of these taxpayers filed their ReadyReturn electronically, and many had not filed electronically in the past. Among those that did not use the ReadyReturn, only 10 percent indicated it was because they felt uncomfortable using a government-produced tax return. The most frequent reasons for not using the ReadyReturn were that the taxpayer had already filed a return,¹⁹ and that the taxpayer used a paid preparer to do his/her return. Overall taxpayer were extremely satisfied with the program according to a survey conducted by the FTB.²⁰

Conclusion

As you consider the issues related to electronic filing and the relationship between federal and state filing programs, there are several points the states would urge the Committee to keep in mind.

- States have made a strategic choice to focus their electronic filing efforts on filing programs that operate jointly with the federal government, a choice that promotes simplicity for taxpayers, practitioners and software developers (and works well for states

¹⁹ ReadyReturns were not mailed until mid-February because of the need to receive and process 4th quarter wage and tax statements from employers.

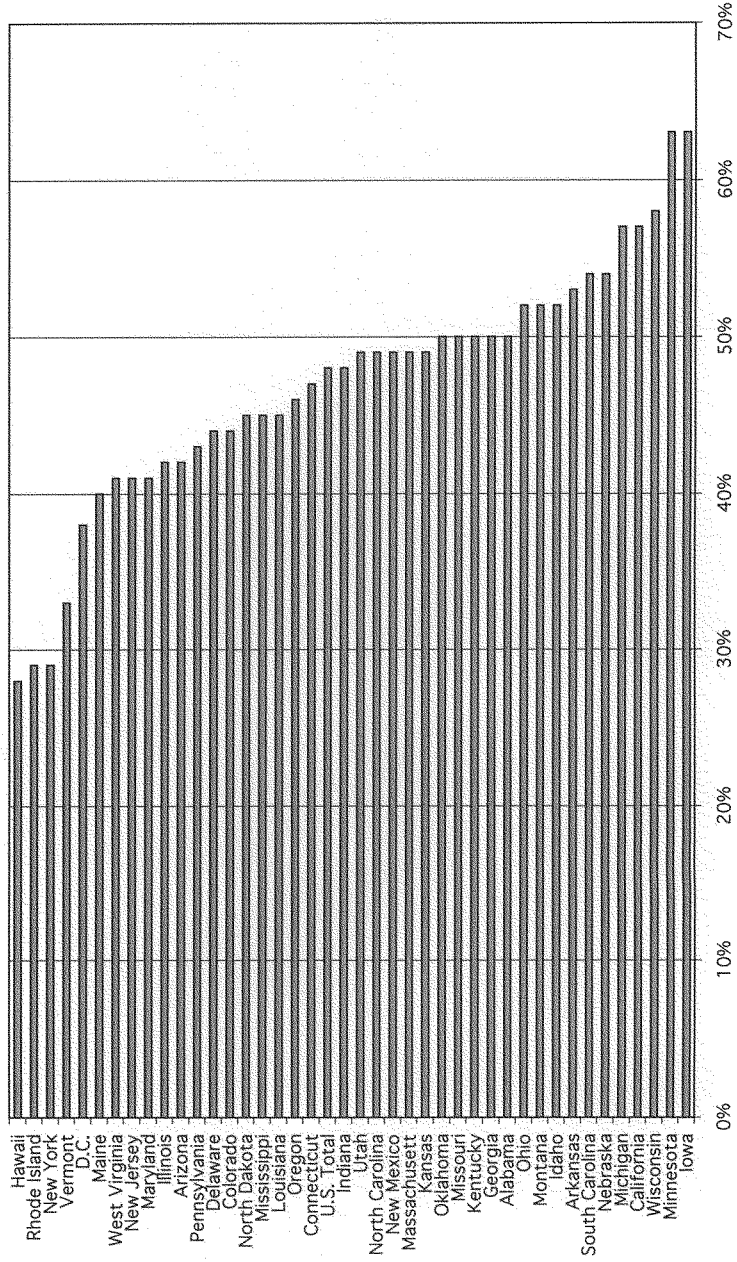
²⁰ Complete survey findings are available at www.ftb.ca.gov/readyrcturn/about.html.

and IRS.) It also means, however, that states are heavily reliant on and affected by choices and decisions made at the federal level and that continued success and growth of state electronic filing programs is heavily contingent on growth of federal electronic filing. Thus, as you deliberate actions to promote federal electronic filing (e.g., extended due dates, mandates, filing alternatives), we would ask that you be cognizant of the impact at the state level, the need for states to adjust to new federal laws, and the desirability of federal and state joint filing programs.

- If the Free File Alliance continues as part of the federal electronic filing program, states believe that it should be modified to insure that taxpayers have quick and easy access to all the information necessary to compare alternative offerings and to know whether they qualify to free state returns. Additionally, we believe the Free File Alliance program needs to be considered as a state and federal filing alternative and that it could be improved if steps were taken to promote greater consistency in state and federal offerings.
- If the Committee gives further consideration to electronic filing such as practitioner mandates, direct I-file programs and “ReadyReturn” initiatives, states have a variety of experiences that could be instructive for IRS and the federal government. We would be glad to work with the Committee and others in evaluating that experience.

Thank you for the opportunity to appear today. I would be glad to attempt to answer any questions you might have.

Chart 1: Proportion of All State Returns Received Electronically (2005)





**Responses to Post-Hearing Questions
Senate Finance Committee
April 4, 2006 Hearing on Electronic Filing and Related Issues**

By: Harley Duncan, Executive Director
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Questions from Senator Hatch

1. Mr. Duncan, how much do states save, per tax return, when taxpayers file electronically rather than by paper?

Indiana estimates that its savings for electronically filed returns compared to paper returns is \$1.039 per return. For bar code returns, Indiana estimates that it saves \$.706 per return compared to a paper-filed return. The Commonwealth of Virginia estimates that its savings for an electronic return compared to a paper return are \$1.16 per return. We have not gathered data from other states, but believe these to be representative numbers. We also understand that they are generally in line with the savings estimates of the IRS.

2. Do some people have to pay to file state tax returns electronically, or is it free to everyone?

There are twenty-one jurisdictions that have developed and maintain a Web-based application that enables nearly any taxpayer in that state to prepare and file his/her state tax return without any charge. These states are listed in footnote 4 on page 2 of my written testimony. In the other 21 states, the only free preparation and filing services are such as are offered by the various members of the Free File Alliance. As indicated in my testimony, there are generally somewhere from 2-4 Alliance members that offer free services in those states that do not have a direct Internet filing program. These free services are limited to certain subsets of taxpayers such as active military, Earned Income Credit taxpayers and the like.

In addition, taxpayers in each state may file electronically using third party preparers or third party commercial software. Filing in this manner, of course, involves fees and charges to the taxpayer for the preparation and filing.

Questions from Senator Baucus

1. Do taxpayers have a right to file tax returns for free, whether they are paper or electronic?

State tax agencies believe they have an obligation to make resources available to taxpayers that will enable them to meet their tax obligations without cost. This has traditionally been accomplished through the provision of paper forms and instructions. State tax agencies also believe it is in their interest (for improved efficiency and compliance) as well as in the interest of taxpayers to provide alternatives that enable taxpayers to file their returns electronically. They also recognize that costs pose a barrier to increased electronic filing. They have, therefore, endeavored to provide free electronic filing alternatives. As I indicated in my testimony, one half of the states have done this by providing a no cost direct Internet filing option, and the other half have done so by working with the Free File Alliance.

2. Do you think that taxpayers should have to pay a preparer, buy software or go through a middleman to file their returns electronically when they can file a paper return directly and for free? Taxpayers don't have to go to a bookstore to buy paper forms to file their returns through the mail. Why should electronic filing be so different from paper filing?

Please see Question No. 1 above. The parallels between paper and electronic filing are not necessarily precise, and the offering of electronic preparation and filing software does impose obligations on the state and insert the state deeper into the preparation process. In particular, the filing alternative must provide computational capability and in some cases will involve the inclusion of entries in the proper place on the form.

3. Should the IRS offer direct, free e-filing through its website? Are there any policy reasons why the IRS should not offer direct and free electronic filing to taxpayers?

FTA has not taken a position on whether the IRS should provide a free online filing alternative to taxpayers. I do not believe there are policy reasons that would prevent the IRS from offering such a service. As indicated, a number of states believe this an appropriate government function and do provide such opportunities. Further, as I indicated in my testimony, if the IRS were to provide such a service, there are issues of complexity, security and scalability that would be significant in my mind.

4. Free File doesn't seem to be doing a good job of serving the purposes for which it was designed. At its peak in 2005, only 5 million taxpayers out of 133 million used it. What do you think should be done to make it easier for taxpayers who want to prepare and file their returns on their own for free to be able to do so?

I am not certain that all parties are necessarily in agreement on what the "purpose" of the Free File Agreement. Some view it as designed only to serve low-income or underserved populations while others see it as a free filing vehicle for all taxpayers and still others see

it as primarily a vehicle to prevent IRS from developing filing applications. In addition, the basic premise of the Agreement involves for profit entities effectively “giving away” a product or service on which they are also trying to make money. Given these differing perceptions and conflicting aims, it is not surprising that there has been some stress in the Free File program.

States believe the operation of the Free File program could be improved by taking several steps: (a) Providing a consistent and complete body of information about the free and paid federal and state offerings on the IRS Web site; (b) Requiring that the criteria used to define eligible taxpayers be the same for both federal and state offerings; (c) Requiring that the ability to access a free service is not contingent on accessing the service through a particular Web site; and (d) Controlling the advertising and ancillary service offerings made to taxpayers when using the free service.

5. Would it be a good idea to open up Free File to everyone until IRS has its own system in place?

States would be concerned about opening Free File to everyone unless steps such as those outlined in No. 4 above are taken. In particular, it would be important that any state-level Free File offerings also be open to all taxpayers. Otherwise, such a move would likely exacerbate the current situation where sometimes taxpayers that are eligible to file for free at the federal level are not able to do so at the state level, but do not find that out until too late in the process.

6. Could the IRS and the states use electronic filing to work together to help people pay their taxes? How might that work? Are there any obstacles that might make such a partnership difficult? What are they?

If the IRS were to move to a Web-based free filing application, it would be important to take steps to integrate the federal application with similar state-level applications in an effort to make the state and federal filing process as seamless as possible for the taxpayer. Several items would seem key to successfully implementing such an approach: (a) State and federal agreement on the desired outcome; (b) Agreement on technology platforms and data format standards; and (c) Sufficient lead time and joint planning for development and deployment. The operational characteristics of such a system would be dependent on the approach taken. For example, one approach might be to have a single federal-state filing application while another might involve separate filing applications that involve the movement of data from the federal application to the state application. It should be noted that states and the IRS have considerable experience in developing joint filing applications. They have done so for individual income taxes as well as corporate income tax and partnership filings.

7. An argument has been raised that the IRS would incur substantial costs to develop software if it were to offer direct and free electronic filing. What are the pros and cons of the IRS developing its own software compared to contracting with outside parties to provide the software?

The strengths of the “licensing approach” would seem to be that it could shorten the time required for IRS to implement a free filing approach. It might also alleviate some of the concerns expressed about potential conflicts of interest if the IRS develops the software. On the negative side, the licensing approach could constrain certain of the technology and customer interface choices of the IRS. Such an arrangement would also raise issues of “picking a winner” in the software industry, the ability of the selected entity to continue fee-for-service basis, control of the software and changes thereto and the like. Evaluating the licensing vs. development approach would seem to be a fairly straightforward business analysis.

8. Please comment on the pros and cons of an IRS mandate that individual taxpayers must file their tax returns electronically. Include in your comments consideration of whether a mandate would apply to all individuals, or certain types of taxpayers.

FTA does not have a policy on whether the federal government should adopt an electronic filing mandate for certain types of taxpayers. Over a dozen states, however, have adopted mandates that require certain tax practitioners (not individual taxpayers) to file the returns they prepare electronically. If the question addresses placing a mandate on tax practitioners (as has been recommended by the IRS Electronic Tax Administration Advisory Committee), I think the state experience can be instructive regarding the implementation of such a mandate. As noted in my testimony, practitioner mandates can be effective in substantially increasing electronic filing and they can be implemented in a relatively straightforward manner. There are certain design and implementation lessons that states have learned, however, that should be reviewed. These are outlined in my testimony and in a FTA publication entitled, “Electronic Filing Mandates: Lessons Learned” (June 2005).

If the question addresses a mandate that is imposed on individual taxpayers (as opposed to practitioners), a series of quite different issues would be raised including how to define the relevant population. Moreover, if individuals are to be mandated to file electronically, it would seem to be incumbent on the federal government to provide a free electronic filing solution to allow taxpayers to meet the terms of the mandate without bearing additional costs.

9. What can Congress do to remedy the problems highlighted at the hearing?

It appears to me that it will be necessary for Congress to enact an electronic filing mandate if the IRS is to achieve the goal of 80 percent electronic returns. Research is available indicating that a large number of practitioner-prepared returns are not filed electronically and that many taxpayers take a lead from their preparer in determining the manner of filing. [See testimony, footnote 15 on page 11.] Likewise, there is research

indicating cost is a barrier to electronic filing, and it would seem that a free electronic filing option would increase electronic filing. Also in the area of free electronic filing, it would seem to be helpful to have Congress clearly articulate its goal for the Free File Alliance or in some other fashion provide clear guidance to IRS on what is to be accomplished through the Free File Alliance.

10. What can Treasury and the IRS do to remedy the problems highlighted at the hearing?

As to IRS and Treasury, states believe that the recommendations outlined in response to Question No. 6 and in my testimony should be implemented by the IRS and Treasury as part of the Free File program. The recommendations are critical to insure that taxpayers receive complete information on the free filing alternatives and do not become confused or hit with unexpected filing charges. We would encourage the Committee to impress upon IRS and Treasury that the Free File Alliance, if it is to be continued, needs to be considered as a federal-state filing program if it is to truly meet the needs of taxpayers.

11. What can the preparer and software communities do to remedy these problems?

The biggest contribution the software and preparer community could make would be to change their approach to electronic filing and consider it as their primary way of doing business as opposed to a product to price and market to taxpayers. [Some have already done this.] Research indicates that many taxpayers rely heavily on the preparer for determining the method of filing. An "electronic filing included" method of pricing (as opposed to additional charges for electronic filing) would seem to go a long ways toward increasing electronic filing.



U.S. SENATE COMMITTEE ON

Finance

SENATOR CHUCK GRASSLEY, OF IOWA - CHAIRMAN

<http://finance.senate.gov>

Hearing, "Preparing Your Taxes: How Costly Is It?"
Statement of Sen. Chuck Grassley
Tuesday, April 4, 2006

In today's hearing we will examine the current state of tax preparation and electronic filing services. We will also look at how states are succeeding in the area of electronic filing. Twenty states plus the District of Columbia now offer direct Internet filing through state-sponsored websites. State electronic filing has consistently grown at a faster rate than federal electronic filing. In 2005, five states actually received more electronic returns than the federal government received from those states. With so many people using paid preparers and electronic filing systems, we need to ensure that these preparation methods are helpful and user-friendly for American taxpayers. The feedback we are receiving is that the tax preparation system is severely breaking down. In this hearing, we will look at some bad practices that seem to be pervasive and systemic in the industry. This hearing should be a call to action for this committee and the Congress. Given the complexity of our current system, taxpayers should be entitled to a tax preparation method that they can trust and rely upon.

Today, more than 60 percent of all returns are completed by paid preparers. This means that the paid preparer community annually prepares more than 78 million individual tax returns. While I believe that the large majority of tax return preparers are honest, highly-educated individuals who serve the community well in providing sound financial advice, we are getting reports that an increasing minority is doing a disservice to the American public — some through bad advice, some through incompetence, and some through taking advantage of the public by unscrupulous means.

Adequate training within the paid preparer community is essential. And for any practitioner who is not abiding by the tax laws, the IRS needs to impose penalties, and prevent that practitioner from preparing returns and representing taxpayers before the IRS. Today, any Joe can hang a shingle and prepare income tax returns — there are no requirements at all. It's incredible that we have legal requirements for someone to qualify as a barber to cut your hair, and yet there are no requirements for someone to prepare your taxes. The worst that can happen when you get a lousy barber is you have a bad hair day. But if you get an unqualified tax preparer who gives you bad advice, you may be audited, owe thousands of dollars, and even face jail time.

The vast majority of Americans want to do the right thing and pay their taxes. Americans have a right to expect that when they hire a tax preparer they are going to get honest, straightforward advice — but as we saw on NBC News last night, and as we will learn from the testimony of the Government Accountability Office today — too often that isn't the case.

Mr. Brostek and his investigative associates from the GAO will testify about their experience in reviewing the practices of tax preparers on an undercover basis. The results of that investigation, which will be outlined by GAO today in more detail, are very troubling.

The GAO visited 19 offices of national tax return preparers in a single major metropolitan area. More than half of those preparers declined to include cash income that was disclosed by the GAO investigator on the tax return. When the return involved the earned income credit, nine out of ten preparers initially left the cash income off of the return and eight out of ten claimed child-related benefits for children who did not live with the taxpayer during the tax year. One of these preparers redid the return upon request of the GAO investigator, but not without charging more than two times the upfront cost estimate.

For those taxpayers who can prepare their own returns, they should be able to do so electronically without cost. To achieve that goal, Congress allowed the IRS to establish the Free File program in 2002. We are reviewing the operations of the Free File program and have asked the Taxpayer Advocate to do the same and comment on their findings as part of today's hearing.

Here is some of what we know from our internal staff review. For the 2004 tax year, the Free File Alliance offered free filing services to everyone – without restriction. For the 2005 tax year, the new Free File Agreement signed by the IRS restricted the availability of Free File by placing income restrictions on the program. Not surprisingly, IRS statistics show that use of the program has decreased more than 21 percent from the same time last year.

Finance Committee staff found that many of the Free File companies place restrictions on the types of income and deductions taxpayers may claim using their free online tax preparation services. Also, taxpayers are being inundated with additional charges that may accrue and the sale of ancillary services. Such charges include fees for state return preparation and filing, resetting passwords, printing and mailing services, professional tax return review, audit protection, live chat help, telephone technical support, per-question fees for consultation with a tax professional, and vault service.

Taxpayers entitled to a refund from the government receive offers for anticipation loans, to have fees deducted from their refunds, or offers to get their refunds by cashier's check, prepaid Visa card, or retail gift card – all with hidden costs to the taxpayer. One free file site even contains a link where the taxpayer can sign up for a tax preparation franchise – no experience necessary – all for the low cost of \$15,500. Meanwhile, H&R Block, the nation's largest tax preparer, is being charged with breaching its fiduciary duty to customers by using a sales force of inadequately trained tax preparers to sell them IRAs and provide financial counseling services.

The lawsuit filed by the New York Attorney General accuses H&R Block of failing to disclose important information about fees and commissions, failing to provide individualized analysis of customers' financial needs, and pressuring customers, many of whom were unsophisticated in financial matters, into making quick decisions to invest in IRAs. This lawsuit comes on the back of a settlement by H&R Block in December for nondisclosure of fees relating to refund anticipation loans. To help us examine these issues, we benefit from the testimony of Michael Brostek, Director of the Strategic Issues Team at GAO; Bert DuMars, Director of Electronic Tax Administration at the IRS; Nina Olson, the Taxpayer Advocate; Robert Weinberger, Vice President of Government Relations at H&R Block, here today as a Member of the Free File Alliance; Francis Degen, President of the National Association of Enrolled Agents; and Harley Duncan, Executive Director, Federation of Tax Administrators.

Written Statement of

**Nina E. Olson
National Taxpayer Advocate**

Before the

**Committee on Finance
United States Senate**

Hearing on

Tax Return Preparation Options for Taxpayers

April 4, 2006

Mr. Chairman, Ranking Member Baucus, and distinguished Members of the Committee:

For most Americans, the annual rite of preparing and filing tax returns represents not merely their most significant contact with the Internal Revenue Service but their most significant contact with the United States Government as well. The importance of making this process run smoothly therefore cannot be overstated. The level of satisfaction – or dissatisfaction – with which taxpayers emerge from this experience shapes, in large measure, their attitudes about the effectiveness and the responsiveness of our government. It is therefore crucial that we establish and enforce rules of the road that enable taxpayers to prepare and file their tax returns easily, transparently, cheaply, and with full respect for the privacy of their personal and financial information.

As you have requested, I will focus my testimony primarily on what my office found in the course of testing the sites of participants in the Free File Alliance. However, I would like to begin by sharing some general thoughts about improving the return preparation and filing process.¹

I. General Tax Return Preparation Issues

Broadly speaking, taxpayers have four options for preparing their returns. They may (1) self-prepare their returns; (2) pay a preparer to prepare their returns; (3) seek assistance from a free volunteer program like the Volunteer Income Tax Assistance (VITA) or Tax Counseling for the Elderly (TCE) programs if they meet specified income or other criteria; or (4) obtain assistance from the IRS at a Taxpayer Assistance Center (TAC). The strengths and weaknesses of each option vary, and I think it's useful to keep in mind the differences between these four options when evaluating how the tax preparation process is working overall. I will offer six general comments, some of which pertain to a single option and some of which pertain to all of them.

A. The return preparation process provides a compelling case for tax simplification.

The percentage of taxpayers who now seek assistance from paid preparers has reached an astonishing 61 percent.² If taxpayers are to gain (or re-gain)

¹ The views expressed herein are solely those of the National Taxpayer Advocate. The National Taxpayer Advocate is appointed by the Secretary of the Treasury and reports to the Commissioner of Internal Revenue. The statute authorizing the position directs the National Taxpayer Advocate to present an independent taxpayer perspective that does not necessarily reflect the position of the IRS or the Treasury Department. Accordingly, Congressional testimony requested from the National Taxpayer Advocate is not submitted to the Commissioner or the Secretary for prior approval. However, we have provided courtesy copies of this statement to both the IRS and the Treasury Department in advance of this hearing.

² IRS Tax Year 2004 Taxpayer Usage Study (Aug. 26, 2005).

confidence in the fairness of the tax system, they need to understand how their taxes are computed – and how their neighbors' taxes are computed. Starting from scratch, no sane person would devise the approximately 1.5 million-word tax code that we have today. As the statutory “voice of the taxpayer,” I strongly urge the Administration and Congress to give the American people a vastly simpler tax code.³

B. The government should make it possible for all taxpayers to file their returns electronically with the IRS without having to pay a fee.

The IRS should place a basic, fill-in template on its website and allow any taxpayer who wants to self-prepare his or her return to do so and file it directly with the IRS for free.⁴

Some representatives of the software industry have taken the position that such a template would place the IRS in the position of improperly competing with private industry or, worse, create a conflict of interest between the IRS's role of tax preparer and tax auditor.

This is nonsense. Since the inception of the tax system, there have always been two categories of taxpayers – those who are comfortable enough with the rules to self-prepare their returns and those who turn to paid professionals for assistance. In the paper-filing world, the IRS has always made its forms and instructions universally available without charge to all taxpayers, and those taxpayers who require help have always been free to seek the assistance of paid preparers.

Imagine that, shortly after the income tax was enacted, a large group of bricks-and-mortar tax preparers had launched a lobbying campaign to try to persuade Congress to prohibit the IRS from making forms and instructions available to the public on the ground that the availability of these materials improperly placed the government in the position of competing with private industry. Or on the ground that it created a conflict between the government's role as preparer and auditor. Congress almost certainly would have rejected such arguments as ludicrous. Yet those are exactly the same conceptual arguments being raised today by those who contend that the government's provision of a basic web-based, fill-in form to all taxpayers would undercut the private sector.

The answer to these arguments in today's electronic environment should be the same answer that Congress would have provided 80 years ago in a paper

³ See National Taxpayer Advocate 2004 Annual Report to Congress 2-7 (Most Serious Problem: The Confounding Complexity of the Tax Code); Testimony of National Taxpayer Advocate Nina E. Olson before the President's Advisory Panel on Federal Tax Reform (March 3, 2005), available at www.taxreformpanel.gov/meetings/meeting-03032005.shtml; see also National Taxpayer Advocate 2005 Annual Report to Congress v (Preface).

⁴ See National Taxpayer Advocate 2004 Annual Report to Congress 471-477 (Key Legislative Recommendation: Free Electronic Filing for All Taxpayers).

environment. For those taxpayers who are comfortable preparing their returns without assistance, the government will provide the means to do so without charge. For those taxpayers who do not find a basic template sufficient and would prefer to avail themselves of the additional benefits of a sophisticated software program, they are free to purchase one.

A brief personal anecdote. Although I prepared tax returns professionally for 27 years before I became the National Taxpayer Advocate and don't need assistance from others to prepare my return, my government salary places me above the income cap to qualify to use Free File products. To prepare my return electronically last month, I therefore spent \$19.99 to purchase tax preparation software. When I completed preparing my return, the software program informed me that, to file electronically, I could choose between having \$29.95 deducted from my refund or charging \$14.95 on a credit card. Although I deeply believe that e-filing is best for both taxpayers and the IRS for a host of reasons, I resented the notion that I would have to pay separate fees to prepare my return and to file it, so I printed out my return and mailed it in.

I am hardly alone. IRS data shows that nearly 45 million returns are prepared using software yet are mailed in rather than submitted electronically.⁵ This is a shame, because the practice delays the length of time for processing refunds, it requires the IRS to devote additional resources to entering the data manually when it receives the return, and it creates a risk of transcription error.

There is no reason why taxpayers should be required to pay transaction fees in order to file their returns electronically. A free template and direct filing portal would go a long way toward addressing this problem and would result in a greater number of taxpayers filing their returns electronically. Both taxpayers and the government would stand to benefit.

C. The Federal government should take steps to professionalize the tax preparation industry to protect both taxpayers and the tax system itself.

The return preparation industry has changed significantly since 1976, when Congress first enacted requirements for preparers to sign returns and provide copies to taxpayers along with the penalty provisions of IRC sections 6694 and 6695.⁶ At that time, persons preparing returns for a fee, including unenrolled preparers, were doing precisely that – return preparation. Today, the tax preparation field has increasingly become a vehicle for cross-marketing of non-tax goods and services. What with used car dealers filing taxes so taxpayers can use their refunds as down payments toward automobiles and preparers in check-cashing storefronts charging pay-day loan rates for refund loans (and who

⁵ IRS Tax Year 2004 Taxpayer Usage Study (Aug. 26, 2005).

⁶ See Tax Reform Act of 1976, Pub. L. 94-455.

disappear without a trace after April 15th), taxpayers have no way of knowing whether these purveyors of products are in any way qualified to prepare federal income tax returns.

It is truly remarkable to me that, in the United States today, an insurance agent can't sell insurance without a license, a contractor can't build without a license, and a hairstylist can't touch a lock on a person's head without a license – yet anyone can prepare a tax return for a fee – with no training, no licensing, and no oversight required.

In my 2002 Annual Report to Congress, I proposed a plan for the IRS to register, test, and certify unenrolled preparers.⁷ My proposal was generally well received, and the United States Senate passed it in the last Congress as part of the Tax Administration Good Government Act. The proposal was introduced again in this Congress as part of S. 832, and I am pleased that the chairman and ranking member of the Senate Finance Committee are again co-sponsors. I encourage Congress to enact this common-sense proposal.

The IRS originally expressed some concern that my proposal could place a strain on its enforcement resources, but I have designed the proposal carefully to avoid that result. California, for example, has adopted a registration system that is funded entirely by modest fees that preparers in that state pay. In addition, I note that the IRS itself has already designed a modest but effective version of a testing and certification program – and it did so within a one-year timeframe. “Link and Learn Taxes” is an online training program that allows VITA volunteers to receive the training and certification necessary to prepare tax returns at VITA sites. The IRS estimates that about 10,000 volunteers received certification through this program for the 2005 filing season. So this is eminently do-able.

Apart from education, I also believe that more needs to be done to address the problem of preparers who lack integrity. The civil penalty regime currently in law is not adequate and, in particular, penalty amounts are too low for the IRS to treat enforcement of preparer penalties as priority work. Therefore, in my 2003 Annual Report, I identified the gaps and inadequacies of the current compliance regime for preparers and Electronic Return Originators (EROs), and I recommended that Congress strengthen oversight of all preparers by enhancing due diligence and signature requirements, increasing the dollar amount of preparer penalties, and assessing and collecting those penalties, as appropriate.⁸

In the EITC area, I recommended enhanced EITC-specific due diligence requirements, progressively higher preparer accuracy penalties where multiple

⁷ See National Taxpayer Advocate 2002 Annual Report to Congress 216-230 (Key Legislative Recommendation: Regulation of Federal Tax Return Preparers).

⁸ See National Taxpayer Advocate 2003 Annual Report to Congress 270-301 (Key Legislative Recommendation: Federal Tax Return Preparers: Oversight and Compliance).

inaccurate returns are prepared, and joint and several liability with the taxpayer for EITC overpayments where the preparer recklessly disregards IRS rules and regulations.⁹ Moreover, I have made several suggestions about how the IRS could strengthen its oversight of EROs.¹⁰

D. The IRS must remain open for business to taxpayers who seek assistance from the government in preparing their returns.

We must not lose sight of the fact that the government is asking its citizens to pay over a significant portion of their annual incomes. For those taxpayers who do not trust private parties, including VITA, with their personal information and want to deal directly with the government, the government should be there to help them compute their tax liabilities. In many cases, the alternative is that these taxpayers won't comply. Yet the IRS has issued annual directives to its walk-in sites to reduce the number of returns they prepare for each of the last several years. As a direct consequence, the IRS will have reduced the number of returns it prepares by more than 50 percent since FY 2003 – from 665,868 returns in FY 2003 to a proposed 305,000 returns in FY 2006. In my view, refusing to assist taxpayers who are literally showing up at the door to try to comply with their tax obligations does not constitute high quality taxpayer service. Nor does it constitute a sound strategy to reduce the tax gap.

While I commend and applaud the outstanding work volunteer preparers perform, I am concerned for several reasons about recent IRS statements that indicate the agency is pulling back from its longstanding policy of assisting taxpayers who seek IRS assistance directly. First, the leaders of many organizations that operate VITA sites tell me that they are already stretched to their limits assisting the numbers of taxpayers that currently seek their help. Second, the IRS is not providing nearly enough support and oversight to volunteer programs to ensure accuracy and confidentiality. Third, the IRS itself imposes limitations on what volunteer programs may do. For example, the IRS directed VITA sites not to prepare returns for taxpayers in the zone where Hurricane Katrina struck, presumably because it believed the returns would be too complex for volunteers to prepare accurately.

The IRS acknowledges that customer service – not mere enforcement alone – is essential to achieving a high compliance rate. Within limits, assisting those taxpayers who seek our help in computing their tax liability and preparing their tax returns should continue to be a central component of taxpayer service.

⁹ See National Taxpayer Advocate 2003 Annual Report to Congress 285-286, 292-294 (Key Legislative Recommendation: Federal Tax Return Preparers: Oversight and Compliance).

¹⁰ See National Taxpayer Advocate 2003 Annual Report to Congress 287, 294-295 (Key Legislative Recommendation: Federal Tax Return Preparers: Oversight and Compliance); see also National Taxpayer Advocate 2005 Annual Report to Congress 223-237 (Most Serious Problem: Regulation of Electronic Return Originators).

E. The government must reaffirm and maintain the longstanding principle that tax return information generally is confidential and will be protected.

In recent months, a number of high-profile proposals and plans have attracted attention that would require the IRS to share taxpayer return information now protected by section 6103 of the Internal Revenue Code with third parties. Lawmakers concerned about illegal immigration have proposed sharing tax information with border control authorities. Government officials seeking to reduce accounting disparities between tax income and financial income on the part of corporate taxpayers have floated the idea of making corporate tax returns public documents. And the IRS will soon be providing confidential tax information to private debt collectors who are being enlisted to help collect back taxes. In my view, we need to tread very carefully as we consider all these proposals to shed taxpayer privacy.¹¹

I am particularly grateful to Chairman Grassley, Senator Baucus, and the members of this Committee for the strong support they have shown for maintaining the confidentiality of tax information. If taxpayers begin to believe that they are losing control over the privacy of their personal and financial information, I am concerned that we could see a discernable decline in compliance. As I have written in the past, I believe our general rule should continue to be that taxpayer return information is kept confidential, and exceptions should be authorized only where there is a compelling need for the information and it cannot be readily obtained elsewhere.

F. The Treasury Department and IRS should strengthen the “consent” requirements in connection with the use or disclosure of tax information by return preparers. While improvements can perhaps be made, recently proposed regulations under section 7216 of the Code constitute a significant improvement over the existing regulations.

In the last two weeks, significant concerns have been expressed about recently proposed Treasury regulations under section 7216 of the Internal Revenue Code that govern the use or disclosure of tax return information by tax return preparers. The IRS is proposing to update the existing section 7216 regulations because the existing regulations were promulgated in 1974 and therefore do not provide adequate guidance for the e-filing environment that has developed in recent years.

I note at the outset that I believe consumer groups have raised legitimate concerns about exploitation of taxpayers by the return preparation industry. In

¹¹ See National Taxpayer Advocate 2003 Annual Report to Congress 232-255 (Key Legislative Recommendation: Confidentiality and Disclosure of Returns and Return Information – IRC Section 6103).

my annual reports to Congress, I have highlighted several of these concerns.¹² In fact, it was precisely these concerns – about current business practices that I view as questionable and in some cases unacceptable – that led me to be a strong advocate for changing the existing regulations. From a consumer protection standpoint, the worst outcome in my view would be to maintain the *status quo*.

Particularly with regard to an issue as important as use and disclosure of return information, it is important to hear taxpayer and tax preparer concerns. That is why this regulation and the related revenue procedure were published in a proposed form, why we asked for comments from the public, and why the IRS is holding a public hearing today. I can assure you that all – I repeat, all – of the comments will be considered in the course of developing the final regulation. For the reasons I will describe, I believe it is urgent that the current regulations be revised as soon as possible.

In discussing section 7216, it is helpful to review the language of the statute and the provisions of the current regulations. The statute provides for criminal sanctions when any person “engaged in the business of preparing, or providing services in connection with” income tax return preparation either knowingly or recklessly:

- *Discloses* any information furnished to him for or in connection with the preparation of the return; or
- *Uses* any of this information for any purpose other than return preparation.¹³

The statute provides for certain exceptions to the “disclosure” and “use” prohibitions, and it authorizes the Secretary to promulgate regulations for additional exceptions.¹⁴ Section 6713 provides for a parallel civil penalty for violations of the “disclosure” and “use” rules under section 7216.

Note that there are two operative terms here – “disclose” and “use.” Neither the statute nor the current section 7216 regulations provide definitions of these key terms, so in many ways, the field today is wide open for return preparers to decide for themselves what constitutes a disclosure or use.

¹² See National Taxpayer Advocate 2005 Annual Report to Congress 162-179 (Most Serious Problem: Refund Anticipation Loans: Oversight of the Industry, Cross-Collection Techniques, and Payment Alternatives); National Taxpayer Advocate 2005 Annual Report to Congress 223-237 (Most Serious Problem: Regulation of Electronic Return Originators); National Taxpayer Advocate 2004 Annual Report to Congress 89-109 (Most Serious Problem: Electronic Return and Filing Preparation); National Taxpayer Advocate 2002 Annual Report to Congress 69-74 (Most Serious Problem: IRS Oversight of EITC Return Preparers Can Be Improved).

¹³ IRC § 7216(a).

¹⁴ IRC § 7216(b).

Under the current regulations, a tax return preparer, with taxpayer consent, may *use* tax return information to promote nontax products and services currently offered by the tax return preparer or a member of the tax return preparer's affiliated group. However, a tax return preparer, even with taxpayer consent, may not use tax return information to promote products and services of unaffiliated entities. For example, a tax return preparer may, with taxpayer consent, use tax return information to calculate the benefits of an IRA product offered by an affiliate, but the tax return preparer may not use that information to calculate the benefits of an IRA product offered by someone outside the affiliated group.

Of greater concern to me are the current regulations' *disclosure* provisions. Today, with taxpayer consent, tax return preparers can disclose (and even sell) tax return information to anyone. The regulations impose no limitations on this disclosure. And once this tax return information is disclosed to a third party, there are no limitations in the tax code on that third party's ability to re-disclose the tax return information.

The distinction between "use" and "disclosure" is significant. In the "use" environment, the tax return preparer herself is holding onto information she already has and is using it to evaluate the appropriateness of a product or service for the taxpayer's situation. The taxpayer has agreed to the preparer's use (but not disclosure) of the data, and if the preparer uses the data in a manner that the taxpayer has not agreed to, the preparer may be subject to civil and criminal sanctions.

In the "disclosure" environment, on the other hand, the tax return preparer can be sending tax return information out to any third person on the open market, where the tax return information can be used in any manner whatsoever, without limitation. There is no way that the taxpayer can know in advance how and by whom his tax return information will be used once it is disclosed. Criminal sanctions apply only if the preparer "knowingly or recklessly" discloses information without the taxpayer's consent. To my mind, this latter situation is extremely worrisome, to put it mildly.¹⁵

¹⁵ Some commentators have argued that the proposed regulation's extension of consent to *use* of taxpayer information by preparers with respect to products and services of unaffiliated entities will harm taxpayers and result in broad dissemination of taxpayer information. I do not agree. First, in the "use" environment, the *preparer* is authorized to use the information, not the affiliated or unaffiliated entity. The information can only be used in the manner to which the taxpayer agrees. Second, under the current regulation, if the taxpayer wants to know how a product of an unaffiliated entity will benefit him, he can consent to disclosure of taxpayer information to that unaffiliated entity. As noted earlier, there are no restrictions on use or re-disclosure once taxpayer information is disclosed to a third party. Thus, the current regulatory ban on use of information by a preparer with respect to products or services by unaffiliated entities probably results in greater dissemination of taxpayer information than the proposed regulation.

We can all imagine how these two provisions – disclosure and use – can be abused and how they can impair tax administration and compliance. Thus, the threshold policy question is whether the regulations should allow any exceptions to the statutory prohibition against use or disclosure.

In fact, the statute and regulation are written so that disclosure and use of such information by a tax return preparer is prohibited except in a few instances. One of those instances, under the existing regulation, is pursuant to the consent of the taxpayer. Unless we ban that consent, the question becomes, “What protections must we provide to ensure that taxpayers have clear and adequate information upon which to decide whether to grant their consent?”

The current regulations require that the consent obtained by the tax return preparer advise the taxpayer about the purpose for which the consent is being furnished. The preparer must obtain the taxpayer’s consent to such use or disclosure in writing.¹⁶ Essentially, that’s it – outside of some additional boilerplate language, that’s the taxpayer protection in the current regulation.

The proposed regulations and a related draft revenue procedure provide significantly greater protections for the taxpayer. These safeguards are specifically designed to ensure that taxpayers are fully informed about the consequences of consent and to limit the open-ended nature of the current structure. Some of these safeguards are:

- Definitions of the terms “use” and “disclosure.”
- A template for the consent language, and a requirement that that language must be prominently displayed.
- Required language, in specified type size, warning the taxpayer that any information disclosed to a third party may be re-disclosed to any other party, *without limit*.
- Required language notifying the taxpayer of his or her right to register a complaint about violations of these regulations with the Taxpayer Advocate Service, including contact information for the Taxpayer Advocate Service.
- Requirements on the placement of these warnings (*i.e.*, they may not be buried in a privacy statement or a licensing agreement but must be prominently displayed).
- A requirement that the preparer must obtain the taxpayer’s consent for each proposed use or disclosure.

¹⁶ Treas. Reg. § 301.7216-3(b).

- A limit on the period of time – one year – during which the tax return preparer may use or disclose the information.
- A clearer definition of what constitutes information covered by section 7216. Some have argued that information entered on a client intake sheet or tax software initial information screen is not covered by section 7216. If such information is not under the protection of section 7216, the tax return preparer may use or disclose it in any manner he chooses, without taxpayer consent and without even notifying the taxpayer. The proposed regulations clarify that client intake or registration information is covered by the regulations' restrictions on disclosure and use.
- Where applicable, a requirement that the tax return preparer disclose to the taxpayer the fact that the tax return preparer intends to use off-shore tax preparers to prepare the taxpayer's return, and a requirement that the preparer obtain the taxpayer's written consent to using the off-shore tax return preparers.
- A requirement that the tax return preparer cannot require the taxpayer to consent to a use or disclosure of taxpayer information as a condition for preparing the tax return.

As the foregoing list demonstrates, the proposed regulations would add significant new taxpayer protections. However, we cannot just stop with the regulations. I do not agree, as some commentators have alleged, that the absence of complaints under the existing regulations indicates there is no real problem with exploitation of taxpayers. First, some taxpayers are not financially sophisticated enough to understand the products that preparers are trying to sell them. Second, taxpayers who do understand are not likely to take the time to lodge formal complaints. Third, the current regulations do not indicate specifically to whom complaints should be addressed.

In my annual reports to Congress, I have criticized the IRS's lax oversight of return preparers and, in particular, of Electronic Return Originators (EROs).¹⁷ I believe the IRS needs to conduct more site visits and better and more frequent suitability and eligibility checks, undertake an extensive education campaign about the need for taxpayers to protect their own tax information and be smart tax consumers, and assess penalties in the appropriate instances. I have also

¹⁷ See National Taxpayer Advocate 2005 Annual Report to Congress 162-179 (Most Serious Problem: Refund Anticipation Loans: Oversight of the Industry, Cross-Collection Techniques, and Payment Alternatives); National Taxpayer Advocate 2005 Annual Report to Congress 223-237 (Most Serious Problem: Regulation of Electronic Return Originators); National Taxpayer Advocate 2004 Annual Report to Congress 89-109 (Most Serious Problem: Electronic Return and Filing Preparation); National Taxpayer Advocate 2002 Annual Report to Congress 69-74 (Most Serious Problem: IRS Oversight of EITC Return Preparers Can Be Improved).

called upon Congress to strengthen the monetary penalties against EROs, so that these penalties cannot be absorbed as a mere cost of doing business.

Absent the protections in the proposed regulation, taxpayers will be harmed. Absent prompt implementation of the proposed regulation, taxpayers will be harmed. And absent strong congressional oversight of the IRS and the tax return preparer community, such as you are undertaking at this hearing today, taxpayers will be harmed.

II. Assessment of the Free File Alliance

A. Background

In 1998, Congress directed the IRS to set a goal of having 80 percent of all returns filed electronically by 2007. To date, the IRS has decided against making e-filing available to all taxpayers without charge. Instead, the IRS entered into a three-year agreement prior to the 2003 filing season with a consortium of tax preparation software companies known collectively as the "Free File Alliance."¹⁸

The agreement had a three-year term that ended last year, and in October 2005, the IRS and the Free File Alliance agreed to extend the contract for four years with some modifications.¹⁹ The initial agreement required the Free File companies, in the aggregate, to make free electronic preparation and filing available to *at least* 60 percent of all taxpayers. The new agreement prevents Free File companies, in the aggregate, from making free services available to more than 70 percent of all taxpayers.²⁰ In the agreement, the IRS pledged that it would "not compete with the [Free File Alliance] in providing free, online tax return preparation and filing services to taxpayers."

From an IRS perspective, the rationale for creating the Free File program was to make e-filing more accessible to taxpayers and thereby help it to achieve the congressionally mandated goal of having 80 percent of all taxpayers filing their returns electronically.

From that standpoint, the Free File program has done little to increase the number of taxpayers who e-file their returns. In 2005, individual taxpayers filed approximately 133 million tax returns. Only about 5 million taxpayers used Free

¹⁸ Free On-Line Electronic Tax Filing Agreement entered into between the Internal Revenue Service and the Free File Alliance, LLC (effective as of Oct. 30, 2002), available at www.irs.gov/efile/article/0,,id=103626,00.html.

¹⁹ Free On-Line Electronic Tax Filing Agreement Amendment entered into between the Internal Revenue Service and the Free File Alliance, LLC (effective as of Oct. 30, 2005), available at www.irs.gov/pub/irs-efile/free_file_agreement.pdf.

²⁰ *Id.* Section I.E provides in relevant part: "IRS will utilize the then current Adjusted Gross Income (AGI) number which equates to 70% of the taxpayers to manage the program, and will not accept or post any offer by an Alliance member which exceeds this AGI amount."

File. Of those, IRS data show that the significant majority had previously filed their returns electronically.²¹ It therefore is far from clear whether Free File attracts new e-filers and brings the IRS closer to its 80 percent goal. In addition, the attractiveness of Free File has diminished markedly this year. In 2005, Intuit and H&R Block made their best-selling tax packages available to all taxpayers through Free File. As noted, the new agreement imposes restrictions on the percentage of taxpayers who may be covered. Not surprisingly, taxpayer usage of the Free File program as of March 30, 2006 has dropped by 21 percent this year compared with the same period last year.²²

B. Overview of Testing of Free File Sites

Partly to follow up on testing my office performed two years ago and partly in response to a request from the staff of this Committee, I asked several tax attorneys in my office to test four scenarios on each of the 20 Free File sites. The results, in my view, are disappointing. Each of the 20 sites has its own eligibility requirements and its own capabilities and limitations. On the whole, we found that trying to navigate the Free File sites was a bit like living in the Wild, Wild West.

In announcing the revised Free File agreement in October 2005, both parties stated that the agreement would result in enhanced services, improved disclosures regarding refund anticipation loans (RALs), and greater privacy protection.²³ With these assertions in mind, my office created four scenarios and tested them on each of the twenty Free File sites accessible through the official IRS website. The goal of the testing was to determine the experience of taxpayers as they attempt to navigate the sites and prepare and file their returns through Free File products accessible through the official IRS website.

I offer one caveat to our results. Our objective was to determine the existence and extent of limitations and problems that a user of the Free File sites would encounter. In some instances, the tax attorneys testing the sites found them very difficult to navigate and were unable to locate forms or answers that later testing was able to locate. Therefore, the results described below reflect simply what our attorneys experienced and not necessarily what a site was capable of accomplishing.

Each of the testers started the return preparation process by going to the official IRS website, www.irs.gov. The IRS website includes a link titled "Check Out

²¹ IRS Wage & Investment Research Group 6, Final Report: Free File Survey Analysis, Research Project 6-05-08-2-038N, 12 (Aug. 31, 2005).

²² IRS Free File statistics (through March 30, 2006); *see also* IRS News Release IR-2006-44, *IRS e-file and Direct Deposit Outpace Last Year's Results* (March 15, 2006) (noting an increase in e-filing overall but a drop of more than 20 percent in Free File usage).

²³ IRS News Release, *IRS and Free File Alliance Reach Agreement*, IR-2005-16 (Oct. 25, 2005).

Free File.” This link brought the testers to the IRS’s “Free File Home – Your Link to Free Online Filing” webpage, which describes the Free File program in general and instructs individuals to carefully review the specifications of each provider. When the testers clicked the “Start Now!” button, they were taken to a page that gave them the option to “Browse All Services” or “Guide Me to a Service!” If the testers chose the first item, they were presented with an apparently randomly sorted list of all the providers. If the testers chose the second item, they were asked specific questions about age, state of residence, adjusted gross income, earned income tax credit eligibility, and military pay. Based on their answers to these questions, the second option provides a list of “Services for Which You May Qualify.” The testers noted which services the IRS guided them to, but tested all of the services available.

C. Description and Results of the Four Scenarios We Tested

1. Scenario 1: Hurricane Katrina and Education Tax Credits

a. Fact Pattern

Mary Doe is a full-time law student at a university located in New Orleans and earned \$25,000 in wages in 2005. During Hurricane Katrina, the entire contents of her car and rental apartment were destroyed. The casualty loss is valued at \$17,000. Ms. Doe also paid \$25,000 for tuition at the university, which is located in the Gulf Improvement Zone. This scenario was designed to determine whether each of the Free File sites supported the tax relief provisions applicable to the victims of Hurricane Katrina²⁴ as well as the complicated education incentive provisions.

b. Results

- Only seven of the Free File sites (TaxACT.com, OLT.com, Taxslayer.com, TaxCut, eSmartTax, CompleteTax, and TurboTax) calculated the correct tax.
- The following sites did not apply the special casualty loss tax benefits available to Hurricane Katrina victims:²⁵ FreeTaxReturns.com, CitizenTax, TaxEngine.com, FreeTaxUSA.com, Online Tax Pros, 123Easytaxfiling.com, FileYourTaxes.com, eFileTaxReturns.net, 1040Now, ExelTax, ezTaxReturn.com, average1040.com, and Free Tax Return. As a consequence, taxpayers using these Free File sites may be unknowingly

²⁴ The Gulf Opportunity Zone Act of 2005, Pub. L. No. 109-35, 119 Stat. 25 (2005); The Katrina Emergency Tax Relief Act of 2005, Pub. L. No. 109-73, 119 Stat. 2016 (2005).

²⁵ Section 402 of the Katrina Emergency Tax Relief Act of 2005 provided that casualty losses attributable to Hurricane Katrina are not subject to the limitations of IRC § 165(h). IRC § 165(h) ordinarily requires casualty losses to be reduced by \$100 and 10 percent of adjusted gross income.

overpaying their taxes by failing to claim the tax benefit that Congress specifically created for them.

- The following sites did not increase the Lifetime Learning Credit for eligible education expenses of individuals affected by Hurricane Katrina as authorized by the Gulf Opportunity Zone Act of 2005:²⁶ FreeTaxReturns.com; 1040Now ExelTax; CitizenTax; FreeTaxUSA.com, Online Tax Pros, 123Easytaxfiling.com, FileYourTaxes.com, average1040.com, and Free Tax Return. Again, taxpayers using these Free File sites may be unknowingly overpaying their taxes by failing to claim the tax benefits that Congress specifically created for them.

2. Scenario 2: The Earned Income Tax Credit

a. Fact Pattern

Jane Jones is a single mother living in an apartment in Buffalo, New York, with her 10-year-old son, her 25-year-old brother (who earned \$3,500 during 2005), and the 5-year-old daughter of a friend. Ms. Jones is a cashier and earned 13,500 in wages and \$100 in interest income in 2005. This scenario was designed to test whether the sites properly determined head-of-household filing status, and accurately calculated the dependency exemption and the child tax credit, based on the new Uniform Definition of a Qualifying Child rules in IRC § 152,²⁷ as well as eligibility for the EITC.

b. Results

- In general, all of the sites accurately determined the head-of-household filing status, the dependency exemption and the child tax credit, based on the new Uniform Definition of a Qualifying Child rules, as well as EITC eligibility.
- The CitizenTax site would not accept the information for the taxpayer's brother, so the test was abandoned at that point.

²⁶ Section 102 of the Gulf Opportunity Zone Act of 2005 provides that for individuals affected by Hurricane Katrina, the Hope Credit in IRC § 25A is expanded from a maximum of \$1,000 per student to 100 percent of the first \$2,000 in eligible expenses and 50 percent of the next \$2,000 (for a maximum credit of \$3,000). The Act also expanded the Lifetime Learning Credit in IRC § 25A to include 40 percent (as opposed to the normal 20 percent) of qualified tuition and related expenses up to a maximum of \$10,000. See IRS Publication 4492, Information for Taxpayers Affected by Hurricanes Katrina, Rita and Wilma.

²⁷ The Working Families Tax Relief Act of 2004, Pub. L. No. 108-311, 118 Stat. 1166 (2004).

3. Scenario 3: Self-Employed Taxpayer (Schedule C)

a. Fact Pattern

Linda Smith is a divorced mother who lives in her apartment in Albany, New York, with her 17-year-old daughter and 12-year-old son. Ms. Smith is a self-employed dressmaker. She purchased a sewing machine during the year for \$2,000, and her cost of goods sold was \$10,000. This scenario was designed to test whether the sites support Schedule C, *Profit or Loss from Business*, as well as IRC § 179 deductions claimed on Form 4562, *Depreciation and Amortization*.

b. Results

- In general, the sites that supported Schedule C and Form 4562, *Depreciation and Amortization*, correctly calculated the federal and state (if available) refunds.
- Schedule C was not supported by several sites.
 - FreeTaxReturns.com allowed the tester to continue with the preparation but never advised the taxpayer that it didn't support business income or loss.
 - CitizenTax only supported Schedule C-EZ. This limitation was not apparent until the tester was about to enter the business information.
 - Several sites (FreeTaxUSA.com, 123Easytaxfiling.com, average1040.com, and Free Tax Return) warned the testers when no income was entered but otherwise gave no indication that they did not support business income or loss.²⁸ This red flag would not be raised if the scenario included other types of income. For example, if the taxpayer was a sole proprietor but also had interest or dividend income, the "no income" warning would not be triggered, and the taxpayer would not be warned that his or her sole proprietorship income was not included in the return.²⁹ As a consequence, taxpayers using these sites might unknowingly be underreporting their income and tax liability.
 - eSmartTax claimed to support Schedule C, but there was no place to enter the information for the IRC Section 179 deduction.

²⁸ Each of the sites includes a link on its home page listing the tax forms it supports. However, many taxpayers do not know tax forms by number.

²⁹ Prior to the act of filing, most sites provide either a tax summary or the ability to view the tax forms. At that point, assuming the taxpayer notices the absence of income on the return, the taxpayer would have to start over and use a different product to prepare his return accurately.

Similarly, although Online Tax Pros claimed to support Schedule C, it did not support Form 4562 for the Section 179 deduction (perhaps leading the taxpayer to try to enter it as a supply or other expense).

- EFileTaxReturns.net claimed to support Schedule C, but it did not ask the pertinent questions. This limitation could possibly lead a taxpayer to claim business income as "other income," which would not trigger the self-employment tax calculation, resulting in an underpayment of self-employment tax and presumably a later IRS assessment.
- ezTaxReturn.com and Free Tax Return did not support Schedule C, which was apparent early in the preparation process.

4. Scenario 4: The Brady Bunch and the AMT

a. Fact Pattern

Michael and Carol Brady live in North Hollywood, California, with their six children, ages 5-16. Mr. Brady is an architect with wages of \$73,160. Mrs. Brady is a part-time teacher with wages of \$25,000. The Bradys claim "married filing jointly" as their filing status. This scenario was designed to determine the results when an ineligible taxpayer attempts to prepare and file a return through Free File. The scenario was also designed to test whether the sites support the alternative minimum tax calculations.

b. Results

- All sites noted that Free File was not available to taxpayers with an adjusted gross income (AGI) of more than \$50,000. Some taxpayers, however, may not be familiar with the terms "adjusted gross income" or "AGI" and may attempt to use a Free File site even when their AGI exceeds \$50,000. When this occurs, all tested sites require the taxpayer to go through the entire federal return preparation process (and sometimes the state return preparation process) before informing the taxpayer that he or she does not qualify for Free File.
- At least two sites (Free Tax Returns and Average1040.com) did not support more than four dependents.
- At least three sites (Average1040.com, CitizenTax.com and eSmartTax) omitted the Alternative Minimum Tax (AMT) calculation and thus incorrectly calculated the "Bradys" taxes. Because millions of American taxpayers are subject to the AMT, many taxpayers may be unknowingly understating their tax liability.

- Several sites (such as OLT.com, FileYourTaxes.com and CompleteTax.com) correctly recognized that the Bradys were subject to the AMT and correctly calculated their tax liability, but these sites did not inform the taxpayer that he was subject to the AMT.

D. Findings Common to All Scenarios

- **“Guide Me To A Service!”** As described above, the IRS website provides a feature called “Guide Me To A Service!” This feature requires the taxpayer to enter information about age, adjusted gross income, state of residence, eligibility for EITC, and military pay. Based on the information entered, the site presents a list of Free File providers for which the taxpayer may qualify for free return preparation and filing. However, many of the sites that were included on the list generated by “Guide Me To A Service!” did not support the four scenarios we tested. Thus, taxpayers could start entering information into the tax preparation program only to discover later that the program lacks the capability to prepare their returns. They are then placed in a position of closing out the program and beginning a different one (and perhaps wondering what will happen to the personal information they entered into the first program) or paying an upgrade fee to continue with their current program to avoid having to re-enter their returns from scratch.

Even more troubling, some taxpayers may not realize that a site does not completely support their facts and may lead them to file inaccurate returns. Moreover, while each site provides a link to a list of supported forms, many only list the form number, which renders the list unhelpful to most taxpayers.

- **Privacy Policy.** Several of the sites include the privacy policy in the license agreement (or Terms and Conditions) and condition the preparation on the taxpayer’s acceptance of the terms. Such sites include TaxCut, Taxlayer.com, OLT.com; EFileTaxReturns.net, and TurboTax. The 1040Now ExelTax site’s privacy policy is displayed on a separate page, and the taxpayer is required to agree to the terms before beginning return preparation. The average1040.com site’s policy could be found on a link at the top of the page and states that, by using the site, an individual is deemed to consent to the terms. However, there is no requirement that the taxpayer actually view the terms of the policy.
- **Customer Service Fees.** At least three sites charge a fee to contact customer service. The FreeTaxReturns.com site charges a \$4.88 fee for each customer service question and a \$14.88 fee for each tax question. EFileTaxReturns.net charges \$9.99 for customer support. Free Tax Return charges \$1.95 per customer service question and \$5.95 per tax law question. Of course, the IRS itself provides this service for free.

- **Error Scan Fee.** FreeTaxReturns.com offered error scans for a \$3.88 fee per return.
- **Cross-Marketing.** All of the Free File sites are accessed through the official IRS website, yet cross marketing of ancillary products and services is common on many of the sites. For example:
 - Upgrades. The following sites, throughout the preparation process, offered to upgrade to a paid service for a more enhanced interview process:
 - TaxACT.com (which charged \$9.95).
 - TurboTax (which charged \$19.95).
 - Gift Card. TurboTax offers to transfer the tax refund, or a portion thereof, to a gift card of a retail partner. A \$14.95 fee is deducted from the balance for this service.
 - Audit Protection. Several programs offered an "audit protection" product, including FreeTaxReturns.com (\$29.88 fee), Free Tax Return (\$25.95 fee), EFileTaxReturns.net (\$47.95 fee) and TurboTax (\$29.95 for federal and \$5.00 for state).
 - Return Packaging. The FreeTaxUSA.com site offers a professionally bound copy or CD copy of the return for \$12.95 and vault service for a \$9.95 fee.
 - Professional Review. Professional review services were offered by TaxCut (\$29.95 fee), TurboTax (\$49.95 fee), and OLT.com (\$49.95 fee).
 - Miscellaneous. The TaxACT.com site offers the option to turn the taxpayer's keyboard into a calculator for a \$9.95 fee.
 - Bank Products. Several of the sites offered bank products as a method to receive tax refunds. Refund Anticipation Loans (RALs) were offered by CompleteTax, Tax\$imple.com, TaxCut, EFileTaxReturns.net, and ezTaxReturn.com. Refund Anticipation Checks (RACs) were offered by 1040Now ExelTax and EfileTaxReturns.net. The H&R Block TaxCut site offered to prepare the state tax return for free if the taxpayer agreed to receive his or her refund on an H&R Block prepaid Visa card. Other sites may have offered these products, but the testers were unable to identify them.
 - Opt Out of Free File. On several sites, the taxpayer must opt out of Free File and pay for tax preparation and filing if the taxpayer

chooses to purchase a bank product as a means of receiving the tax refund. For example, when a taxpayer purchases a bank product, FileYourTaxes.com charges \$23.95 for preparation and filing of a federal return, and EFileTaxReturns.net charges \$24.95 for federal and \$19.95 for state preparation and filing.

- Refund Processing Fee. Where our testers sought to prepare and file state tax returns, TurboTax charged a fee of \$19.95. In addition, TurboTax offered our testers the option of having their return preparation and filing fees deducted from their refund for an additional processing fee of \$29.95 (for a total cost of \$49.90).
- **Technical or Navigational Issues.**
 - The Tax\$imple.com site was not functional at the time of the testing. Hyperlinks on the homepage appeared to work, but it would not permit our testers to start a new return.
 - Taxslayer.com was extremely difficult to navigate and continually kicked our testers out of the program when the “back” button was pressed.
 - The eSmartTax site appeared to have technical difficulties when we tested scenarios 2 and 3. It allowed the entry of either all or substantially all of the information for scenarios 2 and 3 and then failed to continue preparing the returns. The testers were forced to abandon the preparation on that site.
- **Payment of State Fee.** On FreeTaxReturns.com, our testers who elected to prepare both federal and state returns were unable to file the federal return electronically unless they first paid the \$9.88 state return preparation and filing fee.
- **Fee to Mail Returns to Taxpayer.** Several sites offered to print the tax return and mail it to the taxpayer for filing with the IRS. However, due to the late time of the testing and the approaching April 15th deadline, many sites discouraged the testers from selecting this option. FileYourTaxes.com site charged a \$19.75 fee for this service, FreeTaxUSA.com charged \$5.95, and OLT.com charged \$4.95.

E. Where Do We Go from Here?

The results of our testing demonstrate that Free File is not an easy service for taxpayers to navigate, and it can even result in inaccurate returns. As currently structured, Free File amounts to a Wild, Wild West of differing eligibility requirements, differing capabilities, differing availability of and fees for add-on products, and many sites that are difficult to use.

The original rationale for creating the Free File Alliance was to help the IRS achieve the congressionally mandated goal that 80 percent of all returns be filed electronically by 2007. However, the relatively low usage in prior years, the lack of usage by new e-filers, and the decline in usage this year indicate that the program is not meeting its objectives. Taking into account the additional concerns about cross marketing of other products, the appearance that the IRS is endorsing the Free File products (notwithstanding disclaimers, taxpayers are starting out from the official IRS website), and taxpayer concerns about the confidentiality of their tax data, there is little justification to continue with Free File and every justification for the IRS to develop a tax preparation template and to provide free e-filing for all taxpayers – just as it does for paper filers. I believe the IRS template and direct filing portal must be simple, accurate, and confidential.

III. Conclusion

For several years, my office has advocated for the regulation of unenrolled tax preparers as a means to professionalize the tax preparation industry and protect both taxpayers and the tax system. Combined with enhanced due diligence penalties and more robust enforcement, professionalizing the tax preparation industry will strengthen taxpayer confidence in the tax system and improve the accuracy of returns. In addition, the IRS itself must remain open for business. I do not believe it is prudent for the IRS to continue to shift its return-preparation services to volunteer programs, many of which have already reached the limits of their capacity.

The issues I have discussed in my testimony make clear that the role of tax preparation is central to effective tax administration, and as the tax administrator, the IRS should do more both to provide a high-quality free vehicle for paper and electronic filing and to oversee more closely those persons and entities that provide tax preparation services.

I appreciate the Committee's interest in these important issues and would be happy to provide you with any additional information you might find helpful.



National Taxpayer Advocate

Sep 15 2006

Committee on Finance
United States Senate
Washington, D.C. 20510

I am writing in response to Chairman Grassley's letter dated April 6, 2006, which requested that I answer a number of questions for the record submitted by members of the Committee on Finance in connection with the Committee's April 4, 2006 hearing: "Preparing Your Taxes: How Costly Is It?" The questions, and my responses, follow.

Responses to Questions from Chairman Grassley:

Question 1: During your testing of the Free File companies, you found that despite having been guided by the IRS to a particular service, the company to which you were guided could not necessarily complete the return. You have also talked about various ancillary services and cross-marketing of products that you encountered when navigating through the Free File websites. It appears that the Free File system may not be effectively serving American taxpayers.

In your testimony as well as your Annual Report to Congress, you have supported the IRS development of a tax preparation template to provide free e-filing for all taxpayers. Until such time as other options are available or taxpayers can file their returns online with the IRS, what changes should be made to make it more effective?

Response:

In announcing the revised Free File agreement in October 2005, both the IRS and the Free File Alliance stated that the agreement would result in enhanced services, improved disclosures regarding refund anticipation loans (RALs), and

greater privacy protection.¹ As I discussed in my oral and written testimony before the Committee on April 4, 2006, my office tested four scenarios on each of the twenty Free File sites accessible through the official IRS website. The goal of the testing was to determine the experience of taxpayers as they attempt to navigate the sites and prepare and file their returns through Free File products accessible through the official IRS website. I was disappointed in the results of the testing, which are detailed in my written testimony. The following steps would alleviate some of my concerns:²

- Each of the 20 sites has its own eligibility requirements and its own capabilities and limitations. The product limitations need to be made clear so that a taxpayer does not have to start all over again or pay a fee to upgrade the product late in the preparation process. At a minimum, the IRS should require the Free File member companies to clearly state the limitations in the program on the first page. Alternatively, the IRS should itself state the limitations by enhancing the IRS's own "Guide Me to a Service" link on the IRS Free File page. Ideally, however, I would like to see the IRS establish basic requirements for each program. If the programs cannot satisfy these basic requirements, they would not be permitted to participate in Free File. Examples of such requirements include, but are not limited to, the following: (1) properly calculate and report alternative minimum tax (AMT); (2) adequately prompt the taxpayer to determine eligibility for disaster relief as well as the proper calculation and reporting of such relief; and (3) support taxpayers with numerous dependents.
- The fees associated with using the product (*i.e.*, printing, customer service, state preparation) need to be clear at the very beginning of the process. Perhaps the IRS should mandate standardized language and placement of fee disclosures. Preferably, the IRS should mandate that the programs allow printing of returns at no charge.
- Disclosure and privacy provisions need to be more visible and not buried in a hyperlink on the bottom of a screen or in the licensing agreement screen. Furthermore, the preparation should not be conditioned on consent by the user. The Treasury Department should finalize the

¹ IRS News Release, IRS and Free File Alliance Reach Agreement, IR-2005-16 (Oct. 25, 2005).

² I offer one caveat to our results. Our objective was to determine the existence and extent of limitations and problems that a user of the Free File sites would encounter. In some instances, the tax attorneys testing the sites found them very difficult to navigate and were unable to locate forms or answers that later testing was able to locate. Therefore, the test results reflect simply what our attorneys experienced and not necessarily what a site was capable of accomplishing.

proposed regulations under IRC § 7216 as soon as possible to give the program developers time to satisfy the requirements, preferably for the 2007 filing season.

- Free File participants should not cross-market ancillary products and services. The prohibition could be accomplished through several means. Congress could ban the practice legislatively, the IRS could renegotiate the Free File Agreement to include such a prohibition, or the issue could be addressed through IRC § 7216 and the regulations thereunder.
- Finally, it is imperative that the IRS mandate that each Free File program is 508 compliant in order to participate in the program. A program is 508 compliant if disabled employees and members of the public are able to access the information in a way that is comparable to the access available to others.³

Question 2(a): As the Taxpayer Advocate, you must be particularly concerned by GAO's experiences in trying to get relatively simple returns prepared. What do you think we in Congress can do to help the average taxpayer who needs assistance from a paid preparer?

Response:

More than 60 percent of U.S. taxpayers pay preparers to prepare their returns, and GAO's findings underscore the serious problems that exist today in the tax preparation industry. The return preparation industry has changed significantly since 1976, when Congress first enacted requirements for preparers to sign returns and provide copies to taxpayers along with the penalty provisions of IRC sections 6694 and 6695.⁴ At that time, persons preparing returns for a fee, including unenrolled preparers, were doing precisely that – return preparation. Today, the tax preparation field has increasingly become a vehicle for cross-marketing non-tax goods and services. With used car dealers filing taxes so taxpayers can use their refunds as down payments toward automobiles and with preparers in check-cashing storefronts charging payday loan rates for refund loans (and who disappear without a trace after April 15th), taxpayers have no way of knowing whether these purveyors of products are in any way qualified to prepare federal income tax returns. It is remarkable to me that, in the United States today, anyone can prepare a tax return for a fee – with no training, no licensing, and no oversight required.

³ 29 U.S.C. § 794d.

⁴ See Tax Reform Act of 1976, Pub. L. 94-455.

Because the role of tax preparation is central to effective tax administration, the IRS, as the tax administrator, should do more to closely oversee those persons and entities that provide tax preparation services. For several years, my office has advocated for the regulation of unenrolled tax preparers as a means to professionalize the tax preparation industry and protect both taxpayers and the tax system. Combined with enhanced due diligence penalties and more robust assessment and collection of penalties, professionalizing the tax preparation industry would strengthen taxpayer confidence in the tax system and improve the accuracy of returns.

In my 2002 annual report to Congress, I proposed a plan for the IRS to register, test, and certify unenrolled federal income tax preparers.⁵ My proposal to regulate tax return preparers was generally well received, and in the 108th Congress, the Senate passed my proposal to regulate unenrolled preparers as part of the Tax Administration Good Government Act. The proposal was introduced again in this Congress as part of S. 832, and I am pleased that the chairman and ranking member of the Senate Finance Committee are again co-sponsors. I encourage Congress to pass this common-sense legislation.

The IRS originally expressed some concern that my proposal could place a strain on its enforcement resources, but I have designed the proposal carefully to avoid that result. California, for example, has adopted a registration system that is funded entirely by modest fees that preparers in that state pay. In addition, I note that the IRS itself has already designed a modest but effective version of a testing and certification program – and it did so within a one-year timeframe. “Link and Learn Taxes” is an online training program that allows Volunteer Income Tax Assistance (VITA) volunteers to receive the training and certification necessary to prepare tax returns at VITA sites. The IRS estimates that about 10,000 volunteers received certification through this program for the 2005 filing season. So this is eminently do-able.

Apart from education, I also encourage Congress to enact a more stringent compliance and penalty regime to deter reckless disregard of the rules or negligence by paid preparers.⁶ The civil penalty regime currently in law is not adequate and, in particular, penalty amounts are too low for the IRS to treat enforcement of preparer penalties as priority work. In my 2003 annual report, I identified the gaps and inadequacies of the current compliance regime for

⁵ See National Taxpayer Advocate 2002 Annual Report to Congress 216-230 (Key Legislative Recommendation: Regulation of Federal Tax Return Preparers).

⁶ See National Taxpayer Advocate 2003 Annual Report to Congress 270-301 (Key Legislative Recommendation: Federal Tax Return Preparers: Oversight and Compliance).

preparers and Electronic Return Originators (EROs), and I recommended that Congress strengthen oversight of all preparers by enhancing due diligence and signature requirements, increasing the dollar amount of preparer penalties, and assessing and collecting those penalties, as appropriate.⁷

In the Earned Income Tax Credit (EITC) area, I recommended enhanced EITC-specific due diligence requirements, progressively higher preparer accuracy penalties where multiple inaccurate returns are prepared, and joint and several liability with the taxpayer for EITC overpayments where the preparer recklessly disregards IRS rules and regulations.⁸ Moreover, I have made several suggestions about how the IRS could strengthen its oversight of EROs.⁹

Question 2(b): What additional reforms should be included in the Good Government Bill (S. 832)?

Response:

As stated above, I am pleased that Congress has taken interest in my proposal to regulate unenrolled federal income tax preparers by incorporating the main components into S. 832. I encourage Congress to go one step further to enact a more stringent compliance and penalty regime to deter reckless disregard of the rules and/or negligence by paid preparers. The bill currently increases penalties under IRC § 6695(b) for failure to sign the return and IRC § 6695(c) for failure to furnish an identifying number from \$50 per offense to \$500 per offense. While these proposed penalty increases would likely have a general deterrent effect on preparers, I have identified additional gaps and inadequacies of the current compliance regime for preparers and Electronic Return Originators (EROs). As detailed in my 2003 Annual Report to Congress, I recommend that Congress strengthen oversight of all preparers by enhancing due diligence and signature requirements. Specifically, the signature requirements should require preparers to sign Form 656, Offers in Compromise; Form 12153, Request for a Collection Due Process Hearing; and IRS forms pertaining to the taxpayer's financial information statement (Forms 433-A and 433-B). I also recommend increasing the dollar amount of preparer penalties, strengthening the due diligence and

⁷ *Id.*

⁸ *Id.* at 285-286, 292-294.

⁹ *Id.* at 287, 294-295; see also National Taxpayer Advocate 2005 Annual Report to Congress 223-237 (Most Serious Problem: Regulation of Electronic Return Originators).

penalty requirements for EITC preparers, and assessing and collecting those penalties, as appropriate.¹⁰

Responses to Questions from Senator Hatch:

Question 1: Ms. Olson, thank you for being here. We really appreciate your hard work on behalf of the nation's taxpayers, and I especially appreciate the good work done by the Taxpayer Advocate Offices in Utah. I am particularly interested in your comments about having to pay to file tax returns electronically. Since receiving the email from my constituent that I read earlier, I have been struggling to understand why the IRS would charge for the privilege of filing electronically, when it seems to be in everyone's interest to provide an incentive to do so by making it free. In fact, some have even suggested we pay taxpayers if they file electronically. Can you tell me, does any Treasury regulation or other administrative guidance prohibit IRS direct filing? Is it your understanding that legislation would be required to allow IRS direct filing?

Response:

It is my understanding that no regulation or administrative guidance prohibits the IRS from offering a free direct filing option. However, the IRS has not chosen to offer such an option, and I believe it would be appropriate for Congress to require it.

In 1998, Congress directed the IRS to set a goal of having 80 percent of all returns filed electronically by 2007.¹¹ The IRS has done a superb job to increase the e-filing rate above 50 percent, but it has run into a wall among a group of taxpayers who are unwilling to file through third party service providers for either of two reasons. Some taxpayers are unwilling to pay fees to file electronically when they can mail their returns for the cost of a postage stamp. Other taxpayers are concerned about routing their personal tax and financial information through a third-party service provider. For example, one participant in an IRS focus group represented the views of many when he said, "I just get skeptical when one site leads to another site that's supposed to be secure. If it were under the IRS.gov website address and it was just a separate page there, I would feel better about it."¹² As a consequence of these concerns, IRS data

¹⁰ See National Taxpayer Advocate 2003 Annual Report to Congress 270-301 (Key Legislative Recommendation: Federal Tax Return Preparers: Oversight and Compliance).

¹¹ Internal Revenue Service Restructuring and Reform Act, Pub. L. No. 105-206, § 2001(a)(12), 112 Stat. 685 (1998).

¹² Russell Marketing Research, Findings from Focus Groups Among Taxpayers With Self-Simple Returns, screen 22 (March 2003).

shows that nearly 40 million 2004 tax returns were prepared using software, yet were submitted on paper.¹³ That is a bad result for tax administration because it requires the IRS to pay employees to enter data into a computer manually, it increases the risk of transcription errors, and it delays the issuance of refunds. If the IRS were to offer a free direct filing portal, I believe most of these returns would come in electronically and that both the government and taxpayers would benefit.

According to the Federation of Tax Administrators, 21 states (including Utah) and the District of Columbia allow taxpayers to file their returns directly without the use of third-party intermediaries.¹⁴ I urge Congress to direct the IRS to authorize and develop this procedure as well.

Question 2: Ms. Olson, on the issue of tax simplification, I agree we need to find a way to vastly simplify the code. However, fundamental tax reform may be politically impossible in the short run. In the meantime, what would be your top three recommendations for incremental changes Congress should make right away to simplify life for taxpayers?

Response:

I believe these three changes would have the most immediate impact on tax simplification:

1. *Repeal the Alternative Minimum Tax (AMT).* The AMT, originally designed to prevent wealthy taxpayers from escaping taxation through the use of tax-avoidance transactions, has “morphed” into a complicated second layer of taxation that is increasingly affecting middle income taxpayers and is projected to expand to affect nearly 35 million taxpayers by 2010. I discussed the taxpayer burden problems caused by the AMT in my 2003 annual report to Congress¹⁵ and I recommended that the AMT be repealed in my 2001 and 2004 annual reports to Congress.¹⁶

2. *Simplify Family Status Provisions.* The Internal Revenue Code contains six provisions related to a taxpayer’s family status: the Earned Income Tax Credit (EITC), the Child Care Tax Credit (CTC), the Child and Dependent

¹³ IRS Tax Year 2004 Taxpayer Usage Study (Aug. 26, 2005).

¹⁴ Statement of the Federation of Tax Administrators Before the Committee on Finance, U.S. Senate, Hearing on Preparing Your Taxes: How Costly Is It? 109th Cong., (April 4, 2006).

¹⁵ National Taxpayer Advocate 2003 Annual Report to Congress 5-19.

¹⁶ National Taxpayer Advocate 2004 Annual Report to Congress 383-385; National Taxpayer Advocate 2001 Annual Report to Congress 166-177.

Care Credit, personal and dependency exemptions, the head-of-household filing status, and the “separated spouse” rules of IRC § 7703(b). To simplify these various provisions, I recommend that Congress (1) combine the exemptions, CTC, and part of the EITC and head of household filing status into a refundable Family Credit comprising two components – one for the taxpayer (and his or her spouse) and one for whomever is the “main carer” of a child or children based on a per-child amount; (2) separate the Child and Dependent Care Credits into two credits so taxpayers are not confused by eligibility requirements that do not apply to them; (3) eliminate head-of-household filing status; (4) modify the EITC so that it provides a refundable credit to low income workers based solely on the taxpayer’s earned income and is available to workers age 18 and over, regardless of the existence of children in the household; (5) permit married taxpayers who have a legal and binding separation agreement and who live separate and apart as of the last day of the calendar year to be considered “not married” for purposes of filing status; and (6) provide a separate credit for noncustodial parents of qualifying children who pay all child support obligations due for that calendar year. I discuss these proposals in more detail in my 2005 annual report to Congress.¹⁷ At first blush, I recognize that this listing may not seem like simplification. But after working through it and comparing it with the existing rules in this area, I believe these proposals, in toto, more accurately reflect taxpayers’ family structures, while reducing complexity, minimizing opportunities for noncompliance, and improving fairness.

3. Streamline the Number of Incentives for Saving for Education and Retirement. The Internal Revenue Code contains at least nine different provisions designed to encourage savings for and spending on an education, and more than a dozen provisions for tax-advantaged retirement planning vehicles. The education incentives contain various definitions and income phase-outs and the retirement plans are subject to different sets of rules governing eligibility, contribution limits, the tax treatment of contributions and distributions, withdrawals, the availability of loans, and portability. Taxpayers will only respond to these education and retirement savings if they understand them. Thus, I recommend that Congress streamline these incentives. I discuss my education and retirement savings simplification proposals in my 2004 annual report to Congress.¹⁸

Question 3: Ms. Olson, you mentioned the issue of tax preparers disclosing taxpayer information and the need for Treasury and the IRS to strengthen the

¹⁷ National Taxpayer Advocate 2005 Annual Report to Congress 397-406.

¹⁸ National Taxpayer Advocate 2004 Annual Report to Congress 403-431.

consent requirements. Is there a need for Congress to change the law on this issue?

Response:

I believe that a taxpayer's consent to the "use" or "disclosure" of tax return information should be limited to those instances where it is necessary for tax-related purposes. Accordingly, the regulations should define what purposes are "tax-related." Releasing tax return information for purposes of obtaining a Refund Anticipation Loan (RAL) should not be considered "tax-related." The government, as part of its social contract with its taxpayers, should provide a method for taxpayers, including the unbanked, to receive the refund of their hard-earned dollars quickly and without charge. Along the same lines, the release of tax return information by a preparer to a bank – whether affiliated or unaffiliated with the preparer – in order to obtain an IRA or other retirement account should not be considered "tax-related." In this case, the taxpayer should provide his own tax information to the financial institution. Any inconvenience would be minor compared to the risk to the tax system of widespread use and disclosure.

I acknowledge that this is a strong position and one that is not necessarily shared by others within and without the tax administration system. Over the coming year, I will work with the IRS and Treasury to try to incorporate this and other improvements into the proposed regulations. However, it may also be an appropriate area in which Congress could act. I want to emphasize that by virtually any standard, the proposed regulations provide far more protection than the existing regulations. It would be extremely unfortunate if concerns that the proposed regulations do not go far enough create an obstacle, because the existing regulations are clearly inadequate.

Further, I strongly support an exception in the existing regulations that allows return preparers engaged in the practice of law or accountancy to use the tax return information of the taxpayer, or disclose the information to other persons in the same firm, to render other legal or accounting services to or for the benefit of the taxpayer. For example, an attorney who prepares a tax return may use the information or share it with another attorney in the firm for the purpose of preparing estate planning documents for the taxpayer.¹⁹

¹⁹ See Treas. Reg. § 301.7216-2(e); Prop. Treas. Reg. § 301.7216-2(h).

Responses to Questions from Senator Baucus:

Question 1: Do taxpayers have a right to file tax returns for free, whether they are paper or electronic?

Response:

The role of tax preparation is central to effective tax administration, and as the tax administrator, the IRS should do more to provide a high-quality free vehicle for paper and electronic filing. For several years, I have advocated that the IRS should place a basic, fill-in template on its website and allow any taxpayer who wants to self-prepare his or her return to do so and file it directly with the IRS for free. This proposal is detailed in my 2004 annual report to Congress.²⁰

Since the inception of the tax system, there have always been two categories of taxpayers – those who are comfortable enough with the rules to self-prepare their returns and those who turn to paid professionals for assistance. In the paper-filing world, the IRS has always made its forms and instructions universally available without charge to all taxpayers, and those taxpayers who require help have always been free to seek the assistance of paid preparers. For those taxpayers who are comfortable preparing their returns without assistance, the government should provide the means to do so without charge. For those taxpayers who do not find a basic template sufficient and would prefer to avail themselves of the additional benefits of a sophisticated software program, they are free to purchase one.

IRS data show that about 40 million returns are prepared using software yet are mailed in rather than submitted electronically.²¹ This is a shame, because the practice delays the length of time for processing refunds, it requires the IRS to devote additional resources to entering the data manually when it receives the return, and it creates a risk of transcription error.

There is no reason why taxpayers should be required to pay transaction fees in order to file their returns electronically. A free template and direct filing portal would go a long way toward addressing this problem and would result in a greater number of taxpayers filing their returns electronically. Both taxpayers and the government would stand to benefit.

²⁰ National Taxpayer Advocate 2004 Annual Report to Congress 471-477 (Key Legislative Recommendation: Free Electronic Filing for All Taxpayers).

²¹ IRS Tax Year 2004 Taxpayer Usage Study (Aug. 26, 2005).

On a related note, I am also concerned about the reduction in IRS assistance to taxpayers seeking help in preparing their tax returns. We must not lose sight of the fact that the government is asking its citizens to pay over a significant portion of their annual incomes. For those taxpayers who do not trust private parties, including VITA, with their personal information and want to deal directly with the government, the government should be there to help them compute their tax liabilities. In many cases, the alternative is that these taxpayers won't comply. Yet the IRS has issued annual directives to its walk-in sites to reduce the number of returns they prepare for each of the last several years. As a direct consequence, the IRS will have reduced the number of returns it prepares by more than 50 percent since FY 2003 – from 665,868 returns in FY 2003 to a proposed 305,000 returns in FY 2006. In my view, refusing to assist taxpayers who are literally showing up at the door to try to comply with their tax obligations does not constitute high quality taxpayer service. Nor does it constitute a sound strategy to reduce the tax gap.

Question 2: Do you think that taxpayers should have to pay a preparer, buy software, or go through a middleman to file their returns electronically when they can file a paper return directly and for free? Taxpayers don't have to go to a bookstore to buy paper forms to file their returns through the mail. Why should electronic filing be so different from paper filing?

Response:

As I discussed in detail to your previous question, I see no reason why taxpayers should be required to pay transaction fees in order to file their returns electronically. Congress directed the IRS to set a goal of having 80 percent of all returns filed electronically by 2007 and the driving force behind the goal established by Congress is that e-filing significantly benefits both taxpayers and the IRS.²² Such benefits include a quicker turnaround time for refunds, a reduction in the overall return error rate, and cheaper return processing costs for the IRS. As such, the IRS has every incentive to provide either an equal or improved playing field in the electronic arena. In 2004, approximately 40 million taxpayers prepared their returns using software and chose to mail in the paper returns rather than file electronically.²³ A free template and direct filing portal would go a long way toward addressing this problem and would result in a greater number of taxpayers filing their returns electronically.

²² S. Rep. No. 105-174, 39-40 (1998).

²³ IRS Tax Year 2004 Taxpayer Usage Study (Aug. 26, 2005).

Question 3: Should the IRS offer direct, free e-filing through its website? Are there any policy reasons why the IRS should not offer direct and free electronic filing to taxpayers?

Response:

I believe strongly that the IRS should develop a return template and direct filing portal. In fact, I made this recommendation in my 2004 annual report to Congress.²⁴ I do not believe there are any policy reasons why the IRS should not provide a template and filing portal.

Opponents of my proposal to develop a basic fill-in template frequently cite language in the IRS Restructuring and Reform Act of 1998 (RRA 98) conference report which states that the conferees want the IRS and Treasury "to press for robust private sector competition"²⁵ as well as a press release issued by the Treasury Department which states that the IRS should not "get into the software business."²⁶

Further, the IRS entered into a three-year agreement prior to the 2003 filing season with a consortium of tax preparation software companies known collectively as the "Free File Alliance."²⁷ The agreement had a three-year term that ended last year, and in October 2005, the IRS and the Free File Alliance agreed to extend the contract for four years with some modifications.²⁸ The initial agreement required the Free File companies, in the aggregate, to make free electronic preparation and filing available to a minimum of at least 60 percent of all taxpayers. The original Free File agreement did not impose a maximum, and during the 2005 filing season, many Free File participants, including Intuit and H&R Block, made their federal income tax products available to all taxpayers without charge (although they generated revenue by selling ancillary products, including state income tax products, to users of their federal products). By

²⁴ National Taxpayer Advocate 2004 Annual Report to Congress 471-477 (Key Legislative Recommendation: Free Electronic Filing for All Taxpayers).

²⁵ H.R. Conf. Rep. No. 105-599, at 235 (1998). In addition, the conference report states "[T]he conferees also intend that the IRS should continue to offer and improve its Telefile program and make available a comparable program on the Internet."

²⁶ Press Release, U.S. Department of the Treasury, Treasury, IRS Announce New Efforts to Expand E-Filing, Treas. PO-964 (Jan. 30, 2002).

²⁷ Free On-Line Electronic Tax Filing Agreement entered into between the Internal Revenue Service and the Free File Alliance, LLC (effective as of Oct. 30, 2002), available at www.irs.gov/efile/article/0,,id=103626,00.html.

²⁸ Free On-Line Electronic Tax Filing Agreement Amendment entered into between the Internal Revenue Service and the Free File Alliance, LLC (effective as of Oct. 30, 2005), available at www.irs.gov/pub/irs-efile/free_file_agreement.pdf.

contrast, the new agreement prevents Free File companies, in the aggregate, from making free services available to more than 70 percent of all taxpayers.²⁹ In the agreement, the IRS pledged that it would “not compete with the [Free File Alliance] in providing free, online tax return preparation and filing services to taxpayers.”

Notwithstanding this language, I believe the IRS can and should develop its own basic template so that all taxpayers can, if they choose, file electronically without cost. A basic template would not, in my view, “compete” with the private sector because it would merely be the electronic analog of a paper tax form and it would not contain the question-and-answer format or other sophisticated functionality that makes existing private sector products attractive to many taxpayers. But it would allow taxpayers who want to complete and file their returns without such assistance with the opportunity to do so without paying fees – again, just as they have always been able to do when filing paper returns.

I am also mindful that there is no one silver-bullet strategy to get as many taxpayers as possible to e-file - even beyond the 80 percent goal. Thus, the IRS must consider implementing many strategies to address the various barriers to e-file, such as cost and lack of trust transmitting confidential data through intermediaries.³⁰

Question 4: Free File doesn't seem to be doing a good job of serving the purposes for which it was designed. At its peak in 2005, only 5 million taxpayers out of 133 million used it. What do you think should be done to make it easier for taxpayers who want to prepare and file their returns on their own for free to be able to do so?

Response:

As noted in an earlier response, the results of the testing performed by my office of the twenty Free File sites demonstrates that Free File is not an easy service for taxpayers to navigate, and it can even result in inaccurate returns. As currently structured, Free File amounts to a wild, wild West of differing eligibility

²⁹ *Id.* Section I.E provides in relevant part: “IRS will utilize the then current Adjusted Gross Income (AGI) number which equates to 70 percent of the taxpayers to manage the program, and will not accept or post any offer by an Alliance member which exceeds this AGI amount.”

³⁰ For example, one research study found that 11 percent of individual paper return filers avoided e-file due to cost, and nine percent did so due to lack of privacy or security. Russell Marketing Research, Findings From the 2003 Wave of e-file Taxpayer & Preparer Satisfaction Research, Presentation at the 2003 IRS Research Integration Meetings, screens 3, 37 (July 2003).

requirements, differing capabilities, and differing availability of and fees for add-on products.

Where do we go from here? Considering the poor performance of many of the Free File sites, the tiny fraction of taxpayers who use them,³¹ concerns about exploitative cross-marketing of other products, the appearance that the IRS is endorsing the Free File products (because taxpayers start out at the irs.gov website), and taxpayer concerns about the confidentiality of their tax data, there is little justification to continue with Free File and every justification for the IRS to develop a tax preparation template and to provide free e-filing for all taxpayers – just as it does for paper filers. As detailed in my 2004 annual report to Congress, my proposal to provide a return template and direct filing portal should be simple, accurate, and confidential.³²

Question 5: Would it be a good idea to open up Free File to everyone until the IRS has its own system in place?

Response:

During the 2005 filing season, several of the Free File participants made their federal income tax products available to all taxpayers. Even so, only about five million taxpayers utilized the free services, and available data suggests that the majority of Free File users previously e-filed their returns. With approximately 135 million total individual returns, Free File is doing very little to help the IRS meet its 80 percent e-file goal by attracting new e-filers. Given the relatively low usage and the issues associated with the products, which are discussed in more detail above, I do not see a significant benefit to opening up Free File to all taxpayers. Further, it is doubtful that the members of the Free File Alliance would agree to once again open up the products to all taxpayers, without a financial incentive to do so.

Question 6: Could the IRS and the states use electronic filing to work together to help people pay their taxes? How might that work? Are there any obstacles that might make such a partnership difficult? What are they?

³¹ Approximately 3.9 million individual income tax returns were filed through Free File in the 2006 filing season as of April 29, 2006. This amounts to approximately three percent of all individual returns filed and is more than a 22 percent decrease from the rate during the same period in 2005. IRS, 2006 Filing Season Data, for Week Ending 4/29/2006.

³² National Taxpayer Advocate 2004 Annual Report to Congress 471-477 (Key Legislative Recommendation: Free Electronic Filing for All Taxpayers).

Response:

Because many individual taxpayers prepare and file their federal and state income tax returns at or around the same sitting or visit to the tax preparer, the IRS should partner with state tax administrators to encourage a uniform approach to free electronic filing. It is my understanding that the IRS works closely with the states through the assistance of the Federation of Tax Administrators (FTA). For example, the FTA coordinates IRS and state activities in the FedState electronic filing program, in which the returns of 36 states and the District of Columbia are filed in a single transaction between the practitioner and the IRS. The IRS then segregates the state return information and makes it available for downloading by the state. The nonparticipating states receive their returns directly from the practitioners in a separate transaction.

It is my understanding that the Free File Alliance generally does not offer free filing services in any of the states that maintain their own direct filing applications.³³ The IRS has a vested interest in making free electronic filing available to all taxpayers at both the federal and state levels.³⁴

Question 7: An argument has been raised that the IRS would incur substantial costs to develop software if it were to offer direct and free electronic filing. What are the pros and cons of the IRS developing its own software compared to contracting with outside parties to provide the software?

Response:

The most significant advantages to contracting out the development of a software package is that the private sector has demonstrated its ability to do it cheaply and effectively. Moreover, contracting out would avoid concerns that the government is competing with the private sector and would, instead, harness the creative energy and efficiency of the private sector to enable taxpayers to meet their federal tax obligations. In this area, there is a strong argument for encouraging joint public and private sector collaboration.

³³ *Preparing Your Taxes: How Costly Is It?* Hearing Before the Comm. On Finance, United States Senate, 109th Cong (April 4, 2006) (Statement of the Federation of Tax Administrators); Memorandum from Harley T. Duncan, Executive Director of the Federation of Tax Administrators, to the Federation of Tax Administrators Board of Trustees at 5 (June 5, 2004).

³⁴ As noted above, the IRS benefits from an increase in state e-filing. See "State e-File Impact on Federal e-File," ETA Research Project 1-04-08-2-032N, W&I Division, Customer Research Group 1, screen 22 (March 2004).

The most significant advantage if the government develops its own software is that the government might more easily design a system that meets its exact technical requirements. In addition, internally-developed software could more easily assure taxpayers concerned about confidentiality that third-party vendors are not involved in the process.

Whether the IRS develops the software internally or contracts out the development, the resulting product must be accessible to everyone, including disabled taxpayers. The IRS is statutorily required to make electronic and information technology accessible to peoples with disabilities. Referred to as "508 Compliance," disabled employees and members of the public must be able to access IRS information in a way that is comparable to the access available to others.³⁵

Question 8: Please comment on the pros and cons of an IRS mandate that individual taxpayers must file their tax returns electronically. Include in your comments consideration of whether a mandate would apply to all individuals, or certain types of taxpayers.

Response:

As of June 2005, at least twelve states had electronic filing mandates in place for the filing of individual income tax returns by preparers.³⁶ The mandates generally require tax practitioners who file more than a specified number of returns in the prior filing season to file all their returns electronically in the current filing season. The threshold is typically lowered over time, which gradually increases the base of practitioners subject to the mandate. Penalties are imposed for noncompliance, but some mandates provide hardship exceptions for practitioners who cannot satisfy the mandate. They also typically provide "opt-out" procedures if the *taxpayer* chooses to file the return on paper.³⁷

Pros:

In the state filing arena, mandates have had a significant impact on electronic filing rates. Between 2003 and 2004, state electronic filing grew by 25 percent. If the five states which had mandates at that time were removed from the equation, the increase was only 12 percent. Therefore, it appears that the five

³⁵ 29 U.S.C. § 794d.

³⁶ These states include Alabama, California, Connecticut, Massachusetts, Michigan, Minnesota, New Jersey, New York, Oklahoma, Utah, Virginia and Wisconsin. Federation of Tax Administrators, *Electronic Filing Mandates: Lessons Learned* 1-3 (June 2005).

³⁷ See, e.g., Cal. Rev. & Tax. Code § 18621.9; Utah Code § 59-10-514.1.

states with mandates accounted for more than half of the overall rate of state e-file.³⁸ This rate of increase in state e-filing also impacts the rate of federal e-filing. Overall, federal e-filing increased by 16 percent in 2004, and if the federal returns from the five e-file mandate states were excluded from the equation, the federal rate of growth would have been only 9 percent. It has been estimated that the state-level mandates generated 2.5 million additional federal returns in 2004.³⁹ Recent data indicate that the trend continues. Through March 17, 2006, New York and Connecticut, each of which implemented an e-filing mandate for the first time in the 2006 filing season, had e-file growth rates of 30 percent and 20 percent, respectively. In fact, about 25 percent of the increase in electronic state returns in 2006 came from Connecticut and New York, despite the fact that they accounted for only seven percent of all state electronic returns in 2005.⁴⁰

Cons:

Many taxpayers either do not have access to a computer or do not have sufficient proficiency to prepare their returns using a computer program. Low income, elderly, English as a Second Language (ESL), Limited English Proficiency (LEP), and disabled taxpayers are particularly likely to lack the requisite computer access or skills.

As a legal matter, IRC § 6011(e)(1) precludes the IRS from mandating the e-filing of tax returns for individuals, estates and trusts. However, I note that the Senate passed legislation during the 108th Congress that would allow the IRS to mandate electronic filing by preparers that file five or more returns annually.⁴¹

The Federation of Tax Administrators (FTA) has closely studied the issue of imposing e-filing mandates on preparers (as distinct from taxpayers). In a June 2005 report, the FTA described some lessons learned from the state-level mandates. The report listed the following issues for consideration when any taxing authority mandates e-filing.⁴²

- Mandates should be phased in to allow the preparers to prepare for the new rules;

³⁸ Federation of Tax Administrators, *Electronic Filing Mandates: Lessons Learned* 1-3 (June 2005).

³⁹ *Id.* at 2-3.

⁴⁰ *Preparing Your Taxes: How Costly Is It?* Hearing Before the Comm. On Finance, United States Senate, 109th Cong (April 4, 2006) (Statement of the Federation of Tax Administrators).

⁴¹ S. 882, § 105, 108th Cong.

⁴² Federation of Tax Administrators, *Electronic Filing Mandates: Lessons Learned* 3-6 (June 2005).

- Mandates should include “hardship” exceptions to provide a grace period for preparers who cannot convert within the given time period despite best efforts;
- Mandates should provide procedures to allow taxpayers to opt out of electronic filing;
- Mandates should include penalties for noncompliance, especially where preparers have acted intentionally or recklessly; and
- Low-volume forms should be excluded from mandates to avoid the need for costly programming.

Question 9: What can Congress do to remedy the problems highlighted at the hearing?

Response:

For most Americans, the annual rite of preparing and filing their tax returns represents their most significant contact with the U.S. government. The importance of making this process run smoothly therefore cannot be overstated. As stated in various responses above, Congress can take numerous steps to ensure high quality tax return preparation and filing, as well as attempt to make the tax return filing experience more palatable. These legislative actions include:

- Require the IRS to develop a template and direct filing portal to allow taxpayers to file directly with the IRS at no charge.⁴³
- Enact a regulatory system in which the IRS would register, test, certify and require continuing professional education (CPE) for unenrolled federal income tax preparers.⁴⁴ I also encourage Congress to enact a more stringent compliance and penalty regime to deter reckless disregard of the rules and/or negligence by paid preparers.⁴⁵
- Ensure that IRC § 7216 limits taxpayer consent to “use” or “disclose” tax return information to only those instances where it is necessary for tax-

⁴³ See National Taxpayer Advocate 2004 Annual Report to Congress 471-477 (Key Legislative Recommendation: Free Electronic Filing for All Taxpayers).

⁴⁴ See National Taxpayer Advocate 2002 Annual Report to Congress 216-230 (Key Legislative Recommendation: Regulation of Federal Tax Return Preparers).

⁴⁵ See National Taxpayer Advocate 2003 Annual Report to Congress 270-301 (Key Legislative Recommendation: Federal Tax Return Preparers: Oversight and Compliance).

related purposes. The regulations should define what purposes are “tax-related.” Such definitions should make clear that the use or disclosure of tax return information for purposes of marketing a Refund Anticipation Loan (RAL) is not “tax-related.”

Question 10: What can Treasury and the IRS do to remedy the problems highlighted at the hearing?

Response:

Treasury and the IRS can take the following administrative actions to improve the tax preparation and filing environment:

- Renegotiate the Free File agreement to address some of the problems found by the testing performed independently by my office and Finance Committee staff. In addition, it is important that any renegotiations require all Free File programs to be Section 508 compliant, which will ensure that all programs are equally accessible to taxpayers with disabilities.⁴⁶
- Continue to update the IRC § 7216 proposed regulations while giving due consideration to written comments and statements given at the April 4, 2006 public hearing. It is my opinion that, from a consumer protection standpoint, the worst outcome would be to maintain the current regulations, because neither the statute nor the current § 7216 regulations provide definitions of the two key terms – use and disclose. Thus, the return preparers have the current ability to decide for themselves what constitutes a “use” or “disclosure.”
- Halt and reverse the recent year-after-year mandated reductions in the number of tax returns prepared at IRS walk-in sites. The IRS should be open for business to all taxpayers who seek assistance from the government in complying with their tax obligations.
- Provide adequate training and resources (including supplies and computer resources) to Volunteer Income Tax Assistance (VITA) program volunteers.⁴⁷

Question 11: What can the preparer and software communities do to remedy these problems?

⁴⁶ See 29 U.S.C. § 794d.

⁴⁷ See National Taxpayer Advocate 2004 Annual Report to Congress 110-131. I also support a grant program for VITA similar to the one detailed in S. 832, § 7, 109th Cong.

Response:

The preparers and software companies can take several steps to improve the tax return preparation process for taxpayers. I would like to see the Free File Alliance members and software development companies to address some of the issues my office found while testing the twenty sites. Although the issues are detailed more fully above, I would like the programs to state the eligibility requirements more fully up front, improve fee disclosure, and place the IRC §7216 disclosure provisions and consent forms in a visible location with preparation not conditioned upon acceptance of the provisions. I also believe that Free File products should not cross-market ancillary products and services, including franchise opportunities and audit insurance products.

Question 12: Ms. Olson, what are your views on the proposed IRS regulations regarding the use and disclosure of tax return information by paid preparers?

Response:

From a consumer protection standpoint, the worst outcome in my view would be to maintain the status quo. Neither the statute nor the current IRC § 7216 regulations provide definitions of the two key terms -- use and disclose -- so in many ways, the field today is wide open for return preparers to decide for themselves what constitutes a "use" or "disclosure."

Under the current regulations, a tax return preparer, with taxpayer consent, may use tax return information to promote nontax products and services currently offered by the tax return preparer or a member of the tax return preparer's affiliated group. Moreover, with taxpayer consent, tax return preparers can disclose (and even sell) tax return information to anyone. The regulations impose no limitations on this disclosure. And once this tax return information is disclosed to a third party, there are no limitations in the tax code on that third party's ability to re-disclose the tax return information. The taxpayer will never know how or when or to whom his information is re-disclosed.

The distinction between "use" and "disclosure" is significant. In the "use" environment, the tax return preparer herself is holding onto information she already has and is using it to evaluate the appropriateness of a product or service for the taxpayer's situation. The taxpayer has agreed to the preparer's use -- but not disclosure -- of the data, and if the preparer uses the data in a manner that the taxpayer has not agreed to, the preparer may be subject to civil and criminal sanctions. In the "disclosure" environment, on the other hand, the

tax return preparer can be sending tax return information out to any third person on the open market, where the tax return information can be used in any manner whatsoever, without limitation. There is no way that the taxpayer can know in advance how and by whom his tax return information will be used once it is disclosed. Criminal sanctions apply only if the preparer “knowingly or recklessly” discloses information without the taxpayer’s consent. Such sanctions do not apply to non-preparers.

We can all imagine how these two provisions – use and disclosure – can be abused and how they can impair tax administration and compliance. In fact, the statute and current regulation are written so that disclosure and use of such information by a tax return preparer is prohibited except in a few instances. One of those instances, under the existing regulation, is pursuant to the consent of the taxpayer.

In drafting the proposed regulations and a related draft revenue procedure, the IRS, Treasury, and I wrestled with many competing concerns and points of view, both within and without the IRS. Ultimately, we agreed to focus on provisions designed to ensure that taxpayers gave *informed* consent – that is, they are clearly informed about what they are being asked to agree to, including the scope, term, and limitations of that agreement. These provisions are very specific, as I described in my testimony before the Senate Finance Committee in April 2006.

The proposed regulations and a related draft revenue procedure provide significantly greater protections for taxpayers than do the existing regulations. These safeguards are specifically designed to ensure that taxpayers are fully informed about the consequences of consent and to limit the open-ended nature of the current structure. Some of these safeguards are:

- Definitions of the terms “use” and “disclosure.”
- A template for the consent language and a requirement that that language must be prominently displayed.
- Required language, in specified type size, warning the taxpayer that any information disclosed to a third party may be re-disclosed to any other party, without limit.
- Required language notifying the taxpayer of his or her right to register a complaint about violations of these regulations with the Treasury Inspector

General for Tax Administration or the Taxpayer Advocate Service, depending on the nature of the problem.

- Requirements on the placement of these warnings (i.e., they may not be buried in a privacy statement or a licensing agreement but must be prominently displayed).
- A requirement that the preparer must obtain the taxpayer's consent for each proposed use or disclosure.
- A limit on the period of time – one year – during which the tax return preparer may use or disclose the information.
- A clearer definition of what constitutes information covered by IRC § 7216. Some have argued that information entered on a client intake sheet or tax software initial information screen is not covered by IRC § 7216. If such information is not under the protection of IRC § 7216, the tax return preparer may use or disclose it in any manner he chooses, without taxpayer consent and without even notifying the taxpayer. The proposed regulations clarify that client intake or registration information is covered by the regulations' restrictions on disclosure and use.
- Where applicable, a requirement that the tax return preparer disclose to the taxpayer the fact that the tax return preparer intends to use offshore tax preparers to prepare the taxpayer's return, and a requirement that the preparer obtain the taxpayer's written consent to using the offshore tax return preparers.
- A requirement that the tax return preparer cannot require the taxpayer to consent to a use or disclosure of taxpayer information as a condition for preparing the tax return.

As the foregoing list demonstrates, the proposed regulations would add significant new taxpayer protections. However, we cannot just stop with the regulations. I do not agree, as some commentators have alleged, that the absence of complaints under the existing regulations indicates there is no real problem with exploitation of taxpayers. First, some taxpayers are not financially sophisticated enough to understand the products that preparers are trying to sell them. Second, taxpayers who do understand are not likely to take the time to lodge formal complaints. Third, the current regulations do not indicate specifically to whom complaints should be addressed.

While the proposed regulations would constitute a significant improvement over the existing regulations, I believe Congress should amend § 7216 of the Code to provide that taxpayer consent to the “use” or “disclosure” of tax preparation information should be limited to those instances where it is necessary for tax-related purposes. I believe the regulations should define what purposes are “tax-related.” I do not believe that releasing tax return information for purposes of obtaining a Refund Anticipation Loan – or RAL – is “tax-related.” I do not believe that releasing tax return information to a bank – whether affiliated or unaffiliated with the preparer – in order to obtain an IRA or other retirement account is “tax-related.” In the first instance, the government – as part of its social contract with the taxpayer – should provide a method for taxpayers, including the unbanked, to receive the refund of their hard-earned dollars quickly and without charge. In the second instance, the taxpayer should provide his own tax information to the financial institution. Any inconvenience would be minor compared to the risk to the tax system of widespread use and disclosure.

Question 13: Do you think it is appropriate for tax return information to be used for non-tax purposes?

Response:

As stated above, I believe that IRC § 7216 should only permit use or disclosure for tax-related purposes. The regulations under IRC § 7216 could define what purposes are “tax-related.” I believe that releasing tax return information to a bank – whether affiliated with the preparer or not – for purposes of obtaining a Refund Anticipation Loan (RAL), IRA or other retirement account is not “tax-related.” If the preparer believes that the taxpayer would benefit from a bank product, the preparer could inform the taxpayer in a general sense and the taxpayer could independently provide his own tax information to the financial institution.

Further, I strongly support an exception in the existing regulations that allows return preparers engaged in the practice of law or accountancy to use the tax return information of the taxpayer, or disclose the information to other persons in the same firm, to render other legal or accounting services to or for the benefit of the taxpayer. For example, an attorney who prepares a tax return may use the information or share it with another attorney in the firm for the purpose of preparing estate planning documents for the taxpayer.⁴⁸

⁴⁸ See Treas. Reg. § 301.7216-2(e); Prop. Treas. Reg. § 301.7216-2(h).

Question 14: What problems have you encountered as the Taxpayer Advocate as a result of tax return information being used this way?

Response:

I periodically receive complaints directly from taxpayers, but more often, I hear complaints from leaders of organizations that assist low income taxpayers that taxpayers take out RALs – and pay the high fees associated with them – without understanding the nature of the product or the amount of the fees. In particular, some taxpayers do not understand that the product is a loan and not an arrangement with the IRS.

Additionally, due to the lack of informed consent requirements under the current IRC § 7216 regulations, taxpayers may not know that their confidential tax return information is used or disclosed improperly. To make matters worse, taxpayers do not know to whom they should direct complaints, because the current regulations do not provide contact information to taxpayers who have concerns regarding the use or disclosure of information. The proposed regulations will address these issues by requiring informed consent as well as by mandating that all consent forms include language detailing contact information for taxpayers to direct their complaints about inappropriate use or disclosures to the Treasury Inspector General for Tax Administration (TIGTA). The mandatory language also informs taxpayers to contact the Taxpayer Advocate Service with any questions or concerns about the taxpayers' rights regarding the use or disclosure of tax return information.

Question 15: Ms. Olson, do the GAO findings mirror what comes across your desk as the National Taxpayer Advocate?

Response:

Because I have publicly advocated for the creation of a system for the IRS to regulate unenrolled preparers for several years, I have received many letters on the subject, almost all in support of my proposal. In addition, individuals have submitted eight sets of comments on this subject via TAS's Systemic Advocacy Management System (SAMS). Some of the reported problems involve overstated expenses and inflated refunds. However, more alarming problems are also reported, such as identity theft by preparers and preparers pocketing refunds.

Responses to Questions from Senator Kerry:

Question 1: During the hearing you discussed the proposed regulations that would update the disclosure and use of tax returns by tax preparers. Do you think there are specific situations beyond tax preparation in which a tax preparer should be able to disclose taxpayer information with consent?

Response:

As stated above, I believe that IRC § 7216 should only permit use or disclosure for tax-related purposes. The regulations under IRC § 7216 should define what purposes are “tax-related.” I firmly believe that releasing tax return information to a bank, whether affiliated with the preparer or not, for purposes of obtaining a Refund Anticipation Loan (RAL) is not “tax-related.” If the preparer truly believes that the taxpayer would benefit from a bank product, the preparer could inform the taxpayer in a general sense and the taxpayer could independently provide his own tax information to the financial institution.

Further, I strongly support an exception in the existing regulations that allows return preparers engaged in the practice of law or accountancy to use the tax return information of the taxpayer, or disclose the information to other persons in the same firm, to render other legal or accounting services to or for the benefit of the taxpayer. For example, an attorney who prepares a tax return may use the information or share it with another attorney in the firm for the purpose of preparing estate planning documents for the taxpayer.⁴⁹

Question 2: Do you think Code Section 7216 needs to be updated? If so, do you have recommendations on how this section should be changed?

Response:

In accordance with what I stated above, Congress needs to revise IRC § 7216 to permit the use or disclosure of tax return information only for “tax-related purposes.” Whether the third party is affiliated with the preparer should be irrelevant. The statute should direct the Treasury Department to clearly define the term “tax-related purpose” in regulations. However, Congress should make clear that it expects Treasury to define “tax-related purpose” to exclude the marketing of such bank products as refund anticipation loans (RALs), IRAs and other retirement accounts.

⁴⁹ See Treas. Reg. § 301.7216-2(e); Prop. Treas. Reg. § 301.7216-2(h).

Responses to Questions from Senator Schumer:

Question 1: Given the rise of identity theft in the information age, how can we design consent procedures that would protect consumers?

Response:

The proposed regulations and draft revenue procedure under IRC § 7216 were drafted to ensure that taxpayers give informed consent – that is, they are clearly informed about what they are being asked to agree to, including the scope, term, and limitations of that agreement. These provisions are very specific and provide significantly greater protections for the taxpayer than exist today. These safeguards are specifically designed to ensure that taxpayers are fully informed about the consequences of consent and to limit the open-ended nature of the current structure. Some of these safeguards are:

- Definitions of the terms “use” and “disclosure.”
- A template for the consent language and a requirement that that language be prominently displayed.
- Required language, in specified type size, warning the taxpayer that any information disclosed to a third party may be re-disclosed to any other party, without limit.
- Required language notifying the taxpayer of his or her right to register a complaint about violations of these regulations with the Treasury Inspector General for Tax Administration or the Taxpayer Advocate Service, depending on the nature of the problem.
- Requirements regarding the placement of these warnings (i.e., they may not be buried in a privacy statement or a licensing agreement but must be prominently displayed).
- A requirement that the preparer must obtain the taxpayer’s consent for each proposed use or disclosure.
- A limit on the period of time – one year – during which the tax return preparer may use or disclose the information.
- A clearer definition of what constitutes information covered by IRC § 7216. Some have argued that information entered on a client intake sheet or tax

software initial information screen is not covered by IRC § 7216. If such information is not under the protection of IRC § 7216, the tax return preparer may use or disclose it in any manner he chooses, without taxpayer consent and without even notifying the taxpayer. The proposed regulations clarify that client intake or registration information is covered by the regulations' restrictions on disclosure and use.

- Where applicable, a requirement that the tax return preparer disclose to the taxpayer the fact that the tax return preparer intends to use off-shore tax preparers to prepare the taxpayer's return, and a requirement that the preparer obtain the taxpayer's written consent to using the off-shore tax return preparers.
- A requirement that the tax return preparer cannot require the taxpayer to consent to a use or disclosure of taxpayer information as a condition for preparing the tax return.

As the foregoing list demonstrates, the proposed regulations would add significant new taxpayer protections. I want to emphasize that by virtually any standard, the proposed regulations provide far more protection than the existing regulations. It would be extremely unfortunate if concerns that the proposed regulations do not go far enough create an obstacle, because the existing regulations are clearly inadequate.

In my view, however, it would be entirely appropriate for Congress to revise the statutory language to ensure that the confidentiality of tax return information is given high priority.

IRC § 7216 should provide that taxpayer consent to use or disclosure of tax preparation information is limited to only those instances where it is necessary for tax-related purposes. The regulations should define what purposes are "tax-related." The marketing of bank products, such as RALs, should not be considered "tax related." If the preparer believes the taxpayer would benefit from a product, the preparer could so advise the taxpayer and the taxpayer could independently disclose the information to a bank of the taxpayer's choice. Any inconvenience to the taxpayer would be minor compared to the risk to the tax system of widespread use and disclosure.

Further, I strongly support an exception in the existing regulations that allows return preparers engaged in the practice of law or accountancy to use the tax return information of the taxpayer, or disclose the information to other persons in the same firm, to render other legal or accounting services to or for the benefit of

the taxpayer. For example, an attorney who prepares a tax return may use the information or share it with another attorney in the firm for the purpose of preparing estate planning documents for the taxpayer.⁵⁰

Finally, I believe that the IRS needs to have sufficient resources to conduct proper oversight of the requirements under IRC § 7216. The statutory provisions as well as the requirements detailed in the regulations are meaningless unless they are adequately enforced.

Question 2: And when it comes to sharing personal information, shouldn't affiliates and non-affiliates be treated the same? As long as we are rewriting some of the rules, shouldn't we be equally careful about affiliated businesses?

Response:

The regulations under IRC § 7216 should not distinguish between businesses affiliated with the preparer and those that are non-affiliated. Current Treasury Regulation § 301.7216-3 provides that a preparer can use tax return information to solicit the business of a member of the preparer's affiliated group. This means that the preparer can only offer the products of an affiliate. Perhaps this rule was designed to prevent widespread dissemination of tax return information, but it is my understanding that if a taxpayer consents to the use and subsequent disclosure of tax return information to an affiliate, IRC § 7216 does not prohibit the affiliate from re-disclosing the information to unrelated 3rd parties. Thus, the affiliated-group restriction appears to do little to protect the confidentiality of tax return information.

I hope you find these responses useful. If you have further questions, please feel free to contact my office at (202) 622-6100. Thank you.

Sincerely,



Nina E. Olson
National Taxpayer Advocate

⁵⁰ See Treas. Reg. § 301.7216-2(e); Prop. Treas. Reg. § 301.7216-2(h).

**SENATOR CHARLES E. SCHUMER
STATEMENT**

**FINANCE COMMITTEE HEARING ON TAX RETURN PREPARATION AND
COMPLIANCE COSTS**

APRIL 4, 2006

Thank you, Mr. Chairman. There have been a number of tax preparation issues in the news in recent weeks, from continuing problems with refund anticipation loans to the rising compliance costs of our tax system, and from rising user fees at the IRS to the questionable qualifications of certain paid tax preparers. All of these issues are important. With Tax Day less than two weeks away, there could not be a better time for this hearing.

I want to spend my limited time this morning on one particular issue – easily one of the dumbest ideas that the federal government has put out in a long time.

Over the past week or so, a new proposed IRS rule has come to light that would allow paid tax preparers to solicit consent and then disclose taxpayer's sensitive financial information to non-affiliated outside businesses, such as data brokers, marketing companies, and financial institutions.

Tax preparation firms can already sell – with written consent from the taxpayer – information from an individual's return to affiliated businesses, meaning a business owned by the same company as the tax preparers. Honestly, even this troubles me a little bit. But the new IRS proposal goes much further by dropping the affiliation requirement, enabling the tax preparer to market the information to third parties.

As one of the first Senators to introduce comprehensive identity theft legislation in this Congress, I am deeply troubled that the IRS wants to make it easier for tax preparers to sell or disclose the most sensitive personally identifiable information – such as income, social security number, residence, employer, number and age of children, preferred charities – to non-affiliated third parties.

Identity theft is a crime that steals people's money, time, and peace of mind. Every week we hear another story about millions of identities that were either lost or breached at a bank, financial institution, or personal information vendor. The

Federal Trade Commission now estimates almost ten million people a year are victims of some sort of identity theft.

At a time when data security breaches are becoming an everyday occurrence, and public concern about privacy and identity theft is at an all-time high, the federal government should be doing everything it can to safeguard Americans' sensitive information, rather than weakening the laws that protect it. I am concerned that the average taxpayer who is asked to sign a consent form at the end of a long process, while rushing to file a return, may not realize to what he or she is consenting, or be aware of all the risks involved.

Our concerns here are real, and not issues that should be swept under the rug. The scale and frequency of recent privacy breaches underscore the need for greater protections, not weaker ones. The new rule would put the identities, and potentially even the safety, of all taxpaying Americans at greater risk.

Yesterday, I sent a letter to IRS Commissioner Everson on this topic, asking him to scrap the rule change, and I ask consent for that letter to be inserted into the record of this hearing.

I am also pleased to join Senator Thomas on a bipartisan Finance Committee bill, S. 2498, that would prevent paid tax preparers from seeking consent from their clients to sell their personal information to third parties. I understand that the Chairman is also looking at the bill and may be supportive. I hope that the Committee can pass a bipartisan measure in the near future to address this very important issue.

I have discussed with Senator Thomas certain concerns that I have, in terms of developing standard procedures for consent and disclosure in all cases, and for requiring that the taxpayers initiate the consent process even in the case of affiliated businesses. He has promised to work with me on these issues.

CHARLES E. SCHUMER
NEW YORK

COMMITTEES:
BANKING
FINANCE
JUDICIARY
RULES

United States Senate

WASHINGTON, DC 20510

April 3, 2006

The Honorable Mark W. Everson
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Room 3116
Washington, DC 20224

Dear Commissioner Everson:


As one of the first Senators to introduce comprehensive identity theft and data privacy legislation in this Congress, I am deeply troubled that the IRS is proposing a rule that would allow preparers of tax returns to sell or disclose taxpayers' most sensitive personally identifiable information to data brokers and other third parties. At a time when data security breaches are becoming an everyday occurrence, and public concern about privacy and identity theft is at an all-time high, the federal government should be doing everything it can to safeguard Americans' sensitive information rather than weakening the laws that protect it.

The proposed rule would allow tax preparers to solicit a client's consent to share or sell sensitive information contained in the client's return – such as income, social security number, residence, employer, number and age of children, preferred charities, etc. – to unaffiliated third parties. However, I am concerned that the average taxpayer who is asked to sign a consent form at the end of a long process while rushing to file a return may not realize to what he or she is consenting, or be aware of all the risks involved.

For example, under the proposed rule, a commercial tax preparation service could sell its customers' most sensitive information to a data broker or financial institution, which in turn could sell the information to other companies for marketing purposes or, even worse, to criminals posing as legitimate businesses. Taxpayers' personal information could also be sold to companies that have a record of losing their data, or that have proven vulnerable to fraud and computer hacking. Scenarios such as these are not hypothetical, but real-life examples of security breaches that have occurred within the last year. The scale and frequency of such breaches underscore the need for greater privacy protections, not weaker ones, as the IRS now proposes. By allowing tax preparers to disclose their clients' most sensitive personal information to data brokers and other companies, the IRS is putting the identities, and potentially even the safety, of all taxpaying Americans at greater risk.

PLEASE RESPOND TO THE FOLLOWING OFFICE:

<input type="checkbox"/> ALBANY: LEO O'BRIEN BUILDING ROOM 400 ALBANY, NY 12242 (518) 431-4070	<input type="checkbox"/> BINGHAMTON: FEDERAL OFFICE BUILDING 15 HENRY STREET ROOM 801 BINGHAMTON, NY 13901 (607) 732-8109	<input type="checkbox"/> BUFFALO: 111 WEST HUPPEN ROOM 620 BUFFALO, NY 14202 (716) 846-4111	<input type="checkbox"/> HUDSON VALLEY: P.O. BOX A 125 HICKS, NY 12571 (518) 285-8941 (845) 569-0923	<input type="checkbox"/> LONG ISLAND: TWO GALEWAY PLAZA 145 PALM LAUN ROAD ROOM 3024 MELVILLE, NY 11747 (631) 763-0878	<input type="checkbox"/> NEW YORK CITY: 757 THIRD AVENUE SUITE 1702 NEW YORK, NY 10017 (212) 486-4430 TDD: (212) 486-7621	<input type="checkbox"/> ROCHESTER: KARLISCH B. KEATING BUILDING 123 STATE STREET ROOM 5030 ROCHESTER, NY 14614 (585) 263-5866	<input type="checkbox"/> SYRACUSE: 100 SOUTH OLSON ROOM 804 SYRACUSE, NY 13201 (315) 423-5471	<input type="checkbox"/> WASHINGTON: 313 HART SENATE OFFICE BUILDING WASHINGTON, DC 20510 (202) 224-6522 TDD: (202) 224-4420
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 <http://schumer.senate.gov>

CHARLES E. SCHUMER
NEW YORK

COMMITTEES:
BANKING
FINANCE
JUDICIARY
RULES

United States Senate

WASHINGTON, DC 20510

I am even more troubled that the IRS seems to have misled the public about the risks involved with its proposed rule. The press release sent out the day before publication of the official rulemaking notice headlined, "IRS Issues Proposed Regulations to Safeguard Taxpayer Information," and it characterized the proposed rule as "not a significant regulatory action." Clearly, a rule allowing tax preparers to sell their clients' information does not *safeguard* taxpayer information; nor is it insignificant. Given growing public concerns about privacy and identity theft, I am confident that the taxpayers in my State and across the nation would agree.


While I am pleased by some of the changes proposed by the IRS, such as a greater restriction on the ability of tax preparers to outsource their work, I strongly discourage you from adopting a rule that would allow tax preparers to solicit their clients' consent to disclose their most sensitive personal information to non-affiliated third parties. I understand that privacy advocates and experts are planning to testify at the IRS's hearing on April 4, 2006, and I sincerely hope that their voices will not fall on deaf ears.

Sincerely,

Charles E. Schumer
Senator Charles E. Schumer

PLEASE RESPOND TO THE FOLLOWING OFFICE:

<input type="checkbox"/> ALBANY: LEO O'BRIEN BUILDING ALBANY, NY 12227 (518) 431-4070	<input type="checkbox"/> BINGHAMTON: FEDERAL OFFICE BUILDING ROOM 86 BINGHAMTON, NY 13901 (607) 722-8189	<input type="checkbox"/> BUFFALO: 111 WEST HURON BUFFALO, NY 14202 (716) 846-2111	<input type="checkbox"/> HURON VALLEY: P.O. BOX A MILWAUKEE, NY 11747 (845) 559-0923	<input type="checkbox"/> LONG ISLAND: TWO GREENWAY PLAZA ROOM 2026 MELVILLE, NY 11747 (631) 753-0978	<input type="checkbox"/> NEW YORK CITY: 757 THIRD AVENUE FOURTH FLOOR NEW YORK, NY 10017 (212) 456-4420 TDD: (212) 486-7661	<input type="checkbox"/> ROCHESTER: KENNETH B. KEATING BUILDING 100 ALBANY STREET ROOM 3040 ROCHESTER, NY 14614 (585) 253-5866	<input type="checkbox"/> SYRACUSE: 100 SOUTH CORTLAND ALBANY 04 SYRACUSE, NY 13201 (315) 422-5471	<input type="checkbox"/> WASHINGTON: 313 HART SENATE OFFICE BUILDING WASHINGTON, DC 20510 (202) 224-6542 TDD: (202) 224-6420
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**Statement of Senator Gordon H. Smith
U.S. Senate Committee on Finance Hearing
“Preparing Your Taxes: How Costly Is It?”
April 4, 2006**

Thank you Chairman Grassley and Senator Baucus for holding this very important hearing.

Every year Americans go through the annual ritual of filing their tax returns with the IRS. I’m sure there are very few of us who look forward to this process each year. Not only can it be time consuming and confusing, we also are providing the government with large portions of our hard earned income. Therefore, it is our government’s responsibility to make this process as easy as possible for our citizens.

Unfortunately, tax return season reminds us that our tax code is unnecessarily complex. There are very few of us who can actually prepare our tax returns on our own without professional help. In fact, over half of all taxpayers use a paid tax return preparer to assist them with their individual tax returns. This is true for all income levels. Although those earning more than \$100,000 were the most likely to use a paid preparer, 53 percent of taxpayers with income of less than \$20,000 used a paid preparer in 2002.

Many people use paid tax return preparers. In 2002, taxpayers who used a paid preparer received significantly higher tax refunds than those who prepared their returns on their own. The median 2002 tax refund for those who prepared their taxes on their own was \$674 – versus \$1,118 for those who used a paid preparer. Again this demonstrates how complicated the tax rules are. In order to determine all of the deductions and credits that apply to us, we need professional help.

The bottom line is we need to simplify our tax rules. If we are going to require our citizens to pay taxes to the government, it is only fair that they understand how the tax rules work. However, under our current rules, I think it’s safe to say that even the most sophisticated tax attorney doesn’t understand all of our tax rules.

However, under our existing code, we need to make it easier and safer for taxpayers to file their tax returns. I am pleased by the strides that the IRS has made in this regard. For example, the IRS has done a great job of encouraging taxpayers to electronically file their tax returns. During the 2005 filing season, over 50 percent of all income tax returns were e-filed. And as of mid-March, the IRS was seeing an over two percent increase in the number of returns filed electronically this year. Taxpayers who e-file generally receive their tax refund in two weeks or less – which is about half the time it takes for the IRS to process a paper return.

The IRS also has done a good job of making their website user friendly. The IRS website contains lots of helpful information and a number of useful tools. For

example, taxpayers can determine whether they qualify for the Earned Income Tax Credit by using the IRS website.

I believe strongly that more needs to be done. Last June, I introduced legislation that would simplify the tax refund process for taxpayers – and also encourage them to increase their retirement savings. Taxpayers today are not permitted to direct all or a portion of their tax refunds to be directly deposited in an IRA – even though Treasury currently has the authority to permit such direct deposits.

For many Americans, tax refunds are the largest non-paycheck payments that they receive. The average individual refund in 2002 was \$2,057 and refunds for that year totaled \$206 billion. Direct payment opportunities will make it easier for Americans to save. And even if Americans saved just a small portion of the \$206 billion, it would make a big difference in increasing our retirement savings. Therefore, my bill would direct the Treasury Secretary to draft rules permitting taxpayers to elect to have all or a portion of their tax refunds paid directly to an IRA.

Thank you.


H&R BLOCK

**STATEMENT OF
ROBERT A. WEINBERGER, VICE PRESIDENT, H&R BLOCK
ON THE COST OF TAX RETURN PREPARATION
SENATE COMMITTEE ON FINANCE
APRIL 4, 2006**

Thank you for the invitation to comment on the tax filing season from the perspective of a participant in the Free File Alliance. My testimony reflects only H&R Block's experience. Free File Alliance management has submitted a separate statement for the record.

The landscape of tax return preparation has evolved in significant ways since enactment of the IRS Restructuring and Reform Act of 1998. Let me highlight three ways it has changed:

Electronic Filing and the Free File Alliance

First, electronic tax preparation and filing have become commonplace.

Over 80% of returns are now prepared on a computer using tax preparation software, and over 50% are now e-filed. Do-it-yourself tax preparation, assisted by software, is growing, up 17% so far this year, for example. But the majority of e-filed returns come from paid and volunteer return preparers. At H&R Block, 95% of tax returns prepared at our offices are e-filed.

While America will fall short of the 80% e-filing goal set by Congress in the 1998 Act, steady progress is being made. We suggest Congress extend the goal to 2011, as the IRS Oversight Board has recommended, to maintain enthusiasm and remind us of the benefits of e-filing.

Filing channels are no longer rigid. At H&R Block, clients can visit one of 12,000 offices; or fill out an organizer worksheet online and submit it to a tax pro; or start online and access a tax professional by phone; or transfer the return to an in-office tax pro for help. Taxpayers can be served conveniently, in blended ways, when and how they choose.

One innovative channel is the Free File Alliance, initiated in 2003 and recently renewed through 2009. It is an agreement between the IRS and the tax software industry to provide free federal income tax preparation and online filing for low- and moderate-income Americans. Since its inception, over 14 million returns, including 3 million so far this year, have been filed. This public-private partnership today involves 20 companies. Taxpayers have saved over \$42 million through this donation of services.

The first Free File agreement built on the tax software industry's voluntary provision of free services. It was intended to broaden eligibility to 60% of taxpayers. The renewed agreement, signed in 2005, expands it to 70% this year, or 93 million tax filers with adjusted gross incomes of \$50,000 or less. The product offered is the same as available commercially, not a stripped down version, and Free File standards exceed government regulatory requirements.

Free File is proving itself a winner for taxpayers, for the IRS, and for tax software providers — an example of cooperation and partnership in the public interest.

Paid Tax Return Preparation and Financial Education

Second, at the same time, Americans are increasingly turning to paid professionals for tax assistance.

About 60% of all taxpayers and about 70% of applicants for the Earned Income Tax Credit use a paid preparer. Their reasons include not only dealing with tax complexity but also convenience and the opportunity to receive financial education and counseling.

There is increasing recognition that tax time is an opportunity for an annual financial check-up. With nearly 80% of taxpayers receiving a refund averaging over \$2,100, there is both a teachable moment and an opportunity to save for a family's key financial goals of college, homeownership and retirement, using tax-advantaged vehicles like the Retirement Saver's Credit.

In addition, we use the opportunity to alert low-income clients to their eligibility for a variety of government benefits that can improve their family's finances, including children's health insurance, food stamps, and prescription drug discounts. Our Free File offering also provides this information.

Fees vary by location and are based on the forms filed and the work done, not on a client's income or the size of his refund. They can be as low as \$24 for the simplest 1040 EZ. This year they average \$154 for a federal, state and any local return at H&R Block offices as of March 15. This compares favorably to fees charged by many competitors.

Better Regulation and Enforcement

Third, the need for meaningful minimum quality standards has grown.

The IRS has said, "The vast majority of return preparers are honest and reputable." We agree. But consumers who pay for help deserve some assurance of competence.

Thirty years ago, Henry Bloch proposed IRS registration of all paid tax preparers. We renew that call today and go further. We believe IRS certification of paid tax return preparers — which would require validation of applicable tax knowledge, criminal and tax-filing background checks, and minimum levels of continuing tax education — would benefit the public.

This could be accomplished through enactment of section 4 of S. 832, cosponsored by Chairman Grassley, Ranking Member Baucus, and other members of the Committee, which would require testing for technical knowledge, competence and ethics, continuing education, and stiffer penalties for misconduct.

We support enactment. Taxpayers deserve the highest standards of competence and integrity from the tax preparation industry, standards we believe we currently meet.

The new program would complement existing regulation. All preparers today are subject to laws covering fraud, negligence, diligence, misrepresentation and unauthorized disclosure, and can be enjoined from misconduct. Practitioners who represent taxpayers before the IRS on post-filing issues — attorneys, CPAs and Enrolled Agents — are regulated by IRS Circular 230. And there are extensive additional rules to cover Electronic Return Originators.

Because 80 million taxpayers pay for help from over a million tax practitioners in a compact 10-week period, effective enforcement requires adequate funding and staffing. We applaud the IRS's recent increase in investigations of return preparers and upgrading the Office of Professional Responsibility. But the overall record in recent years shows room for improvement. We strongly recommend stepped-up IRS enforcement.

Training, Quality Control, Ethics Requirements

Competence depends on training and continuing education, especially given frequent changes in the tax code.

The average H&R Block tax return preparer has over 225 hours of training and nearly half have 5 or more years experience. Our tax professionals, at a minimum, must take our basic 66-hour tax course, with equal amounts of homework, and receive a passing test grade to be eligible for hiring. To be rehired, they must take at least 24 hours of continuing education each year. We offer 59 advanced courses. Our tax professionals are also trained on systems, products, policies and procedures, which require an additional 20-35 hours in class. Over 5,000 are Enrolled Agents or CPAs.

We have a strict "Code of Business Ethics and Conduct," and must meet the due diligence requirements of tax return preparation and privacy standards in IRS rules. Our Electronic Return Originators require IRS approval, which may include FBI background checks, tax compliance verification and credit checks.

Our tax professionals work with a state-of-the-art computer program that checks calculations, theory and accuracy. There are approximately 10,000 diagnostics in our software that warn tax professionals that there may be something to review, error diagnostics that won't let the user file unless they are corrected, and other diagnostics that check all IRS error codes. We also utilize a second review by another professional for many tax returns.

Our professionals have back-up at headquarters: Information Technology, Tax Research and Training groups provide support including on-demand help and customized research of complex tax questions. Our Compliance Department performs field reviews.

With a complex tax code and 16 million returns prepared in our offices by over 100,000 return preparers, occasional errors are possible. However, we believe our error rate at that volume level is small as compared to competitors or other professions. For all clients, we stand behind the quality of our work and guarantee that we will pay any interest or penalties if we make an error on their tax return. And we guarantee client satisfaction.

Our training and culture are clear on one critical point: We play it straight. Our interpretations of the tax code are grounded in solid research. We assist our clients in determining their correct tax liability to pay precisely what they owe, no more and no less.

Mr. Chairman, for over a half-century, H&R Block has built its reputation as the trusted tax advisor to Middle-America, and, more recently, as a tax and financial partner to our clients. Our best practices and code of ethics reflect a longstanding commitment to integrity and professionalism, which we renew today.



H&R BLOCK

tax and financial services
accounting and mortgage services

August 28, 2006

Hon. Charles Grassley, Chairman
Hon. Max Baucus, Ranking Minority Member
United States Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510

Dear Chairman Grassley and Senator Baucus:

This letter is in response to Senator Baucus' questions for the record following my April 4, 2006 testimony at the hearing of the Senate Committee on Finance on "Filing Your Taxes: How Costly Is It?"

In many cases below, I have provided my personal opinions using examples from my employer, H&R Block. While H&R Block is a member of the Free File Alliance, I did not testify as the Alliance's official representative and it is not responsible for my views.

1. *Do taxpayers have a right to file tax returns for free, whether they are paper or electronic?*

- I'm not aware of any right to file returns free, at least as defined in law, but most U.S. taxpayers can file their returns free or at minimal cost today.
- At H&R Block, for example, about 98% of our 2006 clients were eligible for free e-filing: taxpayers did not pay an extra fee for e-filing at our 12,000 retail tax offices, via H&R Block TaxCut® online, or for almost 80% of first users of our boxed or downloaded TaxCut® software (users in the last category may pay an e-filing fee initially but are eligible for a rebate).
- Federal tax return preparation and filing is also free for 70% of tax filers (93 million) via the Free File Alliance, through www.irs.gov. Entirely free Federal tax return preparation and filing appears available to all taxpayers outside the Free File Program at one or more Web sites, for example <http://www.taxact.com/>. While some tax preparation or tax software firms may charge a fee for e-filing, the service is readily available free via other providers.
- In contrast, the U.S. Postal Service enables filing of paper returns but postage payment is required. The service it provides that is equivalent to e-filing—with acknowledgement of return receipt and speedy delivery—is \$14.40 (overnight delivery). Alternatively, certified mail with return receipt requested (or electronic confirmation), as frequently recommended by accounting firms, costs \$4.59 in addition to basic postage. During the tax filing season, the Postal Service maintains a special Web page showing prices for tax filing options at <http://www.usps.com/tax/sending.htm>. (It is disabled after the tax season has ended.) Examples follow:

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Treasury Department have publicly opposed government-developed or government-provided tax software for tax preparation. It has been government policy through the last 10 presidents to have the government perform limited functions and not compete with its citizens in commercial enterprises. See OMB Circular A-76 and the discussion in Stiglitz, Orszag and Orszag, *The Role of Government in a Digital Age* at http://www.cciinet.org/filings/govtcomp/govtcomp_report.pdf. Moreover, some have argued that there is a basic conflict of interest if the government is the return preparer as well as the tax auditor, rules interpreter, enforcer, and tax collector.

4. *Free File doesn't seem to be doing a good job of serving the purposes for which it was designed. At its peak in 2005, only 5 million taxpayers out of 133 million used it. What do you think should be done to make it easier for taxpayers who want to prepare and file their returns on their own for free to be able to do so?*
- I believe Free File is doing a good job in serving the purpose for which it was designed. A July 2006 IRS survey of 1,800 Free File users found that 94% intend to use it next year and 97% would recommend it to others, consistent with the 98% “very/somewhat” satisfied rating in IRS’s 2006 e-file Customer Satisfaction Study. Nonetheless, the program can do a better job and improvements are being made.
 - The number of taxpayers who use the system reflects several possible factors, including: (1) satisfaction with and loyalty to existing filing channels; (2) limited awareness of the Free File program because of its newness and limited IRS promotion and advertising of it; (3) a gradual ramp-up over time as less technologically sophisticated taxpayers phase out; and (4) distrust of government-sponsored approaches (even with private-sector involvement). By comparison, in the 21 states that offered state-sponsored tax preparation and Internet filing from their Websites in 2005, fewer than 2 million taxpayers participated. Thus, even with far simpler state tax returns filed directly through state-run programs, utilization by taxpayers is at best modest. As the IRS’s former head of Electronic Tax Administration has said:

“Utilization rate on the state Internet offerings is low and in Australia, which has had a free Internet product for a number of years, only 3 percent of their taxpayers use it and over 70 percent still go to a tax professional even though their tax code is simpler. The examples of wide-spread utilization of a basic government Internet tax product has been impossible to find. This may change over time but it is something we consider in determining what investments to make, considering the many IT needs we have in striving to improve overall service to the public.” *Washington Post* online interview with Terry Lutes, Feb. 19, 2002 at http://www.washingtonpost.com/wp-srv/washtech/transcripts/archive_lutes_021902.htm
 - The self-preparation and filing process has been dramatically eased by tax preparation software, which is available free online for most taxpayers and at relatively low cost for others. A tax credit for e-filing to make the process entirely free would help, although a time investment is still required. The IRS could also ease tax preparation and e-filing by making the use of PIN number validations simpler, clarifying what may be included in notes, and making attachments possible to e-file. The tax preparation industry and the IRS Electronic Tax Administration Advisory Committee have made numerous suggestions.
5. *Would it be a good idea to open up Free File to everyone until IRS has its own system in place?*
- No. Free File was never intended to cover all taxpayers. The initial goal was 60% eligibility, an improvement over the 50% already provided free by firms in the tax software industry prior to the inception of the IRS Free File Program. It was properly

would need to modernize the whole system before the start, which would cost \$80+ million. To that would be added the administrative costs of supporting a portal, including fielding many calls – potentially millions – on help desks that private industry is handling today and helping to perfect rejected returns for acceptance. As of August 17, 2006, for example, 8.2 million of the 80 million e-filed returns transmitted this year were rejected. The IRS has over 600 reject codes.

- An important distinction should be made between a direct e-filing system and IRS developing its own tax preparation software—preparation and filing are separate issues. Treasury Secretary Snow and IRS officials have testified to Congress that preparing tax returns is not an appropriate government function. (See *BNA Daily Tax Report*, “Snow Vows Government Has No Intention Of Offering Direct Online Tax Filing Service,” April 6, 2006, at G1.) Beyond a portal, a system with IRS tax preparation software is also very costly to develop and run, in part because of customer service calls.
- As the IRS states about Free File [http://www.irs.gov/efile/article/0_id=118993.00.html]:
“Why is the government doing this through a partnership with private industry rather than providing its own software free to the public?”
 “The government believes private industry, given its established expertise and experience in the field of electronic tax preparation, has a proven track record in providing the best technology and services available. Additionally, Treasury has indicated it does not want the IRS to enter into the tax software business. The Government believes a partnership with private industry will: provide taxpayers with higher quality services by using the existing expertise of the private sector; maximize consumer choice; promote competition within the marketplace; and meet objectives in the least costly manner to taxpayers.”
- If a tax preparation software program is implemented, outsourcing is probably preferable, although either the IRS’s own development or outsourcing the software could be problematic given the IRS’s track record in computer modernization, customer service, and contract management, as well documented by many GAO and TIGTA reports. Recent reports confirm that the IRS is challenged in the development and modernization of its own technology, its security procedures, and its administration of contracts for outsourced systems modernization. See, e.g., Treasury Inspector General for Tax Administration, *Annual Assessment of the Business Systems Modernization Program, 2006-20-102* (June 2006) at <http://www.treas.gov/tigta/auditreports/2006reports/200620102fr.pdf>, finding that, despite improvements, systems modernization was a continuing “material weakness” for the IRS, including cost overruns, deployment delays, and problems in managing contractor performance and accountability, and Senator Baucus’ concerns about IRS information security technology problems at <http://finance.senate.gov/press/Bpress/2005press/prb072606.pdf>. Senators Grassley and Baucus have also expressed concern about the failure of the IRS to adequately monitor outside contractors developing the Electronic Fraud Detection System, resulting in a loss of \$300 million, <http://www.senate.gov/~finance/press/Bpress/2005press/prb071306.pdf> and <http://www.senate.gov/~finance/press/Gpress/2005/prg071406c.pdf>. Two recent examples of the dangers of outsourcing to private contractors are those of Mellon Bank’s mishandling of tax returns and payments, and the embarrassing security breach at the Education Department’s student loan application Website enabling some applicants to see financial data and personal information of borrowers. “Taxpayer Privacy: NTEU President Kelley Says Mellon Deal Highlights Risk of Private Sector Involvement,” *BNA Daily Tax Report*, Aug. 23, 2006, p. G5, at <http://pubs.bna.com/ip/BNADTR.NSF/4bdb7473996f34e385256b57005ad41a/7f181f6f2163ede3852571d3000395ac?OpenDocument>, and Hope Yen, “Ed. Dept. Offers Free

Credit Monitoring," Associated Press, Aug. 23, 2006, at <http://www.guardian.co.uk/us/latest/story/0,,-6033758,00.html>.

- An earlier IRS direct e-file portal effort, Cyberfile, failed badly in 1996 at a cost of \$17 million before even becoming operational. As former IRS Commissioner Rossotti has written, Cyberfile "was plagued by mismanagement, shoddy contracting practices, and numerous security problems.... 'It's an absolute fiasco!' shouted Senator Stevens, after learning that the IRS violated a host of Federal laws and regulations." Charles O. Rossotti, *Many Unhappy Returns: One Man's Quest to Turn Around the Most Unpopular Organization in America* (2005), p. 18. See also General Accounting Office, *Tax Systems Modernization: Cyberfile Project Was Poorly Planned & Managed* (August 1996) at <http://www.unclefed.com/GAOREports/aimd96-140.pdf>.
 - Other technology projects deserve higher priority and, given fiscal pressures, Congress may not be able to fund tax preparation software while fully funding other modernization projects. Implementation of CADE, for example, which could cut refund delivery times to 4-5 days would be a terrific benefit to taxpayers and help reduce the need for refund anticipation loans, but the project is behind schedule with systems modernization funding slowed.
8. ***Please comment on the pros and cons of an IRS mandate that individual taxpayers must file their tax returns electronically. Include in your comments consideration of whether a mandate would apply to all individuals, or certain types of taxpayers.***
- We have suggested a Federal e-file mandate, as has the IRS's Electronic Tax Administration Advisory Committee, but many believe it would be unpopular and the IRS has not recommended it for individual taxpayers.
 - Recent gains in e-filing have largely been fueled by e-filing mandates on tax return preparers in 15 states, as the IRS and ETAAC have reported. Mandates are usually imposed on paid professionals who prepare 100 or more returns, rather than on small firms or taxpayers themselves. To be most effective, mandates should also reach smaller firms and CPAs who have been less aggressive in adopting e-filing. National tax return preparation firms already e-file most of their returns—H&R Block, for example, e-files 93% of the returns it prepares at retail offices. Allowances should be made for taxpayers who feel a need to opt out—for example, some taxpayers may be uncomfortable with e-filing. Return preparers should not be penalized when a recalcitrant client is fearful or unconvinced of the benefits. Exceptions may also be needed for more complex returns that sometimes cannot be e-filed.
9. ***What can Congress do to remedy the problems highlighted at the hearing?***
- With respect to the Free File Alliance, a self-regulatory approach, in consultation with the IRS, should be a first choice and sufficient to address any problems without Congressional action. Some of the problems described may not have been fairly or accurately portrayed, though the Alliance can still be improved.
 - With respect to tax preparer competence, to improve the quality of tax return preparation, we support enactment of Federal testing and certification of tax return preparers with continuing education and ethics requirements, as provided in S.832.
10. ***What can Treasury and the IRS do to remedy the problems highlighted at the hearing?***
- Treasury and IRS can lift their opposition to preparer testing and certification and improve guidance on new tax provisions to improve accuracy and compliance.
 - The IRS can increase enforcement efforts through its supervision of Circular 230 practitioners and Electronic Return Originators and through increased visits to tax preparation offices.

- The IRS can also work through tax professional groups and national firms to strengthen best practices, training and continuing education, and sponsor more programs like the summer tax forums or their online equivalent with seminars on tax law, compliance and ethics.

11. *What can the preparer and software communities do to remedy these problems?*

- Over the last 50 years, H&R Block has addressed many of the issues of integrity and competence raised at the hearing, and our processes and best practices may be helpful examples of self-regulation. H&R Block's tax return preparers must pass a competency test and comply with the company's *Code of Business Ethics & Conduct*. We have an extensive education and training program for return preparers, as described in my testimony. Preparers undergo added annual training related to tax, program and company policy changes. They also must meet company operations protocols and best practices requirements, as well as records management and privacy rules. We engage in an annual compliance review of product and services delivery, and documentation and security practices; investigate and resolve any local performance integrity issues; and periodically test adherence to standards—most recently, for example, on the Uniform Definition of a Child.
- We have also sponsored some roundtables with academics, nonprofit groups, and government officials to discuss tax administration and compliance issues, for example involving the EITC and pre-certification. Meetings, conferences and seminars like this could be expanded. But testing and certification are most important.

12. *The GAO investigation revealed that many of the returns prepared by tax preparation firms are not correct. Investigators thought some preparers lacked basic tax law skills. They also observed that the preparers failed to ask necessary questions to make sure all income was being reported or that earned income credit was accurate.*

a. *Describe the oversight of preparers.*

b. *How often is their work reviewed?*

c. *What is done with preparers who consistently make mistakes?*

- **Oversight.** Beyond training and testing preparers, they are subject to in-office supervision and evaluations. They work with tax preparation software that includes diagnostics that can catch errors or alert them to results that are atypical. Additionally, we monitor tax return characteristics on a per-tax-professional basis to obtain any early warning signs that may suggest that certain tax professionals should be investigated further.
- **Frequency.** Reviews are periodic, depending on the office, the time of year, and the experience of the return preparer. Overall evaluations are annual.
- **Discipline.** In those few cases, the district manager holds coaching sessions with the tax professional and the tax professional is required to retake relevant training. In accordance with our employment policies, tax professionals may be dismissed for poor performance or unethical behavior. If behavior is discovered after the conclusion of the tax season that would warrant dismissal, the associate would then be designated as not being eligible for re-hire.

13. *How can you improve quality control so firms or groups like yours are not contributing to our \$350 billion annual tax gap?*

- We are implementing an expanded quality assurance program with increased field audits. In addition, H&R Block tax professionals are trained to do thorough interviews, and our internal tax preparation system is programmed to provide quality assurance by checking for missing data and possible errors. Our "Quality Plus

Review” program ensures that more complex returns are reviewed by another tax professional. Additionally, our Compliance Department has undertaken a performance integrity program to help us deliver consistency, quality, accuracy and value to our clients and compliant returns to the IRS. (Please see the separate H&R Block Response to questions sent to the company for details of the performance integrity program.) We will continue to emphasize quality and accuracy and hope that the adoption of a national certification program would cause other firms to follow our lead.

14. ***Please provide examples of training materials used to instruct new employees or members.***
 - Training materials include our income tax courses and seminars, tax updates, and office procedures. We are providing more details in connection with our answer to separate questions sent to H&R Block by the Committee, and can provide fuller information under a confidentiality agreement needed because of the proprietary nature of our training materials and their competitive value.
15. ***Please provide informational literature provided to prospective or new employees or members that describes the criteria they must meet in order to be hired, remain employed or become a member.***
 - We are providing more details in connection with our answer to separate questions sent to H&R Block by the Committee (the H&R Block Response).
16. ***How many years of tax preparation experience does an average tax preparer or member have?***
 - The average H&R Block tax professional has more than 225 hours of tax training and nearly half of H&R Block tax professionals have 5 or more years' experience.
17. ***What percentage of your preparers/members are attorneys, CPAs or enrolled agents or none of the above (specify by category)?***
 - H&R Block employs over 5,000 CPAs and Enrolled Agents and the remainder of its tax professionals have passed a 3-hour test with a score of 80% or better following a basic 66-hour classroom tax course, which requires an equal amount of homework. All returning Block preparers must complete at least 24-hours of continuing tax education, choosing from over 50 advanced H&R Block courses or their equivalent elsewhere.
18. ***Are preparers at the tax preparation chains considered to be employees? How are they paid, e.g., by the hour, number of returns prepared, fees generated, etc.?***
 - H&R Block's tax professionals are employees. Generally, tax professionals are paid an hourly wage that constitutes a draw against a bonus that is based primarily upon the number of returns completed.
19. ***Do you think it is important that the preparers/members comply with all tax laws concerning their own tax affairs?***
 - Yes. It is a requirement in our *Code of Business Ethics & Conduct* that personal tax returns be completely and accurately prepared and timely filed. We believe that if a tax professional has not accurately prepared and timely filed his or her personal return, it is unlikely that such person can be trusted to prepare accurate income tax returns for others.
20. ***What processes do you have in place to ensure your preparers/members are compliant?***

- Please see the separate H&R Block Response to the Committee's questions.

21. What do you do about those who are NOT compliant?

- Non-filing or nonpayment of taxes is grounds for dismissal.

22. Please respond to the following questions about preparer use or disclosure of tax return information.

a. Why is it so important for a tax preparation firm to be able to use or disclose tax return information?

- It is important to be able to use or disclose tax return information with appropriate privacy safeguards to better serve clients, lower costs and increase efficiencies.
- Tax return information—which includes the name and address of the client—is needed to communicate about the coming tax season, including an invitation to return and tax news. Information can also be used to streamline the interview process, such as incorporating information from a prior year's return, or saving time by not discussing refund delivery options with a client who has a balance due, for example. Tax return information—such as whether a client has children and their ages—is needed to accurately prepare the tax return and to make a client aware of tax credits or other benefits to which he and his family may be entitled.
- H&R Block also uses tax return information to inform low- to moderate-income clients of government benefits outside the tax code to which they may be entitled—such as Food Stamps, Children's Health Insurance, or prescription drug discounts—and to advise how they might obtain such benefits. Tax preparers need aggregate anonymous tax return information—the number of taxpayers we serve, for example—to run their businesses and, in the case of public companies, to meet Securities and Exchange Commission reporting obligations. Some tax preparers also use information, with client consent, to make clients aware of other financial products or services they offer that may be useful — mortgages, or savings and investment products, for example, or added tax services, all of which often provide additional tax benefits to clients. For example, with appropriate client consent, H&R Block was able to alert many eligible clients to the Retirement Saver's Credit in the first year of its existence — worth up to \$1,000 for low- to middle-income taxpayers who contribute to a qualified retirement account — a valuable client benefit since studies showed that 83% of Americans had never heard of the credit.
- Information can spare taxpayers from offers of products and services which may not be relevant. The communication it enables facilitates more competition for financial products and services that benefits the public through added convenience, lower prices, and more innovation. Congress recognized these consumer benefits in its approval of the Gramm-Leach-Bliley Act that allows data sharing among affiliates of financial firms after customers are notified of privacy policies, and with non-affiliated third parties subject to a customer's option to not to have his information shared (an "opt out" model). Tax return preparers are subject to even stricter rules for tax information; section 7216 of the tax code requires prior written consent (an "opt in" model) for use or disclosure of a client's tax return information, subject to few exceptions.

b. When used within the firm, what is done with it? Describe processes and procedures to analyze data and how it is used within an affiliated firm. What protections are in place to ensure the tax return information is not inadvertently disclosed beyond the scope of the taxpayer's consent?

- I am not aware of the policies of other firms, so my answer is confined to H&R Block. We consider any information furnished by clients to tax professionals and

- 23. What percentage of industry income is from preparing tax returns, the use of tax return information, the disclosure of tax return information, and income from the sale of non-tax products?**
- We are not aware of any compilation of such data for the tax preparation industry. As noted above, H&R Block receives no income from the disclosure of tax return data to third parties.
- 24. Does the impact on the bottom line influence the industry's position on the IRS Section 7216 proposed regulations?**
- While many industry members have commented on the rules, there is no uniformity in their views.
 - The current rules governing tax return information are the strictest in American business and the proposed rules would be as well, even though many industries have equally if not more sensitive client data including banks, investment advisors, credit card companies, etc. Most participants in the tax preparation industry respect the importance of safeguarding client tax information and do not use or disclose information without a client's specific permission except as required for law enforcement or as otherwise permitted by law.
 - The "bottom line" has two aspects that are interrelated: company profits and consumer benefits. Companies that sell products and services cannot profit unless consumers find the products and services advantageous enough to buy them. Consumers must perceive benefit and value in the transaction. Data use restrictions should be designed to strike an appropriate balance, providing adequate privacy protections while still enabling transactions that provide helpful consumer and public benefits.
- 25. When taxpayers input information on the Free File Alliance vendor websites, are "cookies" created that are then used or disclosed by the vendors to solicit business for non-tax products?**
- I can't address Web sites beyond H&R Block's but our identifiers contain only a "session ID" and the user's login ID, not any personal information. These ID's are used to simply identify the "machine" as a returning user and pre-populate the user-ID field in the login screen, allowing the return experience to be cleaner and more user-friendly. The user must manually input their selected password to complete the log-in process. IRS rules require that a return transmitter must enter into agreements with companies to allow access to online filing only if companies correctly capture the IP address of the computer submitting the return and the date, time, and time zone of the computer receiving it. (See IRS Publication 1345, p. 5 and ch. 4, at <http://www.irs.gov/pub/irs-pdf/p1345.pdf>.)
 - We do not use cookies to contact taxpayers about non-tax products or services. Nor do we sell the data to any third-party vendors.
- 26. Is information on the input screens (before the return is filed) considered to be tax return information by these vendors?**
- I can't address all other vendors but, as indicated above, H&R Block considers any information furnished by clients on the input screens for purposes of completing and filing the client's tax return to be tax return information. H&R Block's policies limit the use or disclosure of tax return information for purposes other than tax preparation, in accordance with the Internal Revenue Code and Gramm-Leach-Bliley Act regulations.
- 27. Do taxpayers have a right to know what it is going to cost them to have their tax return prepared before they get started?**

- If the fee is set in advance, taxpayers should have a right to know it. If the fee is not known in advance, taxpayers certainly have a right – and a responsibility – to discuss fees and methods of payment before starting the process and to not proceed without a satisfactory understanding. At H&R Block, our tax professionals can provide a client with an estimate of tax preparation fees; however, we require that our tax professionals do so with the disclaimer that final fees cannot be quoted until the client's full tax situation is known, which can only be determined once the client has fully explained his or her situation.
- When return preparers base fees on the amount of work done, number of forms prepared, etc., it is not possible to know what the fee will be in advance. Some tax preparers may work for a flat fee, but most tailor their fees to reflect the time and expertise required so taxpayers are fairly charged. A pre-set “one-size-fits-all” fee can result in overcharges or undercharges compared to work-based fees.
- At H&R Block, fees for the simplest 1040EZ returns can start as low as \$24. In 2006, average fees were \$160.68 for Federal, state, and any local tax returns for the 15.7 million clients served at our 12,165 company-owned and franchise offices.

28. *Why is it so common for the actual fee to be so much more than the quoted fee?*

- I don't have information as to what is common but H&R Block's policy and training are to have tax return preparers explain to clients how our fees are calculated and why the fee cannot be precisely quoted until the amount of work done is clear. H&R Block clients also receive a Satisfaction Guarantee – clients are not obligated to accept and pay for a return that is unsatisfactory, including for reasons of price.

29. *Explain how the fees are set to have a tax return prepared. Is there a fee schedule? How often do the actual fees differ from the scheduled fees? How much leeway does the individual preparer have to change the price?*

- H&R Block sets prices for tax preparation at a tax form/worksheet level. The form/worksheet prices are intended to reflect the value delivered to the client in the form of time saved for the client and/or the knowledge required for accurately filling out the form or worksheet. Generally, as a tax return becomes more complex, the number of required forms increases and, as a result, the fee is higher.
- Tax professionals have limited discretion to charge amounts that differ from the list price. In some cases, with approval of the Office Leader, tax professionals are allowed to discount from the list price.
- The typical reason the final fee may differ from a preliminary quote is that the client needed forms, schedules or worksheets that were not known at the quote stage. While we can provide upfront price estimates to clients, tax professionals do so with the disclaimer that final fees cannot be quoted until the client's full tax situation is known, which can only be determined once the client has fully explained his or her situation.
- Clients are not charged for additional tax preparation services required due to an H&R Block error. Under H&R Block's guarantees, tax preparation fees are refunded if, due to an H&R Block error, the client did not receive the proper refund or lowest proper tax liability. Additionally, under H&R Block's Standard Guarantee, the company will pay penalties and interest that result from an error the company made in the tax preparation process.
- District Managers are given the discretion to issue discounts to clients for future services as they deem appropriate. Typically, a discount may be granted as a show of good faith if there is a client satisfaction issue. If a client is dissatisfied, we hope to

gain another opportunity to provide the client with the good service that the vast majority of our clients experience.

30. Are taxpayers charged for forms they don't need? For example, if the computer generates a Schedule B for interest income, but the amount is below the threshold to require the form, will the customer be charged?

- H&R Block charges fees only for completed tax forms, schedules and worksheets. If a form is not needed, it will not print in our Tax Preparation Software ("TPS"). TPS is designed with the logic to only charge for legitimate forms. With respect to Schedule B, TPS would not create a charge for this schedule if the amount is below the threshold to require the form.

31. What kind of oversight exists to monitor the prices that each preparer charges to make sure they are fair?

- We have reporting systems that calculate the average charge per tax professional. Individual tax professionals' fees are managed primarily at the local level by District Managers who are given access to this information. In addition to the local management of this issue, our Compliance Department has access to this data and conducts regular audits of individual tax offices. As part of its audit, the Compliance Department reviews certain discrepancies or issues that may arise regarding fees. In light of one of our core values being "Client Focused," our experience is that H&R Block tax professionals generally attempt to charge the lowest fee possible. As a result, we see substantially more incidents of tax professionals charging fees below our standard fees and have experienced far fewer issues of fees being too high.

32. In recent years, there has been a big increase of non-tax products like RALs, IRAs and debit cards being sold by tax preparers. Explain how these are in the best interest of the consumer when exorbitant rates, high fees and low returns are common.

- Each allegation in the question's premises is debatable and worth a separate discussion for which I'd be happy to provide factual information. RALs have not increased in number, for example, nor are the costs higher than those for other kinds of accessible short-term credit. In addition, RALs are tax-related in that they are IRS-regulated, integral to the process of paying for tax preparation and receiving funds tied to an IRS refund, and a major contributor to the number of returns that are e-filed. And debit cards can be tax-related as a means of receiving an IRS refund.
- Bank accounts, bank cards, savings accounts and IRAs can help connect unbanked taxpayers to the mainstream financial system in ways that can save them money, improve their ability to accumulate assets and meet goals of dealing with financial emergencies, financing college, buying a home, and ensuring retirement security. Financial products or services provided at tax time deliver value by meeting taxpayer needs or desires, adding convenience, speed, or security, or lowering costs as compared to alternatives. Taxpayers who do not believe such products are useful or fairly priced are not obligated to choose them, and products may be dropped if consumer demand is low. Studies show, for example, that 85% of taxpayers who choose a refund anticipation loan are satisfied, suggesting they see value, and there is strong consumer demand for the product. (See Gregory Elliehausen, *Consumer Use of Tax Refund Anticipation Loans* (2005), Georgetown University McDonough School of Business Credit Research Center, at http://msb.georgetown.edu/faculty/research/credit_research/pdf/M37.pdf. Failure to offer products or services desired by consumers may result in them using less responsible or more costly alternatives or missing opportunities to plan and improve their financial situation.

- Beyond offering financial products in our offices, we develop and market through online and retail channels, Kiplinger's Home and Business Attorney and Kiplinger's WILLPowerSM software products to provide guidance on legal affairs and aids to will writing and health care powers of attorney, for example. Another product, H&R Block DeductionProTM, provides recordkeeping assistance and information on the value of non-cash charitable donations. These products have consumer benefits that should be apparent.

33. *Is industry opposition to a direct IRS electronic filing portal triggered in part by the potential loss of income from selling non-tax products?*

- There is not uniform opposition. Since income from selling non-tax products is not dependent on whether a taxpayer can file directly with the IRS or through a private-sector service provider, any opposition should not be related. If the e-filing portal includes tax preparation software, the issue of government-financed competition, conflicts of interest, cost, risk, etc. would be sufficient in and of themselves to justify opposition. In that case, non-tax products could still be sold via private-sector channels and the availability of value-added products would be one reason a taxpayer may prefer a private-sector alternative.

34. *We've heard a lot about the burdens on taxpayers as a result of using paid preparers. What are the "benefits" - why should a taxpayer go to a paid preparer?*

- Professionals can ease the burden of tax return preparation and add expertise, advice, planning, accuracy and convenience while reducing anxiety and complexity. A well-trained and experienced professional can help ensure that a taxpayer does not underpay or overpay, is able to take full advantage of all the tax benefits to which he or she is entitled, and can use tax preparation to advance family financial goals. Various studies have documented the need for and benefits of professional help:
 - A recent Urban Institute study found that, among taxpayers aware of the Earned Income Tax Credit, those who used a paid return preparer were about 15% more likely to receive the credit compared to those who did not. See Elaine Maag, *Paying the Price? Low-Income Parents and the Use of Paid Tax Preparers*, (February 2005) at http://www.urban.org/UploadedPDF/411145_B-64.pdf.
 - Studies of the Retirement Saver's Credit by economists at the Joint Committee on Taxation found that "qualified taxpayers were 70% more likely to claim the Saver's Credit if they used a professional preparer or a computer software program." Gary Koenig and Robert Harvey, *Utilization of the Saver's Credit: An Analysis of the First Year*, 58 *National Tax Journal* 787, at 803 (December 2005). Two former Treasury economists found similar results. Peter Brady and Warren B. Hrungr, "Assessing the Effectiveness of the Saver's Credit: Preliminary Evidence from the First Year" (November 2005), p. 9, prepared for the National Tax Association Annual Conference. And a study of retirement savings using H&R Block clients at 60 St. Louis offices found take-up rates doubled as a result of a high-experience tax professional compared to a low-experience professional. Esther Duflo, William Gale, Jeffrey Liebman, Peter Orszag and Emmanuel Saez, *Saving Incentives for Low and Middle-Income Families: Evidence from a Field Experiment with H&R Block*, Retirement Security Project Paper 2005-5 (2005), p. 21, at <http://www.brookings.org/views/papers/20050509galeorszag.pdf>.
 - Tax time can be a "teachable moment" in which paid return preparers can help taxpayers plan, connect to banking institutions, and use refunds to save for key family goals other than retirement. See Anne Stuhldreher, "Tax Time—The Right Time: Federal Policy Recommendations to Help all Americans Save and Build

Assets," *New America Foundation Issues Brief* (March 2004), at http://www.newamerica.net/Download_Docs/pdfs/Doc_File_2124_2.pdf.

- Other studies show many taxpayers miss tax benefits for which they are eligible. For example, a GAO report showed a failure to itemize deductions alone may have caused over 2 million Americans to overpay their Federal taxes in 1998 by an average of over \$400 each. Some of these returns were done by paid preparers, however, suggesting the need for well trained and experienced tax professionals. See *Tax Deductions: Further Estimates of Taxpayers Who May Have Overpaid Federal Taxes by Not Itemizing*, GAO-02-509 (March 29, 2002) at <http://www.unclefed.com/GAOReports/gao02-509.pdf>.
- A Treasury report found over 600,000 eligible low-income taxpayers failed to claim the refundable portion of the child credit, costing them an average of \$390 each, leading to Senator Grassley's complaint to the Treasury Department because of the IRS's decision to cancel its outreach campaign. TIGTA, *Outreach Initiatives Need to Ensure Taxpayers Receive the Benefit of the Child Tax and Additional Child Tax Credits*, 2002-40-203 (September 2002) at <http://www.treasury.gov/tigta/auditreports/2002reports/200240203fr.html> and <http://grassley.senate.gov/releases/2002/p02r10-03.htm>.
- H&R Block found that 1 out of 20 of the half-million taxpayers who took our "Double Check Challenge," allowing us to review past tax returns prepared elsewhere, was able to file an amended return recovering an average tax refund of \$1,300 each.
- A recent study found 39% of taxpayers did nothing to minimize their tax liability, also suggesting likely benefits from using a tax professional for tax planning and preparation. "Two in Five Americans Filing Taxes This Year Doing Nothing to Minimize their Tax Liability," *Wall Street Journal-Harris Interactive Personal Finance Poll* (March 20, 2006), at http://www.harrisinteractive.com/news/newsletters/WSJfinance/HI_WSJ_PersFinPoll_2006_vol2_iss02.pdf.

35. Are these benefits unique to a paid preparer?

- No, some of these benefits are obtainable through a tax preparer who could be a well trained and highly experienced volunteer and who had strong backup research, technology and organizational support. But a good paid preparer adds benefits and value. As examples:
 - **Better Training and Quality:** H&R Block provides 96 hours of training to first year tax return preparers and the average H&R Block return preparer has 225 hours of training and over 3 years experience—nearly half have 5 years experience. In contrast, many volunteer preparers have as few as 6 hours training and IRS reports that about half of VITA volunteers do not show up. H&R Block e-filing acceptance rates are higher than those at volunteer sites, suggesting more compliant returns. Several GAO and TIGTA studies have criticized return preparation accuracy at IRS and VITA sites—error rates were 83% and 21% (IRS) and 100% and 66%(VITA) in recent tests. See TIGTA, *Improvements Are Needed to Ensure Tax Returns Are Correctly Prepared at Taxpayer Assistance Centers*, 2004-40-025 (December 2003) at <http://www.treasury.gov/tigta/auditreports/2004reports/200440025fr.pdf>; *Coordination and Monitoring Are Needed for Continued Improvement in the Tax Return Preparation Process at the Taxpayer Assistance Centers*, 2005-40-147 (September 2005) at <http://www.treasury.gov/tigta/auditreports/2005reports/200540147fr.pdf>; *Improvements Are Needed to Ensure Tax Returns Are Prepared Correctly at*

Internal Revenue Service Volunteer Income Tax Assistance Sites, 2004-40-154 (August 2004) at <http://www.ustreas.gov/tigta/auditreports/2004reports/200440154fr.pdf>; and *Significant Improvements Have Been Made in the Oversight of the Volunteer Income Tax Assistance Program, but Continued Effort Is Needed to Ensure the Accuracy of Services Provided, 2006-40-004* (November 2005) at <http://www.treasury.gov/tigta/auditreports/2006reports/200640004fr.pdf>. While the GAO report issued in connection with this hearing found significant errors at 19 offices of tax preparation chains, suggesting room for improvement by paid preparers, other studies suggest that the more education and training in tax law and the more oversight and support a preparer has, the more likely tax returns he prepares are to be accurate. Finally, paid Electronic Return Originators may be required to undergo FBI criminal background checks, tax filing and compliance checks, and suitability reviews to ensure compliance with IRS e-filing program rules, while volunteer preparers are exempt from background checks. Senator Grassley has also criticized data security practices at volunteer sites. See TIGTA, *Computers Used to Provide Free Tax Help and That Contain Taxpayer Information Cannot Be Accounted For, 2002-40-144* (August 2002) at <http://grassley.senate.gov/releases/2002/august15.pdf>. (Despite these differences, H&R Block strongly supports the VITA program, allows its preparers to participate in it, and has arrangements with some VITA sites to provide backup and 200 scholarships to H&R Block training courses.)

- **Broader Scope:** H&R Block and other paid preparers prepare returns using all forms and schedules, whereas IRS service centers and volunteer sites prepare a limited range of forms and follow guidelines that restrict service to those with AGIs of \$38,000 or less.
- **Accuracy and Guaranteed Work:** H&R Block guarantees client satisfaction and return preparation accuracy. H&R Block will pay penalties and interest in case a client is assessed for an error H&R Block makes. Neither IRS nor volunteer sites guarantee their work.
- **More Convenient Locations, Hours, and Year-Round Help:** H&R Block is open at over 12,000 U.S. locations, from 9 AM to 9 PM during the tax filing season and at reduced hours in district and franchised offices during the remainder of the year to assist late filers or taxpayers with IRS correspondence. While 400 IRS walk-in sites are open year-round, 14,000 Tax Counseling for the Elderly and VITA sites are open for 11 weeks only and rarely available for follow-up help.
- **Faster Funds:** Most taxpayers want refunds quickly. H&R Block expedites refunds via e-filing—about 93% of its returns are e-filed compared to about 75% at VITA sites. Bank products to provide funds more quickly than IRS delivery are available at many paid preparer offices but only at a few VITA sites.
- **Financial Education, Planning and Advice:** Paid preparers often offer tax planning and financial advice, which is generally not available at IRS or volunteer sites. H&R Block offers its clients an annual financial check up and provides tax tips tied to job categories and family circumstances as well as basic financial education materials.
- **Bank Accounts and Savings:** Paid preparers have pioneered in connecting taxpayers to bank accounts or providing refunds on debit cards while also offering financial products to enable savings for college, home ownership, retirement, emergencies, and health care. These are not available at most IRS or volunteer sites.
- **Government Benefit Alerts, Referrals:** H&R Block offers clients alerts on their eligibility for non-tax government benefits, including Food Stamps, Children's

Health Insurance, Women, Infant and Children Nutrition Assistance, Head Start, prescription drug discounts, etc., and is testing enrollment at some locations. Block also refers some clients to nonprofit organizations for financial education, credit counseling, or bank accounts (such as the Institute for Social & Economic Development's *Bank On It* program in Des Moines). IRS and volunteer tax preparation sites do not systematically provide such information and have restrictions on private-sector partnerships.

36. Mr. Weinberger, your written testimony refers to Free File as a "winner". How can you call a program with all of the flaws we heard about at the hearing, and that only 4% of taxpayers have used so far this year, a "winner"?

- It's a winner in: (a) providing a successful model of a government-industry, public-private partnership; (b) saving taxpayers millions of dollars in tax preparation fees and the IRS hundreds of millions of dollars from the cost of establishing its own competing system; (c) getting more accurate and compliant tax returns and more e-filed tax returns to the IRS; (d) removing a massive customer service burden from the IRS including customer support and call centers needed to respond to questions and perfect returns for filing; and (e) avoiding more audit reports from the Governmental Accountability Office and the Treasury Inspector General for Tax Administration on the IRS giving a high percentage of incorrect answers, as have dozens of prior reports on IRS customer service performance.
- Flaws, if accurately stated, should and can be addressed by the Free File Alliance members. The number of users will increase as more taxpayers become aware and find the program attractive. There may be a self-limiting number of interested taxpayers, and flaws and light usage may also occur with any IRS-developed system.

37. Mr. Weinberger, you stated that H&R Block has training, ethics and oversight processes and procedures in place to promote quality and accuracy. The GAO investigation found significant problems among paid preparers working for national tax preparation chains. How diligently does H&R Block practice its processes and procedures? Describe the extent of corporate governance to ensure that they are followed.

- In recent years, H&R Block has strengthened its procedures, establishing a Compliance Department and undertaking a performance integrity program to help us deliver consistency, quality, accuracy, and value to our clients and compliant returns to the IRS. Our tax software guides tax professionals through a comprehensive client interview, ensuring that relevant questions are asked and confining the role of preparer discretion in assessing the client's tax preparation needs to appropriate areas. Built-in alerts and diagnostics flag return characteristics that may cause e-file rejects or subject the return to greater IRS scrutiny. A "Quality Plus Review" by a second tax professional is used for high-complexity returns. Our Tax Research, Training and Knowledge Development Departments provide accurate information and compliant interpretations to our field tax professionals, assisting with challenging questions. As part of our audit and self-assessment process, we annually review office product delivery, documentation, and security compliance. As needed, we identify, investigate and resolve local performance issues. And we periodically perform undercover assessments of adherence to standards or new tax laws.
- Integrity is a core company value. H&R Block requires an annual review and certification by all associates that they have read and comply with our *Code of Business Ethics & Conduct*, which delineates company values, ethical standards and expectations and provides a path for associates to resolve potential ethical issues. We also provide mandatory training on issues with a regulatory dimension: privacy and information security; Electronic Return Originator responsibilities (IRS Publication

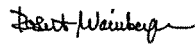
1345); office operations protocols and best practices; delivery of auxiliary products and services; and records management and retention, for example.

- The Tax Compliance Department, while serving H&R Block Services, reports to the parent company's Chief Legal Officer who reports to the Board Chairman and CEO.

Please let me know if clarification is needed or we can respond to any further questions.

Mr. Chairman and Senator Baucus, we appreciate the opportunity to testify and to work with the Committee and its staff as you consider tax administration issues and the positive role professional tax return preparers and private-sector tax software can play.

Very truly yours,



Robert A. Weinberger
Vice President, Government Relations

The following pages provide additional information for the record in response to Finance Committee member questions during the April 4, 2006 hearing "Filing Your Taxes: How Costly Is It?"

How often has your company been called on to [pay penalties and interest for...a mistake on a client return]? (p. 56)

We do not have data on the frequency of such payments because H&R Block's system for payments of clients' penalties and interest claims is decentralized with field district managers given the authority to resolve claims that do not exceed \$2,500.

Are there demographic groups that would tend to use the do-it-yourself software, while other groups tend to use paid preparers? (p. 74)

The IRS has the best information on this. Other studies have shown different demographic breakdowns. In "The TurboTax Revolution: Can Technology Solve Tax Complexity?" Austan Goolsbee compared do-it-yourself (DIY) tax software users to non-users (based on his calculations from 2001 IRS data), but did not include any information about what portion used paid tax return preparers:

<i>Demographic Characteristics of Tax Planning Software Users</i>		
Percent, except as indicated		
<i>Demographic Characteristics</i>	<i>Tax Software Users</i>	<i>Tax Software non-users</i>
Income (thousands of dollars)	78.3	56.8
Age (years)	46.8	49.9
White	0.92	0.89
Single	0.21	0.32
HS or less	0.15	0.39
College	0.61	0.48
Postgraduate	0.24	0.14
Republican	0.45	0.37
Democrat	0.28	0.37
Unaffiliated	0.27	0.26
Have mutual funds	0.42	0.26
Have retirement account	0.70	0.45
Have a brokerage account	0.46	0.26

A Wall Street Journal Online/Harris Interactive Personal Finance Poll of 2,009 adults, released March 20, 2006, compares tax preparation software users to taxpayers who use a paid preparer:

- Men are more likely to be DIY tax preparers than women.
- Single people are almost twice as likely to be DIY tax preparers.
- Lower income and higher income taxpayers are more likely to prepare tax returns by themselves using tax software; \$35K – \$75K incomes prefer a paid preparer.
- Men ages 45 to 54 who are online are most likely to say they have filed or will file their taxes themselves using tax preparation software or an online tax preparation program (47%). Women in this age category who are online are less likely to say this (33%).
- Women ages 35 to 44 are most likely to say they will utilize an accountant or tax service (47%), compared to only 36% of men in the same age category.
- Perhaps due to the more complicated nature of the forms needed when filing, married adults (42%) and those who are divorced, separated or widowed (37%) are more likely

than those who are single or have never been married (19%) to utilize an accountant or tax service to prepare their taxes.

- Among online adults, those with household incomes of \$75,000 or more, 46% are more likely than those with incomes less than \$75,000 (35%) to file their taxes themselves using tax preparation software or an online tax preparation program.
- **Marital Status:** % of people who use tax prep software vs. paid prep by marital status (*not* filing status):
 - married: 37% vs. 42%
 - single: 34% vs. 19%
 - separated 34% vs. 37%
- **Income:** % of people who use tax prep software vs. paid prep by income:
 - less than \$35,000: 33% vs. 26%
 - \$35,000 - \$49,900: 40% vs. 40%
 - \$50,000 - \$74,900: 33% vs. 43%
 - \$75,000 or more: 43% vs. 38%
- **Gender:** % of people who use tax prep software vs. paid prep by gender:
 - Women: 37% vs. 28%
 - 18-34 yr old: 37% vs. 28%
 - 35-44 yr old: 39% vs. 47%
 - 45-54 yr old: 33% vs. 36%
 - 55+: 28% vs. 44%
 - Men: 37% vs. 35%
 - 18-34 yr old: 35% vs. 23%
 - 35-44 yr old: 45% vs. 36%
 - 45-54 yr old: 47% vs. 28%
 - 55+: 29% vs. 41%
- **Age:** % of people who use tax prep software vs. paid prep by age:
 - 18-34 yr old: 36% vs. 26%
 - 35-44 yr old: 42% vs. 41%
 - 45-54 yr old: 40% vs. 32%
 - 55+: 29% vs. 43%

Sources:

- Austan Goolsbee, "The TurboTax Revolution: Can Technology Solve Tax Complexity?" in *The Crisis in Tax Administration*, Henry J. Aaron and Joel Slemrod editors, p. 129 (2004).
- Wall Street Journal Online/Harris Interactive Personal Finance Poll at <http://www.harrisinteractive.com/news/allnewsbvdate.asp?NewsID=1032> and http://www.harrisinteractive.com/news/newsletters/WSJfinance/HI_WSJ_PersFinPoll_2006_vol2_iss03.pdf

“I would be happy to provide something” (p. 87) on whether there is a policy reason “why I should have to go through a preparer to file electronically”. (Sen. Baucus, p. 84)

In my testimony, I indicated that I did not see a policy reason why the IRS should not establish its own electronic *filing* portal if it was not a prelude to the IRS developing its own tax return *preparation* system, but I do see cost, technology, security and administrative reasons. I’ve amplified this in response to questions sent to me after the hearing (see especially answers to Questions 3 and 7):

- I don’t see policy reasons (as distinguished from significant cost, technology, and administrative reasons) why the IRS should not offer free *e-filing* at its Website if it is not a prelude to the IRS developing its own tax return *preparation* system. But it is unnecessary for the IRS to build a portal because the private sector provides free e-filing already and because it would be very expensive for the IRS to implement: cost estimates exceed \$80 million and the cost per return would likely exceed the cost advantage e-filing has over paper return processing given the likelihood that most taxpayers using existing service providers would remain loyal. In addition, there would be a significant customer service and call center expenses related to perfecting rejected returns, a cost now absorbed by private-sector transmitters.
- My answer separates return *filing* from return *preparation*. I do believe there *are* policy reasons, in addition to cost, technology, security and administrative obstacles, why the IRS should not be in the business of *preparing* tax returns. Both the IRS and Treasury Department have publicly opposed government-developed or government-provided tax software for tax preparation. It has been government policy through the last 10 presidents to have the government perform limited functions and not compete with its citizens in commercial enterprises. See OMB Circular A-76 and the discussion in Stiglitz, Orszag and Orszag, *The Role of Government in a Digital Age* at http://www.ccianet.org/filings/govtcomp/govtcomp_report.pdf. Moreover, some have argued that there is a basic conflict of interest if the government is the return preparer as well as the tax auditor, rules interpreter, enforcer, and tax collector.
- As the IRS has written in answer to the question of why it does not provide its own tax preparation software free to the public:

“The government believes private industry, given its established expertise and experience in the field of electronic tax preparation, has a proven track record in providing the best technology and services available. Additionally, Treasury has indicated it does not want the IRS to enter into the tax software business. The Government believes a partnership with private industry will: provide taxpayers with higher quality services by using the existing expertise of the private sector; maximize consumer choice; promote competition within the marketplace; and meet objectives in the least costly manner to taxpayers.”

<http://www.irs.gov/efile/article/0,,id=118993,00.html>

COMMUNICATIONS

**TESTIMONY
BEFORE THE
SENATE COMMITTEE ON FINANCE**

BY:

**TIMOTHY HUGO
Executive Director
Free File Alliance**

**Tuesday, April 4, 2006
10:00 a.m.
219 Dirksen Senate Office Building**

Good morning, Mr. Chairman, and other distinguished Members of the Committee.

I am the Executive Director of the Free File Alliance, LLC ("Alliance"). I have served in that capacity since July of 2005. I am only part time on this role. I also serve as an elected Member of the Virginia General Assembly where I am in my third term.

The Free File Alliance is a voluntary association of tax software companies that provide free tax preparation and efilings services under the growing set of rules that govern the IRS Free File Program. Currently, we have twenty member companies. Member companies can and do come and go. We are open to new members each year.

I am very proud of the public-private partnership the Alliance and IRS have created. Over the life of the program, now in its fourth year, the Alliance companies have donated over 14,000,000 free tax returns to the U.S. taxpayers. I estimate that each return has saved U.S. taxpayers approximately \$30 and a case can be made for an even greater number. That would indicate U.S. taxpayers have directly saved over \$42,000,000. But the savings to the IRS are far greater, and can be summarized as follows.

First, the IRS has been able to avoid the costs industry must accept to develop a software product – which must be changed each year as Congress makes its changes in the Code.

Second, the IRS has avoided the necessity of building the computer and telecommunications infrastructure to take individual returns from taxpayers – Alliance companies pay these costs.

Third, the IRS saves \$7 or more each time a paper return filer converts to submitting a return electronically.

Fourth, and perhaps most importantly, it keeps the IRS from accepting the conflicting role of tax preparer and tax cop.

Fifth, the IRS has also avoided significant technological and political risks of a security breach or failure of an IRS product.

Sixth, the Free File Program makes the IRS and Alliance members partners, not opponents. If the IRS becomes a competitor, it will create a very different and dynamic relationship with industry.

The 2005 renewal of the Agreement between the IRS and the Alliance after three pioneering years was a mark of the program's maturity and success, but required a balance between conflicting policy goals. The 2005 Agreement continues the same core agreement as was originally negotiated, but with some interesting changes. The IRS is still not permitted to take on the role of a tax preparation company.

The Alliance member companies do not always agree on what is good policy, or what is good for their companies. Within the government there is also disagreement as to what should be the requirements of this program, which revealed itself when the IRS and Treasury took slightly different negotiating positions with the Alliance in 2005, notwithstanding that they both work for the same President. Important Members of Congress have urged different policies for the Free File Program. The 2005 Agreement is a product of all these forces. Let me tick off what I think are the key elements of the 2005 Agreement.

First, the Alliance member companies have over time voluntarily agreed to impose standards of conduct on themselves which exceed all government regulation and requirements. These standards were often suggested or sought by the IRS. While accepting this challenge, the Alliance has an appropriate corresponding fear that over time the IRS or Congress will use the

existence of the Free File Program to create a new regulatory regime that will burden the companies in the Free File Program, but not companies who do not participate, or the theoretical companies who have two sets of business practices -- one when they are on the IRS website as Free File participants, and another set of business practices on their own corporate website. After years of experience, it became clear that both the IRS and the Alliance need to have authority to restrict any Alliance member company that does not meet the voluntary high standards. Correspondingly, a dispute resolution mechanism was created in the 2005 Agreement to utilize the General Services Board of Contract Appeals ("GSBCA") to arbitrate with companies who contest IRS determinations that their practices do not meet the high standards.

Second, and related to the first issue, Alliance members agreed to restrictions on sale of certain ancillary products, particularly Refund Anticipations Loans ("RALs"), that exceed those required by law and regulation.

Third, the IRS and the Alliance agreed to certain measures designed to refocus the Free File Program on its original intent to service lower income, disadvantaged and underserved taxpayer populations. How and why did we do so?

The Alliance companies are currently required to provide free services to 93 million taxpayers, which is 70% of the U.S. taxpayers. This is an increase from the 60% of taxpayers the Alliance agreed to cover in the original Agreement. This binding 70% coverage requirement will increase in numbers as the taxpayer population increases.

This focus on the poor, lower income, disadvantaged and underserved was an underpinning of the original Alliance-IRS agreement. It has been recognized throughout the Program's history. It is contained in many of the documents that collectively constitute our forming our agreement.

For example, this language is written in the first and only Supplemental Memorandum of Understanding Between the IRS and Free File Alliance. A copy of this one page document is appended to my statement.

It also appears as a portion of the Purpose in the Alliance Operating Agreement (a copy of paragraph 2.6 of that document is appended to my statement).

It is contained in the Preamble of the Memorandum of Understanding on Service Standards and Disputes Between the IRS and Free File Alliance executed in 2005 (“offer online preparation and filing services to taxpayers least able to afford e-filing tax returns”).

It also appears in a letter from Chairman Ernest Istook, then Chairman of the Transportation, Treasury and Independent Agencies Appropriations Subcommittee, to the current Treasury Secretary and IRS Commissioner, and states in part that the program should be focused upon the “under served and lower income citizens ... There should be no uncertainty that the Free File Alliance program is not intended to provide universal free service to all regardless of need. Such an objective could break the market-based model that enables the donation of the services at no cost to those who truly need them.”

Some may assert the program should provide Bill Gates and Warren Buffett, or other wealthy folks, with free returns. But I do not think a compelling policy case can be made that such high wealth individuals need such free services. Last year \$4 billion in eligible EITC payments were not paid to U.S. taxpayers who qualify. Those are the people to whom I want to provide free services to, and potentially transform their lives.

Fifty-five million people in this country have no bank account. Let’s bring them into some aspect of the modern financial system, even if they have to do their Free File return at a VITA site or public library. A very few miles from this hearing room, in Anacostia, on the aptly

named Good Hope Road, Operation HOPE, an African American focused financial literacy group, provides 16 internet work stations where people in the community can and do take advantage of Free File services. Those are the people I believe we should focus upon.

Both the IRS and the Alliance made their own evaluations of how to ensure the long term success of the program. Both concluded the 2005 agreement meets a variety of needs. The 2005 Agreement has created a stable program with well understood rules. Free for everyone may sound great, but it has consequences, such as creating pressure for sales of ancillary products. We have tried to appropriately balanced policy concerns, and now we need to see how that balance works out in practice. If any company wants to give away their product free to everyone, there is no restriction in their choosing to do so at the their own web page, or in Union Station, or anywhere else but the Free File site.

We do not yet know the final volumes of Free File returns in this tax season. The IRS and Alliance annually cooperate in evaluating each season, decided what went well, what needs to be fixed, and what research is needed to better evaluate this season. We need to do so again, and evaluate how the IRS can help the 93 million eligible taxpayers generate savings for themselves and the IRS.

The Alliance program remains dynamic. But it cannot be used to satisfy every policy. Let me give an example. All fifty states have little IRS-type organizations to collect taxes, and these agencies have a professional association called the Federation of Tax Administrators (FTA). Approximately 20 states, led by New York, Michigan and many others, are working to replicate the success of the Free File model. We appreciate those states' efforts. But the Alliance does not administer these state Free File programs. But the FTA has in the past focused their efforts on the other 20 states that have chosen to compete and create tax software products.

FTA took the position that the IRS should require that the Alliance provide free state tax returns to states that compete. We do not feel comfortable dealing in an indirect manner with groups like the FTA. If the FTA wants to talk to us about this program, we welcome them — but note that the FTA walked out of such talks when the Free File Program was starting and hence are not fully reaping the benefits of the program.

CONCLUSION

We appreciate the Committee's interest in the Free File Program, and look forward to answering your questions.

**William A. Nash
10105 Arbor Trail
Fort Wayne, IN 46804**

**Re: Hearing on
Tax Return Preparation Options for Taxpayers**

Mr. Chairman, Ranking Member Baucus, and distinguished Members of the Committee:

I have read the testimony from this hearing which is available on your website, and find that much of it echoes my experience. I was particularly pleased by the testimony of Nina Olsen, National Taxpayer Advocate. Her statement that *"The government should make it possible for all taxpayers to file their returns electronically with the IRS without having to pay a fee"* was right on target.

As a self-preparer for many years, I have used hand-written paper forms, several iterations of home computer software including Turbo Tax and TaxCut, and in 2005 and 2006 have used the online offerings from the Free File Alliance. Additionally, my home state of Indiana has direct, free e-filing from their website, which I have used since it was first offered.

My experience with these electronic tax preparation methods, and the general direction of change which I see, has caused me to write to you today.

- I am very much in favor of solutions which save the IRS man hours of labor, increase accuracy, and allow direct deposit of refunds, or direct debit of taxes owed.
- I am unwilling to pay for increasingly cumbersome software, or pay a filing fee to accomplish a simple electronic transmission of data.

I believe that Ms. Olsen's suggestion for the IRS to provide "a basic, fill-in template on its website and allow any taxpayer who wants to self-prepare his or her return to do so and file it directly with the IRS for free" is the best solution.

When you have thousands of taxpayers who are comfortable self-preparing using paper forms, but are not making the change to electronic format, you have to look at the barriers. My experience is typical. In the early days of Turbo Tax, the software replicated the IRS forms, so the process was familiar. Over the years, the software companies have switched to an interview format, which is tedious, slow, frustrating, and filled with multiple offers for "premium help" for an additional fee. A simple forms-based fill-in template on the IRS website is all I need to prepare my taxes.

I strongly disagree with the position taken by Bert Dumars, who stated "The IRS believes that private industry, given its established expertise and experience in the field of electronic tax preparation, has a proven track record in providing the best technology and services available."

The entire tax preparation experience is based upon Forms and Instructions. It is simple enough to fill-in-the-blanks. The IRS has always provided Forms and Instructions in some manner, from the printed booklets mailed to taxpayers in past years, to the pdf documents currently found on the IRS website. Now it is time to take the next step, and let taxpayers fill out the forms online, from the IRS portal. This does not put the IRS in the tax preparation business. The software companies are not in the tax preparation business either. They are not responsible for the data that I enter into their software, they only promise to do the math correctly. I see no conflict at all in the mission of the IRS to provide a simple, free method for self-preparers to file their tax returns.

I was pleased to learn about Free File when preparing to file my 2004 taxes. I chose the H&R Block product to both prepare and e-file my tax return, mainly because of my previous unpleasant experience with Turbo Tax software. Returning to the Free File website to prepare my 2005 taxes, I was disappointed to find that neither H&R Block nor Turbo Tax was available this year. I began the slow process of evaluating the other offers, attempting to find a company that offered a "forms" approach rather than the interview process, with no success. The quality of information available varied greatly between companies and I decided to use TaxAct after failing to find a "forms based" supplier.

After gathering my shoebox of tax documents, I prepared my taxes by hand, on paper, in about 50 minutes. This included schedules A, B, C and D. I then went to the Free File website, hoping to quickly enter the information, let the computer check my math, and e-file the return. This time it took over 2 ½ hours to enter the data, due to the poorly constructed software, and the tedious interview process. When my tax return was finally complete, I was asked if I wanted to spend \$10 to prepare and e-file my state return. Since Indiana has free, direct I-filing from their website, I chose to save both my time and my money.

Next year, I'm likely to download forms from the IRS website, prepare and print from my computer, then mail. I will gladly use a 39-cent stamp rather than spend another afternoon clicking through poor software.

Summary:

- I want to do what is best for both myself and the IRS, to cut costs, ensure accuracy, and speed both payments and refunds.
- I would like to prepare and submit my schedules and forms directly on the IRS website, for free.
- I will never be willing to spend any money for software, or for an electronic transmission of data.

Sincerely,



William A. Nash



NATIONAL ASSOCIATION OF TAX PROFESSIONALS

**Comments Before the Committee on Finance
U.S. Senate**

Preparing Your Taxes: How Costly Is It?

April 4, 2006

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The National Association of Tax Professionals (NATP) is a nonprofit professional association that is committed to the accurate administration and application of tax laws and regulations by providing education, research and information to all tax professionals. For 27 years, NATP has existed to serve professionals who work in all areas of tax practice. NATP's 17,500 members and 35 Chapters include individual practitioners, enrolled agents, certified public accountants, accountants, attorneys and certified financial planners. These members prepare more than 7.5 million tax returns annually on behalf of individuals and other entities. NATP also serves the public through regular news releases, brochures, newsletters, and a designated taxpayer website as well as significant member involvement in local and state communities.

NATP is and always has been dedicated to high professional and ethical standards in support of the foundation of trust upon which our economy and system of taxation are built. Our membership supports the efforts of those Senators, Congresspersons and IRS personnel to address the sizable tax gap and its causes in some practical and efficient way. We also support efforts to ease the burden of reporting tax liabilities by the public. We do find the contents of the GAO study presented by Mr. Brostek stunning, but not nearly so as the reaction to it made in today's testimony. In an effort to "balance some of the rhetoric," we hereby submit our comments.

The Limitations of the GAO Study

The subtitle of this document indicates that it is a "Limited Study." To ascribe the word "study" to a biased sampling of 19 preparers out of a community of potentially 600,000, according to the Taxpayer Advocate, is beyond stretching statistical credibility. We have heard such "studies" referred to by other names. Any college graduate would know that such a study would not earn a passing grade due to its extremely limited scope and unconventional subjective testing.

Obviously, we would hope, such a "study" would not be used to brand retail tax return preparers as unfit to prepare tax returns for the public. To be fair to Mr. Brostek, he clearly stated so in the GAO document: "Our 19 visits cannot be used to generalize our findings to the retail tax preparation community. That small fact was covered by some media and missed by others, particularly televised media. Televised media were pleased to ignore this caution by Mr. Brostek and started their frenzy with sound bites condemning retail tax return preparers the day before the hearing was even held. Legislators and special interest groups also ignored this caution in a rush to engender support for a flawed piece of legislation that purports to

protect the public from fraudulent and unscrupulous preparers. It will do nothing of the sort. We will expand upon that more later in this commentary.

One other fact, glossed over by everyone except Mr. Brostek, is the small detail that this "study" did not include preparers other than those who worked for large retail chains like H&R Block, Jackson-Hewitt, Liberty Tax and others. Mr. Brostek specifically stated: "We did not visit any law firms, CPA firms, or single-office tax return preparation businesses." Yet, from this, law makers are asking for the passage of legislation that would license all preparers except CPAs, attorneys and EAs. The implication is that such licensure would solve all the issues raised in this "study."

Emotion Run Amuck

NATP is concerned that such publicity and emotional reaction on the part of responsible media could ensue on the basis of this kind of "evidence." Do not misunderstand. NATP does not deny that the behavior discussed in the GAO report takes place in the market. Our members report anecdotes of such behavior every tax season. They would be the first to relate that such practices are not the norm, however. We concur with that as does the Commissioner of Internal Revenue and the Director of the Office of Professional Responsibility. The perpetrators of such behavior are lawbreakers. That means they break the law. That means that there are laws that already govern such behavior. Licensing tax return preparers will not address this issue. Licensing will address some other issues, but not those of unscrupulous and unlawful practitioners.

Senator Grassley stated that "It's incredible that we have legal requirements for someone to qualify as a barber to cut your hair, and yet there are no requirements for someone to prepare your taxes." We have heard this statement from Nina Olson and many others in their quest to pass licensure legislation over the past few years. Yet, the "limited study" by the GAO substantiates that there are regulations supporting the tax code that apply to all paid preparers. Yes, even the "unenrolled." To wit, Mr. Brostek states on page 9 of the study that "All paid preparers are subject to IRS penalties and the regulations that implement them. According to the Internal Revenue Manual, penalties are IRS's key tools against noncompliant preparers." What penalties would those be? They vary in Code Sections 6694, 6695, 6701, 6713, 7206, 7207, 7216 and 7407 from penalties as light as \$50 per failure to provide a copy of a return to a taxpayer, to \$100,000, 3 years imprisonment, or both for willful preparation of a false or fraudulent return or other document. The IRS already has the ammunition to put a stop to the behavior noted in the GAO limited study.

The problem faced here is not one of the need to license preparers. It is one of enforcement of laws that already exist. Mr. Brostek states on the very first page of the GAO limited study: "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." Let us ask a pertinent question here: Would licensing help the IRS discover these problems? Let us ask a few more pertinent questions: What if IRS Criminal Investigation had gone undercover in this operation instead of the GAO? Might that have been more efficient and produced better results than this study? Might that have been a more productive use of taxpayer dollars? Might it otherwise have better served the tax-paying public?

The Commissioner decries what he might do with more funding for enforcement. His payback for each dollar spent on enforcement is considerable. Senator Grassley, in his press release for this hearing, as much as admitted that the problems posed by this limited study call for enforcement. He states that the proposed *Taxpayer Protection and Assistance Act of 2005* would:

- Require non-monetary sanctions (i.e., suspension or termination) for failure to comply with these regulations.

That certainly sounds like an enforcement measure. He further stated in his testimony: "...for any practitioner who is not abiding by the tax laws, the IRS needs to impose penalties, and prevent that practitioner from preparing returns and representing taxpayers before the IRS. This is a call for enforcement, and we agree with it. The problem is that the sponsors of Senate Bill 832 and special interest groups want to enact licensure as an enforcement measure. It's not needed as an enforcement measure.

The GAO, as a result of its limited study, does not recommend licensure. Mr. Brostek and his staff clearly understand that the study results do not warrant such an expansionary and impulsive response. The GAO recommends that the IRS 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. Again, we agree.

S. 832 is Flawed as it is Currently Proposed

The *Taxpayer Protection and Assistance Act of 2005* (S. 832), as it is currently proposed, contains flaws that will cost unnecessary expenditure of

taxpayer dollars and result in increased and unnecessary taxpayer burden. The sponsors did not likely intend for such a consequence, but it exists nonetheless. The bill was encouraged, edited and promoted by self-serving entities that stand to gain if low-cost tax preparation alternatives are taken out of the marketplace. They say that they find themselves at a disadvantage when competing in the marketplace against the unscrupulous, and the intimation is that all non-credentialed preparers are unscrupulous. This simply is not true as is attested to by the IRS from field level to the Commissioner. Another insinuation is that all non-credentialed preparers are uneducated and incompetent. That also is not true. A little more than half of our membership is "non-credentialed" because legislators and the IRS only recognize attorneys, CPAs and EAs as credentialed. Over 77% of our "non-credentialed" members have degrees beyond high school. Over 40% have a bachelor's degree; 17% have a master's degree (some in taxation); and 2% have doctoral degree.

S. 832 places oversight and enforcement of all unenrolled preparers under the Office of Professional Responsibility (OPR). It further funds the necessary staff increase and expansion of this office through fees, fines and penalties. Such funding presents an obvious conflict of interest. Consider, for example, the notion of funding the operation of a police department through fines and penalties. The undertaking would be phenomenal, more than doubling, perhaps tripling the oversight currently under the Office of Professional Responsibility.

TIGTA released a very revealing report on March 31, 2006. It focused on the IRS increased emphasis on the oversight of tax practitioners. The review of OPR's tax practitioner disciplinary actions was performed at the IRS National Headquarters during the period October 2004 through December 2005. That's a period of 15 months as opposed to the two-month "study" done by GAO on the "paid tax return preparer community." The report stated that, despite OPR's growing budget and visibility, the office has failed to rein in abusive tax practitioners, several of whom are convicted tax cheats. According to TIGTA, "Some tax practitioners who have been convicted of tax-related crimes or whose licenses have been suspended or revoked by State authorities have not been suspended from practice before the IRS." The report further concludes: "Based on our sample, we estimate there are approximately 22,500 licensed tax practitioners who are not compliant with their tax obligations but who have not been identified for referral to the OPR.... The OPR still does not have the information needed to effectively monitor program activities and resources, and the case management system still contains unreliable information." This is the status and atmosphere into which the sponsors of S. 832 propose to place the licensure and administration of all those "unscrupulous, non-credentialed" tax preparers.

The bill further wastes money in requiring government to engage in an expensive "public relations campaign" to promote all licensed and credentialed tax return preparers. Again it proposes to fund this campaign through fines and penalties, another clear conflict of interest. Consider, once again, the public response to funding the promotion of "Support Your Local Police" through speeding fines handed out in the community.

S. 832, as it is presently proposed, will cause a great many good tax return preparers to leave the industry. These are older, seasoned, experienced professionals who have been in business to deliver high quality tax service at economical prices. There are a significant number of good, accurate and ethical non-Circular 230 preparers who provide a gigantic service to millions of taxpayers...taxpayers that do not have \$400 to spend on a return. NATP cautions against the "law of unintended consequences." There are massive numbers of taxpayers with limited means that truly want to comply with our tax laws. They place reliance on uncredentialed preparers who do excellent work for millions of taxpayers. The chilling effect of S. 832 as it is currently proposed would force many of these already compliant taxpayers to use more expensive, credentialed preparers therefore inducing unnecessary and unwarranted taxpayer burden. This will hurt the many small businesses and good preparers who play a key role in compliance for our tax administration system. It will also ultimately, yet unnecessarily raise the cost of preparation and other tax services to the public. Care needs to be exercised not to create another government domain to add more bureaucracy, red tape and consequent taxpayer cost to the tax system. It would be a gross disservice to taxpayers and the tax administration system to drive "good preparers" out of business to reduce the number of "bad preparers."

NATP Recommendations Regarding Licensure

NATP supports the concept of licensing all tax return preparers because it will raise the bar for a very important service industry. We hear of instances of incompetence far more than we hear of fraudulent and unscrupulous activity. Licensure will not stop fraudulent and unscrupulous behavior, but it will improve competent service. NATP believes that simplified, but thoughtful legislation would serve the need to protect the interests of taxpayers and bolster tax administration without adding burdensome and costly regulation either to taxpayers or the IRS. NATP's membership supports simplified and targeted legislation because it will drive taxpayers to qualified return preparers and increase their business. It will provide all legitimate paid preparers recognition by the IRS and the public. It will help identify problem preparers and reduce the ability of unethical and unscrupulous "fly-by-night" preparers to prey on American taxpayers.

NATP believes that any legislation to monitor paid tax return preparers should be straightforward, uncomplicated and incorporate the following specific suggestions:

Registration/Licensure – Registration or licensing will enable the government to determine the number of people that prepare tax returns and the quality of the work that they do. Any attempt to address fraud and error in the tax administration system should logically and sensibly first determine the extent of the population through which it is occurring. The population of unscrupulous and unethical tax return preparers is not defined and is currently not determinable. For that matter, no one knows just how many tax return preparers there are. Despite all the rhetoric and anecdotes, there is currently no way to determine which preparers are law-abiding, ethical and competent. Registration will do just that and it is a simple measure. At last the government will know how many people are preparing tax returns, who they are, and how good their work is.

NATP suggests that the existing Preparer Tax Identification Number system, also called PTIN, is one possible way to contain costs associated with a registration/licensing process. The structure is already in place, and it would be an economical way for the IRS to implement a registration/licensing process. A PTIN could be part of the preparers' signature on all returns, whether electronic or paper. It would seem this measure could be accomplished in short order.

This measure, alone, would go a long way toward addressing the identification and remediation of unscrupulous, unethical and incompetent tax return preparers as well as the need for testing and education. For the American public as a whole, this measure makes all paid preparers accountable unless they go "underground." Registration will not stop fraud, but it may indicate who and what is responsible for it.

Minimum Standards Testing and Education– An initial competency examination demonstrates an individual's minimum competency level for entry at the point in time of the exam. It does not ensure the maintenance of that competency level nor does it ensure raising the bar from that level. Continuing professional education and experience does ensure the maintenance and growth of competency. It goes beyond the

statement that one has met the minimum requirements to be proficient in the industry. It's a measure of what the professional does on an ongoing basis to maintain and improve those skills. It provides evidence that the professional is keeping up with rule changes and the dynamics of taxation so that he/she can do the job well for the American public.

Legislation in this area should be flexible enough to allow the Secretary broad power to administer the assurance of competency through an examination or its equivalent, leaving the details to the regulatory process. It should, however, follow the realities of the tax preparation industry. Well over ninety percent of all income tax returns are individual returns. Most paid preparers work only with individual returns. To require them to be knowledgeable in all facets of taxation would not only be burdensome, but could increase costs to taxpayers and significantly reduce the number of otherwise competent and legitimate tax return preparers currently servicing the tax administration system. Such a requirement would be counter-productive to the goal of such legislation.

The competency examination should be re-administered to all identified "problem preparers." In the past, the IRS has had the ability to identify "problem preparers," those whose return preparation work results in repeated errors, negligence, other audit issues and outright fraud. The IRS used to publish a list of such preparers. Registration/licensing and subsequent monitoring will enhance the tracking and remediation of "problem preparers."

There must be a transition from being unregistered or unlicensed to becoming registered or licensed. There should be a reasonable phase-in period to allow current unregistered or unlicensed preparers to become registered or licensed before they are prohibited from preparing returns. Registration or licensing and testing have the potential to negatively affect the livelihood of hundreds of thousands of small businesses, self-employed individuals and millions of their taxpayer clients. Again, care needs to be taken to ensure that the tax administration system is not seriously and negatively impacted.

Credentialing Terminology - There needs to be some way to easily identify qualified tax return preparers and inform the public of who is authorized to prepare their tax returns.

Taxpayers must have a clear understanding of where to go for professional service when getting their returns prepared. The American public deserves that. Terminology used to identify such preparers must be clear to the public, clear to the tax administration system and clear to the tax preparation community. Any government marketing effort to educate the public regarding newly registered preparers must distinguish them so as not to confuse the public with existing credentials already in use such as Certified Public Accountant (CPA), Enrolled Agent (EA) and attorney.

Codification of the EA credential under Title 31, Section 330 of the USC – Enrolled Agents have been designated by the Internal Revenue Service through testing and continuing education as competent to practice in representation areas including audit, collections and, in some cases, before the United States Tax Court. Several states have precluded Enrolled Agents from using their deserved E.A. credential, a matter causing even further confusion to the taxpaying public. Codification under Title 31 will remedy this omission and misunderstanding. Any such provision in the legislation should be flexible enough to permit the Secretary to adjust any descriptor or credential change that the Secretary may want to undertake in the future in order to make this credential more understandable and marketable to the taxpaying public. Enrolled Agents have been in existence since the Civil War. Yet the public continues to be confused over who they are and what they do even though they have spent considerable sums trying to promote the concept of what being “enrolled” means.

NATP believes these provisions will effectively and adequately address the practical realities of a reasonable, cost-efficient policing of paid tax return preparers. We reiterate that ridding the system of dishonest charlatans that bilk the American public every tax season is an enforcement problem that the IRS must address. We would hope that other tax appropriation legislation would provide the Commissioner of the IRS with the resources needed to enforce already existing law enacted to stamp out unethical and unscrupulous behavior within our tax system.

There are surely other provisions that could be brought to the fore, but we emphasize that legislation such as S. 832 needs to be simple and streamlined, easily understandable and supportable.

We support regulating Refund Anticipation Loan Providers as has been proposed in recent attempts at this legislation. Such attempts have been fraught with loopholes, however, and would result in unfair circumstances. Some businesses would be precluded from providing these loans where others would unfairly benefit. The reason for this is because the House Ways and Means Committee cannot regulate the banking industry. We recommend that the House Committee on Financial Services work with the House Ways and Means Committee to develop separate comprehensive regulation of this practice apart from this legislation.

Previous legislative attempts have also fostered the idea of a public relations campaign to promote a requirement that American taxpayers use Registered Income Tax Return Preparers as part of the effort to regulate. NATP agrees that awareness will assist in the adoption of the utilization of registered preparers by the taxpaying public, but we see no need to create another costly process with convoluted funding. The IRS already has significant promotions for electronic return originators (EROs) and electronic filing. It spends millions of dollars annually marketing and promoting awareness of "e-file" and "Authorized EROs." We believe the promotion of "Registered Income Tax Return Preparers" could easily and efficiently be combined into existing programs at little, if any, cost to the IRS or the American taxpayer.

We trust that these comments have been helpful and we hope that our expressed concerns will be given deliberation and reflection as Congress moves forward in this area.

**Senate Committee on Finance
Written Statement of the National Society of Accountants
On
Preparing Your Taxes: How Costly Is It?**

April 20, 2006

The National Society of Accountants (NSA) welcomes the opportunity to submit our views regarding the “Estimates of Taxpayer Burden” tables that appeared in the instructions for the 2005 Form 1040 and the regulation of federal income tax preparers. NSA is a voluntary association of certified public accountants, enrolled agents, licensed public accountants, licensees of State Boards of Accountancy, tax practitioners who are licensed by state agencies and accountants and tax practitioners who hold credentials from ACAT, a nationally recognized credentialing body.

NSA and its affiliated state organizations represent approximately 30,000 practitioners who provide accounting, advisory and tax related services to more than 19 million individuals and small businesses. NSA represents accountants who serve Main Street rather than Wall Street.

2006 Filing Season

NSA members have encountered a greatly increased work load during the current tax return filing period and believe that this has proven costly to taxpayers due to the increased number of hours required to prepare their returns.

Some of the increase in the work load has resulted from changes to forms and instructions. For example, one NSA member was asked to prepare a return that required more than 600 stock transaction entries on Schedules D and D-1 in order to e-file the return. Another example involved one of our members whose client received a Form 1099 from a stock brokerage firm and just recently received an amended Form 1099B due to the division between ordinary and qualified dividends. This resulted in a delayed filing that will be followed by the filing of an amended return. I am sure that entities that must send and re-send Forms 1099 are frustrated by the complexity of the requirements, but a taxpayer is virtually unable to prepare a return during the early part of the filing season if there is any possibility of receiving an amended Form 1099. All of this also dramatically increases the cost of preparing a return accurately the first time.

In preparation for the current filing season the Internal Revenue Service has also encouraged taxpayers to prepare their own tax returns using computer tax software programs. A number of NSA members have heard from taxpayers who are finding it often takes an entire day to prepare their tax return, even though it may not be a complex return. In many instances, our members have been called upon to correct costly mistakes that have been made.

Preparers from all over the country are being bombarded with taxpayer complaints due to the Alternative Minimum Tax adding to the taxpayer's tax burden and tax liability. Taxpayers feel they are unable to present their views to the IRS, so preparers are forced to take the brunt of these protests. This adds more hours to the preparers' already overloaded schedule and can add significantly to the cost of preparing a return as preparers explain the AMT and why it adds to the tax that must be paid.

IRS Estimates of Taxpayer Burden

The Internal Revenue Service recently published an "Estimates of Taxpayer Burden" tables as part of its Form 1040 instructions. The National Society of Accountants (NSA) believes these estimates to be patently wrong, make no distinction with respect to the sophistication of the self-filing preparer or the complexity of a return even assuming the criteria the tables set forth. Further, the tables encourage the conclusion that business self-filers use improper and invalid assumptions to prepare their tax returns. Finally, the tables purport to set forth the fees charged by tax preparation professionals without any apparent thought to regional cost of living differences or in the types of schedules required for various types of income.

NSA questions the estimates and how they were obtained. Clearly, judging from the number of comments we and other representatives of the

professional tax preparation community have received, very few if any of our members were asked to provide any estimates of the time spent to prepare a particular return and the fee charged. Any such request would have quickly revealed that our members believe that every taxpayer is different. For example, one table makes a particular estimate about a nonbusiness filer who files a Schedule D but not a Schedule A. How many transactions are assumed to be reflected on the Schedule D? Even if there is only one transaction, what is assumed about the availability of information related to basis, capital improvements and other necessary and relevant information? There is no way a tax professional can “blanket charge” his clients in light of those differences.

Further, the fee charged for tax preparation services is likely to vary substantially based on where the services are performed. Tax preparation professionals practicing within a large metropolitan area such as New York or Chicago must charge more than their counterparts living in small town or farming communities because their overhead is far greater. Every area of the United States is different. For the IRS to issue a table suggesting to taxpayers how much a tax professional should charge to prepare a return is absolutely misleading and counterproductive.

Another concern is the assertion in the table that a business filer who prepares a return himself without tax software will spend less time (45.1 hours)

preparing the return than if that same individual used tax software (67.1 hours) or used the services of a paid professional (47.9 hours). It seems obvious that someone who sees a particular form once per year will spend more time than a professional who is not only familiar with the form but has likely prepared the same form thousands of times. The only way this can possibly be true is if the self-preparer ignores the time needed to actually obtain the numbers required to prepare a return properly and instead relies on estimates (or the numbers on last year's return). Reputable tax professionals know that the majority of time spent on a return is the process of compiling all of the figures necessary. That being the case, the numbers are either wrong or the tables assume that taxpayers who self-file are using estimates rather than going through the tedium of looking through their records for the actual numbers. If the latter is true, where does that put the IRS's push for compliance?

We sincerely hope the IRS will reconsider the publication of these estimates of taxpayer burden contained in the tables.

S.832

NSA members have noticed an increase in the number of fraudulent tax preparers. In fact, a recent GAO report found that, of the 19 chain tax preparer offices tested, all returns were prepared incorrectly. Further, USA Today conducted a recent study and concluded that the number of fraudulent preparers

has increased substantially in the last 5 years. Competence and reliability can be very hard for taxpayers to determine, especially in light of limited government oversight. The IRS has pushed electronic filing to the forefront, and unfortunately this has led to an abundant increase of unenrolled preparers who operate from their cars, their homes, storefronts, on a table in their businesses, etc.

Senate Bill S. 832 proposes new regulation for the federal tax preparation industry. This proposed legislation would have a significant impact on the profession and the Internal Revenue Service. Estimates of the number of tax practitioners required to register in the first year of the program range from 200,000 to as high as 600,000.

The Senate bill instructs Treasury to develop (or approve) and administer an eligibility examination designed to test the knowledge and technical competency of individuals who prepare federal income tax returns. NSA has supported the concept of registration for federal income tax preparers since we first introduced the concept several years ago. NSA further supports the use of an eligibility examination. However, NSA can fully support the Senate bill, and any similar legislation, only if it provides recognition of tax practitioners who have already demonstrated their professional competence and their commitment to life-long learning either by earning credentials offered by a nationally recognized credentialing body or by being licensed to practice accounting by a state Board of Accountancy or by being licensed to prepare income tax returns by an agency established under state law. Allowing individuals who possess such credentials or licenses to receive a waiver from the initial examination requirement will

achieve that recognition. These individuals would still be required to register, pay the appropriate fees and meet the other requirements specified in the bill.

The Accreditation Council for Accountancy and Taxation (ACAT), a nationally recognized credentialing organization, offers three credentials that fully satisfy the competency and ethical standards that the Senate bill seeks to achieve. Those credentials are: *Accredited Business Accountant (ABA)*, *Accredited Tax Advisor (ATA)* and *Accredited Tax Preparer (ATP)*. Individuals who hold these credentials have demonstrated their knowledge and competency through a regimen that includes education, experience and examination on topics that include substantial taxation and ethical components. To maintain their credentials, they comply with rigorous annual continuing professional education requirements. ACAT credentials are recognized for licensing or regulatory purposes in a number of states, including Iowa and Minnesota, and NSA believes that S.832 should be modified to recognize that any individual who has taken and passed an ACAT examination and maintains his accreditation is exempt from any testing required by the bill.

Any individual holding a license from a state Board of Accountancy has likewise demonstrated a level of competence that is based on a long-established regulatory standard that has education, experience and examination as required components. Every state accountancy regulatory scheme requires continuing professional education as a condition for license renewal.

The states of California and Oregon license tax preparers in their respective jurisdictions. The licensing qualifications differ slightly in each state, but both require a substantial educational element, including state and federal taxation and ethical conduct, as a prerequisite to granting a license. In both states, continuing professional education is a requirement for license renewals. California currently licenses approximately 36,000 tax preparers and Oregon

licenses approximately 8,000 preparers under their respective programs. These states already impose adequate and efficient licensing requirements on their tax and accounting professionals. We do not believe additional federal requirements should be imposed on these individuals or similarly situated individuals in other states.

In addition, the Internal Revenue Service has extended Circular 230 privileges to public accountants in the States of Pennsylvania, New Jersey and Rhode Island. Under the provisions of Circular 230, a “certified public accountant” is a person duly qualified to practice as a certified public accountant in any state, territory, or possession of the United States. Certified public accountants that are not currently under suspension or disbarment from practice before the Internal Revenue Service may practice before the Internal Revenue Service. A number of other states have a public accountant license class that has practice rights substantially equivalent, if not identical, to those granted to CPAs. These licensed public accountants, like their CPA counterparts, are subject to regulation and supervision by state Boards of Accountancy and must meet continuing education, professional standards and other requirements in order to maintain their practice rights. We firmly believe that if the Internal Revenue Service has already recognized the competence and integrity of these tax and accounting professionals in these states, Congress should as well.

The Senate bill has a section that “clarifies” the Enrolled Agent credential. NSA supports this concept because it will establish a uniformity of regulation and eliminate ambiguities and conflicting restrictions that have evolved in many state regulatory schemes over time. The truthful use of earned credentials is an individual right that all responsible regulatory legislation should serve. National attention to this issue is both appropriate and overdue.

The descriptor used to identify this new class of regulated tax preparers deserves the attention of your Committee. The staff notes, accompanying the Senate bill, include the term “enrolled preparer” when referencing those individuals subject to the proposed regulation. NSA believes that this term diminishes the Enrolled Agent credential and has the potential to confuse the public. Further, it does not adequately describe the services performed by this group of tax preparers. We recommend that terminology used to describe this group be neutral. We suggest “Registered Federal Tax Return Preparer.”

Another section of the Senate bill provides for levying fines and then keeping the money to fund a public awareness campaign. We question the propriety of this provision and ask that Congress reconsider the potential for abuse. Principled legislation should allow Treasury to abate a punitive fine for an inadvertent human error. Perhaps there should be a “pattern of neglect or misconduct” before heavy fines are levied.

The “one-year from enactment” provision is another area that must concern everyone. Such a short time period to develop both a testing and a registration system certainly has the potential to disrupt the subsequent tax-filing season. The staff description of the Senate bill states, “Efficiencies will be gained by coordinating the exam requirement with the enrolled agent exam.” Until such time as the enrolled agent exam is successfully outsourced and its structure entirely revised, we believe this conclusion is questionable at best and could lead to a disruption of the filing season in the first year of implementation. Processing the exams and the attending record keeping for 200,000 to 600,000 individuals certainly has the potential to overwhelm the system. A safer approach would be to instruct Treasury to devise a testing system independent of the Special Enrollment Examination that applicants could use throughout the year. Such a process would follow the proven model that the securities and

insurance industries use. We think that development of a workable regulatory structure, as anticipated by S. 832, simply requires more time to both develop and implement. Extending the time frame to two years or perhaps three would be more realistic.

In summary, with respect to S.832 NSA supports:

1. The concept of registration of tax preparers.
2. The use of an initial examination by those who have not taken and passed an existing national examination, including those offered by the Accreditation Council for Accounting and Taxation.
3. A requirement for ongoing continuing professional education
4. The requirement for registration renewal every three years.
5. A waiver of initial examination for individuals who:
 - a. Hold credentials offered by nationally recognized credentialing bodies; or
 - b. Hold a license to practice accountancy from a state Board of Accountancy; or
 - c. Hold a license to prepare tax returns established under state law.
6. The clarification of the Enrolled Agent credential.
7. Finding a better descriptor than 'enrolled preparer'
8. Reconsideration of using preparer penalty money to fund public awareness efforts.
9. Extending the time period for development and implementation of the structure.