



---

***Oversight of Tax Return Preparers:  
A Major Step in Reducing the Tax  
Gap?***

***February 3, 2010***

---

**DISCUSSION PAPER SUBMITTED TO THE  
IRS OVERSIGHT BOARD**

---

By Paul Cinquemani, Director of  
Government Relations

---



## **DISCUSSION PAPER SUBMITTED TO THE IRS OVERSIGHT BOARD**

### ***Oversight of Tax Return Preparers: A Major Step in Reducing the Tax Gap?***

February 3, 2010

#### **Overview/background**

The National Association of Tax Professionals (NATP) is honored to submit this paper to the IRS Oversight Board and comment on this issue which we believe is critical to tax administration. NATP appreciates the opportunity to comment as a partner with the IRS in addressing this serious concern and to contribute toward its resolution.

NATP lends tremendous influence to 11 million taxpayers' decisions about compliance through its educated membership of over 19,000 tax professionals. NATP is an eclectic group of tax professionals. Our membership is comprised of attorneys, CPAs, EAs, CFPs, BBAs, LLBs, MBAs, PhDs, as well as Associate degrees, part-time professionals, and those who have entered the profession as a second career. Approximately half of our members are Circular 230 professionals. Therefore, we have no bias for any one group of tax professionals over another. Approximately 82% of our non-Circular 230 professionals have undergraduate or graduate degrees.

NATP is a nonprofit professional association that is committed to the integrity of the tax administration system and the application of tax laws and regulations by providing education, research, and information to tax professionals. For over 30 years, we have existed to serve professionals who work in all areas of tax practice. We provide our members with over 250 tax education offerings in more than 100 locations throughout the United States, as well as webinars, online interactive, and self-study programs, a service unmatched by any other national tax association. In total, this equates to approximately 130,000 CPE credits annually. In addition, our 36 Chapters and National headquarters serve the public through regular news releases, client brochures and newsletters, and a designated taxpayer website. Our Chapters provide significant member involvement in local and state communities. Our headquarters with 44 employees is located in Appleton, Wisconsin.

The previous Chair of the IRS Oversight Board, Mr. Paul B. Jones, noted that the IRS cannot be expected to solve the tax gap problem on its own, that it doesn't have the resources to do that. He pointed out that taxpayers themselves decide upon their own posture of compliance. We agreed with that statement in 2007 and we continue to agree with it now. Despite the improvement in the budgeted funds available as a resource for the IRS, it still has limited resources with which to achieve its goal of compliance such that all citizens pay their fair share of taxes. That's because there is a new version of the old adage: "Congress giveth, and Congress taketh away." It goes like this: "Congress giveth more resources, but Congress also giveth more work." We'll elaborate on that later in this paper. We would like to point out here that closing the tax gap is an effort in keeping with NATP's mission to its membership and is a problem we would like to help solve.

## **The Tax Gap**

Publicity surrounding the gross and net tax gap is ubiquitous. We do not feel the need here to dwell on the \$345 billion shortfall in the American taxpayers' remittance of its tax bill other than to point out that it is estimated and it is out of date. Tax Gap data is almost ten years old and the world has dramatically changed since those numbers were generated. Further, tax legislation has proliferated in unprecedented proportions during that time frame, adding myriad and reactionary provisions to address every economic and natural disaster. Witness the following list:

- The Economic Growth and Tax Relief Reconciliation Act of 2001
- The Job Creation and Worker Assistance Act of 2002
- The Jobs and Growth Tax Relief Reconciliation Act of 2003
- The Medicare Prescription Drug, Improvement, and Modernization Act of 2003
- The Working Families Tax Relief Act of 2004
- The American Jobs Creation Act of 2004
- The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005
- The Katrina Emergency Tax Relief Act of 2005
- The Energy Incentives Act of 2005
- The Gulf Opportunity Zone Act of 2005
- The Tax Increase Prevention and Reconciliation Act of 2005
- The Pension Protection Act of 2006
- The Tax Relief and Health Care Act of 2006
- The Small Business Work Opportunity Act of 2007
- The Mortgage Forgiveness Relief Act of 2007
- The Economic Stimulus Act of 2008

- The Food, Conservation, and Energy Act of 2008
- The Heroes Earnings Assistance and Relief Tax Act of 2008
- The Housing Assistance Tax Act of 2008
- The Emergency Economic Stabilization Act of 2008, Energy Improvement and Extension Act of 2008 and Tax Extenders and Alternative Minimum Tax Relief Act of 2008
- The Worker, Retiree, and Employer Recovery Act of 2008
- The American Recovery and Reinvestment Act of 2009
- The Consumer Assistance to Recycle and Save Act of 2009
- The Worker, Homeownership, and Business Assistance Act of 2009

These enactments have added significant and additional "opportunities" for contributions to the tax gap by virtue of the newly created, untried, and un-interpreted deductions and credits. Items such as the Domestic Production Activities Deduction; special depreciation allowances with special rules for certain kinds of assets (automobiles, etc.); Child Tax Credits (with "uniform definition of a qualifying child"); special dividend treatment; Health Savings Accounts; special sales tax deduction provisions; new treatment of bankruptcy and foreclosure provisions; hurricane and other disaster provisions; new pension and charitable contribution provisions; Work Opportunity Credits; ever-changing estimated tax payment requirements; cancellation of debt exceptions; rebates; relief for the military; first-time homebuyers credits and so much more have all not been measured as to the effect they may have on the tax gap. And to further complicate the angst surrounding this number, it is an "estimate." No one knows the real gap with any certainty. But testing by the National Research Program indicates that the details of many of these provisions are probably not being followed in the manner intended by legislation. Some problems are caused by fraud and abuse. Others are caused by the complexity of the provisions. Those that head our bureaucracy and administer these laws are even unsure as to how they work. It takes a staff of lawyers to figure out the correct and incorrect interpretations of these laws and regulations. Note that Commissioner Shulman himself uses a professional tax return preparer.

The problem with "estimates" or "approximations" and other such broad concepts is that they do not provide "real world" examples or teachable moments that hit the experience of tax preparers and become therefore relevant. Specificity is required in order for tax professionals to efficiently focus their efforts on eliminating or reducing the tax gap. As greater study is given to the tax gap, more information becomes available regarding those behaviors (or the lack thereof) which cause the gap. To fulfill our mission and partnership with the IRS, our members need specific information from the IRS on exactly what is causing the gap. Our members need to know what they are to look for in working with their clients...then they can take specific action to reduce or eliminate the causes of the gap.

In some instances, the IRS is specific such as when it publishes its famous "dirty dozen" tax scams. They deal mainly with fraud. NATP members, on the other hand, are servicing the majority of taxpayers who are trying to comply with the complexity of our tax code. The IRS needs to enhance their marketing efforts to tax professionals, as well as taxpayers, on specific "real world" tax gap problems. It would help tremendously to get the same specificity contained in the "dirty dozen" tax scams to be brought to bear on problems faced by well-intended and compliant-oriented taxpayers. If, for example, the IRS were to better inform the public that "these three things are causing a gap in the service station business" or "these four items are the cause of a gap in automobile dealerships," tax professionals would immediately go about addressing those problems and rectifying them with their clients.

The most recent undertaking by the IRS, sending over 10,000 letters nationwide to those members of the tax preparer community with large volumes of specific tax returns where the IRS typically sees significant and frequent errors, is a meaningful step in the right direction. It was more specific and targeted in its intent to get at areas of tax calculation and reporting that contribute to the tax gap. In particular, the IRS did a great job in its letter with respect to the exact kinds of problems it sees with the first-time home buyer's tax credit and the common errors seen in the taking of the Earned Income Tax Credit. This kind of specificity will undoubtedly result in a reduction in these specific errors.

The direction given with respect to common Schedule C and Schedule A errors was far less specific and realistic, however. In essence, the IRS threatened these preparers with penalties if they do not examine the books and records of taxpayers or otherwise gather information to reconstruct their income. This is tantamount to requiring preparers to "audit" and "examine" their clients records, a laborious task assigned rather to the nation's tax collector: the IRS. That's exactly how those receiving the letter interpret those instructions. Circular 230 practitioners are not held to this standard. Section 10.34(d) concerning standards with respect to tax returns specifically states:

*"A practitioner advising a client to take a position on a tax return, document, affidavit or other paper submitted to the Internal Revenue Service, or preparing or signing a tax return as a preparer, generally may rely in good faith without verification upon information furnished by the client."*

The time and expense to perform such a procedure on clients would drive the cost of tax return preparation beyond the ability of most taxpayers to afford it. Despite these short-comings, this effort is still progress on the part of the IRS and we applaud it.

It seems obvious to NATP, and we have heard it expressed by Congress itself, that the answer to the tax gap is tax simplification. It is evident that the major contributor to problems like the lack of voluntary compliance, the high error rate, and the growing tax gap, is the complexity of the tax code. It would also stand to reason that the problem cannot, and will not be resolved until Congress takes the necessary steps to pass the laws that are needed to ensure a fair tax system without causing unnecessary burden on taxpayers, tax professionals, or the IRS. The attention and rhetoric addressing this concept is perennial and has been so for decades. As much as Congress and Presidential administrations agree with this when it is brought up, they continue to further complicate tax administration. We urge the IRS Oversight Board to reiterate this maxim in each and every appearance it makes before the Congress. Something has to be done or it's going to break the back of the tax administration system.

### **Oversight of Tax Return Preparers –**

We are encouraged that Commissioner Shulman took the bold step of embracing the responsibility for the regulation of tax return preparers on the part of the IRS. We have long thought that the IRS had the authority and wherewithal to accomplish this, though it has resisted the undertaking in the past. Truly, the Service is in a much better position to understand the needs, vagaries, pitfalls and practical considerations to regulating all tax return preparers than is the Congress. So it is with regard and relief that we applaud and embrace the open and transparent manner in which the Final Report to the Treasury and the President of the United States regarding Return Preparer Review was undertaken. The process was reasonably thorough, as those kinds of undertakings go. The IRS has plenty of history and experience to draw from as well as sources for information. The recommendations were cautious and measured as well they should be.

The report points out that over 80 percent of all federal tax returns filed in 2007 and 2008 used either a tax return preparer or tax return software. The tax administration system enjoys its current rate of compliance - high as it is among free world nations - due in large part to the efforts, ethics and integrity of this group of practitioners. It would seem prudent, therefore, to recognize the contributions they make to the tax administration system, and to use caution so as not to cause an exit of their talents and knowledge from the marketplace. This prudence calls for well-thought-out transition. The report indicates that such prudence was taken in adopting a 3-year transition and we think the process will be better for all concerned because of it.

The IRS stated in a recent Fact Sheet (FS-2010-8) that it received 32 million tax returns that were self-prepared using "off-the-shelf" software. That's

fully 50% of the number of tax returns filed by tax return preparers and it was up 20% from the previous year. Software vendors constitute the "other preparers" that the Final Report on Return Preparer Review states will be the subject of a task force risk assessment. The IRS is going to continue to look at the risks of high level dependence on consumer and commercial software. We believe the exposure to inaccurate return preparation from free filing and "off-the-shelf" products could be very significant for the following reasons:

- Taxpayers do not know what they do not know. These software products utilize a question-and-answer methodology to fill out the forms. Taxpayers often do not know how to answer these questions correctly according to the tax laws and regulations. Should taxpayers be tested? Or should the software be designed such that if the answers to questions demonstrate incompetence on the part of taxpayers, they are prevented from completing their returns without seeking help? Is that even possible?
- Some taxpayers use the "smart Q&A feature" in some of this software to shop the results given so that they pay the least tax, not the correct tax.
- The Report notes that some in the industry suggest that the market adequately regulates the industry. They postulate that if their software is not accurate and compliant, customers will find software that is. That makes sense if the IRS is in a position of catching and responding to all such instances. There is a price associated with finding out that the software is inaccurate, quite typically paid by the taxpayer. There is a price paid by the tax administration system as well.

We thought it interesting that the contribution this oversight process will make to the tax gap was not mentioned even once in the entire report. It's almost as if the thought that this could be true had not occurred to anyone. It has surely been referenced in other literature, in studies by GAO and in testimony before Congress and committees and boards such as this one. Several of these presentations have indicated that such regulation will not alleviate fraud and unscrupulous behavior. Indeed, such issues will be left to enforcement as they have in the past. But careful and thoughtful regulation of all paid tax return preparers will "raise the bar" in terms of the quality of work that is being done on tax returns by those who do not belong to any professional organizations, take any continuing education, or otherwise prepare themselves for the requisite competence necessary to do accurate tax work. That cannot but help contribute to closing the tax gap, especially as it relates to these newly developing areas of concern such as errors in computing the EITC and determining those who qualify for it. The same can be said for the first-time homebuyers credit and other such provisions in the tax code. Raising the proficiency of the preparer community in these areas has to have a major positive impact on the fair and proper payment

of taxes. One would think that the Commissioner would take credit for this bold move as a significant step in reducing the tax gap.

The industry and the Service now find themselves at a crucial point in laying the foundation for this oversight and the system that will underlie it. A request for proposal to administer the registration of all paid professionals has been issued to procure vendor support in establishing a system for on-line registration. We would urge that caution and prudence again be exercised to ensure that professional outside independence be maintained in the selection of a vendor. Care must be taken that no inside organizations that could even appear to benefit from being on both sides of the regulatory process be selected. It should be kept pristine from the standpoint of independence so that the public sees it as a fair, equitable and respected process and that the industry sees it that way as well. The vendor selection process should look beyond an organization capable to deliver on-line registration. Continuing education and testing will be a larger and longer-term contribution in the way of needed service to the success of this process. Any vendor selected should be able to handle fair testing and CPE oversight as well as registration. Continuing education should also contain federal standards for tax CPE without departure from the CPE requirements. In other words 1 CPE credit should equal 50 minutes of tax-related education, and no less. Credential-specific organizations as potential vendors will be zealous in their pursuit for requiring the attainment of knowledge levels comparable to those required to attain their specific credential, whether needed or not. Tax franchises will hold an iron in this competitive fire. There will be strong movements from these and other groups to put up barriers for small business tax preparers who have practiced their talents at "economic pricing" in the marketplace.

*Prometrics* has proven to be an excellent provider of testing services in so many fields of endeavor including the SEE. This is yet another opportunity for the IRS to "build on pieces it already has in place." This company has the capability to handle registration, testing and continuing education oversight. It is capable, has demonstrated its ability and its independence as a top-flight provider of quality service. It has "no horse in the race" as regards a constituency that could be deemed to benefit from its award of a contract. Another like organization with eminent qualifications and demonstrated experience is the National Association of State Boards of Accountancy (NASBA). NASBA is also capable of administering the entire process of registration, testing and oversight/monitoring of continuing education for tax professionals through its wholly owned subsidiary Professional Credential Services (PCS). PCS provides complete application processing and administrative services to include all levels of assistance for examination, certification and licensure services needed by state agencies and all national associations. Their client list includes organizations as diverse as engineering and cosmetology.

This is an unprecedented opportunity for the IRS to make a lasting contribution to the solution of many of the problems it faces with accurate tax reporting. It's a marked historical point wherein the IRS can benefit the taxpaying public and the professional community of preparers that it relies upon to provide able, wise and needed assistance. If this is done correctly, the results of it will provide a long-lived legacy to the courageous and sage decisions made by the current IRS executive leadership and its advisors. What an opportunity to put real transparency and fairness into the process that will govern those who will serve the tax administration system for time to come.

### **A Major Concern for the Future of the IRS –**

As we wrap up our thoughts and comments, we feel constrained to offer a genuine concern for the ability of the IRS to fulfill its role adequately as the nation's tax collector. Congress has a tendency to enact legislation that puts requirements on the Treasury and, consequently, the IRS that exceed their traditional role. While it's true that the first enactment of the Earned Income Tax Credit took place as a modest experiment in 1975, it exploded in the 1990s to where today it is one of the largest anti-poverty tools in the United States. The IRS was not designed to undertake and oversee social service programs. Further, the IRS was not given additional employee resources to accommodate this significant growth in its responsibilities. That has undoubtedly contributed to the widespread fraud in this program as it has not had the resource coverage needed for oversight and enforcement.

We lend our voice to many governmental leaders who have expressed a fear that the IRS is being worn and battered by such impossible demands to oversee and implement the ideas of legislators in governance of matters far afield from its mission. Whether it's energy or construction stimulus, social services or farming, the demands made upon the Service keep it from being an efficient administrator of our tax system. When oversight does not go as anticipated, when problems occur because the Service is pulled beyond reasonable expectation to spread itself too thin, it becomes the "whipping boy" of the very Congress that puts it in that position...to say nothing of the public outcry and the criticism leveled by GAO, TIGTA and its many watchdogs. The Taxpayer Advocate took a recent swipe at the IRS because it cannot provide the expected telephone service the public demands. And now Congress contemplates giving it yet another venue which it is entirely unequipped to undertake: healthcare. If the Taxpayer Advocate's office believes that telephone service is not acceptable now, wait until the public starts to call to determine whether a medical procedure is covered under the government plan. No one will be able to address tax matters at all. Is this what the nation's tax collector is supposed to be doing? History provides evidence that the IRS will not get the resources it needs to

administer such an extension of its responsibility. We've noted above that the complexity of the tax code all by itself is enough to break the back of our tax administration system. As prominent advisors to the government concerning the affairs and needs of the IRS, we entreat you to address this issue with the Congress.

Thank you for your graciousness in presenting us with this opportunity to express our thoughts regarding what we consider to be important issues for tax administration. We were pleased to be able to tie our thoughts in with one of the panel topics. We are available to share our unbiased knowledge on issues of tax administration from the perspective of both Circular 230 and non-Circular 230 tax professionals. We have been answering questions on behalf of all small business preparers since 1979.