



**Testimony before the
U.S. SENATE COMMITTEE ON FINANCE**

regarding

“Protecting Taxpayers from Incompetent and Unethical Return Preparers”

April 8, 2014

Chi Chi Wu

Staff Attorney

National Consumer Law Center

7 Winthrop Square, 4th Fl.

Boston, MA 02110

617-542-8010

cwu@nclc.org

Testimony of Chi Chi Wu, National Consumer Law Center

Before the U.S. Senate Committee on Finance

regarding

“Protecting Taxpayers from Incompetent and Unethical Return Preparers”

April 8, 2014

INTRODUCTION

Mr. Chairman, Ranking Member Hatch, and Members of the Subcommittee, thank you for inviting me here today. My name is Chi Chi Wu, I am a Staff Attorney at the National Consumer Law Center, and I offer my testimony on behalf of our low income clients.¹

Mr. Chairman, thank you for holding this hearing on the need to protect taxpayers from incompetent and unethical tax preparers. This issue is critically important, not just for taxpayers as consumers of preparation services, but also to protect the integrity of the tax system and the coffers of the United States Treasury. Simply put, there needs to be licensing and competency standards for paid tax preparers. Either Congress needs to give the Internal Revenue Service the authority to regulate paid preparers, or the states need to enact such laws. Indeed, mindful of the difficulty in getting federal legislation passed, we at NCLC have issued a model act to encourage states to adopt such laws.

¹ The National Consumer Law Center is a nonprofit organization specializing in consumer issues on behalf of low-income people. We work with thousands of legal services, government and private attorneys, as well as community groups and organizations, from all states who represent low-income and elderly individuals on consumer issues. NCLC has worked on tax-related consumer protection issues for over a decade, including issuing twelve annual reports on the problems posed by tax refund anticipation loans and other tax-time financial products. This testimony was written by Chi Chi Wu of NCLC, with assistance from Carolyn Carter of NCLC and David Rothstein, Director of Resource Development & Public Affairs, NHS of Greater Cleveland.

THE SUPRISING LACK OF MINIMUM STANDARDS FOR PAID TAX PREPARERS

I have worked on issues at the intersection of taxpayer and consumer rights for over a decade, and it still astounds me that paid tax preparers are essentially unregulated in forty-six states. When I began this work, I assumed – as do most Americans – that tax preparers were licensed professionals with certain educational credentials, and that they needed some sort of accounting degree or specialized training to prepare tax returns. After all, the tax return is the most important financial transaction during the year for many Americans, and it would only make sense that the preparers in whom Americans place their trust and their sensitive financial information would be required to take some courses and pass a test.

To my surprise, the exact opposite was true – with the exception of a handful of states,² paid preparers are not governed by any minimum educational standards, competency testing, or continuing education requirements. While there are some preparers who are certified public accountants or credentialed by the IRS as enrolled agents, the great majority do not have such qualifications. Ironically, the only tax preparers apart from CPAs and enrolled agents subject to testing and regulatory oversight are the unpaid volunteers at Volunteer Income Tax Assistance sites. Contrast this with other professions that do require licensing in all or most states, such as hairdressers³ and landscape architects.⁴

To its credit, the IRS did attempt to institute minimum competency requirements and was on the verge of implementing them, when a federal judge struck down the agency's regulations,

² These states are California, Maryland, New York, and Oregon.

³ Bureau of Labor Statistics, U.S. Department of Labor, Occupational Outlook Handbook (2014-15 Edition), Barbers, Hairdressers, and Cosmetologists, *available at* www.bls.gov/ooh/personal-care-and-service/barbers-hairdressers-and-cosmetologists.htm (visited March 31, 2014) (noting that all states require hairdressers to be licensed).

⁴ *Id.*, Landscape Architects, *available at* www.bls.gov/ooh/architecture-and-engineering/landscape-architects.htm (visited March 31, 2014).

a decision that was upheld just this past February by the Court of Appeals for the D.C. Circuit.⁵ Note that the Court of Appeals invalidated the IRS's regulations because it believed the agency did not have the statutory authority to issue them, not because the Court believed the regulations to be a bad idea. In fact, the Court stated “[i]t might be that allowing the IRS to regulate tax-return preparers more stringently would be wise as a policy matter.”⁶ Thus, Congress could easily fix this problem with a single sentence giving the IRS authority, and the IRS already would have many of the elements in place to implement a program.

LACK OF REGULATION LEADS TO INCOMPETENCE AND FRAUD

The lack of regulation for tax preparers has resulted in an environment that breeds incompetence and fraud. One indication of these problems is the existence of “fringe preparers” – tax preparation offered by businesses such as payday lenders, pawn shops, check cashers, used car dealers, jewelry shops, furniture stores – even liquor stores and a “rent-a-wheel” business.⁷ We have noted examples of all these businesses engaged in tax preparation, sometimes encouraging their customers use the refunds to buy their goods. This of course raises questions about the quality and competency of tax preparation from such businesses – how accurate are tax returns prepared by used car dealers? One can imagine that the incentive for accuracy might take a back seat to a desire to sell a car by using the taxpayer's refund as a down payment.

Unfortunately, the problems with incompetence and fraud go beyond just fringe preparers. In 2008, several consumer and advocacy groups, including NCLC, conducted mystery

⁵ *Loving v. I.R.S.*, 742 F.3d 1013 (D.C. Cir. Feb. 11, 2014).

⁶ *Id.* at 1022. In addition, five former IRS Commissioners, appointed by both Democratic and Republican Presidents, filed an amicus brief in this case expressing support for the IRS's preparer regulation program.

⁷ Chi Chi Wu, National Consumer Law Center, RALs, Tax Fraud, and Fringe Preparers (Feb. 2009), at 17-18, available at www.nclc.org/images/pdf/high_cost_small_loans/ral/2009-ral-appendix.pdf.

shopper testing of a number of different types of tax preparers.⁸ Our original purpose for these tests was to determine whether preparers were properly making disclosures concerning refund anticipation loans (RALs)⁹ and refund anticipation checks (RACs).¹⁰ To our surprise, what we found were serious tax errors and fraud. This occurred in four out of the 17 tests we conducted — or nearly 25% of the tests. One example of incompetence involved a preparer in Durham, N.C. who did not know how to handle an IRS Form 1099-D, issued to report dividend income:

After sitting in the office for an hour or so, [the preparer] said that there was a problem that she did not know how to handle. The problem was that there was a \$5000 [fictional number] “dividend” that we must pay taxes on. With the dividend, our return would only return \$100. If she was to “ignore” it, then we would receive \$3000 in returns. She then called her “tax people,” [who] told her that we do not need to report the dividends and just ignore it.¹¹

Essentially, this preparer was advising the tester to commit tax fraud.

In 2010, we conducted another round of testing, and found incompetence or fraud in six of 19 tests – or about 30%. One example involved a tester in New York City who described how the preparer, when realizing the tester would receive only a \$1,000 federal refund and would owe state taxes, began making up deductions:

⁸ Chi Chi Wu, National Consumer Law Center, Riddled Returns: How Errors and Fraud by Paid Tax Preparers Put Consumers at Risk and What States Can Do (updated Mar. 2014), at 6-7, *available at* www.nclc.org/issues/riddled-returns.html [hereinafter “Riddled Returns”].

⁹ A refund anticipation loan (RAL) is a short term loan secured by and repaid from the proceeds of a consumer’s tax refund. RAL lending was dramatically curtailed as a result of regulatory actions by federal banking regulators and the IRS. Currently, RALs are only available from a limited number of non-banks.

¹⁰ A refund anticipation check (RAC) is a bank product involving temporary bank account. The temporary account is used to receive a direct deposit of the consumer’s refund from the IRS. After the refund is received, the bank deducts a fee for the RAC, as well as the tax preparation fee. The remainder is issued to the consumer in the form of a paper check, prepaid debit card, or a direct deposit to the consumer’s own bank account.

¹¹ Riddled Returns at 6.

[The tester] reported that the tax preparer tried to entice her to commit tax fraud by showing her how much her federal refund would increase if she took deductions in excess of the standard deduction. [The tester] does not attend church, but the tax preparer included a \$2,000 church donation. The preparer also deducted the cost of work clothes and laundry, then showed [the tester] that her federal refund would increase to \$3,000 from about \$1,000. The preparer also tried to convince [the tester] to make up a dependent as she does not have any — showing her that her refund would go up to \$5,000 if she did so. The preparer also tried to qualify her for EITC even though she is not eligible. Finally, the tax preparer deducted \$400 in 2008 tax preparation costs even after [the tester] told the preparer that she did not pay for tax preparation last year.¹²

A third round of limited testing in 2011 similarly revealed errors or fraud in four out of the nine tests, or 44%.¹³

Unfortunately, our test results were not isolated or unique. As discussed in our report *Riddled Returns*, attached, similar testing by other advocacy groups, by the Government Accountability Office, and by the Treasury Inspector General for Tax Administration have found equal or even greater levels of fraud and incompetence.¹⁴ Looking at the totality of all these tests, we can see that these problems are not limited to a handful of bad apples. There is a substantial level of incompetence and corruption in the tax preparation industry.

REGULATION IS NEEDED TO HELP CONSUMERS

Protecting individual taxpayers and the federal and state treasuries from this fraud and abuse demands some basic fundamental standards. It calls for establishing minimum qualifications for the practitioners who handle consumers' most sensitive information. It is only

¹² Riddled Returns at 7-8.

¹³ Riddled Returns at 9-10.

¹⁴ Riddled Returns at 10-15.

common sense to require paid tax preparers to obtain basic training, pass competency exams, and seek continuing education to stay current on our ever-changing tax laws.

Given the widespread level of incompetence and fraud, bringing enforcement actions on a one-by-one basis is simply inadequate as a response. For example, the lawsuit by U.S. Department of Justice (DOJ) against Instant Tax Service involved a multi-year investigation that revealed an “astonishing array of repeated fraudulent and deceptive conduct.”¹⁵ While it might be ultimately considered a success because it shut down that chain, the case probably cost the government tens or even hundreds of thousands of dollars in staff time by IRS personnel and DOJ lawyers – and there are allegations that the principals of Instant Tax might be continuing to operate under a new structure.¹⁶ There are simply not enough resources to go after all of the bad actors. While it would get rid of a few of them, relying on enforcement alone is akin to treating just a skin lesion when the related disease has invaded a patient’s entire body.

Regulating tax preparers is urgently needed to protect both taxpayers and the U.S. Treasury. Furthermore, we disagree with notion that preparer regulation could harm taxpayers because preparers will raise their fees to cover the cost of education and testing. First, the interests of consumers in obtaining competent, accurate and ethical tax preparation assistance far outweighs any increased marginal cost. After all, an erroneous return can put the taxpayer at risk of an IRS audit or even criminal sanctions. Second, we believe that regulation will not actually even create significantly greater costs to consumers. Preparers’ compliance costs are minimal – for example, prior to the adverse court decision, the IRS had planned to charge less than \$120 for its exam.¹⁷ These costs are dwarfed by the hundreds of dollars in fees that some paid preparers

¹⁵ United States v. ITS Fin., LLC, 2013 WL 5947222, *1 (S.D. Ohio Nov. 6, 2013).

¹⁶ Adam Rust, Instant Tax to Dodge DOJ Order, Bank Talk blog, Nov. 20, 2103, at <http://banktalk.org/content/instant-tax-dodge-doj-order> (visited Mar. 2014).

¹⁷ IRS, Registered Tax Return Preparer Test - Candidate Information Bulletin, Apr. 16, 2012, at 2-3.

charge for a single tax return. Our mystery shopper tests uncovered tax preparation fees of \$400 or \$500 in some cases,¹⁸ and the DOJ's lawsuit against Instant Tax Service revealed that that chain typically charged about \$550, for as little as 15 minutes of work.¹⁹

It is worth noting that tax preparation fees are entirely non-transparent. This is one of the few services for which consumers typically cannot obtain a price before they incur the service. Tax preparers assert that they charge by the tax forms required in preparing a particular return, and cannot predict which forms will be generated until they actually finish the preparation process. Thus, consumers cannot obtain quotes to comparison shop.²⁰ This lack of transparency is responsible in part for the very high, and possibly inflated, tax preparation fees. Thus, preparer regulation has more potential to lower costs than to increase them, by improving transparency and reducing abuses.

Finally, competent and ethical tax preparers will benefit from regulation. Basic standards are important to protecting the integrity of an industry. Paid preparers who are honest and ethical, investing in training and education, are hurt when their competitors cut corners, commit outright fraud, and give tax preparation a bad name.

Thank you for the opportunity to testify, and I look forward to your questions.

¹⁸ Riddled Returns at 18 (Table 18).

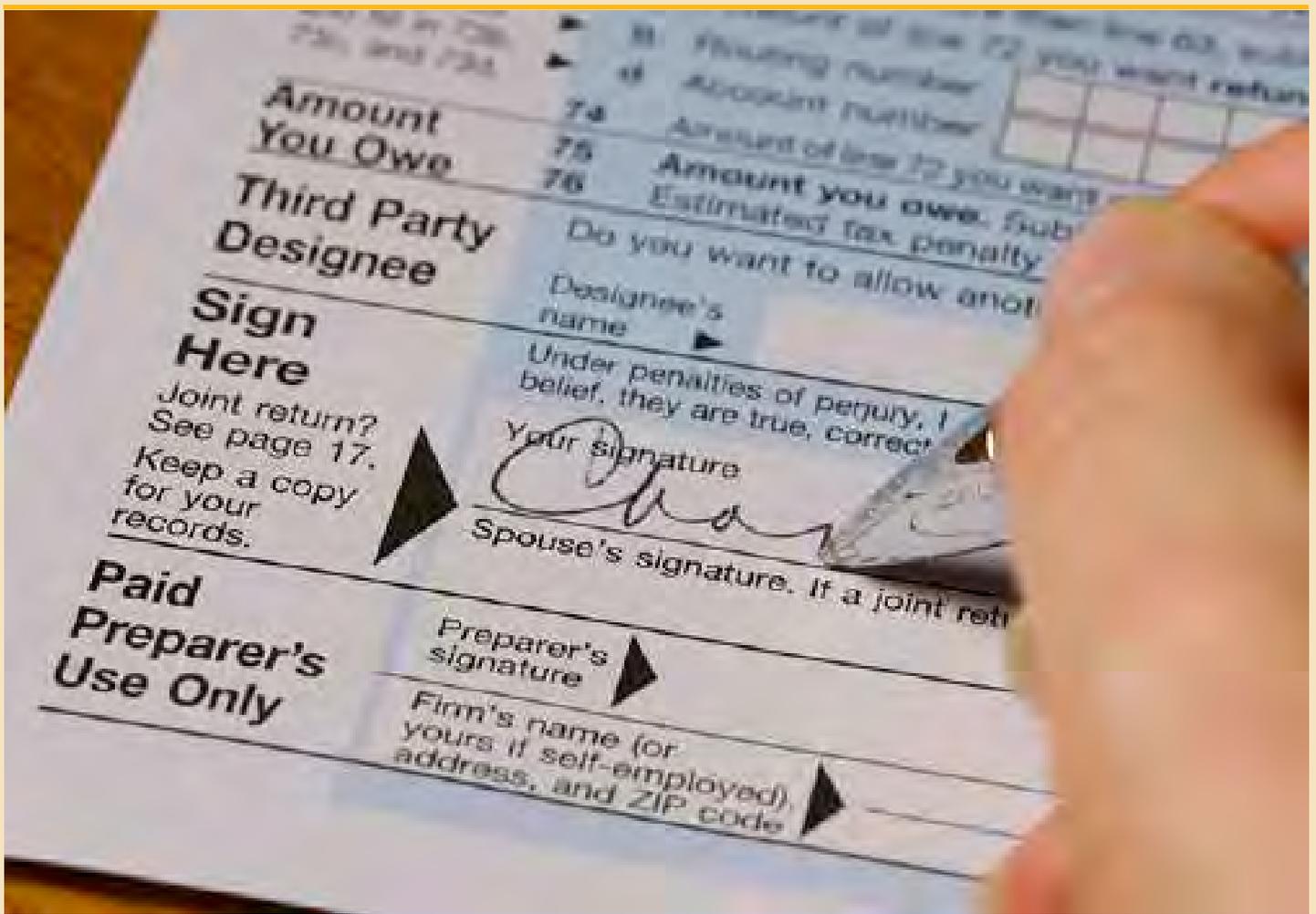
¹⁹ United States v. ITS Fin., LLC, 2013 WL 5947222 (S.D. Ohio Nov. 6, 2013), ¶¶ 329, 349-350.

²⁰ See David Rothstein, Policy Matters Ohio, Improving Tax Preparation With a Model Fee Disclosure Box, June 2013, available at www.policymattersohio.org/wp-content/uploads/2013/06/FeeDisclosure_Jun2013.pdf.

ATTACHMENT A

RIDDLED RETURNS

HOW ERRORS AND FRAUD BY PAID TAX PREPARERS PUT CONSUMERS AT RISK AND WHAT STATES CAN DO



© Copyright 2014, National Consumer Law Center, Inc. All rights reserved.

ABOUT THE AUTHOR

Chi Chi Wu is a staff attorney at the National Consumer Law Center. She is an expert on consumer credit issues, including refund anticipation loans (RALs), credit reporting, credit cards, and medical debt. Wu has authored eleven years of annual reports on the RAL industry issued by NCLC and the Consumer Federation of America. She is co-author of the legal manuals *Fair Credit Reporting Act* and *Collection Actions*, and a contributing author to *Consumer Credit Regulation* and *Truth in Lending*. Wu frequently serves as a resource for policymakers and the media on consumer credit issues. Previously, Wu worked in the Consumer Protection Division at the Massachusetts Attorney General's office and the Asian Outreach Unit of Greater Boston Legal Services.

ACKNOWLEDGEMENTS

The author would like to thank the following for their invaluable review and comments: Carolyn Carter and Jan Kruse of National Consumer Law Center; David Rothstein, Director of Resource Development & Public Affairs at NHS of Greater Cleveland; and Robin McKinney, Director of the Maryland CASH Campaign and the lead consumer advocate in the successful effort to pass the Maryland Individual Tax Preparer Act. Thanks to Beverlie Sopiop of NCLC for formatting this paper; and Jan Kruse of NCLC for communications support. Also thanks to all of the advocates who conducted the mystery shopper reports in Part C of this report, including Peter Skillern and Adam Rust of Reinvestment Partners; Deyanira Del Rio and Alexis Iwanisziw of the New Economy Project; Michael Rowett of Arkansans Against Abusive Payday Lending; Kerry Smith and Nadia Hewka of Community Legal Services of Philadelphia; Jean Hunt of the Campaign for Working Families; and Sarah Dewees, Ben Marks and Shawn Spruce of First Nations Development Institute.

This research was funded by the Annie E. Casey Foundation. We thank the Foundation for its support but acknowledge that the findings and conclusions presented in this report are those of the author alone, and do not necessarily reflect the opinions of the Foundation.



ABOUT THE NATIONAL CONSUMER LAW CENTER

Since 1969, the nonprofit National Consumer Law Center® (NCLC®) has used its expertise in consumer law and energy policy to work for consumer justice and economic security for low-income and other disadvantaged people, including older adults, in the United States. NCLC's expertise includes policy analysis and advocacy; consumer law and energy publications; litigation; expert witness services, and training and advice for advocates. NCLC works with nonprofit and legal services organizations, private attorneys, policymakers, and federal and state government and courts across the nation to stop exploitive practices, help financially stressed families build and retain wealth, and advance economic fairness.

TABLE OF CONTENTS

Executive Summary	1
A. Startling Lack of Regulation for Tax Preparers	3
B. Nature of the Tax Preparation Industry	4
C. Abuses Uncovered by Mystery Shopper Testing	5
1. 2008 Mystery Shopper Testing.....	6
2. 2010 Mystery Shopper Testing.....	7
3. 2011 Mystery Shopper Testing.....	9
4. 2011 First Nations Development Institute (FNDI) Mystery Shopper Testing.....	10
5. 2012 First Nations Development Institute (FDNI) Mystery Shopper Testing.....	11
6. Impact Alabama Testing.....	12
7. Testing by the Treasury Inspector General for Tax Administration (TIGTA).....	12
8. Testing by the Government Accountability Office (GAO).....	13
D. Abuses Uncovered by Government Enforcement Actions	13
1. U.S. Department of Justice (USDOJ) v. Jackson Hewitt.....	14
2. USDOJ v. Instant Tax Service.....	14
3. Illinois v. Mo' Money Taxes.....	14
4. Chicago Department of Business Affairs and Consumer Protection.....	15
5. New York Department of Taxation and Finance.....	15
E. Tax Preparation Fees	15
F. Why Regulation Is Needed and Enforcement Actions Alone Are Not Adequate	19
G. The Model Individual Tax Preparer Regulation Act	19

Table

Tax Preparation Fees.....	18
---------------------------	----

Appendices

Appendix A: Number of Taxpayers Using Paid Tax Preparers by State.....	21
Appendix B: Model Individual Tax Preparer Regulation Act.....	22

EXECUTIVE SUMMARY

A tax return is one of the most critical financial events for many consumers during the year. Over half of these consumers rely on paid tax preparers, putting their financial lives in the hands of these practitioners. Yet there is no regulation for most tax preparers in the vast majority of states. There are no minimum educational, training, competency, or other standards. In 46 states, there are more regulatory requirements for hairdressers than tax preparers.

Because of this lack of regulation, incompetence and abuses by tax preparers have flourished over the years. Mystery shopper testing by consumer groups, other advocacy organizations, and government agencies has found frequent examples of this incompetency and outright fraud — a disturbingly high number, given the limited number of tests conducted. Some of the examples uncovered in this testing were:

- Intentional omission of income;
- Falsifying information to make the taxpayer eligible for various credits and deductions, such as charitable deductions, job-related or business expenses, and the Earned Income Tax Credit (EITC);
- Inability to properly deal with education-related credits and income;
- Misclassifying filing status; and
- Data entry errors resulting in incorrect refunds.

These numerous examples of fraud and incompetence, comprising a significant percentage of the preparers tested, shows that this problem is not isolated or the case of a few bad actors. Instead, it is an endemic problem and regulation is urgently needed to protect both taxpayers and public treasuries.

Another problem faced by taxpayers is the inability to comparison shop or predict how much tax preparation will cost them, because many tax preparers claim they cannot give a quote or give inaccurate ones. As a result of this lack of transparency, consumers face tax preparation fees that are very high, and sometimes inflated – up to \$400 or \$500 in some cases.

The IRS attempted to address fraud and improve preparer competency by developing a system to regulate tax preparers. However, in early 2013, this effort was blocked by a federal court, which invalidated the regulations as exceeding the IRS's statutory authority. This decision was upheld in February 2014 by the D.C. Court of Appeals. Thus, it is up to Congress or the states to institute a system of preparer regulation.

To assist states toward this goal, this report includes the **Model Individual Tax Preparer Regulation Act**, which a state legislature can enact for the regulation of tax preparers, based in large part on three of the four existing state laws, as well as the IRS regulations.

The Model Act requires paid tax preparers to:

- Obtain a registration unless they fit into one of the handful of exceptions,
- Pass a basic competency exam,
- Have 60 hours of initial education and 15 hours per year of continuing education, and
- Provide a standardized disclosure of their fees.

For consumers, an incorrectly prepared tax return can lead to dire economic consequences or even criminal sanctions. This is especially true for low-income EITC recipients, of whom over 60% — or 16 million families — pay for tax preparation. For these consumers, especially EITC recipients, their refund is the single largest sum of money that they will receive during the entire year. Passage of the Model Act will allow these consumers to be confident that the tax preparer that they rely upon has the basic skills and knowledge needed to prepare their tax returns correctly.

A. Startling Lack of Regulation for Tax Preparers

For many individuals, filing a tax return is the most critical financial interaction they have with the federal government during the year. An incorrectly prepared return can lead to dire economic consequences or even criminal sanctions. And for many consumers, especially recipients of the Earned Income Tax Credit (EITC), their tax refund is the single largest sum of money that they will receive during the entire year.

Over half of these consumers rely on paid tax preparers, putting their financial lives in the hands of these practitioners. This is especially true for low-income EITC recipients, of whom over 60% – or 16 million families – pay for tax preparation.¹

Yet for many decades, there was no regulation for these critical actors in the vast majority of states, with only a handful of exceptions.² There were no minimum educational, training, competency, or other standards for the businesses that could determine the consumer’s financial fate for the coming year. While some tax preparers are licensed as certified public accountants or credentialed by the IRS as enrolled agents, the vast majority do not have such qualifications. Indeed, the only tax preparers apart from CPAs and enrolled agents subject to testing and regulatory oversight are the unpaid volunteers at Volunteer Income Tax Assistance sites.³

In 46 states, there are more regulatory requirements for hairdressers than tax preparers.

In 46 states, there are more regulatory requirements for hairdressers than tax preparers.⁴ Yet the impact of a bad haircut is far less damaging than an inaccurate tax return.

In 2011, the IRS attempted to address this issue by developing a system to regulate tax return preparers. The IRS regulations required preparers to register with the IRS, take a competency

¹ Data from IRS Stakeholder Partnerships, Education & Communication (SPEC) Return Information Database for Tax Year 2010 (Returns Filed in 2011) (Jan. 2013). In general, over half of taxpayers (56%) use a paid tax preparer. *Id.*

² The exceptions are California, Maryland, New York, and Oregon. *See* Cal. Bus. & Prof. Code §§ 22250 to 22259; Md. Code §§ 21-101 to 21-502; N.Y. Comp. Codes R. & Reg. tit. 20, pt. 2600 (Dec. 2013), and Or. Rev. Stat. §§ 673.605 to 673.740. In addition, some states require registration of persons that offer RALs. *See* National Consumer Law Center, *Model Refund Anticipation Loan Act*, Appendix A (Dec. 2008) (summary of state RAL laws), available at <http://www.nclc.org/ralmodel>.

³ VITA sites have long followed fundamental training and certification requirements. *See* IRS, Pub. 1084 - IRS Volunteer Site Coordinator’s Handbook 29 (Oct. 2012)(requiring that all “[v]olunteer preparers must pass at least the basic certification test. A minimum score of 80% is required for each certification test”)

⁴ Bureau of Labor Statistics, U.S. Department of Labor, *Occupational Outlook Handbook, 2012-13 Edition*, Barbers, Hairdressers, and Cosmetologists, available at www.bls.gov/ooh/personal-care-and-service/barbers-hairdressers-and-cosmetologists.htm (visited July 22, 2013)(noting that all states require hairdressers to be licensed).

examination, and stay current with tax law developments through continuing education.⁵ However, the IRS effort was blocked on January 18, 2013, when the federal district court for the District of Columbia issued a surprising decision invalidating the regulations as exceeding the agency's statutory authority.⁶ In February 2014, the D.C. Court of Appeals upheld the lower court's ruling.⁷

This report discusses the need for preparer regulation to protect both taxpayers and the public treasury. It details the massive amount of fraud and incompetence uncovered by just a handful of mystery shopper tests by consumer groups, advocacy organizations, and government agencies. These repeated examples of fraud and incompetence, comprising a significant percentage of the preparers tested, shows that this problem is not isolated or the case of a few bad actors. Instead, it is an endemic problem that must be addressed by systemic reform, that is, comprehensive regulation of tax preparers.

B. Nature of the Tax Preparation Industry

The tax preparation industry consists of three larger commercial chains (H&R Block, Jackson Hewitt, and Liberty Tax Service), a number of smaller chains, and many thousands of small or solo independent preparers.⁸ There is a wide range of independent preparers, from licensed professionals – such as attorneys, enrolled agents, and certified public accountants – to businesses that primarily deal in another line of goods and services.

Among the last group, there is a segment that is highly problematic – the fringe preparer. Fringe preparers include businesses that are historically associated with the exploitation of consumers, such as payday loan stores, check cashers, and used car dealers. Some retailers, such as jewelry and furniture stores, also act as fringe tax preparers. Many of these preparers encourage clients to use their tax refunds for large purchases.

In June 2008, the Government Accountability Office (GAO) conducted mystery shopper testing that focused on identifying types of businesses where financial products related to tax refunds, such as refund anticipation loans (RALs)⁹ were marketed.¹⁰ Of the 27 paid preparers subject to testing, 13 were located in businesses that target low-income consumers, such as check cashers,

⁵ Internal Revenue Service, *Regulations Governing Practice Before the Internal Revenue Service*, 76 Fed. Reg. 32,286 (June 3, 2011).

⁶ *Loving v. I.R.S.*, 920 F. Supp. 2d 108 (D.D.C. 2013).

⁷ *Loving v. I.R.S.*, ---F.3d ---, 2014 WL 519224 (D.C. Cir. Feb. 11, 2014).

⁸ See Chi Chi Wu and Jean Ann Fox, NCLC and Consumer Federation of America, *RALs, Tax Fraud, And Fringe Preparers* 11 (Feb. 2009), available at http://www.nclc.org/images/pdf/high_cost_small_loans/ral/2009-ral-appendix.pdf.

⁹ See note 14 for an explanation of what a refund anticipation loan is.

¹⁰ Government Accountability Office, *Refund Anticipation Loans*, GAO-08-800R, June 5, 2008, available at <http://www.gao.gov/new.items/d08800r.pdf>.

payday loan vendors, rent-to-own stores, and pawn shops. Nine of the preparers in the GAO study offered incentives to encourage tax customers to spend their refunds on the businesses' primary goods and services. For example, an auto dealer told GAO investigators that if they didn't have enough money for the down payment on a car, they could get their taxes done by its tax preparer and use the refund as a down payment. Another preparer operated out of a shoe store, and offered a free pair of shoes with tax preparation.

A fundamental problem with fringe preparers is the questionable quality of tax preparation by a business that specializes in goods and services other than tax preparation. The mystery shopper tests discussed later in this report found several instances of incompetent tax preparation by fringe preparers. One particular example was an Alabama small loan company that prepared a tester's return to show a \$6,247 refund when the tester actually owed \$112 to the IRS.¹¹

There are even third-party vendors that specialize in providing software and back office support to businesses that want to prepare taxes "on the side" to boost sales in their primary line of business. One example is Tax Max, which specifically caters to used car dealers. Tax Max advertises that it is "the leading tax consultant in the industry with a portfolio of over 3000 car dealerships nationwide."¹² Tax Max informs car dealers that "[t]here is no experience required, and our web-based program was designed for use by someone who knows nothing about taxes."¹³

C. Abuses Uncovered by Mystery Shopper Testing

Due to the lack of regulation, abuses by tax preparers have flourished over the years. Mystery shopper testing by consumer and other advocacy groups has found frequent examples of incompetency and fraud by tax preparers – a disturbingly high number, given the limited number of tests conducted. Regulation, whether by the federal or state government, is urgently needed to prevent incompetence and fraud by ensuring that paid preparers meet minimum standards.

Some of the types of incompetence and fraud uncovered in this testing were:

- Intentional omission of income;
- Falsifying information to make the taxpayer eligible for various credits and deductions, such as charitable deductions, job-related expenses, Schedule C business expenses, and the EITC;

¹¹ Impact Alabama, *Impact Alabama Undercover Investigation of Commercial Tax Preparers in Alabama Results and Analysis*, Jan. 2009.

¹² Tax Max, About Us, at <https://www.taxmax.com/TRSTaxMax/AboutUs.aspx>.

¹³ Tax Max, FAQ, at <https://www.taxmax.com/TRSTaxMax/FAQ.aspx>

- Inability to properly deal with education-related credits and income;
- Misclassifying filing status; and
- Data entry errors resulting in incorrect refunds.

1. 2008 Mystery Shopper Testing

In 2008, advocacy groups conducted 17 mystery shopper tests of paid tax preparers in Durham, North Carolina and Philadelphia, Pennsylvania.¹⁴ Testers were instructed to have their returns prepared and to obtain RALs from commercial preparers. The original intent of the testing was to determine whether tax preparers were properly making disclosures concerning refund anticipation loans (RAL)¹⁵ and refund anticipation checks (RACs).¹⁶ Unfortunately, the testing also uncovered instances of serious tax errors and fraud in 4 out of 17 tests – or nearly 25%.

The worst example involved a preparer at a small loan company in Durham, where the tester withdrew because of the seriousness of the incompetence. According to this tester:

After sitting in the office for an hour or so, [the preparer] said that there was a problem that she did not know how to handle. The problem was that there was a \$5000 [fictional number] “dividend” that we must pay taxes on. With the dividend, our return would only return \$100. If she was to “ignore” it, then we would receive \$3000 in returns. She then called her “tax people,” [who] told her that we do not need to report the dividends and just ignore it.¹⁷

Mystery shopper testing by consumer and other advocacy groups has found frequent examples of incompetency and fraud by tax preparers – a disturbingly high number, given the limited number of tests conducted.

Essentially, this preparer gave the tester advice to commit tax fraud. This tester concluded: “My experience with [the independent preparer] has been a scary one. I say that mainly because the

¹⁴ Chi Chi Wu, et al., NCLC, Community Reinvestment Association of NC, and Community Legal Services of Philadelphia, *Tax Preparers Take a Bite Out of Refunds: Mystery Shopper Test Exposes Refund Anticipation Loan Abuses in Durham and Philadelphia* (Apr. 2008), available at www.nclc.org/images/pdf/high_cost_small_loans/ral/shopper_report.pdf [hereinafter “2008 Mystery Shopper Testing Report”].

¹⁵ A refund anticipation loan (RAL) is a short term loans secured by and repaid from the proceeds of a consumer’s tax refund. RAL lending was dramatically curtailed as a result of regulatory actions by federal banking regulators and the IRS. Currently, RALs are only available from a limited number of non-banks, who cannot make the loans on the same scale.

¹⁶ A refund anticipation check (RAC) is a bank product involving temporary bank account. The temporary account is used to receive a direct deposit of the consumer’s refund from the IRS. After the refund is received, the bank deducts a fee for the RAC, as well as the tax preparation fee. The remainder is issued to the consumer in the form of a paper check, prepaid debit card, or a direct deposit to the consumer’s own bank account.

¹⁷ 2008 Mystery Shopper Testing Report at 9.

lack of confidence in the preparer's ability to competently complete our return even though she was generally nice."¹⁸

In Philadelphia, a Jackson Hewitt preparer failed to include \$3,500 in unemployment income in the return of a married couple who were testers. This omission resulted in a refund that was \$600 greater than the couple was entitled to, and required them to file an amended return. This preparer also had never seen a mortgage interest Form 1098 and didn't know how to deal with it.

An independent preparer in Philadelphia made numerous errors in dealing with education-related tax credits. Among other mistakes, the preparer incorrectly treated a taxable education award as though it were an exempt scholarship, resulting in an additional tax liability of \$66 and a loss of \$134 worth of Earned Income Tax Credit. The tester was also forced to file an amended return.

At least two of the preparers in this 2008 testing were businesses that primarily sold other goods or services. One preparer was a small loan lender/payday lender, and the other preparer was in a store that primarily operated as a gift shop.

2. 2010 Mystery Shopper Testing

In 2010, consumer groups conducted 19 mystery shopper tests in Arkansas, New York City, and Durham, North Carolina.¹⁹ As in the 2008 testing, several testers became the victims of incompetent tax preparation or outright fraud – at least 6 out of the 19 testers, or over 30%.

A very disturbing example came from a tester in New York City who described how the preparer, when realizing the tester would receive only a \$1,000 federal refund and would owe state taxes, began making up deductions:

[The tester] reported that the tax preparer tried to entice her to commit tax fraud by showing her how much her federal refund would increase if she took deductions in excess of the standard deduction. [The tester] does not attend church, but the tax preparer included a \$2,000 church donation. The preparer also deducted the cost of work clothes and laundry, then showed [the tester] that her federal refund would increase to \$3,000 from about \$1,000. The preparer also tried to convince [the tester] to make up a dependent as she does not have any – showing her that her refund would go up to \$5,000

¹⁸ *Id.* at 10.

¹⁹ Chi Chi Wu, et al., National Consumer Law Center, Arkansans Against Abusive Payday Lending, New Economy Project (formerly NEDAP), Community Reinvestment Association of NC, *Tax Preparers Out of Compliance: Mystery Shopper Testing Exposes Violations of Refund Anticipation Loan Laws in Arkansas, New York and North Carolina* (Apr. 2010), available at www.nclc.org/images/pdf/high_cost_small_loans/ral/mystery_ral_report.pdf [hereinafter "2010 Mystery Shopper Testing Report"].

if she did so. The preparer also tried to qualify her for EITC even though she is not eligible. Finally, the tax preparer deducted \$400 in 2008 tax preparation costs even after [the tester] told the preparer that she did not pay for tax preparation last year.²⁰

Another example of attempted tax fraud by a preparer came from a tester in Arkansas who described how:

[The preparer] took the forms I had completed and requested my W2's which I gave them to him. He mistakenly thought that my 1099 was my tithing statement from my church. I told him it was my salary from my second job. He entered the amount and stated that I would be really disappointed if I knew the difference in my refund now that I have this additional income reported. I asked what was the difference, he stated I went from around \$30?? [i.e. \$3,000] To only \$15?? [i.e., \$1,500]. He wanted to know if I still wanted to report the additional income. I told him yes, I did because this income has already been reported to the IRS. Since I have been working this part time job, my refund has been less and I even have to pay State Taxes sometimes. He then told me how much I will owe the state for taxes. He again asked me if I was sure I wanted to report this. I told him again, yes, I do. I need to keep it clean. He said he had to ask because some people don't want them to report additional income because it lowers their refund amount. So he has to do what the customers tell him to do.²¹

Other testers reported either fraud or incompetent preparation, including:

- A tester in New York reported that a Jackson Hewitt preparer advised her not to include \$300 in income for which the tester had not received a 1099 form.
- A tester who went to a small chain in Arkansas later had her tax return reviewed by a Volunteer Income Tax Assistance (VITA) volunteer. The VITA preparer found numerous errors, resulting in the tester being required to file an amended return and to reimburse the IRS \$822.

Another example of preparer abuse came from a complaint in North Carolina against Freedom Tax Services, an independent preparer. This consumer could not participate in the testing. Why? Freedom Tax Services had already prepared her taxes without her permission, after she had given them her documents merely to get an estimate of the tax preparation fees.

Finally, there were several violations of requirements for tax preparers to provide certain documents to the taxpayers. The IRS Code requires preparers to provide a copy of the tax return to the taxpayer no later than the time that the taxpayer signs it.²² Yet 3 of the 19 preparers did not provide a complete copy of the tax return at the time of filing, but instead withheld the copies until the refund was received and the preparer was paid from the refund.

²⁰ *Id.* at 3.

²¹ *Id.* at 3-4.

²² I.R.C. § 6107(a).

3. 2011 Mystery Shopper Testing

In 2011, consumer groups conducted nine mystery shopper tests in New York City and Durham, North Carolina.²³ As in the earlier rounds of testing, several testers were the victims of incompetent tax preparation or were encouraged to engage in tax fraud — at least four out of the nine testers, or a whopping 44%.

A very disturbing example in the 2011 testing came from a New York City tester who went to a Liberty Tax office. The tester described how the preparer could not initially process a 1099 form that she had received for a credit card debt that was settled:

His boss came over to assist the tax preparer with the 1099. [The tester] asked if the 1099 would change her tax refund, and the preparer answered that they would “fix it.” The tax preparer and his boss proceeded to ask her a number of questions including: did she have money in the bank, valuables like jewelry, a 401k or other investments, or other debts. [The tester] answered that she had a 401k at work, some money in the bank as she recently deposited a substantial check for one of her daughters, and that she had about \$10,000 in combined credit card and student loan debt. She asked how they would “fix it.” The preparer responded that they needed to make it look like she had other debts that prevented her from affording the credit card debt that was forgiven (to make her look deserving of the forgiveness, was [the tester’s] understanding), and that she had no assets to sell. The preparer and his boss filled out a worksheet with her answers to their questions, but they did not provide her with a copy.²⁴

In addition, this preparer improperly claimed the EITC for one of the tester’s daughters. Finally, the tester observed that the preparer reported on a form that the tester did not know the location of her children’s father. However, the preparer never asked that question and the tester did know where her children’s father was.²⁵

Another example involved a Jackson Hewitt preparer in New York City who gave questionable advice to a tester who owed money to the IRS. The preparer told the tester that she “needed to get a kid” in order to get a bigger tax refund.

A third tester reported that she informed the preparer that she was no longer a student but the preparer incorrectly claimed the New York State tuition credit. The tester also reported that the

²³ Chi Chi Wu, et al., NCLC, New Economy Project (formerly NEDAP), Community Reinvestment Association of NC, *Tax Time 2011: Mystery Shopper Testing in New York and North Carolina Finds Continuing Problems with Tax Preparers* (Apr. 2011), available at www.nclc.org/images/pdf/pr-reports/report-mystery-ral-shopper-2011.pdf [hereinafter “2011 Mystery Shopper Testing Report”].

²⁴ *Id.* at 3.

²⁵ This was probably a follow-up question to “Can anyone else claim this child?,” which is asked by IRS Form 8867, the checklist for the EITC. This information would be listed in the tax preparer’s internal notes, not on the actual tax return.

preparer incorrectly inputted student loan interest, misspelled her address, and pressured her to sign the return without explaining the paperwork.

In North Carolina, a Jackson Hewitt preparer erroneously failed to claim Head of Household status for a tester. As a result, the tester's refund was smaller by \$269 for her federal refund and \$84 for her state refund, and she was forced to file an amended return.

4. 2011 First Nations Development Institute (FNDI) Mystery Shopper Testing

First Nations Development Institute (FNDI) is an organization focused on strengthening American Indian economies to support healthy Native communities. Two of its key areas of work are combating predatory lending and promoting financial education. FNDI conducted 12 mystery shopper tests in New Mexico, all in communities with high Native American populations and located near reservations.²⁶ In this testing, 10 of the 12 taxpayers encountered problems with inaccurate, illegal, or unprofessional behavior. In 7 cases, the tax preparation process was stopped or changed to avoid having the paid preparer file an inaccurate tax return.

One of the worst errors was a preparer's failure to include unemployment insurance benefits as taxable income. This omission incorrectly qualified the taxpayer for the EITC, which could have significant ramifications. If the IRS caught the omission of the unemployment income, the refund would be lowered and the EITC would be denied. A taxpayer can be disallowed from taking the EITC for 10 years if the credit is claimed but the taxpayer is later determined ineligible. This taxpayer was required to file an amended return. This same preparer lacked the knowledge to properly handle dividend income. This preparer also told the tester: "Oh, they are just forms. If I get \$4,000, I am not going to ask a lot of questions. I just want it!"²⁷

Two preparers failed to report qualified student grant funds as taxable income. Both preparers became confused about Form 1098-T, which reports scholarships, grants, and tuition payments from higher education institutions. In the case of the first tester, her scholarship amount exceeded the qualified expenses and therefore the tester was required to report some income from the scholarship. The preparer for the first tester asked her supervisor what to do, and the supervisor incorrectly responded that the tester didn't have to report the income.

The second tester had a 1098-T that listed \$662.65 in line 4 (adjustment from prior year). The preparer became confused and stated, "Technically I think I'm supposed to subtract \$662.65 from \$2,235, but I'm not sure. We can probably just leave it out because it's highly unlikely that IRS can track it."²⁸ Before completing the return she addressed the issue again, asking the taxpayer for permission to just ignore the \$662.65.

²⁶ Sarah Dewees and Shawn Spruce, First Nations Development Inst., *Tax Time Troubles: Mystery Shopper Testing Exposes Poor Quality Tax Preparation and Refund Anticipation Check Abuses*, Apr. 15, 2011, available at www.nmlegis.gov/lcs/handouts/IAC%20092412%20FNDI%20Taxtime%20Mystery%20Shopper.pdf.

²⁷ *Id.* at 22.

²⁸ *Id.* at 7.

Another tax preparer indicated she used her own bank account to receive direct deposits of taxpayers' refunds, which is prohibited under the IRS Code. I.R.C. § 6695(f). A tester asked this preparer what she did if someone could not afford to pay upfront. The preparer responded: "I just put my account number and routing number on the return and write the client a check when their refund comes in. I take my fee out before I write the check."²⁹

One tax preparer encouraged tax fraud by making up frivolous expenses for the Schedule A form. This preparer included numerous expenses for which taxpayers do not usually qualify for a deduction, *i.e.* clothing expenses, personal cell phones (calculated for 99% business use), and numerous commuter expenses that the taxpayer was not eligible to claim. She asked questions such as, "about how much did you spend on clothing?" and then recorded answers without asking for records of expenses. This same preparer told the tester, who was a tribal member, that he did not have to pay state income tax on income earned from employment not on his reservation, which was incorrect under New Mexico law.³⁰

Other problems included preparers who:

- Showed a lack of knowledge regarding how to properly file a Schedule C business return.
- Told a tester that federal employees do not pay Social Security taxes because they have a good retirement plan (this has not been the case since 1984).
- Didn't know how to handle paperwork associated with a rollover of a Roth IRA.

Finally, 5 of the 12 preparers did not provide a copy of the tax return to the testers at the time of signing, in violation of I.R.C. § 6107(a).

5. 2012 First Nations Development Institute (FDNI) Mystery Shopper Testing

In 2012, FDNI conducted 10 mystery shopper tests in communities near Native American reservations in New Mexico.³¹ Once again, this testing revealed poor quality service provided by tax preparers. Nine of the 10 testers encountered some issue when filing their taxes. FDNI concluded "[w]hile our sample of participants was small, the frequency of these errors calls into question how many Native American taxpayers, and moreover, how many taxpayers across the country are being overcharged and underserved by paid tax preparers."³²

²⁹ *Id.* at 10.

³⁰ *Id.*

³¹ Benjamin Marks, et al., First Nations Development Institute, *More Tax Time Troubles: Mystery Shopper Testing Exposes Refund Anticipation Loans in Reservation Border Towns*, 2012, available at www.nmlegis.gov/lcs/handouts/IAC%20092412%20FDNI%20Taxtime%20V3.pdf

³² *Id.* at 3.

In one example, an inexperienced preparer miscalculated the total refund for the tester. A FDNI staffer who accompanied the tester noted:

Unfortunately, I had completely assumed the preparer correctly listed the daughter as a dependent because she asked so many questions, so I didn't catch the omission until reviewing the return later. I ended up having to write a whole new paper return, changing the filing status to Head of Household and listing the daughter as a dependent. This raised the refund from \$55 to \$70... missing a dependent standing next to a taxpayer across your desk is probably inexcusable.³³

Since all of the testers were Native American, they potentially qualified for the New Mexico state exemption for this community. Yet several preparers skipped over this step. In one case — in which the tester was eligible for this exemption yet the preparer missed it — the tester had \$571 of state withholding from which she might have received some refund.

Finally, 6 of the 10 preparers did not provide a copy of the tax return to the testers at the time of signing, in violation of I.R.C. § 6107(a).

6. Impact Alabama Testing

Impact Alabama conducted mystery shopper tests of 13 tax preparers.³⁴ Testers described themselves to preparers as parents with one or two children who lived with them less than six months of the year, which would make them ineligible for the EITC.

The testing by Impact Alabama found that 11 of the 13 preparers nonetheless incorrectly claimed the EITC. In addition, 10 preparers did not report income from other jobs such as babysitting; nine preparers did not report interest income; and 11 allowed testers to claim “head of household” status without being qualified for it.

None of the testers should have qualified for refunds, yet each preparer calculated a refund ranging from \$65 to \$6,247. Five preparers calculated a refund of \$6,247 for a taxpayer who actually owed \$112 to the IRS. These five preparers included a fringe preparer (a finance company), a Mo' Money Taxes outlet, and three other independent preparers.

7. Testing by the Treasury Inspector General for Tax Administration (TIGTA)

In 2008, TIGTA testers conducted mystery testing of 28 paid preparers — 12 commercial chains and 16 independent preparers.³⁵ The TIGTA testers found that just 11 of the 28 preparers

³³ Id. at 17.

³⁴ Impact Alabama, *Impact Alabama Undercover Investigation of Commercial Tax Preparers in Alabama Results and Analysis*, Jan. 2009.

prepared an accurate tax return. The other 17 preparers prepared the returns incorrectly. Of these 17 preparers, 6 of 17 preparers produced returns that contained misstatements and omissions TIGTA considered to have been willful or reckless. These six preparers engaged in conduct such as adding or increasing deductions without the testers' permission — in some situations after the testers had questioned whether they were entitled to receive the deductions.

Examples included:

- When informed by the tester that s/he paid for babysitter expenses in cash, the preparer increased the child care expenses beyond what the tester stated s/he paid. In addition, the preparer instructed the tester to tell the babysitter to file a Schedule C with the inflated amount and deduct expenses for operating a home business equal to the inflated amount. The preparer also offered to change the expenses back to the original (real) amount if the babysitter did not agree to change his or her records. The preparer's actions increased the tester's refund by more than \$325.
- A tester completed an information worksheet showing children living in the home for less than one-half of the year. The preparer stated that he or she was going to show on the tax return that the children lived in the home with the tester for a full 12 months. The decision erroneously changed the tester's filing status from Single to Head of Household, increased the dependency exemptions, and qualified the tester for the Child Tax Credit and the EITC. The net effect was to increase the refund from \$100 to approximately \$6,000.
- Even though a tester informed the preparer s/he had no charitable contributions, the preparer included contributions on the return and did not inform the tester that they were being added. The preparer also added a deduction for property tax for a car without the tester's assertion or documentation. The effect was a refund of more than \$200, when the refund should have been less than \$140.

8. *Testing by the Government Accountability Office (GAO)*

In 2006, the GAO conducted mystery shopper tests of 19 paid preparers.³⁶ The GAO found errors in 17 out of the 19 tests, including preparers not reporting business income in 10 of 19 cases and claiming an ineligible child for the EITC in 5 out of the 10 applicable cases. These errors led to inflated refunds exceeding \$1,000 in 6 out of the 19 test cases.

³⁵ Treasury Inspector General for Tax Administration, *Most Tax Returns Prepared by a Limited Sample of Unenrolled Preparers Contained Significant Errors*, Reference Number: 2008-40-171, Sept. 3, 2008, available at www.ustreas.gov/tigta/auditreports/2008reports/200840171fr.pdf.

³⁶ Government Accountability Office, *Paid Tax Return Preparers: In a Limited Study, Chain Preparers Made Serious Errors*, GAO-06-563T, April 4, 2006, available at www.gao.gov/new.items/d06563t.pdf.

D. Abuses Uncovered by Government Enforcement Actions

Enforcement actions by the federal and state regulators have found numerous instances of fraud committed by preparers. Some of the most prominent actions include:

1. *U.S. Department of Justice (USDOJ) v. Jackson Hewitt*

A particularly notable tax fraud case was the civil enforcement action in April 2007 brought by the United States Department of Justice (USDOJ) against five Jackson Hewitt franchisees that operated 125 offices.³⁷ The USDOJ brought the civil enforcement action against the five Hewitt franchisees for preparing fraudulent tax returns that falsely claimed \$70 million in tax refunds. The USDOJ alleged that the owners and managers of these franchisees created and fostered an environment in which fraudulent tax return preparation was encouraged and flourished. Examples of fraud alleged by the USDOJ include filing false returns claiming refunds based on phony W-2 forms; using fabricated businesses and business expenses on returns to claim bogus deductions; claiming fuel tax credits in absurd amounts for customers clearly not entitled to any such credits; and massive fraud related to EITC claims.

2. *USDOJ v. Instant Tax Service*

The USDOJ filed a lawsuit against the owner of the tax preparation chain Instant Tax Service in March 2012.³⁸ The complaint alleged that Instant Tax franchisees intentionally prepared fraudulent tax returns to maximize customers' refunds in order to extract large tax preparation fees from these refunds. The USDOJ also alleged that Instant Tax Service issued guidance documents that encouraged franchisees "to lie to the IRS in the event of an audit."³⁹ The complaint states that the estimated tax losses from the allegedly fraudulent returns prepared in 2011 at Instant Tax locations in five cities exceeded \$16 million. After a two-week trial, a federal judge issued a permanent injunction banning Instant Tax Service and its owner, Fesum Ogbazion, from operating or being involved with any business related to tax preparation.⁴⁰

3. *Illinois v. Mo' Money Taxes*

The Illinois Attorney General's Office sued Mo' Money Taxes for filing tax returns without consumers' authorization, filing erroneous tax returns, and charging undisclosed and exorbitant

³⁷ See Complaint, *United States v. Smart Tax of Georgia, Inc.*, 1:07CV-0747 (N.D. Ga. Apr. 2, 2007); Complaint, *United States v. Smart Tax Inc.*, 07C-1802 (N.D. Ill. Apr. 2, 2007); Complaint, *United States v. Sofar, Inc.*, Civ. No. 2:07-cv-11460 (E.D. Mich. Apr. 2, 2007); Complaint, *United States v. Smart Tax of North Carolina, Inc.*, Civ. No. 5:07-cv-00125-FL (E.D.N.C. Apr. 2, 2007). All of the complaints are *available at* <http://www.usdoj.gov/tax/txdv07215.htm>.

³⁸ Complaint, *United States v. Fesum Ogbazion*, Civil No. 3:12-cv-95 (S.D. Ohio. Mar. 28, 2012).

³⁹ *Id.* at ¶¶ 27-28.

⁴⁰ *United States v. ITS Fin., LLC*, 2013 WL 5947222 (S.D. Ohio Nov. 6, 2013).

fees for tax preparation.⁴¹ The complaint alleged that Mo' Money used offers of RALs to lure consumers into providing their personal information, and signing a form that – unbeknownst to the consumer – gave Mo' Money the right to file tax returns on their behalf. Mo' Money would then file the consumers' tax returns and automatically deduct hundreds of dollars in undisclosed fees from their refunds – as much as \$700 per person. Many of these returns included incorrect information.

4. *Chicago Department of Business Affairs and Consumer Protection*

Investigators from this Chicago agency went undercover to investigate hundreds of tax preparers. They found more than 80 percent of the preparers investigated were in violation of new City ordinances governing them.⁴² One common violation was the failure to give consumers a required “Taxpayer Bill of Rights” and disclosure forms listing their services, the price for each service, and an estimate of the total charges. (The CBS news story also cites the case of a Chicago consumer whose return was filed by a tax preparer who did not have authorization to do so, and was even expressly told by the consumer not to file his return).

5. *New York Department of Taxation and Finance*

A 2008 sting operation by this New York state agency found evidence of fraud among about 40 percent of the 85 tax preparers it visited.⁴³ According to a news article about the sting, state officials were startled by the brazen nature of the fraud. In one case, a preparer told an undercover investigator: “I did not declare your full gross income from your business because you will pay a lot of taxes.”⁴⁴

E. Tax Preparation Fees

Another problem faced by taxpayers is the lack of transparency around tax preparation fees. Tax preparation is one of the few consumer services in the United States for which consumers often cannot obtain a price for the services before they incur them. Many tax preparers assert that they charge by the form and cannot predict which forms will be generated until they actually

Mystery shopper testing has documented tax preparation fees up to \$500.

⁴¹ See Complaint, *People v. Mo' Money Tax Service*, Civil Ac. No. 12CH09136 (Cook Cty Cir. Ct. Mar. 14, 2012).

⁴² Pam Zekman, “2 Investigators: Tax Preparers May Be Ripping You Off”, CBS Chicago, Feb 4, 2013, available at <http://chicago.cbslocal.com/2013/02/04/2-investigators-tax-preparers-violating-city-consumer-laws/>.

⁴³ See Press Release, New York Department of Taxation and Finance, “*Wall Street Journal* Story Highlights Department's Efforts To Expose Crooked Tax Preparers”, Dec. 4, 2008.

⁴⁴ See Tom Herman, “New York Sting Nabs Tax Preparers”, *Wall Street Journal*, Nov. 26, 2008.

finish the tax preparation. Thus, consumers cannot comparison shop or predict how much tax preparation will cost them.⁴⁵

As a result of this lack of transparency, low-income consumers face tax preparation fees that are already very high, and, in many instances, inflated. Mystery shopper testing has documented preparation fees up to \$400 or \$500. There are numerous examples of preparers giving low-ball estimates on preparation fees or even refusing to provide testers with a quote.⁴⁶ The U.S. Department of Justice's lawsuit against Instant Tax Service is the latest example of these types of abuses. The USDOJ alleged that:

Collectively, Instant Tax Service's tax preparation and junk fees⁴⁷ typically average more than \$400–\$500, and sometimes run as high as \$1,000 for as little as 15 minutes of tax return preparation. Because Instant Tax Service deliberately targets low-income taxpayers, these unconscionably high fees often pose a significant financial hardship for their customers Frequently, franchisees also fail to disclose all fees, or they tell customers that they charge one amount for fees and then later increase the fees without the customer's knowledge or consent.⁴⁸

The Illinois Attorney General's lawsuit against Mo' Money Taxes is another example of abuses in tax preparation fees.

Mo' Money Taxes advertised that the cost of their services would be between \$150 and \$350....In fact, Mo' Money Taxes charged consumers between \$480 and \$550 to prepare and file their returns, and charged them additional fees totaling \$178 for processing the returns....As a result, consumers were typically charged over \$700 in fees for preparing, filing, and processing their tax return.⁴⁹

The ability to deduct tax preparation fees from a tax-time financial product, such as a refund anticipation check (RAC) or refund anticipation loan (RAL), compounds this problem, as it makes taxpayers less sensitive to the price of preparation. Normally, a merchant's refusal to provide price information might discourage a consumer from buying a product. However, since the fee is deducted from the financial product, consumers may not be as sensitive to this

⁴⁵ See David Rothstein, Policy Matters Ohio, Improving Tax Preparation With a Model Fee Disclosure Box, June 2013, available at www.policymattersohio.org/wp-content/uploads/2013/06/FeeDisclosure_Jun2013.pdf; Chi Chi Wu and Jean Ann Fox, NCLC and Consumer Federation of America, *The Party's Over for Quickie Tax Loans: But Traps Remain for Unwary Taxpayers*, 14-16 (Feb. 2012), available at <http://www.nclc.org/images/pdf/pr-reports/report-ral-2012.pdf>.

⁴⁶ See *id.* at 17.

⁴⁷ These "junk fees" were the add-on fees often associated with refund anticipation checks and loans, such as "data and document storage," "administrative," "e-filing," "service bureau," "transmission," or "processing" fees.

⁴⁸ Complaint, *United States v. Fesum Ogbazion*, Civil No. 3:12-cv-95 (S.D. Ohio. Mar. 28, 2012), ¶¶ 33-34.

⁴⁹ Complaint, *People v. Mo' Money Tax Service*, Civil Ac. No. 12CH09136 (Cook Cty Cir. Ct. Mar. 14, 2012), ¶¶ 79-81.

lack of pricing information. Furthermore, mystery shopper testing has found that the tax preparation fee is often lumped together with the fee for the RAC/RAL and other junk fees, so that it is impossible to tell how much a consumer paid for each item.⁵⁰ Some tax preparers subjected to mystery shopper testing were even reluctant to provide a breakdown of the fees when asked.⁵¹

Clearly, there is a need for reforms in the disclosure of tax preparation fees. As part of any tax preparer regulation, preparers should be required to provide a clear, simple disclosure of tax preparation fees to consumers before beginning the process of tax preparation. This disclosure should be in a tabular format, similar to the disclosure table that accompanies credit card applications and solicitations.

⁵⁰ See 2011 Mystery Shopper Testing Report at 5-6; 2010 Mystery Shopper Testing Report at 9; See also Sara Dewees, First Nations Development Institute, *Tax Time Troubles: Mystery Shopper Testing Exposes Poor Quality Tax Preparation and Refund Anticipation Check Abuses*, Apr. 15, 2011, at 14, 24.

⁵¹ See 2011 Mystery Shopper Testing Report at 5; 2010 Mystery Shopper Testing Report at 9.

The following table provides examples of the different tax preparation fees documented by mystery shopper studies and other sources.

Table of Tax Preparation Fees

Source	Location	Range of Tax Prep Fee	Range of Total Fees (inc. RALs, RACs and Related Fees)
US Dept of Justice v. Instant Tax Serv. (2012)	Multiple states	----	\$400 – over \$1000
Illinois AG v. Mo’ Money Taxes (2012)	Illinois	\$480 - \$550	\$658 - \$728
Consumer Groups 2008 Testing	North Carolina (Durham)	\$75 - \$355	\$75 – \$502
	Pennsylvania (Philadelphia)	\$60 - \$298	\$148 - \$487
Consumer Groups 2010 Testing	Arkansas	\$79 - \$396	\$224 - \$487
	North Carolina (Durham)	\$195 - \$275	\$343 - \$388
	New York (New York City)	\$40 - \$443	\$40 - \$497
Consumer Groups 2011 Testing	North Carolina (Durham)	\$64 - \$320	\$69 - \$466
	New York (New York City)	\$143 - \$540	\$100 - \$570
First Nations Dev. Inst. 2011 Testing	New Mexico (towns bordering Native American reservations)	\$48 - \$308	Same
First Nations Dev. Inst. 2012 Testing	New Mexico (towns bordering Native American reservations)	\$55 - \$1,318	Same
Treasury Inspector General(2008)	Not disclosed	\$60 - \$402	-----

F. Why Regulation Is Needed and Enforcement Actions Alone Are Not Adequate

The massive amount of fraud, incompetence, and abuse in the tax preparation industry is astounding. Just a handful of limited mystery shopper tests have consistently uncovered numerous instances of these problems, indicating that such problems are widespread and common in the tax preparation industry. This is not an anomaly or a handful of bad apples. There is an enormous level of incompetence and corruption across the entire industry. The IRS regularly ranks “preparer fraud” highly among its “Dirty Dozen Tax Scams.”⁵²

Bringing enforcement actions on a one-by-one basis is simply inadequate as a response to this problem. While it would get rid of a few bad actors, relying on enforcement alone ignores tens of thousands of other violators. It is akin to only treating a skin lesion when the related disease has invaded a patient’s entire body.

Protecting individual taxpayers and the federal and state treasuries from this massive fraud and abuse demands some basic fundamental standards. It calls for establishing baseline considerations for the practitioners who handle consumers’ most sensitive information. It is only common sense to require commercial preparers to obtain basic training, pass competency exams, and seek continuing education to stay current on ever-changing tax laws.

It is only common sense to require commercial preparers to obtain basic training, pass competency exams, and seek continuing education to stay current on ever-changing tax laws.

G. The Model Tax Preparer Regulation Act

To assist states in developing a system to regulate tax preparers, the National Consumer Law Center (NCLC) has developed text for a Model Act for the regulation of tax preparers (see Appendix B). This Model Act is based in large part upon the laws of three of the four states that currently regulate paid tax preparers – Maryland, Oregon, and California⁵³ – as well as the IRS regulations that were invalidated as being outside the IRS’s authority.⁵⁴ It combines the best elements of these laws with some additional provisions for administrative and private relief.

⁵² See, e.g., IRS, *IRS Releases the Dirty Dozen Tax Scams for 2013*, Mar. 26, 2013.

⁵³ The fourth state to regulate tax preparers was New York. New York’s regulations governing preparers were finalized in December 2013, after the Model Act had been already drafted in November 2013.

⁵⁴ Note that the D.C. Court of Appeals invalidated the IRS regulations solely on the basis that they were outside the scope of the IRS’s authority as an administrative agency, and not for any deficiencies in the regulations themselves. See *Loving v. I.R.S.*, ---F.3d ---, 2014 WL 519224 (D.C. Cir. Feb. 11, 2014). Obviously, the issue of the scope of administrative authority is not a problem for a state legislature that is enacting a new law.

The Model Act consists of three core components that require all paid tax preparers to:

- Obtain a registration from the designated state agency unless they fit into one of the handful of exceptions, such as certified public accountants.
- Pass a basic competency exam to demonstrate their knowledge of tax law and practice.
- Have 60 hours of initial education and 15 hours per year of continuing education courses on tax law, theory, and practice.

In addition, the Model Act has provisions requiring preparers to provide a standardized disclosure of their fees. This addresses the problem with the opacity of tax preparation fees discussed in section E.

The Model Act can be combined with another model statute available from NCLC that regulates preparers who broker or “facilitate” tax-time financial products, particularly refund anticipation loans and refund anticipation checks. This model statute, the Model Refund Anticipation Loan Act, is available at www.nclc.org/ralmodel.