

**TAXPAYER ALERT: CHOOSING A PAID PREPARER  
AND THE PITFALLS OF CHARITABLE CAR  
DONATION**

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**HEARING**

BEFORE THE

**COMMITTEE ON FINANCE  
UNITED STATES SENATE**

ONE HUNDRED EIGHTH CONGRESS

FIRST SESSION

APRIL 1, 2003



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## **TAXPAYER ALERT: CHOOSING A PAID PREPARER AND THE PITFALLS OF CHARITABLE CAR DONATION**

**TUESDAY, APRIL 1, 2003**

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

The hearing was convened, pursuant to notice, at 10:03 a.m., in room 215, Dirksen Senate Office Building, Hon. Charles E. Grassley (chairman of the committee) presiding.

Also present: Senators Snowe, Baucus, and Bingaman.

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

The CHAIRMAN. I want to thank everybody for their attendance at this hearing, particularly for our witnesses who are here and the hard work that every witness goes through to prepare for a hearing like this.

This hearing is going to deal with three issues. First, we look back at the issue of schemes and scams that was raised by this Finance Committee 2 years ago. Next, we bring to the public's attention two new issues, paid preparers and donation of cars to charities.

On the matter of tax schemes and scams, the IRS reports very good news. The IRS says, in their words, "the tide has turned" on going after abusive tax activities that can devastate taxpayers. I urge taxpayers that they pay close attention to the "Dirty Dozen" tax schemes identified by the IRS in Ms. Hart's testimony.

I hope the media widely reports these "Dirty Dozen," because sunshine is probably our best friend in this fight. I also encourage the media to report to the public the very useful nine tips that the General Accounting Office highlights in Mr. White's testimony on page 12 on how to choose a paid preparer.

With over 50 percent of the taxpayers relying on preparers, it is important that Americans be careful in choosing their tax preparer. This hearing is meant to focus on several issues regarding paid preparers, and particularly what taxpayers need to be aware of in choosing a tax preparer, and also whether the IRS is doing all it can to protect taxpayers from unscrupulous tax preparers.

I should make it clear that the strong majority of preparers serve their clients well. However, with some 70 million taxpayers taking advantage of paid preparers, it can only take a few bad apples to cause real problems for many Americans.

Finally, this committee is going to look at the growing trend of the donation of cars to charities. In the year 2000, 733,000 people filed a return stating that they had donated a vehicle. Taxpayers claimed the worth of these cars to be \$2.5 billion and realized \$654 million in tax savings per year.

Now, it is good that Americans are so very generous. However, we have two concerns with charitable donations of cars. One, is whether or not the charities are seeing the lion's share of the benefits from the donation of cars, and second, are taxpayers claiming a fair and accurate amount for the value of their cars? We want to make certain that Uncle Sam is not the one being taken for a ride by aggressive valuations.

The General Accounting Office will tell us about a case where the donor claimed a deduction of \$2,400, yet the truck was sold for \$375 and the charity ended up with \$31.50. This is, in fact, a troubling picture.

To help us examine these three issues, we benefit from the testimony of James White and Cathleen Berrick from the General Accounting Office; Pam Gardiner, the Acting Inspector General for Tax Administration; Dale Hart from the IRS; Nina Olson, the Taxpayer's Advocate; and Jeffrey Yabuki from the H&R Block Company.

I thank all of you, as I have before, for your participation and your preparation for this meeting. It is my opportunity now to invite the Ranking Minority Member and my friend, Senator Baucus, and a person who, during his chairmanship of this committee was very much active in the promoting of these studies that we are hearing about today.

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

Senator BAUCUS. Thank you very much, Mr. Chairman. I appreciate you calling this hearing. It is critically important in our oversight role of the tax system that we do our part to help ensure that the system works and that taxpayers meet their tax filing obligations.

For the year 2002 tax year, 132 million individuals and families will file a tax return; 132 million. Over half of the returns will be prepared by 1.2 million tax preparers.

In the next 2 weeks, a lot of taxpayers will be calling a paid preparer to ask for help in filing their return. Most taxpayers want to pay their fair share. That is, they want to do the right thing.

These taxpayers recognize that paying their taxes is one of the most patriotic things they can do. These dollars provide the government with resources to defend our shores, educate our children, protect our environment, improve highways, and they help provide for our seniors suffering in hard times.

Our voluntary self-assessment tax system is one of the triumphs of our democracy, the very idea that taxpayers come forward and provide an accounting of their income and deductions. They step up and they pay what they owe in taxes.

This system ensures a smaller government because the government does not prepare the tax returns, the people do. This system

also demonstrates our confidence that most Americans are honest and want to comply.

What we need to help taxpayers do, is get it right the first time in order to avoid headaches down the road. The saying, "an ounce of prevention is worth a pound of cure" could not be more appropriate when it comes to filing income taxes.

Today's hearing will focus on how taxpayers can avoid problems with the IRS. Our witnesses will identify common sense steps taxpayers can take when they want to use a paid preparer, and what schemes to stay away from.

Given the complexity of our tax laws, it is easy to understand why so many taxpayers seek the assistance of a paid preparer. Our society values specialization. Many taxpayers do not understand tax laws. Some simply do not have the time to do their own taxes, and others use paid preparers in the hope of obtaining a larger refund.

The hearing should not be interpreted as criticism of the important role that they play. The vast majority of paid preparers provide a valuable service. Undoubtedly, paid preparers help make the tax system work better.

But despite the important role taxpayers play in the annual filing season, very little information exists on who provides tax preparation services and the quality of their work.

There are instances where taxpayers are not well served by paid preparers. As the GAO will point out, even a small percentage of users of paid tax preparers can translate into millions of affected taxpayers.

For these taxpayers, the filing of their return may begin a long, costly process to resolve a tax dispute with the IRS. But for some taxpayers, visiting a questionable preparer means a loss of money they were rightfully entitled to receive.

Last year, GAO estimated that up to 2 million taxpayers overpaid their 1998 taxes by almost \$1 billion because they claimed the standard deduction, when it would have been more beneficial to itemize. Half of these taxpayers used a paid preparer.

Another area we should examine more closely, is anyone can be a paid tax preparer. Anyone can. There are no laws or regulations that limit who can sell tax preparation services. The types of training of paid preparers varies, and varies widely.

Most taxpayers do not realize that there is such a lack of monitoring of tax petitioners. Buyer beware is just as relevant with tax preparation and planning as it is with buying a new stereo.

I hope today's hearing will provide useful, common sense information for taxpayers as they meet their tax responsibilities. I very much appreciate the witnesses who are here today to help make all that happen.

Thank you very much.

The CHAIRMAN. I am going to call on Senator Bingaman. Normally we only have the two of us make opening statements, but Senator Bingaman has had a long interest in this issue as well, and I think it would be appropriate for Senator Bingaman to join in at this time with anything he wants to say.

**OPENING STATEMENT OF HON. JEFF BINGAMAN, A U.S.  
SENATOR FROM NEW MEXICO**

Senator BINGAMAN. Well, thank you very much, Mr. Chairman. Thanks for having this hearing. I do think it is very important to look at some of the practices that have developed.

One that I have been particularly concerned about, and I know that Taxpayer Advocate Nina Olson has been trying to address this also, are refund anticipation loans. We have circumstances in our State where, particularly citizens on our Indian reservations, come into communities to get their tax returns prepared.

The tax preparer is also primarily in the business of making refund anticipation loans at extremely high interest rates. Oftentimes they don't have funds to pay for the tax preparation. Accordingly, they wind up forfeiting a substantial amount of the tax refund to get the preparation done.

Then in some cases we found that the balance, instead of being paid in cash, is actually provided through a line of credit that they worked out with some trading company or merchant of some kind.

So the bottom line is, the taxpayer winds up with very little and the folks providing the so-called service and the refund anticipation loans wind up with the lion's share of what the government intends to be returned to the taxpayer.

So I hope we can find some solutions to this. I have a bill Senator Akaka and I have introduced, S. 685, that tries to put in some very modest protections. But I would be anxious to hear from the witnesses as to what else could be done. Thank you.

The CHAIRMAN. Well, thank you, Senator Bingaman, for a very important issue that you have been following for a long period of time, and one that has recently been in the news as well as yet a problem.

Now, except for the General Accounting Office issuing their report, we are going to give each of those 7 minutes. I hope the rest of you have been informed about 5 minutes each.

Then each of you will automatically, if you have a longer written statement, that will be included in the record without your asking. And I do not ever shut anybody off right when the red light goes on, but I would appreciate it if you would just kind of summarize from that point on, or finish a point at that time.

Mr. White?

**STATEMENT OF JAMES R. WHITE, DIRECTOR OF TAX ISSUES,  
GENERAL ACCOUNTING OFFICE, WASHINGTON, DC**

Mr. WHITE. Thank you, Mr. Chairman.

Mr. Chairman and members of the committee, I am pleased to be here to discuss our ongoing work on paid tax preparers.

A few facts show that paid preparers are an important part of our tax system. Over half of individual taxpayers pay someone to prepare their return. They pay over \$14 billion annually. IRS estimates there are over one million paid preparers.

Given the complexity of the Tax Code, it is easy to understand why so many taxpayers depend on the help of paid preparers. Today I will discuss the quality of those services.

First, a little background. Anyone can be a paid tax preparer. No laws or regulations limit who can sell tax preparation services. Pre-



parers include attorneys, certified public accountants and enrolled agents who are tested in tax laws. Preparers also include unenrolled agents who are not tested. Commercial tax preparation services may hire any of the above and provide their own training.

In summary, most taxpayers who use preparers are satisfied with the quality of service they receive. The available evidence suggests a small percentage have problems with their preparers, but even a small percentage of the 70 or so million taxpayers who hire preparers translates into millions of taxpayers.

Let me now discuss the good performance. Taxpayers hire preparers for a variety of reasons. Many taxpayers do not understand the tax laws and cannot fill out their return by themselves. One taxpayer described to us how she started using a preparer to help her with estate tax issues following the death of her father.

Other reasons include the hope of larger and quicker refunds and time. A mother of four who operates her own business and is finishing her degree at night said it takes too much of her time to do her own taxes.

The results of a national random survey of taxpayers are summarized in the graphic, which also appears on page 3 of my statement.

The two biggest slices of the pie show that most taxpayers, 77 percent, who hired preparers are confident that they did not overpay their taxes. A word of caution. Many taxpayers do not have enough understanding of the tax laws to be an informed judge of whether their preparer missed something. Thus, our estimate could be overstated.

Preparers provide several benefits. One, is probing to understand taxpayers' personal circumstances, dependents, sources of incomes, and expenses.

One preparer told us about a new client who had overpaid his taxes by \$6,000 over 3 years because the client had overlooked earned income and child tax credits. Other benefits include educating clients about the tax laws.

One preparer who deals primarily with immigrants said he and his staff spends considerable time explaining that paying taxes is part of the civic duty of being an American.

On the negative side of preparer performance, a variety of evidence suggests that a small percentage of taxpayers are poorly served. Looking at our graphic, we estimate that 5 percent of preparer clients had no confidence that they had not overpaid their taxes, and another 7 percent had little confidence.

While taxpayers do not catch all preparer errors, other evidence also suggests the percentage of poorly served clients is small. For example, last year we estimated that up to one million taxpayers who paid a preparer may have overpaid their taxes by claiming the standard deduction instead of itemizing.

Even if all of these errors are preparer mistakes, and some are undoubtedly due to taxpayers, as a percentage of the roughly 70 million taxpayers who hire a preparer, the errors are relatively small.

Now, preparer errors can have serious consequences for taxpayers. Three percent of preparer clients do not believe their preparer probed adequately, putting them at risk of overpaying.

In one case, a preparer told us about a disabled taxpayer with limited English who received notices from the IRS stating he might be eligible for the Earned Income Credit. Each year, his preparer failed to claim the credit. Eventually, he changed preparers and is trying to get a refund of several thousand dollars.

Sometimes preparers offer questionable advice. One preparer advised a married couple with two children to claim the Earned Income Credit twice. We do not know whether these taxpayers were complicit in this scheme, but the preparer's advice was costly. IRS found the over-claim and the taxpayers now owe \$4,000.

In extreme cases, preparers engage in clear-cut fraud. One preparer cost the Treasury \$1.1 million by altering taxpayer returns to inflate their refunds after he provided a copy to clients. He was sentenced to 51 months in prison.

Another problem is over-paying the preparer. Refund anticipation loans, or RALs, illustrate the point. RALs are short-term loans secured by refunds that are paid off when IRS sends the refund to the lender, often in 10 days.

According to the directors of low-income tax clinics we spoke to, some taxpayers are confused about the benefits and costs of RALs. Some ads, excerpted in our second chart which is also on page 10 of my statement, may contribute to the confusion.

We found one preparer who quoted us a RAL fee of \$174 on a \$700 refund, which translates into an annual interest rate of over 900 percent. I want to be clear here that RALs may meet legitimate taxpayer needs. The problem, is the lack of awareness of the benefits and costs.

Another form of overpayment is purchasing services that may not be needed. An IRS employee, for example, told us about an elderly taxpayer who, 2 years in a row, went to a large preparer and paid about \$200 to file. However, the taxpayer's sole income from Social Security and a small pension was so low, she was not required to file.

To reiterate, most taxpayers believe they benefit from preparers, but some have problems. When using a preparer, taxpayers can take steps to help ensure they benefit and avoid the types of problems we describe by following the advice of IRS and others.

Our last graphic, also shown on page 13, shows some of the most common advice, such as ensuring that your preparer understands your personal circumstances.

Mr. Chairman, this completes my statement.

The CHAIRMAN. Thank you, Mr. White.

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

The CHAIRMAN. Now, Ms. Berrick?

**STATEMENT OF CATHLEEN A. BERRICK, ACTING DIRECTOR  
OF HOMELAND SECURITY AND JUSTICE, GENERAL AC-  
COUNTING OFFICE, WASHINGTON, DC**

Ms. BERRICK. Thank you, Mr. Chairman and members of the committee. I am pleased to be here today to discuss our ongoing work on vehicle donation programs.

As you may be aware, as you mentioned, taxpayers are increasingly choosing to donate their used vehicles to charities, creating an important source of revenue for charities. These donations also

allow taxpayers to claim a tax deduction to dispose of an unwanted vehicle.

To help taxpayers make informed decisions about these donations, you asked that we describe the vehicle donation process, the proceeds received by charities from vehicle sales, and steps taxpayers should take when donating their vehicles.

There are essentially two types of vehicle donation programs, those operated in-house by a charity and those operated by a third party fundraiser on a charity's behalf.

The graphic to your left, which can be found on page 6 of my written statement, outlines the vehicle donation process. This process generally begins with an advertisement. I am going to play for you now a typical radio advertisement for a vehicle donation program.

[Whereupon, a tape was played.]

Senator BAUCUS. Could you do that again, holding the tape recorder up to the microphone?

Ms. BERRICK. Sure.

Senator BAUCUS. Just pick it up and see if that works. Oh, I am sorry. I did not realize you had a computer.

Ms. BERRICK. That is all right. I think this may work better.

[Whereupon, the tape was replayed.]

Senator BAUCUS. Thank you.

Ms. BERRICK. You are welcome.

We did find that a small number of advertisements could mislead potential donors about benefits they might expect from donating a vehicle. For example, some ads claim that taxpayers could claim full or maximum market value when claiming a deduction on their taxes, rather than the fair market value allowed by the IRS.

The proceeds a charity receives from a vehicle donation may be less than what a donor expects. We found two factors that help explain this difference. First, vehicles are often sold at auto auctions or to salvage yards at liquidation prices rather than prices that may be received if the vehicles were sold to private parties.

Second, proceeds received from vehicle sales are further reduced by vehicle processing and fundraiser costs. The graphic to your left which you mentioned, Mr. Chairman, and you can find on page 9 of my written statement, is an example of an actual vehicle donation.

Here, a taxpayer donated a 1983 truck to a charity whose vehicle donation program is operated through a fundraiser. The donor deducted \$2,400 on his tax return for the donation. The gross sales price of the vehicle at an auto auction was \$375. After deducting processing and fundraiser costs, the charity received about \$31 for this vehicle.

California is the only State that systematically collects data on vehicle donation programs, but only for those programs that are operated through fundraisers. California found that charities received an average of 31 percent of total proceeds received from vehicle sales from fundraiser programs in the year 2000.

Whether a taxpayer is donating a vehicle to claim a tax deduction or just to get rid of a vehicle, there are several steps they should make prior to making a donation, as shown on the board

to your left. These steps can also be found on pages 13 and 14 of my written statement.

First, taxpayers should verify that the recipient organization is a tax-exempt charity if they want to claim a deduction by reviewing IRS's Publication 78. A taxpayer should ask the charity to provide its full name and address and its employer identification number to assist in the verification.

Second, taxpayers should determine whether the charity is properly registered with the State office that regulates charities. This is generally the State attorney general's office or Secretary of State.

Taxpayers should also ask questions about how the donated vehicle will be used of a charity to make sure that the vehicle will be used as the donor intends.

In addition, the taxpayer should itemize their deductions to receive a tax benefit from the donation, but only if their total itemized deductions exceed the standard deduction.

Taxpayers should also only deduct the fair market value of the vehicle and document their contribution. The fair market value takes into account a lot of factors, including the vehicle's condition, and can be substantially different from the blue book value.

Finally, taxpayers should follow State laws regarding car title transfers and the removal of license plates. Some donors have received tickets and been held responsible for damages caused by vehicles after they donated the vehicle because their titles were not properly transferred.

Following these steps should assist taxpayers in avoiding organizations that the IRS and some States have found do not comply with laws and regulations related to vehicle donations.

Mr. Chairman, this completes my prepared statement and I would be happy to respond to any questions you or other members of the committee may have.

The CHAIRMAN. Thank you, Ms. Berrick.

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

The CHAIRMAN. Ms. Gardiner?

**STATEMENT OF PAMELA J. GARDINER, ACTING INSPECTOR  
GENERAL FOR TAX ADMINISTRATION, U.S. DEPARTMENT OF  
THE TREASURY, WASHINGTON, DC**

Ms. GARDINER. Mr. Chairman, Senator Baucus, and members of the committee, I appreciate the opportunity to appear before you today to discuss the IRS's oversight of electronic return originators and my office's efforts in assessing alleged abuses in this program.

EROs are individuals or businesses that the IRS accepts to be authorized to file tax returns electronically. To be an authorized ERO, one must be a U.S. citizen or an alien lawfully admitted for permanent residence, and be 21 years of age as of the date of application. Unlike an enrolled agent, EROs are not required to have experience or skill in return preparation.

The IRS is responsible for ensuring that EROs authorized to participate in the e-file program maintain a high degree of integrity and adhere to the highest professional and ethical standards.

Toward this end, the IRS publicizes that it has an extensive screening and monitoring process. In a recent audit report, TIGTA

found that the IRS has made strides with its ERO monitoring program efforts.

Specifically, the IRS has developed and revised procedures and training materials and established a goal to annually visit 1 percent of all EROs. The ERO monitoring program achieved this goal in both 2001 and 2002. However, resource constraints prevent the IRS from monitoring all ERO-related complaints.

There are additional challenges the IRS faces in administering the ERO program successfully. TIGTA has identified weaknesses in the screening process that present a risk of ineligible individuals being admitted into the program.

Screening checks the IRS publicized as extensive were limited primarily to whether the EROs filed the returns and paid taxes due. Applicant screening deficiencies included: the IRS did not independently validate age and citizenship requirements; screening checks, including tax compliance checks, were not performed for individuals who participate as e-file providers in the IRS's Volunteer Income Tax Assistance Program.

Only limited criminal background checks were performed, and applicants were approved to participate in the e-file program prior to the IRS's receipt and analysis of criminal background information.

TIGTA has also conducted investigations into alleged abuses in the ERO program. In fiscal year 2002, TIGTA's Office of Investigations conducted 77 investigations involving EROs and paid preparers. TIGTA investigations have involved allegations that preparers stole taxpayer refunds and remittances, and that preparers submitted false declarations.

In a recent case, TIGTA participated in a joint investigation of an authorized ERO who had, over a three-year period, filed approximately 9,000 fraudulent returns, receiving in 1 year alone an estimated \$7 million in fraudulent tax refunds.

The investigation disclosed that the risk and program weaknesses that TIGTA identified in its audit work allowed the ERO's illegal activity to flourish. The ERO was in the United States illegally when perpetrating the fraud, and 41 percent of returns the ERO initially submitted were rejected.

TIGTA became aware of the fraudulent filing of tax returns after the ERO was caught cashing stolen refund checks. The ERO plead guilty in October, 2002 and is currently awaiting sentencing.

As budgetary pressures increase, it will become all the more essential that taxpayers remain persuaded of the benefits of electronic filing so that costs of processing tax returns are contained and limited enforcement resources can be directed where they are most needed. Providing strong risk-based oversight of the ERO community and the e-file program in general will help provide the public with this assurance.

I would be happy to address any questions at this time.

The CHAIRMAN. Thank you, Ms. Gardiner.

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

The CHAIRMAN. Ms. Hart?

**STATEMENT OF DALE F. HART, DEPUTY COMMISSIONER,  
SMALL BUSINESS/SELF EMPLOYED OPERATING DIVISION,  
INTERNAL REVENUE SERVICE, WASHINGTON, DC**

Ms. HART. Thank you, Mr. Chairman.

The IRS is working smarter to identify and combat the greatest areas of risk to the tax system, such as abusive tax avoidance schemes. These schemes and scams cover the waterfront, from abusive offshore trusts, to slavery reparation scams, to frivolous constitutional arguments.

They are marketed by a wide variety of individuals, from sophisticated promoters to crooked return preparers and con men. In some instances, a promoter can also double as a preparer, and vice versa.

Mr. Chairman, I do want to stress that the overwhelming majority of return preparers are honest and reputable and serve their clients with the greatest integrity. In fact, they give us important leads about unscrupulous preparers and assist us in warning taxpayers away from shady overtures.

However, the number of abusive tax return preparers has increased, and so have our actions against them. We have more than doubled the number of criminal investigations of preparers of Federal tax returns in 2002 compared to the previous fiscal year.

In 2002, 254 investigations were initiated, compared to 116 the year before, and more cases were referred to the Department of Justice for prosecution, 89 in 2002, up from 73 the year before. Preparers convicted of tax crimes received longer average prison terms, 27 months in 2002, compared to 20 months the year before.

Through our outreach efforts, we have also warned taxpayers about the telltale signs that a preparer could be abusive. An alarm should go off if a preparer claims that they can obtain larger refunds than other preparers, bases their fee on a percentage of the amount of the refund, refuses to sign the tax return or provide the taxpayer with a copy of their records, or promotes a too-good-to-be-true scheme.

We are also warning taxpayers about individual schemes and scams that promoters offer, what we call the "Dirty Dozen." Our aggressive media and outreach campaigns have produced impressive results.

For example, in 1 year, the number of slavery reparation claims fell by 97 percent. Our presence on Internet search engines and web sites has grown dramatically and it serves as a stiff warning for those thinking of wading into these dangerous waters. Type in "offshore credit card" into a Google search, and the IRS comes up first in the results.

Through our lead development centers, we are better at identifying scheme promoters and participants. The current receipt of new leads is averaging approximately 70 to 80 per month.

As of March 1, we have 267 civil promoter investigations being worked in the field, with 466 being evaluated for further action. There are another 464 ongoing criminal investigations of promoters and return preparers of abusive schemes and scams.

We are also better coordinating our actions with the Justice Department to shut down the schemes before they do more damage.

As of March 19, 22 promoter injunctions have been granted and 13 promoter injunctions are pending in District Court.

Our joint streamlined procedures with DOJ results in civil injunctions being granted at a much faster pace. Indeed, in the case of 861 scams, we have gone from months to weeks after identifying the scheme.

Just as important, we are bringing taxpayers into compliance. For example, our offshore voluntary compliance initiative is allowing taxpayers to square themselves with the government while providing valuable information on crooked promoters.

While there are only 2 weeks left to the program, taxpayers who are involved in these schemes should come clean before it is too late and before we begin civil or criminal proceedings against them.

Although I do believe that the tide has turned, there is still an enormous amount of work to do. This type of organized tax evasion and cheating poses an enormous threat, one that we as an agency and a Nation have not previously confronted.

But this is our top priority and we are taking clear and aggressive actions to combat it. With the continued support of the administration, Congress—in particular this committee—and the American people, I believe we can succeed. Thank you.

The CHAIRMAN. Thank you, Ms. Hart.

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

The CHAIRMAN. Ms. Olson?

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

Ms. OLSON. Thank you, Mr. Chairman.

As you know, today anyone can prepare Federal income tax returns for a fee. Paid preparers do not have to show that they have any expertise in tax. Some tax professionals are, in fact, regulated by the IRS or the States, namely accountants, attorneys, and enrolled agents. But the majority of preparers are not regulated. We estimate that half of all Federal return preparers, between 300,000 and 600,000, are unenrolled preparers.

Unenrolled preparers perform a very important service for both the tax system and the taxpayer. Many taxpayers cannot afford the services of the regulated preparers. Many taxpayers do not need sophisticated tax advice, they merely need help in preparing their returns. In some places, an unenrolled preparer is the only person available to provide that help.

A tax return preparer is the gateway to the tax system. Returns prepared by unqualified or unscrupulous preparers have negative impact on taxpayers and the IRS. For taxpayers, inaccurate returns mean over-claims as well as under-claims. Either they pay more taxes than they should, or their returns may be examined. For the IRS, these returns consume valuable resources, both in terms of processing, examination, and collection.

Here are examples of tax preparer problems we have seen in the Taxpayer Advocate Service. In determining a taxpayer's tax home for employee business expenses, a tax preparer used an outdated, 15-year-old provision of the tax home rules for four consecutive years. The taxpayer owed over \$40,000 for the corrected returns.

A local taxpayer advocate overheard two store clerks discussing a local tax return preparation business that was advertising to low-income taxpayers. The clerk said that the business was providing clients with Social Security numbers to claim dependents in order to generate larger refunds and the Earned Income Tax Credit.

This filing season, some preparers are filing returns without EITC claims in order to offer refund anticipation loans for the non-EITC portion of the refund. They later prepare amended returns for the EITC. Not only does the taxpayer incur costs for the preparation of two returns along with the RAL charge, but the IRS must process two returns.

And my favorite, if that is what you can call it. A few years ago, I personally noticed a sign in front of a used car dealer whose mascot was a duck. The sign read, "File your taxes with the duck, use your refund for a truck."

Now, this dealer has a strong incentive to maximize the taxpayer's refund, since that results in a larger down payment toward a more expensive vehicle. If the refund is denied, the truck is repossessed. The taxpayer ends up with no refund, no truck, and a tax bill for the next year from cancellation of indebtedness income.

I am concerned about the appearance of an implied IRS approval of the types of transactions I have described above. I do not want taxpayers to say, I have filed my taxes, and look what happened to me. No tax agency can afford this guilt by association.

So what do we do about this? Clearly, the Federal Government has an interest in protecting the integrity of the tax administration system. Taxpayers have the right to expect that the tax administrator of a complex Tax Code will take the appropriate and necessary steps to ensure that commercial return preparers possess the requisite skills and ethics.

We propose that unenrolled preparers who prepare more than five returns per year for a fee be required to register with the IRS, take an initial examination about return preparation and an annual refresher examination, and display a current certification card indicating their certified status. Our proposal is described in greater detail in my written testimony in my 2002 annual report to Congress.

The lynch pin of this proposal is a consumer education campaign modeled after our Earned Income Tax Credit campaign, which utilizes paid advertising, outreach, and partnering with other organizations to deliver two simple messages to tax consumers who will enforce the program through their market behavior.

First, if you pay for tax preparation, ask to see the preparer's certification card. Two, if you pay for tax preparation, do not pay until you see the preparer's name, address, and certification on the tax return and on your copy of the return.

We believe that requiring minimum levels of competency for return preparers will restore the connection between tax preparers, tax expertise, and tax filing.

Under our plan, preparers who are providing tax preparation and filing, primarily because it brings in consumers of unrelated products or financial products such as check cashing, will have to demonstrate knowledge of return preparation. This approach will ben-



efit the taxpayer, both as a taxpayer and as a consumer, and it will benefit the tax system.

Thank you. I will be glad to answer any questions.

The CHAIRMAN. Thank you, Ms. Olson.

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

The CHAIRMAN. Mr. Yabuki?

**STATEMENT OF JEFFREY W. YABUKI, CHIEF OPERATING  
OFFICER, H&R BLOCK, KANSAS CITY, MISSOURI**

Mr. YABUKI. Mr. Chairman and members of the committee, I am pleased to be here. Thank you for the invitation and the opportunity to present our views.

Thirty years ago, Henry Block testified on tax preparer integrity and quality. He addressed issues such as competence, confidentiality, and advertising practices. Many reforms he proposed were enacted, but additional reforms may still be needed.

Today I would like to discuss the tax preparation field generally and describe some of the actions we take to ensure quality and integrity.

Good tax preparers help millions of Americans navigate our complex tax system and also ease the burden and anxiety that most Americans feel at tax time. Various studies show that many Americans inadvertently over-pay their taxes. Varying levels of knowledge of skills, theirs or that of their return preparers, is one reason.

A GAO report done for Senator Grassley showed missed deductions and credits alone may have caused over 2 million Americans to overpay their taxes by an average of \$400 each.

A Treasury report found 600,000 low-income taxpayers missed out on an average of \$390 each by not claiming the refundable portion of their child tax credit.

H&R Block amended returns for 1 out of 20 of over one-half million taxpayers who took our double check challenge, allowing us to review their past tax returns, recovering an average of \$1,300 each.

For this year, research shows that 83 percent of Americans have never heard of the saver's credit. So far this year, we have helped more than 1 million clients save an average of \$169 each using the new credit.

Consumers who pay for help deserve some assurance of competence, which is why we support meaningful standards for tax return preparers. Henry Block proposed IRS registration of paid tax preparers. We renew that call today and ask to go further.

We believe IRS certification, which would require validation of applicable tax knowledge, background checks, and minimum levels of continuing tax education, do, and would, benefit the public.

To succeed, however, this or any program depends on preliminary studies to carefully define problems, public education, adequate funding, and effective enforcement.

The new program would join with existing regulation. All preparers today are subject to laws covering fraud, negligence, diligence, misrepresentation, and unauthorized disclosure and can be enjoined from misconduct. Practitioners who represent taxpayers before the IRS on post-filing issues—attorneys, CPAs, and enrolled agents—are regulated by IRS Circular 230.

There are also additional rules to cover electronic return originators. We applaud the IRS's recently doubling of investigations of return preparers and upgrading the Office of Professional Responsibility.

But the overall record shows room for improvement. We strongly recommend stepped up IRS enforcement. Even the best government's Good Housekeeping seal is no substitute for consumers exercising diligence. Some do's and don'ts include checking a preparer's training, experience, reputation, and references, and expecting clear and concise disclosure of all fees and services, and avoiding preparers promising the biggest refund, charging fees on the basis of a specific tax result, asking you to sign a blank return, failing to sign the return himself, asking that the refund be mailed directly to him, or being vague about this availability in case of follow-up IRS notices or audit.

Let me describe our training in quality control. Today, 100,000 H&R Block employees and franchisees prepare 17 million, or 1 in 7, of every individual tax return filed in the United States at 9,300 U.S. locations, including 137 in Iowa, 43 in Montana, and 66 in New Mexico.

Through our tax schools, we are one of the largest adult educators in the country, training 250,000 students annually in a variety of classes and seminars, including 84,000 that enroll in our basic 66-hour tax course.

Applicants, at a minimum, must take our basic tax course and receive a passing grade to be eligible for hiring. To be rehired, our professionals take at least 24 hours of continuing tax education each year and are also trained for 20 to 35 hours on internal systems, products, policies, and procedures.

Additionally, about 5,000 of our tax preparers are enrolled agents or CPAs. Advance training lets preparers move up the ladder from tax associates or master tax advisors, who must also meet the rigorous exam to become an enrolled agent.

Our professionals work with a state-of-the-art computer program that checks and double-checks calculations, theory, and accuracy. It contains approximately 10,000 diagnostics to warn tax professionals that there may be something to review and to prevent filing unless errors are corrected. We also utilize a second review by another professional for many of our tax returns.

For clients who are audited, we help to prepare them, and if they so choose, will accompany them to explain how the return was prepared. For all clients, we stand behind the quality of our work and guarantee that we will pay any interest or penalties if we make an error on their tax return.

Mr. Chairman, for nearly half a century H&R Block has built its reputation as a trusted tax advisor to middle America. Our practices and code of ethics reflect a longstanding commitment to integrity and professionalism. I appreciate the opportunity to testify and would be happy to respond to questions.

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

The CHAIRMAN. I thank all of you for your testimony. You have been very courteous to the committee by staying within the time lines, and we all really appreciate that, so we have time to ask questions.

We will have 5-minute rounds and they will be in the order of: the Chairman, the Ranking Member, and Senator Bingaman.

Mr. Yabuki, I think my first question may be just a little bit general, but I would like to draw on your experience because you do so much tax preparation nationwide, as well as in my State of Iowa, and particularly since you are right there in the Midwest anyway.

I would like to ask what issues or trends your tax preparers are seeing this year in both a nationwide scope and in my State of Iowa.

Mr. YABUKI. Thank you, Mr. Chairman. The biggest trend that we are seeing this year generally across the United States is a lack of understanding of what may have changed in the Tax Code this year. There has been a lot less publicity this year than there had been in prior years.

The saver's credit is something that has not gotten a lot of press and discussion, and it is a very good vehicle to help Americans save for retirement. We have several stories of taxpayers who have benefitted specifically in Iowa.

There are situations where, by using the saver's credit, you can substantially reduce the cost of putting money into an IRA. We have one example where a taxpayer in Iowa put \$1,500 into an IRA, and through using the saver's credit and other credits available to that individual, was able to take their net cost down to \$80 by various tax subsidies, which we think is the right idea for the saver's credit.

The other thing, frankly, is we see a fair amount of distraction across the tax filing population with the things that are going on in the geopolitical landscape. It has taken the press away from talking about taxation. That said, we think over the next few days people will recall that it is tax time and we will probably see a very large push of tax returns over the last 2 weeks.

The CHAIRMAN. When you said that there is less information this year than other years from IRS, is that your gut feeling? I am not asking you to quantify it, but is it a quantifiable statement you made?

Mr. YABUKI. Yes, it is. I am unable to quantify it here. I suspect we could turn in testimony that would show that. It is not so much an IRS issue. The IRS has done actually a good job in publicizing e-filing, along with its Free File Alliance.

It is more, the press has not spent time talking about the tax changes. Again, the saver's credit has not gotten any play, and because of the other events in the world, there just has not been emphasis on tax issues right now.

The CHAIRMAN. I think Ms. Olson, Ms. Hart, and you, again, Mr. Yabuki, might be prepared to give us information on Circular 230, so I want your views. That governs paid preparers that sign the tax return.

I have to admit that I am troubled by any situation where Circular 230 only applies to those paid preparers who actually sign the return. If you do not sign the return, then of course you are not covered. It seems it is these very people we are most concerned about and are the ones who are least likely to sign the return.

My question is, should Circular 230 be expanded and strengthened?

Ms. OLSON. I think Circular 230 will certainly raise the professional standards and be the beginning of a scheme for paid preparers. But I do not think it is sufficient, because Circular 230 itself does not mean we will find out who these people are. It is just if we find them out can we do anything with them, such as tell them not to prepare returns.

I think that, in addition to Circular 230, we do have to have something stronger, a requirement for education and a testing device. To go to Mr. Yabuki's point about the kinds of errors that he saw in his testimony, we had proposed an annual refresher exam which would be based, in part, on the errors that we saw from the filing season before, as well as the new tax law changes so we could be sure that people who had entered the system as preparers were staying up to date.

The CHAIRMAN. Ms. Hart, if you want to lend anything to that.

Ms. HART. The only thing that I would mention, sir, is expanding Circular 230 to cover preparers who do not sign the tax return would be fine. The problem would be actually enforcing that, since we would not know who they are. These would typically be the preparer who does this and does not sign the tax return in the first place, and is already operating outside of the proper bounds to begin with.

The CHAIRMAN. Mr. Yabuki?

Mr. YABUKI. We would agree with the comments that are made and believe that the enforcement aspect of any regulation is most important. We also think there may be ways through technology to either bar code or other types of mechanisms to track the returns that are filed and not signed.

The CHAIRMAN. Thank you.

Senator Baucus?

Senator BAUCUS. Thank you, Mr. Chairman.

I think IRS plans to have 80 percent of all returns filed electronically by the year 2007. Is that correct? Maybe Ms. Gardiner, Ms. Hart.

Ms. HART. Senator, that is our goal, yes.

Senator BAUCUS. And I might ask others on the panel, how much is that going to help some of the problems we now have with people making mistakes on returns, whether with paid preparers or not?

Ms. OLSON. It will certainly help people making clerical mistakes, adding mistakes, missing forms, not calculating the Alternative Minimum Tax, that sort of thing, going through software to do that.

It does raise another issue, which is what we have seen with these ancillary products, these financial products or using your refund for a car through a refund anticipation loan.

The influx of those products has been with the influx of e-filing, because you do not have to be a tax preparer any longer in order to just open your doors and let people come in and e-file.

So I am concerned that, as more and more people e-file and go to people who may not be qualified return preparers, that they will be subject to these kinds of sales pitches, what you can do with your refund once you get it.

Senator BAUCUS. I am not quite clear on that. Say I want to pay my taxes and I want to do it electronically. I guess I would have to have some kind of a program. Where do I get the program, generally? Is that out in the open market or is that something the IRS would do? I can just go online directly with the IRS?

Ms. OLSON. Right now we have the Free File Alliance, and those are off-the-shelf products through the agreement that we have with Free File. Or you could go to the store and buy the products. But a lot of people, what they do, is they will go to a check cashing place or a furniture store.

This furniture store will prepare their returns, even though they have no expertise in preparing returns. They will issue a refund anticipation loan and then they will say, now, why do you not use this for a down payment on some furniture, this bedroom suit that we have. In communities where those things are happening, I was just speaking to someone who was at a bank who was doing a "banking the un-banked" type of initiative.

They are finding that in those communities, rather than banking their refund and maybe going shopping and buying and being a good consumer, they will go to the store that is offering them the refund anticipation loan where the rates are invariably higher for the same product that you could get elsewhere. So, it just spirals.

Senator BAUCUS. Right. But could I not file electronically without going to that store?

Ms. OLSON. You could, but that means that you have to be computer savvy, that you have to be able to purchase a product or get onto the Free File Alliance.

Senator BAUCUS. So your concern is, with the rise in electronic filing, a third party will do the filing and take advantage of his or her position by selling some other product in the meantime.

Ms. OLSON. And if they were required to have some competency in tax return preparation, then suddenly it becomes less of a financial interest to them.

Senator BAUCUS. I might ask you, Mr. Yabuki. The allegation is that there are often pop-ups on H&R Block returns, preparation. That is, you are going through all the steps, and the computer learns, because you have just entered the data, that you have a mortgage interest payment. So then a pop-up comes up that says, hey, maybe we could refinance your loan, or something like that.

Is that used? Does H&R Block have commercial arrangements, financial arrangements with other companies that provide such service?

Mr. YABUKI. Actually, Senator, this was an issue that was raised last week, and thank you for raising it at this point.

Senator BAUCUS. Right. You are welcome.

Mr. YABUKI. I expected it to come up. This was actually through the IRS Free File Alliance. Built into our software, if a consumer indicates up front before they begin their tax return that they would like to become aware of financial services that would benefit them, they acknowledge, they opt in, and say, yes, I would like to be made aware by H&R Block. We, within our technology, have the ability to link into that data. So in this case, the story was that someone had put in mortgage interest.

We asked them, on a separate screen, not a pop-up, if they would be interested in refinancing or looking at, was there a way to save them money, which is what the client had told us up front they would be willing to do.

Senator BAUCUS. How many such boxes are signed, or potentially could be signed by a preparer before your company helps prepare the return?

Mr. YABUKI. I am not sure of the question.

Senator BAUCUS. Well, apparently the question was, do you want to be informed of certain other financial services.

Mr. YABUKI. Yes.

Senator BAUCUS. This taxpayer indicated yes, apparently, in this case.

Mr. YABUKI. Yes, that is correct.

Senator BAUCUS. I am asking, how many different kinds of questions does H&R Block ask, or how many does it ask of taxpayers along these lines before going ahead and preparing the return?

Mr. YABUKI. This is a situation of a self-preparer. This was not a return that was prepared in one of our 9,300 offices. This was on the online product. I do not know the number, but there are probably 10 or 12 different places where people can avail themselves of financial advice. Some of this advice, we are able to execute through an affiliate, and this is one of the cases.

Senator BAUCUS. And clearly you charge a fee for that, affiliate page or something.

Mr. YABUKI. Well, it is our company. We own the company.

Senator BAUCUS. Oh. You own all these affiliates.

Mr. YABUKI. This is the H&R Block mortgage, so this is a company that we own and this is a service to the client. The client does not pay for this over and above. If they decided to refinance, then there would be the normal costs.

Senator BAUCUS. So what kinds of services does H&R Block provide in addition to tax preparation?

Mr. YABUKI. In addition to tax preparation, we have a financial services company where we help people with investments, mutual funds, those kinds of things. Also, a mortgage company where we help people with purchase money and refinancing.

Senator BAUCUS. That is interesting. What percent of your income is in tax preparation only?

Mr. YABUKI. Approximately 60 percent of our revenues are tax preparation.

Senator BAUCUS. And the other 40 percent is other services that you have outlined.

Mr. YABUKI. For example, not included in that, we are the owner of the fifth-largest accounting firm in the United States. So, that is probably three-quarters of a billion dollars of revenue, which also is included.

The revenue that is generated from the affiliates related to tax clients is a very small percentage of the company's revenue.

Senator BAUCUS. Well, my time has long expired. I appreciate it very much. Thank you.

The CHAIRMAN. Now, Senator Bingaman?

Senator BINGAMAN. Thank you, Mr. Chairman.

Let me just say, I have a problem with this whole notion that the government is sponsoring a web page called Free File, which, when a person goes to it, they then are essentially solicited to buy a bunch of products.

It seems to me that that is the kind of thing you expect when you are a member of AOL or a member of Microsoft, MS. You expect them to be selling you some kind of product when you go online there. But I do not know why people should be expecting that when they go onto a government web site.

It strikes me as objectionable for us to be using taxpayer dollars to support a web site that then gives vendors the opportunity to sell their private products.

Let me ask Ms. Hart.

Ms. HART. Yes, Senator.

Senator BINGAMAN. Is this something that we directed you to do or did you guys think of this?

Ms. HART. Well, if it was a good idea, we thought—no.

Senator BINGAMAN. Well, I do not think it is a good idea.

Ms. HART. Senator, let me just tell you what Free File is. Free File is an alliance of private software companies. It is not paid for by the IRS. These companies are offering free electronic filing opportunities to taxpayers.

Senator BINGAMAN. That part I like.

Ms. HART. All right. It is not an IRS web site. It is a coalition of companies who have come together, and taxpayers, for free, can go in and use this.

Senator BINGAMAN. Now, they can access these sites through the IRS web site.

Ms. HART. Through our web site. Yes, that is correct.

Senator BINGAMAN. Yes. So that is the part that bugs me. Why are we using the government web site to promote access to these sites that then try to sell people all these services?

Ms. HART. Well, first off, we are trying to provide opportunities for people to get help with their preparation of their tax return. These companies have come together in order to provide that.

Before a taxpayer is offered those services, they are asked a question in each case by the software provider as to whether or not they want to get these kinds of additional ads. It is only after they say yes that, in fact, those additional solicitations come up.

Senator BINGAMAN. But that is true any time you are on the Internet. They are always saying, would you like this, would you like that. I am just saying, is it the IRS's judgment, or the Treasury Department's judgment that if you just said, you can use our web site in order to provide free tax preparation services and that is it, you cannot also advertise all of your other products, we would not have anyone participate? Is that your thinking?

Ms. HART. I think it would be a question as far as whether the companies would want to participate in this coalition.

Senator BINGAMAN. Have we asked them?

Ms. HART. We have had that discussion, sir. There has to be a profit motive or a business motive for these companies to participate.

Senator BINGAMAN. Well, they develop some good will, presumably.

Ms. HART. What we think, is we have got a system that actually is pro-consumer. It gives taxpayers an opportunity to use these programs for free to prepare their tax return. It gives these companies an opportunity to engender the good will that you are talking about, and potentially get business for other purposes.

Senator BINGAMAN. So you think it is a good idea.

Ms. HART. We think it is a good idea. I would like to add a couple of other things. This is the first year we have offered Free File, and 2 million taxpayers have used this service in order to prepare and file their tax returns. We have worked with these companies in order to make this a service that, in fact, will work for taxpayers.

Senator BINGAMAN. As I say, I have no problem with providing the tax preparation service. I think that is a good thing to be doing. It just strikes me that the rest of it, I do not think the government ought to be in the business of facilitating the solicitation of taxpayers to refinance, to take out refund anticipation loans, to do all the rest of it.

Ms. HART. Again, those do not come to the taxpayer unless the taxpayer says, yes, I am interested.

Senator BINGAMAN. Yes.

Ms. HART. Just one other point I would make. The taxpayers' information that they provide through the software program cannot be used for any purpose other than tax return filing unless the taxpayer authorizes it.

Senator BINGAMAN. Let me just ask one other question since my time is nearly up here. Ms. Olson, you talk about Section 2001 of the 1998 Act, the Restructuring and Reform Act of the IRS, and indicate that you believe it has had the unfortunate effect of inhibiting the IRS from undertaking a rigorous analysis of the products being offered in connection with tax return preparation, et cetera. Could you just elaborate on that a little bit?

Ms. OLSON. I think that the IRS took that legislative history to say that we should be hands-off of the commercial activity that is related to tax return preparation, that Congress clearly did not want us to interfere with the tax return software market.

To go back to a point about the return information that is provided in the software. I actually did my taxes with the H&R Block product this year through Free File. I actually ended up downloading the product and found that there were 12 pop-up screens.

Now, I first did my taxes by de-linking, going directly to the forms, and filling in just on the form because I was an unenrolled preparer for 16 years, so I know how to prepare returns.

I got to the end of the package and clicked on e-filing and was told that I could not e-file. Now, since the whole point of this Free File Alliance was, in fact, to reach our 80 percent electronic filing by 2007, that is very interesting.

So I closed out of that return and I opened a new return. It took me an hour longer, but I went through and had to answer, do some affirmative act, saying either, no, I do not want this product, or yes, I want this product on all 12 of those screens so that I could get through and be able to e-file at the end of the day.

I have since been told that another large product on our Free File Alliance also does that. We had my employees go through



every single one of the products that we could on the Free File Alliance to see what sorts of things prevented people from e-filing.

It is that sort of thing that I think the IRS needs to actually think very carefully about and create standards, working with the software industry and also working with some of the consumer groups and the representatives of taxpayers to decide what should we have on a site that is a governmental site.

Ms. HART. Senator, just one other point.

Senator BINGAMAN. Yes.

Ms. HART. This is the first year. We do consider 2 million people who have filed already to be a success and expect that number to go up. But it is our intent to work with these providers at the end of the filing season to review and assess what has occurred this year, and to make improvements for next year.

Senator BINGAMAN. Mr. Chairman, we may want to just look at that legislatively. I do not know. It just strikes me that we have got a bad situation here with the government essentially facilitating a lot of merchandising of products that may or may not be worthwhile.

The CHAIRMAN. I do not have a judgment to make on that statement right now, but I would welcome your staff, or you and I, to talk about it, or your staff and my staff to visit about it.

Senator BINGAMAN. All right. Thank you.

The CHAIRMAN. We can involve Senator Baucus' staff as well, and we can look into that for you.

Senator BAUCUS. I think it is a legitimate question.

The CHAIRMAN. Yes.

We will have another round. I would like to ask this question of, I think, Mr. Yabuki, Ms. Hart, Mr. White. It is a kind of a follow-on where I left off with my last question and the comment that maybe Ms. Olson was making.

The Taxpayer Advocate suggested that the volume of taxpayers that used paid preparers indicates that taxpayers would be better served and compliance would likely improve if tax preparers were required to meet minimum standards and possible licensing.

So I would like to hear your response to the Taxpayer Advocate's proposal, particularly any or all of these three points, the costs and benefits, the evidence in support of the Taxpayer Advocate's proposal, and whether the Taxpayer Advocate's proposal would accomplish what it wants to accomplish.

Mr. Yabuki, then Ms. Hart, then Mr. White.

Mr. YABUKI. As I mentioned in my testimony, Mr. Chairman, we support continuing improvements in the oversight of paid tax preparers.

At this point, we are unclear as to how the administration of, for example, a testing program would actually occur. Continuing education, we believe, is critical to any program. So if you have a test, you have to have some kind of refresher on a year-to-year basis.

The challenge that I think we have, is how will we measure or how will we manage the enforcement aspect of it? Because, as Ms. Olson indicated, there are lots and lots of tax preparers who are filing tax returns for reasons other than the fact that they enjoy tax preparation.

So, we have come across an insurance agency in a different part of the country who was charging \$15 for a tax return, and charging a couple of hundred dollars for other add-on services. We do not believe that that type of pricing disclosure is reasonable.

So, to the extent that you get the preparation licensure issue handled, we still think you have to continue to look at what kinds of disclosures are made by certain tax preparers, and again, how will you enforce it.

The other point that I would like to make is on the 80 percent e-file point. While I do not believe that the 80 percent e-file, in and of itself, will free up or will mitigate this issue, we do think that the 80 percent e-file or more would free up resources to add to the enforcement side and allow preparers who go awry of the standards to be able to be taken out of the system or to be disciplined appropriately.

So we think that from a cost efficiency perspective, the e-filing proposal is a positive proposal. Perhaps Treasury should look, or legislatively to mandate, e-filing across paid preparers at some point.

The CHAIRMAN. Ms. Hart?

Ms. HART. Yes. Thank you, Senator. There is no question that taxpayers have an absolute right to quality representation at a reasonable cost. We have had the Advocate's proposal for a while and are actually studying the consequences of the proposal, as outlined. This would be a major change and one that does, in fact, need to be carefully weighed.

There are some significant cost implications here that need to be carefully considered. It would be a substantial cost to administer what is proposed, and presumably a cost to taxpayers that would have to be borne.

We are also concerned about the burden that it might impose on both practitioners and taxpayers, as practitioners need to register, and then the taxpayers need to ensure that, in fact, the practitioner they are going to is one who has been approved.

We also want to consider the metrics that would be involved to determine whether or not quality would actually improve through this process or not. That is something that needs to be considered in relation to the cost.

There is some thought that there is the potential that, in fact, some preparers might actually go underground and be very difficult for us to police and to administer.

So what we want to do is consider all of those, the cost, the burden and the quality, as well as other alternatives to improving the quality of the preparation services that are available. Increased enforcement, expanded taxpayer education, increased publicity explaining how and when to choose a preparer, are things that should be considered, as well as the role of the States, who have historically licensed professionals of this sort.

The CHAIRMAN. Mr. White?

Mr. WHITE. Thank you, Mr. Chairman. The decision to regulate is a policy judgment. Regulating any industry involves some trade-offs. There are going to be winners and losers from that. GAO does not have a position on what the policy judgment ought to be. That is a decision that Congress needs to make.

We can provide information about what some of those trade-offs are, but in this case, Mr. Chairman, I must caution you that there is precious little hard data about the size of the problem, the cause of the problem, and what the impact of regulation would be on that problem.

Just briefly, talking about the benefits. On the benefit side, you can imagine that regulation might result in fewer preparer errors. Well, there we do know a little bit based on our survey.

Most taxpayers are confident that their preparers did a good job. However, there are problems. The problems are a small percentage of the total, but those problems do have serious consequences for taxpayers. What we do not know, however, is what impact regulation would have on those errors.

Right now, for example, wilful errors made by preparers in filling out a return are subject to penalty. So, this gets us back to the compliance problem. We do not know, for example, the proportion of preparers who are unenrolled agents. The States of California and Oregon both regulate preparers, but there is no hard evidence out there so far on what the impact of that regulation has been.

It is also possible that regulating preparers could improve compliance overall, but it is not known right now how much non-compliance preparers are responsible for. So, it is very difficult to know what that impact might be.

On the cost side, there could be costs to the industry from regulating, and some of those costs would likely be passed on to taxpayers. In terms of the impact on taxpayers, one impact of licensing in many industries is to reduce the supply of the service and to raise the price. How much that occurs depends on the responsiveness of suppliers and the industry, but that is a potential cost that would be borne by taxpayers.

Then, finally, there is cost to the government. I think Ms. Hart has mentioned several times the compliance cost aspect of this, and that is one important determinant of what the cost would be to the government. There may be some other options in addition to licensing preparers, options such as better consumer education that have been mentioned.

Finally, another option that would impact at least part of what we have been discussing here is improvements in the turnaround time in issuing refunds. Right now, IRS can issue a refund in the case of the return that is electronically filed in around 10 days.

If they can get that time down, and this would have to be something that would occur over several years as a result of their ongoing modernization efforts, but if they could reduce the turnaround time for refunds, that ought to have the impact of reducing the demand for RALs.

The CHAIRMAN. Thank you.

I am going to call on Senator Baucus now. I only have one or two more questions. I wanted to get into the area of car donations, and I have not done that yet. But, except for that, when Senator Baucus is done, unless he wants further questioning, that will be the end of our questioning.

Senator BAUCUS. Thank you, Mr. Chairman.

It has been reported that about \$200 billion of individual income taxes are not paid, roughly, something like that, either through

under reporting, non-reporting. I am just talking about the individual side right now.

Roughly 17 percent of American taxpayers account for that. That is, about 17 percent of American taxpayers are the ones who do under report or do not report, to the tune of about \$200-some billion a year. No small change.

To what degree do paid preparers interact with that 17 percent? To what degree can you help us solve that problem? Anybody want to take a crack at that?

Mr. WHITE. Let me start, Senator, and make a couple of points. One, is IRS, right now, does not have very good estimates of how much non-compliance there is out there and what causes that non-compliance. Therefore, it is difficult to know how to address it.

IRS is under way with what they call their National Research Program, which is an effort to measure, for the first time since the late 1980's, the amount of non-compliance out there and some of the reasons for that non-compliance.

As IRS gets the results of this National Research Program, that should help them get a better handle on the compliance problem and how to address it. But right now, it is very difficult to know how much paid preparers are contributing to the overall non-compliance problem.

Senator BAUCUS. Ms. Hart, do you want to take that question? Mr. White says the IRS does not really have the data yet, that they are going through the study, to know who these people are.

Ms. HART. Well, actually we are going through the study to be able to better quantify it.

Senator BAUCUS. Is that complete? Is that study complete or is that ongoing?

Ms. HART. No, it is ongoing right now.

Senator BAUCUS. Do you know, roughly, when we might have it?

Ms. HART. I think the data would begin to be available around 2005. This is a very large survey.

Senator BAUCUS. 2005?

Ms. HART. Yes.

Senator BAUCUS. Why does it take so long?

Ms. HART. Because we need to make sure that it is statistically valid and actually does provide all of the information that we need in order to make the kind of quantifiable assumptions about it.

Senator BAUCUS. Does this indicate that the computer system is ancient?

Ms. HART. No, sir. What we are actually doing is auditing 50,000 taxpayer returns. It just takes some time in order to pick the proper sample and then to have those work through the system and be audited properly in order for us then, in turn, to drive statistically valid conclusions about that population.

Senator BAUCUS. I do not know. It just strikes me, that is too long. There have got to be ways to shorten it. But, anyway, go ahead. Sorry. Go ahead.

Ms. HART. In any event, that is the plan right now, is that the data would be available in that general time frame. But I would say that I think our largest compliance problem, as we see it today based on the information we have, is organized non-compliance that is promoted by preparers and by promoters who make money

on schemes that they sell. To the extent that we can combat that, then I think we will have a fair amount of impact on the tax gap as we know it today.

Senator BAUCUS. To what degree do you, or Mr. Yabuki, your people, interface with these people? That is, those who are maybe not telling you the straight stuff.

Mr. YABUKI. We would like to believe that we have a few people who are doing that without understanding—

Senator BAUCUS. Would like to believe? What do you believe?

Mr. YABUKI. I do believe. I like to believe, and I do believe, that we have few people who are participating, but without understanding the facts it is difficult to comment.

Senator BAUCUS. Well, what you are basically saying, all of you, is that the paid preparers that you are talking about and representing, do not interface with this very much, this tax gap problem. Is that accurate? Do you agree with that?

Ms. OLSON. The IRS just came out with a voluntary disclosure policy with regard to various initiatives, and I advocated very strongly that in there there be a very clear example that if someone were a non-filer, and before we had found them, communicated with them directly, if they came forward to us and filed their returns and made arrangements to pay the tax, that they would not be subject to criminal prosecution.

That was a very important statement for me, because as a former practitioner, as a former attorney representing non-filers, it is an extraordinarily difficult task to bring someone in who has not been filing for years and years and years and convince them that it is a good thing to do.

The IRS, several years ago, did a non-filer initiative which worked with the tax professionals to do volunteer work, and had non-filing days where folks could come in and there would be IRS officials, attorneys, accountants, and enrolled agents who would help them re-enter the system. I think it is time to do something like that again.

This public policy is also important, too. It gives assurance that if you want to get right, we will work with you to come in.

Senator BAUCUS. That leads me to the question about the IRS policy, I guess it was earlier this year, to bring taxpayers using offshore credit cards and other offshore financial arrangements back into compliance with the tax law. That raises several questions. One, Ms. Hart, what is the status of that?

Ms. HART. I am very glad you asked that question, Senator. Before I start on that, what I would like to mention is that there are only 2 weeks left for the deadline on that program, so people have until April 15 to come in. So if they are at all considering it, now is the time.

Senator BAUCUS. So, anybody watching television here, come on in.

Ms. HART. Come on in. That is right. Actually, we were very encouraged by the early results that we have as far as this initiative is concerned.

Our large and mid-sized division ran an opportunity for people to disclose in various situations not too long ago. What they found,

was the vast majority of their influx of receipts came in in the last week or two, and that is what we are now entering.

So we expect that we will get most of the intake over the next few days, but we are very encouraged by what we are seeing so far.

What we would like to do is actually come up towards the end of April, early May and actually brief your staff and you, to the extent that you are interested, on the results.

Senator BAUCUS. That would be a good idea.

Ms. HART. I would also like to point out that this is not just a design to bring in taxpayers. Also, an element of this is that they have to produce information about the promoter or who put them into this offshore arrangement.

From that information, we then in turn can get information about how these things are structured and who else has purchased these similar kinds of arrangements, which will give us a big compliance tool and a big compliance hook that we have not had in the past.

Senator BAUCUS. Do you agree with last year's IRS estimate that about 1 to 2 million financial accounts offshore, with an estimated \$40 to \$70 billion in taxes, were avoided?

Ms. HART. I think we have learned a good deal since that initial estimate was made. We had information from one credit card company at that point in time that we used to draw that estimate from. We had not at that point had an opportunity to actually work through the data and get to understand.

Senator BAUCUS. So what is the result from that?

Ms. HART. The estimate right now is, we believe there are hundreds of thousands of taxpayers that are in offshore arrangements, and tens of billions of dollars at stake.

Senator BAUCUS. So it is large, but it might not be quite as much.

Ms. HART. Not quite as much. We have learned a good deal since then.

Senator BAUCUS. Still, it is tens of billions of dollars.

Ms. HART. It is still a very significant problem.

Senator BAUCUS. That is really something, because around here in this committee we sometimes are worried about \$4, \$5, \$6 billion over a 10-year period. We are not talking about tens of billions in 1 year not collected each year?

Ms. HART. Not necessarily each year. What we are saying, is there are probably tens of billions of dollars in unpaid taxes as a result of that. It could be over a several-year period that the taxpayers have not filed the proper tax returns.

Senator BAUCUS. And how many investigations have been opened up?

Ms. HART. We have over 1,000 open right now. We have several dozen that are in criminal investigation. We expect to be opening thousands more in the very near future.

Senator BAUCUS. Well, I just urge you to be very vigorous. I assume you need more resources.

Ms. HART. Well, actually, the administration's budget proposal for 2004 actually does contain some additional resources for us. It is a combination of expansion resources, as well as redirection from

other parts of the service. So, I would appreciate your support as far as that budget is concerned.

We also have a few legislative changes that are on the Hill that we could use some support for as well. Most importantly, I would like to take this opportunity to thank both you and Senator Grassley for all of the support that your committee has given us as far as our compliance initiatives and all of the offshore work in particular that we have been doing, and all of the work as far as trying to root out tax evasion and avoidance that is structured in a very organized way.

Senator Grassley mentioned at the beginning of this that sunshine is the best disinfectant, and I could not agree more. The work that this committee has been doing has helped us an enormous amount, in fact, in providing that kind of sunshine.

Senator BAUCUS. Well, good. If you want us to call Mitch Daniels, let us know. [Laughter.]

Senator BAUCUS. Thank you very much, all of you. I want to thank you, Mr. Yabuki. I may be a little tough on you, but you do point out a lot of worthy alternatives to taxpayers and that is very much appreciated.

The CHAIRMAN. I have got some questions, but I beg maybe that we not have as long of answers as we have had because Senator Baucus and I have to conduct a hearing on Tax Court judges just as soon as this is over.

But I do have to get into some point about this donation, so it brings Ms. Berrick into the discussion. Your testimony is disturbing about instances where charities sometimes get pennies on the dollar for donated cars.

What is your sense of the charities' viewpoint on this? Specifically, do you think that charities care or inquire about the amount of proceeds that are retained by the fundraisers and other middle people?

Ms. BERRICK. Based on the charities that we spoke with, generally they are not overly concerned about this. They view any proceeds they get in from this program as revenue they otherwise would not have, so they are very happy to be able to participate in these programs.

Some of the smaller charities in particular would not be able to participate in these programs without a fundraiser because they do not have the resources.

We have talked to a lot of charities that shop around with different fundraisers to try to find the best deal, but overall they were happy with the way the program was established.

We are going to conduct a nationwide survey of charities as a follow-on to this hearing to get more information on how these programs operate within the charities, and the focus is going to be on how charities view these fundraisers and their relationship with the fundraisers.

The CHAIRMAN. Just very obvious, I am not sure that, until your report came, that I was aware of how little might end up in the pockets of charity. But you cannot help but listen to WTOP in the morning for a couple of hours, and you just hear a lot of these ads. Probably we are hearing a small percentage of those.

Let me follow up with this example that we talked about of truck donation, where the charity got very little in benefits as compared to the deduction to the taxpayer.

Have you, Ms. Berrick, seen similar cases out there? I note your testimony highlights actions in several States in this area.

Ms. BERRICK. Yes, Senator, we have seen similar cases out there. The example that we showed and that you mentioned actually is pretty typical. It falls right in the middle of the range of vehicles that we looked at.

We found some vehicles where the sales price received for the vehicle averaged about 1 percent of what was claimed as a deduction, and the charity obviously received less than that after the fundraiser costs were deducted.

We found some individuals, in a few cases, undervalued their vehicle in claiming a deduction. So the situation is pretty typical as far as amounts that charities get back.

There are a couple reasons that we found why this occurs. First of all, when charities and fundraisers take in vehicles, sometimes they take in a high volume of vehicles, maybe up to 1,000 a month depending on the size of their program, and they need to turn these vehicles over quickly to get revenues as quickly as they can, otherwise they have to pay storage costs and they would essentially become a used car lot.

So when they turn these vehicles over quickly, generally through auctions, or they sell the vehicles for parts, they may get less in proceeds than what a private party would get if they sold the vehicle themselves.

Another issue, is taxpayers may not be claiming the appropriate value when they take a deduction for vehicle donations. For the vehicles we reviewed, we look at what was claimed for deduction with the type and year of the vehicle to see whether or not those ranges fell within national used car guidebooks.

We found that they generally did, but that still does not answer the question on whether a taxpayer claimed the appropriate amount for a deduction because we did not know the value of the vehicle. So, they could be over-valuing the vehicles when they claim a deduction.

The CHAIRMAN. All right. I am going to ask Ms. Hart to expand just a little bit on what I would consider relatively good news about some accomplishment and movement in reducing the number of scam artists.

But I would also like, besides her just maybe giving short, further details, see if GAO and whether the Inspector General would agree with that. Ms. Hart? Just a little bit.

Ms. HART. Yes. Thanks for this opportunity, Senator. We do think we are shining a lot of light on what is a pervasive problem. The result of that light, is that people will, in fact, make different decisions about whether or not to participate in these schemes.

The offshore approach that we are using is actually opening up something that has been veiled in secrecy for many, many years and we think will bring taxpayers back into compliance.

Abusive schemes and large-scale tax shelters is the Service's top priority, and we are using all kinds of tools in order to impact that. We are creating voluntary opportunities like the Offshore Vol-



untary Compliance Initiative to get people back. We are using civil injunctions and other tools, as well as examinations to bring taxpayers back into play.

We are making better use of our criminal enforcement techniques in order to bring taxpayers back in, as well as education and outreach. I would note that our compliance programs have turned the corner. They had been on the decline for several years. They are now coming back up as far as results and activity.

The cooperation that we have across the Service, both within all of the operating divisions, CI, and counsel, is better than I have ever seen at any time in my career. I would also add that Treasury is providing an enormous amount of leadership here and we are working closer with DOJ than I have ever seen. So, from my standpoint, we are doing much, much better with the resources available to combat this problem.

The CHAIRMAN. Ms. Gardiner and Mr. White, I guess, mostly, if you would agree, or if there is some disagreement, state disagreement.

Ms. GARDINER. We would agree. We have seen certain types of schemes that really have gone down dramatically. One of them that was discussed last year was the Black Reparations Credit.

As a result of a lot of the outreach, media attention, press releases, IRS having it on the web site, the "Dirty Dozen," those types of things, even hearings like this have really helped get the word out.

That is the biggest thing, is to prevent them in the first place so that people do not believe that they are legitimate, because it is a confusing Tax Code and sometimes people think, oh, well, this might be all right.

So they have gone after the promoters, they have done excellent outreach, and the computer programs that were implemented have stopped a lot of those, too. So that is just one example of a success story, but certainly the way they have approached the others has had equal benefits.

The CHAIRMAN. Mr. White?

Mr. WHITE. Mr. Chairman, we generally agree. IRS should be commended for using its new planning, budgeting, and performance management process to try to better allocate what are scarce compliance resources to emerging compliance problems.

Promoters of these kinds of schemes are always trying to stay one step ahead of the IRS, so IRS is always chasing. They are trying to reallocate resources to better target these needs.

Just one caveat here. We do not know the effect of these efforts on the voluntary compliance rate, and we will not know that until IRS is done with their national research program. That should start to give us better information about the actual results on compliance of these kinds of efforts.

The CHAIRMAN. Well, I thank all of you. I think we have learned an awful lot today about these issues of tax preparers. It happens that the CARE Act, which hopefully will soon be before the Senate, contains some language that tries to control bad actors at the high end involving tax shelters, lawyers, accountants, investment bankers, are all playing a role. For instance, in Enron's tax shelters.

We have learned today about the bad actors involved in the low- and middle-income taxpayers and about tax preparation. We need to consider action here as well. Senator Baucus and I will be working on those things in the future.

Do you have anything to say?

Senator BAUCUS. I am fine, thank you.

The CHAIRMAN. All right. We thank you all very much.  
[Whereupon, at 11:37 a.m. the hearing was concluded.]

# APPENDIX

PREPARED STATEMENT OF CATHLEEN A. BERRICK

April 1, 2003



## VEHICLE DONATIONS

### Taxpayer Considerations When Donating Vehicles to Charities

#### Why GAO Did This Study

According to the Internal Revenue Service (IRS), charities are increasingly turning to vehicle donation programs as a fund-raising activity, resulting in increased solicitations for donated vehicles. Therefore, to make informed decisions about donating their vehicles, taxpayers should be aware of how vehicle donation programs operate, the role of fund-raisers and charities in the vehicle donation process, and IRS rules and regulations regarding allowable tax deductions. Due to the increased use of vehicle donation programs, GAO was asked to describe (1) the vehicle donation process, (2) the amount of proceeds received by charities and fund-raisers, (3) donor tax deductions, and (4) taxpayer cautions and guidance.

#### What GAO Recommends

GAO is not recommending executive action. However, based on guidance issued by the IRS and other sources, GAO identified several steps that taxpayers should take before donating their vehicles and claiming tax deductions.

- These steps include
- verifying that the recipient organization is tax-exempt,
  - asking questions about vehicle donation proceeds,
  - deducting only the fair market value of the vehicle, and
  - following state laws regarding title transfer for vehicles.

[www.gao.gov/cgi-bin/getrpt?GAO-03-608T](http://www.gao.gov/cgi-bin/getrpt?GAO-03-608T). To view the full testimony, click on the link above. For more information, contact Cathleen A. Berrick at (202) 512-3404, or [berrickc@gao.gov](mailto:berrickc@gao.gov).

#### What GAO Found

Revenue from donated vehicles is a welcomed, and sometimes crucial, source of income for a number of charities. Donors, by following available guidance and making careful selection of charities for their donations, can provide charity support while benefiting themselves through tax deductions or disposing of unwanted vehicles.

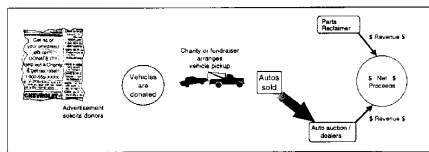
Taxpayers generally first learn about vehicle donation programs through advertisements. Interested donors call the advertised number and either reach a charity that operates its program in-house, or a third-party fund-raiser acting on the charity's behalf. The charity or fund-raiser asks questions of the potential donor regarding the vehicle, and then collects and sells the vehicle for proceeds.

The proceeds a charity receives from a vehicle donation may be less than what a donor expects. Two factors contribute to this difference. First, charities often sell vehicles at auto auctions for wholesale prices rather than the prices donors may receive if they sold their vehicles themselves. Second, vehicle processing costs—whether the charity's or the fund-raiser's—as well as the fund-raiser's portion of net proceeds further reduces the amount of proceeds a charity receives.

Of the 129 million individual returns filed for tax year 2000, an estimated 0.6 percent, or 733,000 returns, had tax deductions for vehicle donations. These deductions lowered taxpayers' income tax liability by an estimated \$654 million of the \$1 trillion tax liability reported on returns.

To assist donors in making decisions regarding vehicle donations, IRS and other organizations have issued guidance on steps potential donors should take before making vehicle donations. These steps include verifying that the recipient organization is tax-exempt, asking questions about vehicle donation proceeds, and deducting only the fair market value of the vehicle on tax returns.

The Vehicle Donation Process



Source: GAO.

United States General Accounting Office

Mr. Chairman and Members of the Committee:

I am pleased to be here today to discuss our ongoing work on vehicle donation programs. According to the Internal Revenue Service (IRS), an increasing number of charities are turning to vehicle donations as an effective way to raise money. In order to make informed decisions about these donations, however, taxpayers should be aware of how vehicle donation programs operate, the role of charities and third-party fund-raisers in the vehicle donation process, and IRS rules and regulations regarding allowable tax deductions.

The tax code generally allows taxpayers to deduct vehicle donations and other noncash contributions from their federal taxes if the donations go to certain qualified organizations such as churches and most nonprofit charitable, educational, and medical organizations. There is no national data identifying the percentage of charities that operate vehicle donation programs,<sup>1</sup> or the number of third-party fund-raisers that solicit donated vehicles on charities' behalf.

The proceeds from vehicle donations can be an important, and sometimes crucial, source of support for charities. One charity reported that starting a vehicle donation program helped it avoid a potential deficit after it had to cancel a major fund-raising event due to the events of September 11, 2001. Other charities we spoke with estimated that vehicle donations made up from less than 1 percent to about 98 percent of their respective budgets. We plan to conduct a nation-wide survey of charities to determine their use of vehicle donation programs, and the importance of the programs to their operations.

Because charities have increasingly turned to vehicle donation programs to raise funds, interest has been raised regarding how these programs operate. Accordingly, you asked us to describe how vehicle donation programs work, as well as information taxpayers should be aware of when donating their vehicles. Today, I will discuss (1) the vehicle donation process, (2) the amount of proceeds received by selected charities and

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<sup>1</sup> We use the term "vehicle donation" to refer to vehicles, boats, and farm equipment donated to a charity, although vehicles are most commonly donated. The term "vehicle donation program" refers to situations wherein a charity officially solicits donated vehicles, rather than occasionally accepting unsolicited vehicles.

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commercial fund-raisers, (3) donor tax deductions, and (4) taxpayer guidance and cautions.

For my statement today, we relied on several sources, including an analysis of donor surveys regarding vehicle donations conducted by two charities, vehicle donation advertisements, and a sample of tax returns where taxpayers claimed deductions for donated vehicles. To determine how vehicle donation programs work, we also interviewed officials of IRS, 10 states, 17 charities, 4 fund-raisers, and 5 related interest groups. We began our review in October 2002, and plan to issue a final report in September 2003.

In summary, our work to date shows the following.

- There are two basic types of vehicle donation programs: those operated in-house by charities and those operated by third-party fund-raisers. For in-house programs, charities advertise for donated vehicles, pick up the vehicles, and sell the vehicles, generally at auto auctions or they salvage the vehicles for parts. For fund-raiser programs, fund-raisers generally perform the advertising, pick up, and selling functions, and also retain a portion of the net vehicle proceeds, after expenses. Individuals generally learn about vehicle donation programs through advertisements. A small percentage of the advertisements we reviewed could potentially mislead donors regarding allowable tax deductions.
- Charities operating in-house vehicle donation programs, and those using the services of third-party fund-raisers, consider proceeds received from vehicle donations as a welcome source of revenue. However, the total proceeds a charity receives from a vehicle donation may be less than what a donor expects. We identified two factors that contribute to this difference. First, charities and fund-raisers often sell vehicles at auto auctions and receive wholesale prices rather than the prices donors might receive if they sold their vehicles to private parties. Second, vehicle processing and fund-raising costs are subtracted from vehicle revenue, further reducing proceeds. Although charity proceeds may be less than what a donor expects, results of donor surveys identified that in addition to supporting charitable causes, individuals most often donated their vehicles in order to claim a tax deduction, or to dispose of an unwanted vehicle.
- Of the 129 million individual returns filed for tax year 2000, an estimated 0.6 percent, or 733,000 returns, had tax deductions for vehicle

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donations. The vehicle donation deductions totaled an estimated \$2.5 billion of the \$47 billion in noncash contributions claimed. The vehicle donations deductions lowered taxpayers' income tax liability by an estimated \$654 million of the \$1 trillion tax liability reported on returns.

- Because of the number of charities that are involved in vehicle donation programs, IRS and other organizations have issued guidance on steps potential donors should consider before donating their vehicles to charity and claiming associated tax deductions. These steps include verifying that the recipient organization is a tax-exempt charity, asking questions about vehicle donation proceeds, deducting only the fair market value of the vehicle, and following state laws regarding title transfers for vehicles. In addition, in 2001 IRS created a cross-functional Donated Property Task Force to study issues surrounding donated property, including vehicle donation programs, and identify methods to monitor this area.

I would now like to discuss these areas in more detail.

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## The Vehicle Donation Process

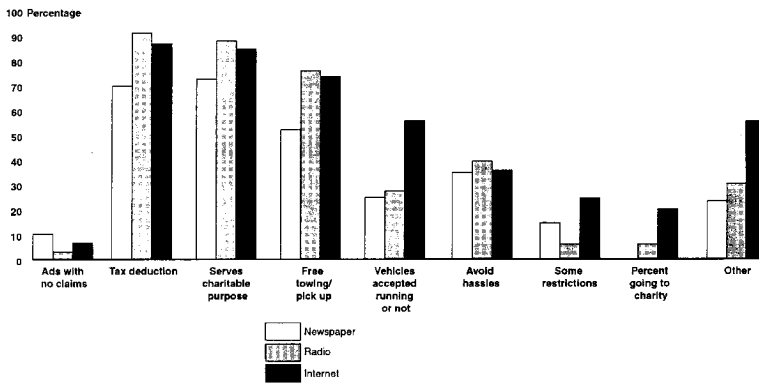
Individuals often first learn about vehicle donation programs through advertisements. Vehicle donation advertisements can be found on billboards, truck banners, and television, as well as in newsletters and even on small paper bags. Some of the most common mediums for vehicle donation advertisements include the radio, newspapers, and the Internet.

Based on a sample of advertisements we reviewed,<sup>2</sup> we found that advertisements for vehicle donations often identified that individuals could claim tax deductions for the donations, the donations served charitable purposes, and the donors' vehicles would be towed free of charge. Figure 1 identifies the most common claims made in the newspaper, radio, and Internet advertisements we reviewed.

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<sup>2</sup> We analyzed 147 advertisements for vehicle donations, including 69 newsprint advertisements from a sample of 50 newspapers nationwide, 33 radio advertisements from 19 radio stations in the top 10 U.S. markets, and 45 Internet advertisements. Our results cannot be projected to all vehicle donation advertisements.

Figure 1: Most Common Claims in Newspaper, Radio, and Internet Advertisements Reviewed



Source: GAO.

Note: GAO analysis of 147 vehicle donation advertisements. Claims classified as "other" included promises that vehicles would be picked up in 24 hours, title transfer would be handled, or contributions would be used locally.

IRS has expressed concern about some vehicle donation advertisements.<sup>3</sup> According to an official from IRS's Tax Exempt Division, tax deduction claims are potentially deceptive when they do not specify that taxpayers must itemize their deductions to claim a vehicle donation, since many taxpayers do not itemize. Of the 147 advertisements we reviewed, 117

<sup>3</sup> Responsibility for oversight of advertisements is diffused. The Federal Communications Commission defers regulatory authority regarding false advertising on radio or television to the Federal Trade Commission (FTC). FTC is charged with taking action against unfair or deceptive acts that affect commerce. FTC does not have specific jurisdiction over charities, but may become involved in cases of fraud. State officials are primarily responsible for false advertising by charitable organizations. Officials we interviewed from two states said that limited resources prevent them from providing broad oversight over advertisements, and that they generally review advertisements in response to consumer complaints, or when they discover that charities or fundraisers are soliciting in their state without being registered.

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identified that taxpayers could claim a tax deduction, but only 7 advertisements specified that donors must itemize in order to claim a deduction.

IRS also expressed concern when advertisements claim donors can value their vehicles at full, or maximum, market value when claiming a tax deduction. IRS does not define full or maximum value, but believes these claims may be misleading since vehicles are required to be valued at fair market value. IRS stated that these advertisements may be particularly misleading when they also claim that vehicles will be accepted whether they are running or not. Fair market value equals what a vehicle would sell for on the market, and takes into account a vehicle's condition and mileage, among other factors. Of the 117 advertisements we reviewed that mention tax deductions, 38 specified that donors could claim fair market value on their tax returns when donating their vehicles; while 8 identified that a donor could claim full or maximum market value. Other advertisements referred potential donors to the IRS Web site, an accountant, used car guides such as the Kelley Blue Book,<sup>4</sup> or other sources for guidance on claiming a tax deduction.

After deciding to donate a vehicle to charity, a donor will generally encounter one of two types of vehicle donation programs: those operated by charities (in-house) and those operated by a for-profit or not-for profit fund-raiser (fund-raiser). Donors may not know whether they are donating vehicles directly to charities or through fund-raisers.<sup>5</sup> Figure 2 identifies the vehicle donation process for both in-house and fund-raiser vehicle donation programs.

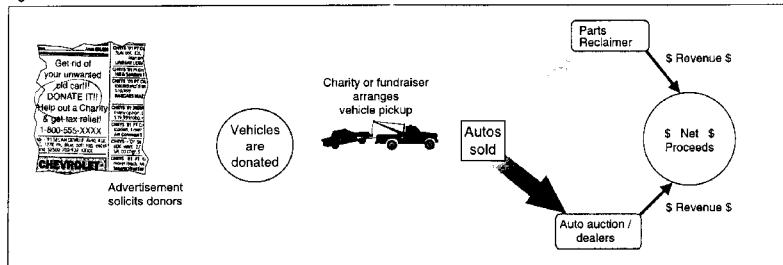
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<sup>4</sup>The Kelley Blue Book is one of several guides listing values for various models of used vehicles based on their condition and mileage.

<sup>5</sup>This may not be a factor for donors if their primary motivation is disposing of their vehicle.



Figure 2: Vehicle Donation Process



Source: GAO.

For in-house programs, charities, typically larger ones, advertise for vehicle donations, and respond to donor's initial call inquiring about a donation. After the charity determines that it will accept the vehicle,<sup>6</sup> it arranges to have the vehicle picked up, often towed, and delivered to wherever it will be stored until it is liquidated. The charity provides the donor with a receipt when the vehicle is picked up, or at a later time to document the donation for tax purposes. At the time the vehicle is picked up, the charity obtains the title of the vehicle from the donor, and some charities may provide donors with state-required forms (e.g., release of liability) or references for establishing the tax deductible value of their donated vehicles (e.g., Kelley Blue Book or IRS guidance). Charities we spoke with stated that it is up to the donor to establish the vehicle's value. Once the donated vehicles are collected, they are generally sold at auto auctions or salvaged for parts, but may also be sold to auto dealers or to the general public. Charities with in-house programs keep 100 percent of the net proceeds after deducting costs associated with processing the vehicles.

<sup>6</sup> When a charity or commercial fundraiser receives the initial call from a potential donor, the donor is asked questions about the vehicle, including the vehicle's make, year, and condition, and whether the donor has the title. Some programs will only accept vehicles expected to produce a profit after towing and other expenses. Charities sometimes will accept vehicles regardless of condition, because, as one charity stated, they view accepting vehicles with little value as generating goodwill for future donations.

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For fund-raiser programs,<sup>7</sup> fund-raisers generally perform some or all of the tasks associated with advertising, vehicle pick up, and vehicle disposal. After deducting expenses, fund-raisers keep a portion of the net proceeds from the vehicle sale or salvage, providing the remainder of the proceeds to the specified charity. A charity working with a fund-raiser may have no oversight of the process, leaving the operation of the program, and distribution of proceeds, up to the fund-raiser.

The relationship between charities and fund-raisers varies, depending on the agreements they have established. Some commercial fund-raisers may handle vehicle donation programs for many charities. For example, one national fund-raiser has contracts with about 140 charities, and another works with about 200 charities. Charities may also contract with multiple fund-raisers. Fund-raisers often support smaller charities that would not otherwise be able to participate in vehicle donation programs. For example, at one California charity, a staff person spent half her time working with two vehicle donation fund-raisers, which together generated about \$110,000 for the first six months of the current year (approximately 8 - 10 percent of its annual budget).

In addition to the in-house and fund-raiser programs described above, we identified some variations in how vehicle donation programs operate. For example, see the following.

- Some charities refurbish donated vehicles for their own program services or clients, rather than for sale or salvage.
- One state consortium of 14 charities jointly runs a vehicle donation program in conjunction with a wrecking yard. The charities share in oversight of the operations, such as inspecting donated vehicles and monitoring vehicle donation reports. Donors can select one charity to receive the proceeds, or proceeds are split among members of the consortium equally if no charity is designated.
- One large charity runs a national vehicle donation program and serves regional offices as a fund-raiser would, charging its regions vehicle processing costs. Some of the charity's affiliates choose other fund-raisers and do not participate in the national program.

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<sup>7</sup> Some charities perform vehicle donation fund-raising for other charities, but most of the vehicle donation fund-raisers we identified were for-profit businesses.

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- Another large charity runs a national program and serves charity affiliates but also has a nonprofit vehicle donation program for other smaller charities.

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### Vehicle Donation Proceeds

The total proceeds a charity receives from a vehicle donation may be less than what a donor expects. We identified two factors that contribute to this difference. First, charities and fund-raisers often sell vehicles at auto auctions for wholesale or liquidation prices or to salvage yards for parts, rather than obtaining the amount they would receive if vehicles were sold to private parties. Second, vehicle processing and fund-raising costs are subtracted from vehicle revenue, further lowering proceeds.

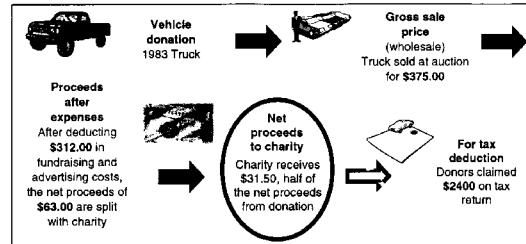
According to a survey of year 2001 charitable donors commissioned by the Wise Giving Alliance, donors expect at least 70 to 80 percent of a charity's funds to be used for charitable purposes rather than fund-raising or administrative costs. Actual charity receipts reported to state officials for charity fund-raising are less. For example, in New York telemarketing fund-raisers (not specifically vehicle donations) returned 32 percent of funds raised for charities in 2000. Although donors are often motivated by serving a charitable cause when donating their vehicle, the results of donor surveys identified that individuals are also motivated by the ability to claim a tax deduction and to dispose of an unwanted vehicle.<sup>4</sup>

Figure 3 provides an example of the amount a charity received from an actual vehicle donation. In this case, a 1983 truck was donated in 2001 to a charity whose vehicle donation program is operated through a fund-raiser. The gross sale price for the truck (sold at an auction) was \$375. After deducting fund-raiser and advertising expenses, net proceeds totaled \$63.00. This amount was divided evenly between the fund-raiser and charity, leaving the charity with \$31.50 from the vehicle donation. The donor claimed a deduction of \$2,400 on his or her tax return, based on the fair market value of the vehicle as identified in a used car guidebook.

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<sup>4</sup> Two charities shared voluntary feedback provided by vehicle donors. Over 3,000 donors responded in one survey and about 400 responded in the other. We did not review the methodology for the surveys and consider the results to be illustrative.

Figure 3: Example of Vehicle Donation



Source: GAO

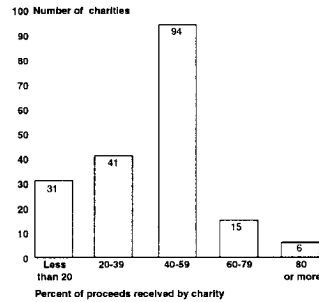
Note: GAO analysis of an actual vehicle donation.

Charities operating in-house vehicle donation programs incur costs associated with processing vehicles for sale or salvage, but do not incur additional fees generally associated with fund-raiser programs. Processing costs cannot be compared among in-house programs because charities may record their costs differently. One of the few in-house charities we spoke with reported that it earned a net average of 42 to 44 percent of the sales price of donated vehicles. Another charity operating a national program for local affiliates reported a range of 13 to 32 percent net proceeds for programs operating for over 2 years, and a deficit to slightly in excess of breakeven for newer programs.

Proceeds received by charities participating in vehicle donation programs run by fund-raisers also varied, in part due to the different processing costs deducted by fund-raisers, as well as different agreements between charities and fund-raisers for splitting net proceeds. Some charities receive a percentage of the net proceeds, after the fund-raisers costs are deducted. Other charities receive the net proceeds remaining after the fund-raiser deducts a flat fee for expenses.

California is the only state that systematically captures information on the percentage of proceeds received by charities through vehicle donation programs.<sup>9</sup> However, California only captures information related to programs run by fund-raisers, and cannot separately identify the number of charities that operate in-house programs. According to a report from the California State Attorney General's Office, less than 1 percent of registered charities in California have vehicle donation programs that are managed by commercial fund-raisers. In 2000, these fund-raisers generated approximately \$36.8 million in sales revenue, with about \$11.3 million (31 percent on average) being returned to the charities. As shown in figure 4, California charities received proceeds from fund-raiser programs ranging from less than 20 percent to over 80 percent of the net proceeds from vehicles, but most were in the 40 – 59 percent range.

**Figure 4: Vehicle Donation Proceeds to California Charities Using Fund-raisers**



Source: California Attorney General's Office.

<sup>9</sup> National data on the proceeds charities receive from vehicle donation fund-raising do not exist. Although IRS's Form 990 collects information from charities on fund-raising costs, it does not identify the portion, if any, related to vehicle donations.

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Issues relating to charity proceeds from fund-raising reached the Supreme Court on March 3, 2003, in arguments related to "Ryan v. Telemarketing Associates". The Attorney General of Illinois is appealing a decision of the Illinois Supreme Court<sup>10</sup> to dismiss fraud charges against Telemarketing Associates. At issue were solicitations implying that cash donations would go to a charity to buy food baskets and blankets for needy veterans, while only 15 percent of the funds raised actually went to the charity. As part of the case, donor affidavits were reviewed stating that some individuals would not have donated if they knew the percentage of proceeds the charity would actually receive. The Supreme Court has ruled in three previous cases that percentage-based limitations on charitable solicitations were unconstitutional. The Supreme Court decision in this case is not expected until July 2003.

We plan to conduct a national survey of charities to further review vehicle donation proceeds received by charities and fund-raisers. We will identify any concerns regarding the amount of net proceeds fund-raisers keep from vehicle donations and the significance of vehicle donation programs to charity operations. Charities may consider proceeds from vehicle donations to be a welcomed, if not crucial, source of revenue to support their operations. For example, one charity stated that vehicle donations are "just keeping their heads above water."

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### Donor Tax Deductions

The results of donor surveys we reviewed indicated that the ability to claim a tax deduction is one of the most important reasons individuals donate vehicles to charity. However, we found that a small percentage of Americans claim tax deductions for vehicle donations. Specifically, we reviewed a representative sample of taxpayer returns that claimed noncash contributions for the tax year 2000. Of the 129 million returns filed that year, a projected 0.6 percent, or an estimated 733,000 returns<sup>11</sup>, had tax deductions for vehicle donations.

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<sup>10</sup> The Illinois Supreme Court held that the fund-raiser's conduct was protected under the First Amendment and the Attorney General's complaint was not legally sufficient because it was an attempt to impose a constitutionally impermissible percentage-based limitation on the fund-raiser's ability to engage in a protected activity.

<sup>11</sup> Ninety five percent confidence intervals: 0.6 percent +/- 0.2 percent, and 733,000 returns +/- 520,000 returns.

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We also found that deductions for vehicle donations accounted for a small fraction of forgone tax revenue. Based on the sample we reviewed, vehicle donation deductions totaled an estimated \$2.5 billion<sup>12</sup> of the \$47 billion in noncash contributions claimed.<sup>13</sup> Stocks and thrift store donations accounted for most of the tax dollars deducted for noncash charitable contributions. We estimate that in 2000, vehicle donations deductions lowered taxpayers' income tax liability by an estimated \$654 million<sup>14</sup> of the \$1 trillion tax liability reported on returns.

IRS guidance limits the amount of an allowable deduction to the vehicle's fair market value, or the amount a willing, knowledgeable buyer would pay for the vehicle. We reviewed each deduction for vehicle donations in our sample to determine the average value claimed for donated vehicles in 2000, and whether these values fell within the ranges identified in a nationally recognized blue book. We estimated that the average value claimed for donated vehicles in 2000 was \$3,370,<sup>15</sup> and that the amounts claimed for almost all of these vehicles fell within the blue book. However, since we did not have additional information regarding the vehicles' condition and mileage, we could not determine whether reported values accurately reflected fair market value.

For a donor to claim a vehicle tax deduction, the contribution must be made to a qualified organization. Churches and most nonprofit charitable, educational, and medical organizations are qualified.<sup>16</sup> We submitted the names of charities from our sample that taxpayers reported on their returns to IRS to verify whether the recipient organization was qualified to receive tax deductible donations. Of the 22 charities IRS reviewed, it was able to verify that 10 of the charities were qualified to receive tax-deductible donations. IRS could not determine whether the remaining 12

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<sup>12</sup> Ninety-five percent confidence interval: \$2.5 billion +/- \$2.0 billion.

<sup>13</sup> Our estimates are based on taxpayers who were required to file Form 8283, "Noncash Charitable Contributions," for noncash contributions exceeding \$500. Some of these taxpayers may have claimed tax deductions for vehicle donations, but they were not required to list these transactions on their returns.

<sup>14</sup> Ninety-five percent confidence interval: \$654 million +/- \$480 million.

<sup>15</sup> Ninety-five percent confidence interval: \$3,370 +/- \$790.

<sup>16</sup> Other types of organizations that qualify for donations include war veteran organizations, domestic fraternal societies, certain nonprofit cemetery companies or corporations, and the United States and any state or local government.

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charities were qualified organizations because it needed more information than taxpayers reported on their tax returns, such as the organizations' full names and addresses and employer identification numbers.

IRS has a compliance program to review noncash donations, including vehicle donations generating revenue over \$5,000, which compares the amounts received by a charity upon the sale of a donated item with the amount claimed by the taxpayer as the fair market value of the item.<sup>17</sup> Although differences exist between fair market values and the proceeds from items sold at wholesale prices, this program gives IRS an indication of whether a particular donation should be further scrutinized. However, IRS has no data identifying whether cases referred for further review by this program are ever pursued.

IRS is also in the process of implementing a National Research Program, which may provide data on compliance issues dealing with vehicle donations and other noncash contributions. Under the program, officials will randomly select about 49,000 tax year 2001 returns to determine whether taxpayers complied with statutory income, expense, and tax reporting requirements. Returns with noncash contributions, including donated vehicles, could be subject to audit to verify donation claims. Once this project is completed, IRS plans to assess individuals' compliance related to deductions for noncash contributions, and determine whether more enforcement is needed to help ensure proper reporting in this area.

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## Taxpayer Guidance and Cautions

IRS and other organizations, including the National Association of State Charity Officials and the Better Business Bureau, have issued guidance on steps potential donors should take before donating their vehicles to charity and claiming associated tax deductions. These steps include the following.

- Verify that the recipient organization is a tax-exempt charity. Potential donors can search IRS's Publication 78, which is an annual cumulative list of most organizations that are qualified to receive deductible contributions.

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<sup>17</sup> Charities file Form 8282 when donated property valued at over \$5,000 is disposed of within 2 years of receiving it.



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- Determine whether the charity is properly registered with the state government agency that regulates charities. The state regulatory agency is generally the state attorney general's office or the secretary of state.
  - Ask questions about how the donated vehicle will be used to determine whether it will be used as intended. Such questions include the following: Will the vehicle be fixed up and given to the needy? Will it be resold, and if so, what share of the proceeds will the charity receive?
  - Itemize deductions in order to receive a tax benefit from the donation. The decision to itemize is determined by whether total itemized deductions are greater than the standard deduction.
  - Deduct only the fair market value of the vehicle. The fair market value takes into account many factors, including the vehicle's condition, and can be substantially different from the blue book value. IRS Publication 526, "Charitable Deductions," and IRS Publication 561, "Determining the Value of Donated Property," provide instructions on how to calculate the fair market value of donated property.
  - Document the charitable contribution deduction. IRS Publication 526 identifies requirements for the types of receipts taxpayers must obtain and the forms they must file.
  - Follow state law regarding the car title and license plates. Generally, the donor should ensure that the title of the vehicle is transferred to the charity's name, by contacting the state department of motor vehicles, and keep a copy of the title transfer. Donors are also advised to remove the license plates, if allowed by the state.

The IRS and the states have identified few significant occurrences of abuse by charities and fund-raisers operating vehicle donation programs. However, the guidance above may help potential donors avoid donating vehicles to organizations that have not complied with laws or regulations related to vehicle donation activities, and prevent problems sometimes encountered with vehicle title transfers. For example, see the following.

- IRS revoked the charity status for one Florida organization that solicited boat donations after finding that its charitable activities were insubstantial, and that proceeds were kept for personal gain.

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- California charity officials prosecuted and jailed the owner of a used car lot soliciting vehicles for charity. The organization raised an estimated \$1 million, none of which benefited charity.
  - In Massachusetts, a for-profit company solicited cars through newspaper ads, and led potential donors to believe that the organization was a charity and that all, or a substantial portion of, proceeds would go to a charitable purpose. In May 2002, Massachusetts brought an enforcement action in which the company's president agreed to cease all further activity related to the car donation operation and dissolve.
  - According to state agency officials, they often receive complaints from donors when charities do not transfer vehicle titles as promised. Donors found themselves responsible for parking violations, penalties, and in some cases damages when donated vehicles were subsequently involved in accidents.

In addition to noncash contributions guidance found in various IRS publications and news releases, the IRS has publicized guidance regarding vehicle donations, and developed a training video for state and IRS compliance regulators. In 2001 IRS also created a cross-functional Donated Property Task Force to study issues surrounding donated property and identify methods to monitor this area. The task force, in cooperation with the National Association of State Charity Officials, is also surveying state charity officials to identify information that states collect on charity fund-raising, and on vehicle donations in particular. As of March 2003, only California reported having data available on vehicle donation handled by fund-raisers.

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

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PREPARED STATEMENT OF PAMELA J. GARDINER

Mr. Chairman, Senator Baucus and members of the Committee, I appreciate the opportunity to appear before you today to discuss an aspect of the Internal Revenue Service's (IRS) electronic filing (e-file) Program, specifically its use of electronic return providers or originators (Providers or EROs). I would like to report on my office's efforts in assessing the IRS' monitoring of EROs and in investigating individuals who corruptly interfere with this aspect of the tax administration system.

In considering major changes to the IRS' processes in 1998, the Congress determined that electronic filing should be the preferred and most convenient filing method. The IRS concurs that it is more convenient and economical and less time consuming to do business electronically rather than sending paper through the mail. The IRS has stated that while the government saves money, the real benefits of electronic filing are realized by the taxpayer. These benefits include reduced preparation time, faster refunds, greater accuracy of returns processing, and acknowledgement of return receipt.

As part of the IRS Restructuring and Reform Act, the Congress set a goal of having 80 percent of all tax and information returns filed electronically by 2007. The Congress also directed the IRS and Treasury Department to eliminate barriers, provide incentives, and use competitive market forces to create a vigorous private sector competition to increase taxpayer use of electronic filing. In response, the IRS has aggressively marketed the e-file Program to return preparers, and continues to encourage widespread participation by the preparer community.

For the 2002 Filing Season, more than 138,000 EROs participated in the IRS' e-file Program, electronically transmitting more than 33 million returns accepted by the IRS. This number represents 71 percent of all accepted e-file returns.

EROs are individuals or businesses that the IRS accepts to be authorized to file tax returns electronically. To be an authorized ERO, one must be a United States citizen or an alien lawfully admitted for permanent residence, and be 21 years of age as of the date of application. Unlike an Enrolled Agent, EROs are not required to have experience or skill in return preparation.

The IRS is responsible for ensuring that EROs authorized to participate in the e-file Program maintain a high degree of integrity and adhere to the highest professional and ethical standards. Toward this end, the IRS publicizes that it has an extensive screening process that includes:

- A Federal Bureau of Investigation (FBI) criminal background check;
- A credit history check;
- An IRES records check to ensure that all individual and business returns are filed, all payments are up to date, and there are no instances of fraud and preparer penalties; and
- A check for prior non-compliance in the IRS e-file Program.

The IRS' ERO Monitoring Program is a key control over the e-file Program; its purpose is to verify participating EROs' compliance with IRS e-file requirements. E-file Monitoring Coordinators are responsible for the oversight of EROs' operations, including on-site visits. The visits may be of two types: random and mandatory. Random visits are used to determine general compliance within the IRS e-file Program. Mandatory visits, by contrast, are used to investigate allegations and complaints submitted against EROs. Violations of IRS ERO requirements may result in a verbal or written warning, written reprimand, suspension, or expulsion of the ERO from the IRS e-file Program, depending on the seriousness of the infraction.

In a recent audit report, TIGTA found that the IRS has made strides with its ERO Monitoring Program efforts. Specifically, the IRS has developed and revised procedures and training materials, and established a goal to annually visit 1 percent of all EROs. The ERO Monitoring Program achieved this goal in both 2001 and 2002; however, resource constraints prevent the IRS from monitoring all EROs on whom it receives complaints.

There are additional challenges the IRS faces in administering the ERO program successfully. TIGTA has identified weaknesses in the screening process that present a risk that ineligible individuals are being admitted into the program. Screening checks the IRS publicized as extensive were limited primarily to whether the EROs filed their returns and paid taxes due. Other identified applicant screening deficiencies included:

- The IRS does not independently validate age and citizenship requirements. TIGTA's analysis of IRS data identified 350 individuals who were not U.S. citizens; 63 individuals who were not over 21 years of age; and 30 individuals who were deceased prior to January 1, 1986 (the inception of the IRS' e-file Program).
- Screening checks (including tax compliance checks) were not performed for individuals who participate as e-file Providers in the IRS' Volunteer Income Tax Assistance (VITA) Program. For the 2001 Filing Season, VITA volunteers e-filed more than 700,000 tax returns.
- Criminal background checks were limited to 25 percent of those applicants<sup>1</sup> who are required to submit a fingerprint card.
- Applicants were approved to participate in the e-file Program prior to the IRS' receipt and analysis of criminal background information obtained from the FBI.
- Subsequent non-tax screening checks are not performed to ensure individuals already authorized to participate in the IRS' e-file Program continue to maintain a high degree of integrity and adhere to the highest professional and ethical standards.

IRS disagreed with TIGTA's June 2002 audit results and indicated that the IRS' existing screening process and participation rules strike a good balance between meeting taxpayers' needs for increased electronic filing options and ensuring integrity of the e-file Program. However, TIGTA did not concur with this assertion and, in a January 2003 audit report, TIGTA reiterated concerns with the IRS' e-file Program and recommended that the IRS establish meaningful performance measures to assess not only relevant outputs (i.e., number of monitoring visits completed) but also program outcomes (i.e., the impact of the ERO Monitoring Program on compliance).

<sup>1</sup>Applicants that are required to submit fingerprint cards are those businesses (sole proprietors, partnerships, or appropriate corporation or organization officials) who want to become an Authorized ERO and are not attorneys, CPAs, Enrolled Agents, banking officials who are bonded and have been fingerprinted in the last 2 years, or officers of a publicly owned corporation.

TIGTA has also conducted investigations into alleged abuses in the ERO Program. In Fiscal Year 2002, TIGTA's Office of Investigations conducted 77 investigations involving EROs and paid preparers, 26 of which were EROs. TIGTA investigations have involved allegations that preparers stole taxpayer refunds and remittances, and that preparers submitted false declaration concerning their professional or eligibility status to the IRS. In one recent example, TIGTA participated in the joint investigation of an authorized ERO who had filed approximately 9,000 fraudulent tax returns over a three-year period, resulting in an estimated loss of over \$7 million in fraudulent tax refunds for one year alone; the total extent of the fraud is still under investigation. This investigation disclosed that a number of risks and program weaknesses previously reported in TIGTA audit reports to the IRS allowed this individual to illegally file fraudulent returns. For example, the ERO was in the United States illegally while perpetrating the fraud and there is no documentation that the ERO was ever the subject of an ERO Monitoring Program inquiry, even though this individual had 41 percent of the tax returns submitted to the IRS returned due to an error on the tax return. As an indicator of potential problems with EROs, TIGTA found there is no national process to leverage information that the IRS captures on how many tax returns are sent back to an ERO due to errors identified by the IRS. TIGTA became aware of the fraudulent filing of tax returns after the ERO was caught cashing stolen refund checks. The ERO pled guilty in October 2002 and is currently awaiting sentencing.

The reorganized IRS is focused on both helping people comply with the tax laws and ensuring the fairness of enforcement efforts. As budgetary pressures increase, it will become all the more essential that taxpayers remain persuaded of the benefits of electronic filing so that the costs of processing tax returns are contained, and limited enforcement resources can be directed where they are most needed. Providing strong, risk-based oversight of the ERO community and the e-file Program in general will help provide the public with this assurance.

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PREPARED STATEMENT OF HON. CHARLES E. GRASSLEY

Today's hearing focuses on three issues. First, we look back at the issue of schemes and scams that was raised by the Finance Committee two years ago. Next, we bring to the public's attention two new issues: paid preparers and donation of cars to charities. On the matter of tax schemes and scams the IRS reports good news. The IRS says the "tide has turned" on going after these abusive activities that can devastate taxpayers. I urge taxpayers to pay close attention to the "dirty dozen" tax schemes identified by the IRS in Ms. Hart's testimony. I hope the media widely reports these dirty dozen, because sunshine is probably our best friend in this fight. I also encourage the media to report to the public the very useful nine tips the GAO highlights in Mr. White's testimony on p. 12 on how to choose a paid preparer. With over 50 percent of taxpayers relying on preparers, it's important that Americans be careful in choosing a tax preparer.

This hearing will focus on several issues regarding paid preparers: in particular, what taxpayers need to be aware of in choosing a tax preparer; and, also whether the IRS is doing all it can to protect taxpayers from unscrupulous tax preparers. I should make it clear that the strong majority of preparers serve their clients well. However, with some 70 million taxpayers taking advantage of paid preparers, it can take only a few bad apples to cause real problems for many Americans.

Finally, we will look at a growing trend, the donation of cars to charities. In 2000, 733,000 people filed a return stating that they had donated a vehicle. Taxpayers claimed the worth of these cars to be \$2.5 billion, and realized \$654 million in tax savings per year. It's good that people are so generous. However, there are two concerns with charitable donations of cars: one, are the charities seeing the lion's share of the benefits from the donation of cars?; and, second, are taxpayers claiming a fair and accurate amount for the value of their car? We want to make certain that Uncle Sam isn't the one being taken for a ride by aggressive valuation. GAO will tell us about a case where the donor claimed a deduction of \$2,400, yet the truck was sold for \$375 and the charity ended up getting only \$31.50. It's a troubling picture.

To help us examine these three issues, we benefit from the testimony of James White and Cathleen Berrick from GAO; Pam Gardiner, the Acting Inspector General for Tax Administration; Dale Hart from the IRS; Nina Olson, the Taxpayer Advocate and Jeffrey Yabuki from H&R Block. Thank you all for time.

Given the complexity of our tax laws, it is easy to understand why so many taxpayers seek the assistance of a paid preparer. Our society values specialization. Many taxpayers do not understand the tax laws. Some simply do not have time to

do their own taxes. And others use paid preparers in the hope of obtaining a larger refund.

This hearing should not be interpreted as a criticism of the important role they play. The vast majority of paid preparers provide a valuable service. Undoubtedly, paid preparers help make the tax system work.

But despite the important role tax preparers play in the annual filing season, very little information exists on who provides tax preparation services and the quality of their work. There are instances where taxpayers are not well served by paid preparers. As the GAO will point out, even a small percentage of users of paid preparers can translate into millions of affected taxpayers.

For these taxpayers, the filing of their tax return may begin a long costly process to resolve a tax dispute with the IRS. But, for some taxpayers, visiting a questionable preparer means a loss of money they were rightfully entitled to receive.

Last year, GAO estimated that up to 2 million taxpayers overpaid their 1998 taxes by almost \$1 billion because they claimed the standard deduction when it would have been more beneficial to itemize. Half of these taxpayers used a paid preparer.

Another area we should examine more closely is that anyone can be a paid tax preparer. There are no laws or regulations that limit who can sell tax preparation services. The types and training of paid preparers vary widely. Most taxpayers do not realize that there is such a lack of monitoring tax practitioners. "Buyer beware" is just as relevant with tax preparation and planning as it is with buying a new stereo.

I hope today's hearing will provide useful, common sense information to taxpayers as they meet their tax filing responsibilities. I look forward to hearing from our witnesses.

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## PREPARED STATEMENT OF DALE HART

### INTRODUCTION AND SUMMARY

The IRS is committed to ensuring everyone pays a fair share, including those who have the resources to move money offshore or engage in abusive schemes or shelters. Honest taxpayers should not bear the burden of others who skirt their responsibility.

I also want to thank you and Senator Baucus for your visible and vocal support. Your actions demonstrate the united front we are mounting against those who evade paying their taxes and violate the trust of honest taxpayers, while respecting fully taxpayers' rights.

The IRS is working smarter to identify and refocus its resources on the biggest areas of risk to the tax system in a comprehensive strategy. Toward the end of FY 2002, the IRS began realigning its resources to focus on key areas of non-compliance with the tax law, including:

- The promotion of abusive tax schemes.
- The misuse of devices such as offshore accounts to hide or improperly reduce income.
- The use of abusive corporate tax avoidance transactions.
- The underreporting of income by higher-income individuals.
- Non-filing by higher-income individuals.
- Earned Income Tax Credit program.
- The National Research Program.

The IRS Fiscal Year 2004 budget complements and supports this through three key proposals aimed at improving the fairness of tax administration and compliance.

The first proposal focuses additional resources on high-income taxpayers and businesses in areas where noncompliance is likely to be greatest. The second proposal permits private collection agencies to support the IRS' collection efforts while affording full protection of taxpayer rights, allowing the IRS to devote resources to more complex enforcement and collection issues. The third proposal strives to improve the effectiveness of the Earned Income Tax Credit (EITC) program by ensuring that benefits go to those who qualify for them.

Indeed, the principal focus of the President's proposed FY 2004 budget is strengthening compliance activities in these and related areas. We are most encouraged by the additional funds requested to help us address these difficult compliance issues.

The IRS Small Business/Self-Employed (SB/SE) Division is leading the new civil compliance effort on issues affecting individuals and businesses. However, compliance efforts will continue in other parts of the agency, such as the abusive tax shel-

ter initiative in the Large and Mid-Sized Business (LMSB) Division. IRS Criminal Investigation also continues its investigative efforts regarding abusive schemes and promoters.

We will use a full scope of tools and techniques ranging from summons enforcement, injunctions, and criminal investigation of promoters to civil audits of participants. We are also using every possible communications channel to issue warnings about these scams and the consequences of participating in one of them.

Our strategy reflects the new way of doing business at the IRS. Several of these efforts, such as the offshore credit card initiative, display innovative approaches to tackling long-standing tax problems. Moreover, the agency's restructuring allowed key parts of the organization to work together in ways they did not previously.

New levels of cooperation and coordination have been woven into initiatives that involve both civil actions and criminal investigations. Our response to the problems of scams and schemes illustrates how the new IRS business model better positions the agency to respond to high-risk tax areas.

Mr. Chairman, I believe we are making progress combating these pernicious attacks against our tax administration system. We are better warning taxpayers about the dangers of the schemes and scams. We are better identifying the promoters and participants in them. We are using our enforcement powers more effectively. We are better coordinating our actions with the Justice Department to shut the schemes down before they do more damage. We are bringing taxpayers back into compliance. We are helping to restore public confidence in the fairness of our tax administration system.

Although I believe the tide has turned, there is still much work to do. This type of organized tax evasion and cheating poses an enormous threat—one that we as an agency and a nation have not previously confronted. But we now have a concrete plan to deal with the threat and are taking clear actions to implement it. With the continued support of the Administration, Congress, and the American people, I believe we can succeed.

Mr. Chairman, I would now like to describe briefly the various scams and schemes and then illustrate in greater detail the actions we have taken since last year's hearing to warn the public, identify promoters and participants, and take enforcement actions against them.

#### SCAMS AND SCHEMES: THE DIRTY DOZEN

With the filing season in full swing, we are seeing the traditional increase in tax trickery. Although we are witnessing few new schemes per se, the traditional ones are wrapped in a variety of guises—from the highly sophisticated to the patently absurd—and marketed through a host of means—from the Internet to word of mouth. Some are mere taxpayer rip-offs and hoaxes.

In an update of our annual consumer alert, we urged taxpayers not to fall victim to one of the "Dirty Dozen" tax scams. In the new 2003 ranking, several scams reached the top of our consumer watch list, including offshore bank transactions and identity theft schemes. Taxpayers who suspect tax fraud can report it to the IRS at 1-800-829-0433.

#### *Offshore Transactions*

As we discussed at last year's hearing, schemes designed to allow upper-income, and now middle-income, taxpayers to hide their income are proliferating. They cause the greatest revenue loss, are the hardest to detect, and have the greatest potential for undermining the fairness of the tax system. The devices used to hide income include trusts, both foreign and domestic, and offshore bank accounts. Diversion of income to offshore tax havens with strict bank secrecy laws adds an additional layer of complexity, which, in turn, has permitted the taxpayers to hide their income more effectively.

However, once the income is offshore, the taxpayer has the problem of getting the money back when he or she wants to spend it. Credit and debit cards issued by banks in tax haven countries are often used as a convenient and efficient way of bringing back and spending the money hidden offshore. These cards, sometimes hawked on the Internet, are used by the taxpayer in the U.S. to withdraw cash and to pay for everyday expenses, including groceries, medical bills and gasoline.

While it is not illegal to have a credit card issued by an offshore bank, there is ample basis for believing that many people are using offshore credit cards to repatriate funds hidden offshore to evade paying U.S. taxes. Use of an offshore credit card, trust, or other arrangement to hide or underreport income or to claim false deductions on a federal tax return is illegal.

The offshore credit card problem has the dubious honor of making the top of our watch list—and for a very good reason. Our investigations suggest hundreds of thousands of U.S. citizens are holding debit/credit cards issued by offshore banks.

#### *Identity Theft*

Identity theft is one of the fastest growing crimes in the nation. Identity thieves—use someone's personal data to steal his or her financial accounts, run up charges on the victim's existing credit cards, apply for new loans, credit cards, services or benefits in the victim's name, and even file fraudulent tax returns.

Tax-related identity theft takes different forms, as demonstrated by two schemes that recently came to our attention. In one, tax preparers allegedly used information, such as Social Security numbers and financial information, from their clients' tax returns to commit identity theft. In another, con men sent bank customers fictitious bank correspondence and IRS forms in an attempt to trick them into disclosing their personal and banking data.

Last May, we warned taxpayers about a fraudulent scheme that uses fictitious bank correspondence and IRS forms in an attempt to trick taxpayers into disclosing their personal and banking data. The information fraudulently obtained is then used to steal the taxpayer's identity and bank account deposits.

We received reports of the scam surfacing from coast-to-coast, including Maine, New York, Georgia, North Carolina, Texas, California and the state of Washington. Dozens of U.S. and foreign victims have been identified.

In this scam, a letter claiming to be from the taxpayer's bank states that the "bank" is updating its records in order to exempt the taxpayer from reporting interest or having tax withheld on interest paid on his or her bank accounts or other financial dealings. Legally, banks must report interest to the IRS, and taxpayers must include it as income.

The "bank" correspondence encloses a phony form that purports to come from the IRS and seeks detailed personal and financial data. The letter urges the recipient to fax the completed form to a specific number within 7 days or lose the reporting and withholding exemption, resulting in withholding of 31 percent on the account's interest. The scheme promoters then use the faxed information to impersonate the taxpayer and gain access to the taxpayer's finances.

One such phony form is labeled "W-9095, Application Form for Certificate Status/Ownership for Withholding Tax." The form requests personal data frequently used to prove identity, including passport number and mother's maiden name. It also asks for sensitive financial data such as bank account numbers, passwords, and PIN numbers that can be used to gain access to the accounts.

The fictitious W-9095 appears to be an attempt to mimic the genuine IRS Form W-9, "Request for Taxpayer Identification Number and Certification." The only personal information a genuine W-9 requests is the taxpayer's name, address and Social Security number or employer identification number.

Another form used in the scam is Form W-8BEN, "Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding." There is a legitimate IRS Form W-8BEN, which is used by banks to ensure that their non-U.S. customers meet the criteria to remain exempt from tax reporting requirements. However, the W-8BEN used by the scam promoters has been altered to ask for personal information much like the W-9095. This altered form targets residents of foreign countries who bank in the United States.

Another totally fictitious IRS form used in this scam is labeled "W-8888." It too asks for information similar to the phony W-9095 and W-8BEN. The real Forms W-9 and W-8BEN can be found on the IRS's web site at [www.irs.gov](http://www.irs.gov).

The Treasury Inspector General for Tax Administration (TIGTA) investigates a wide variety of offenses, including the misuse of the IRS' insignia, seals and symbols and identity theft related to tax administration. Taxpayers who have received a fraudulent letter and form should report this to TIGTA by calling the toll-free fraud referral hotline at 1-800-366-4484, faxing a complaint to 202-927-7018, or writing to the TIGTA Hotline, P.O. Box 589, Ben Franklin Station, Washington, D.C. 20044-0589. TIGTA's Web site is located at [www.ustreas.gov/tigta](http://www.ustreas.gov/tigta).

#### *Phony Tax Payment Checks*

In this scheme, con artists sell fictitious financial instruments that look like checks to pay a tax liability, mortgage, and other debts. They may also counsel their clients to use a phony check to overpay their taxes so they can receive a refund from the IRS for the overpayment. The false checks, called sight drafts, are worthless and have no financial value. It is illegal to use them to pay a tax liability or other debts.

*African-Americans Get a Special Tax Refund*

Thousands of African-Americans have been misled by people offering to file for tax credits or refunds related to reparations for slavery. There is no such provision in the tax law. Some unscrupulous promoters have encouraged clients to pay them to prepare a claim for this refund. But the claims are a waste of money. Promoters of reparations tax schemes have been convicted and imprisoned. Taxpayers could face a \$500 penalty for filing such claims if they do not withdraw it.

In early 2002, the slavery reparations scam ranked as the No. 1 scheme on our “Dirty Dozen” list. However, I am pleased to report that we made a real dent in this particular scheme. Following a sweeping public outreach campaign last year and assistance from members of the Congressional Black Caucus and other organizations, the number of slavery reparations claims fell sharply. Tens of thousands of claims were received in 2001, but they dropped to less than 50 per-week in 2002. Nevertheless, the scam has not died out completely. This filing season, there have been flare-ups in both North Carolina and Mississippi to which we are devoting special media and outreach attention.

*No Taxes Withheld From Wages*

Some individuals falsely claim that pursuant to Section 861 of the Internal Revenue Code, Americans are exempt from taxation on income earned within the United States. They argue, instead, that federal income taxes are excise taxes imposed only on nonresident aliens and foreign corporations for the privilege of receiving income from sources within the United States. These scams, referred to here as “Section 861” schemes, frequently go under the names of “Zero Tax” or “Employer Abatement” promotions.

Some illegal 861 schemes being promoted instruct employers not to withhold federal income tax or employment taxes from wages paid to their employees. These schemes have been refuted in court and at the request of the IRS, the Department of Justice has obtained injunction to stop seven Section 861 promoters. Taxpayers who have concerns about their employers and employment taxes can get help by calling the IRS at 1-800-829-1040.

*Improper Home-Based Business*

This scheme purports to offer tax “relief” but is really illegal tax avoidance. The schemes’ promoters claim that individual taxpayers can deduct most, or all, of their personal expenses as business expenses by setting up a bogus home-based business. However, the tax code firmly establishes that a clear business purpose and profit motive must exist in order to generate and claim allowable business expenses.

*Pay the Tax, Then Get the Prize*

The caller says you have won a prize, and all you have to do to get it is to pay the income tax due. Don’t believe it. Someone who really wins a prize may need to make an estimated tax payment to cover the taxes that will be due at the end of the year, but the payment goes to the U.S. Treasury—not the caller. Whether the prize is cash, a car, or a trip, a legitimate prize giver generally sends both the winner and the IRS a Form 1099 showing the total prize value that should be reported on the winner’s tax return.

*Frivolous Arguments*

Frivolous arguments, including the 861 scheme on withholding taxes previously described, are false arguments that are unsupported by law. When a scheme promoter says “I don’t pay taxes—why should you” or “Untax yourself for \$49.95,” taxpayers should be beware. These scams are as old as snake oil, but people continue to be taken in. Now, they are on the Internet.

The ads may say that paying taxes is “voluntary,” but that is simply wrong. The U.S. courts have continuously rejected this and other frivolous arguments. Unfortunately, hundreds of people across the country have paid for the “secret” of not paying taxes or have bought “untax packages.” Then they find out that following the advice contained in them can result in civil and/or criminal penalties. Numerous sellers of the bogus schemes have been convicted on criminal tax charges; they are described later in this testimony.

*Social Security Tax Scheme*

Taxpayers should not fall victim to a scam offering refunds of the Social Security taxes they paid during their lifetimes. The scam works by the victim paying the con artist a “paperwork” fee of \$100, plus a percentage of any refund received, to file a refund claim with the IRS. The victims are fleeced for the up-front fee. The law does not allow such a refund of Social Security taxes paid. The IRS processing centers are alert to this scam and have been stopping the false claims.



*"I Can Get You a Big Refund . . . for a Fee!"*

Refund scheme operators may approach someone wanting to "borrow" their Social Security number or give him or her a phony W-2 so it appears that the person qualifies for a big refund. They may promise to split the refund with that person, but the IRS catches most of these false refund claims before they go out. And when one does go out, the participant usually ends up paying back the refund along with stiff penalties and interest.

There are two lessons taxpayers should remember: (1) Anyone who promises someone a bigger refund without knowing their tax situation is likely to be misleading them; and (2) Never sign a tax return without looking it over to make sure it is honest and correct.

*Share/Borrow EITC Dependents*

Unscrupulous tax preparers "share" one client's qualifying children with another client in order to allow both clients to claim the Earned Income Tax Credit. For example, one client may have four children but only needs to list two to get the maximum EITC. The preparer will list two children on the first client's return and the other two on another client's tax return. The preparer and the client "selling" the dependents split a fee. The IRS asks the Department of Justice to prosecute the preparers of such fraudulent claims, and participating taxpayers could be subject to civil penalties.

*IRS "Agent" Comes To Your House To Collect*

First, taxpayers should not let anyone into their homes unless that individual identifies himself/herself to their satisfaction. IRS special agents, field auditors, and collection officers carry picture IDs and will normally try to contact taxpayers before they visit. If a taxpayer thinks the person on the doorstep is an impostor, he or she should lock the door and call the local police. To report IRS impostors, taxpayers should call the Treasury Inspector General for Tax Administration's Hotline at 1-800-366-4484.

## BEYOND THE DIRTY DOZEN

Mr. Chairman, I want to be clear that beyond the "Dirty Dozen," there are many other tax schemes and scams that warrant our considerable attention and concern. For example, although for the purposes of today's hearing we are focusing on *off-shore* trusts and accounts, we are also identifying and taking action on *domestic* abusive trusts which pose a major threat.

The abusive trust scheme generally starts with the transfer of a business or other source of professional income to a trust. Taxpayers then typically offset income by overstating business expenses or deducting personal expenses from the income in the trust. To cover their tracks or mislead, these schemes often use tiered multiple entities, such as partnerships, limited liability companies, or secondary level trusts.

Some of these schemes give the appearance that the taxpayer has given up control of his or her business to a trust and progressively reduces the income distributed to the beneficiaries by charging administrative or other expenses at each level. Of course, the transfer of income into the trusts is a sham because the taxpayer continues to control and enjoy the use of the income and assets.

These abusive trusts are marketed largely to higher-income individuals. However, many promoters of illegal schemes will take a dollar from whomever they can and we are seeing a lot of scams marketed on the retail level. For example, in addition to taxpayers submitting frivolous returns, this type of promoted scheme manifests itself in another way—by encouraging taxpayers to stop all withholding, thereby, removing the incentive to file returns at all.

Taxpayers may be encouraged to claim "Exempt" or a large enough number of exemptions on their W-4 form that they submit to their employer so that they have no withholding. Each year, approximately 800,000 questionable W-4s (QW4s) are forwarded to the IRS from employers.

A W-4 is considered questionable if the employee claims more than 10 exemptions or claims to be exempt from withholding. After reviewing the Questionable W-4, a letter can be issued to the employer instructing them to withhold the correct amount of the employee's wages. This, in turn will promote the filing of a return since the taxpayer will no longer be facing a large balance due.

The IRS is currently conducting an investigation into the very real link between taxpayers who claim an excessive amount of allowances on their Form W-4 and those that choose not to file returns. We are also identifying a link with promoters who encourage taxpayers to adjust their Form W-4 as the first step in non-compliance.

Non-filing is no small problem. Of the 800,000 or so QW4s, we estimate that last year after processing, we issued 7,950 “lock-in” letters to employers instructing them to withhold from employees’ wages.

We must also deal on a daily basis with questionable refund schemes that involve tax returns claiming refunds based on false income, false federal income tax withheld, and false refundable credits, such as the EITC, Fuel Tax Credit, Foreign Income Tax Credit, etc.

One scheme that did not make our Dirty Dozen list, but causes continuing problems, is the scam involving the Disabled Access Credit for pay phones.

Unscrupulous promoters sell expensive coin-operated pay telephones to individual investors, rather than businesses. As part of the sale, the company agrees to lease back and service the phones, usually for a fee. Investors are promised low-risk, steady income with guaranteed annual returns. Investors also are incorrectly being advised that they are entitled to claim the Disabled Access Credit of up to \$5,000 on their individual tax returns because the telephones have volume controls.

The Federal Trade Commission determined that these promises are false and misleading. Consumers are being deceived about the availability of local, profitable payphone locations, start-up assistance, and equipment they would receive as part of the venture, as well as their ability to claim the Disabled Access Credit. The telephones are not even delivered in some schemes.

To be eligible to claim the credit, the taxpayer must have a *bona fide* business, and must have incurred expenses to bring the business into compliance with the Americans with Disabilities Act.

The IRS disallows this credit if it is claimed by taxpayers not operating as a business or who do not qualify as an eligible small business. The IRS also will disallow the credit if the purchase is not an expense that would make a business accessible to disabled individuals.

#### INFORMING AND WARNING

An informed taxpayer is the best first line of defense against these scams and their unscrupulous promoters. As Justice Brandeis rightly observed, “sunshine is the best disinfectant.” The more taxpayers who know about these scams, the less likely they will become the latest victim of one of them. They must know that the biggest mistake anyone can make is the first one: getting into a tax scam to begin with.

We raise taxpayer and public awareness about scams and schemes through a variety of methods and tools.

#### *Media Outreach*

Our Media Relations Office plays a critical role in our outreach effort. Between our “Tax Tips” and “Newswire” e-subscription services, we reach up to 10,000 media outlets, practitioners, stakeholders, and other interested groups.

This past year, they received press releases, fact sheet, and tax tips related to the “Dirty Dozen” and specific scams that merited individual warnings, such as identity theft. We also heavily publicized initiatives, such as the John Doe Summons on credit cards and the Offshore Voluntary Compliance Initiative.

These stories garnered enormous media and public attention throughout the nation, resulting in hundreds of articles in newspapers, magazines, professional journals, and specialty publications and sweeping coast-to-coast pickup by radio, network and local television stations, web sites, and Internet search engines (*see below*).

This type of saturation helps us to reach down to our primary audience—America’s taxpayers—and make them aware of the scams and schemes and that we are identifying promoters and participants and taking action against them.

In addition, IRS Criminal Investigation (CI) public affairs officers have significantly increased publicity on legal actions relating to scams and schemes. They and CI managers have appeared on talk radio and television talk shows to discuss many of the schemes.

#### *Web Site*

Our web site is also one of the most important tools at our disposal for disseminating information and educating taxpayers and practitioners. Using it, we have taken aggressive steps to throw more light on the shadowy world of scams and schemes.

Two years ago, it was admittedly difficult for taxpayers to get from our web site the information they needed about scams and schemes. Today, this material is featured prominently on our portal page and we have built special pages on our site

to house it. In fact, two of the four current items are related to our fight against scams and schemes:

- “Beware of Scams, Unscrupulous Preparers—Don’t let the Dirty Dozen tax scams or crooked preparers get you in trouble. Defend yourself.”
- “New Effort on Offshore \$ Schemes—It’s time for those involved in abusive avoidance schemes to make things right.”

Moreover, our web site efforts to alert taxpayers to the scams and schemes are not limited to the filing season. For the entire past year, they have found a place on the *irs.gov* portal page. And, although the IRS website is one of the most popular in the nation, we have also worked with both government and private sector organizations to have links from their web sites to ours. Taxpayers visiting the Departments of Treasury and Justice (Tax Division) web sites can link directly to the IRS Criminal Investigation page which has in one place a wealth of information about schemes, as well as case summaries of those convicted of committing crimes.

Our private sector stakeholders are also lending their support in the fight against scams and schemes. For example, *TaxTips4U.org* is a new and innovative website offered as a public service by the American Bar Association’s Section of Taxation. This page is designed to provide helpful, up-to-date information to consumers seeking a better understanding of their rights and responsibilities as taxpayers.

A taxpayer visiting this site would see, “Make Yourself Right with the IRS.” From there, he or she could click on the Offshore Voluntary Compliance Initiative and be taken to the IRS newsroom and the press release on the subject. Practitioner groups, such as the National Association of Enrolled Agents, the American Association of Attorney CPAs, and the National Association of Tax Professionals (NATP) have links to the IRS, and NATP features the updated “Dirty Dozen” list on its portal page.

Even more promising in our fight against scams and schemes is our heightened presence on the Internet, and particularly, search engines which play an increasingly important role in people’s searches. A taxpayer curious about obtaining an offshore credit card might use an Internet search engine as a first step in obtaining one. For example, he or she might type “offshore credit card” into a Google™ search. However, that individual would be in for a big surprise.

Because of our aggressive scams and schemes media campaign, and use of the Internet, the first three Google™ results (3/26/03) relate to our Offshore Voluntary Compliance Initiative (OVCI). The first two link to the IRS Newsroom web page prominently displaying our press release on the OVCI and then, our fact sheet, “Chronology on Credit Cards and John Doe Summons.” They are followed by a *USA Today* article on the OVCI. Also in the top ten, is a DOJ press release on its efforts to seek offshore credit card records. A similar Lycos™ search also features the IRS in its top ten results. Type in “slavery reparations tax credit” into a Google™ search and *every one* of the top ten results is a warning or story about the scam.

Although it is difficult to measure quantitatively the impact of such a presence, having so many direct references to the IRS is bound to have a deterrent effect. More than links to our web site, they are highly visible stop signs to someone considering one of these scams.

Also this year, IRS Chief Counsel again updated its web site document—*The Truth About Frivolous Tax Arguments*—addressing false arguments about the legality of not paying taxes or filing returns. The revisions add citations from several cases decided by the courts during 2002 and respond to one additional argument, making a total of 21 frivolous contentions that are addressed. There are also links to the document from “The Newsroom” section’s “What’s Hot”, the “Tax Pro News,” and the “Topics for Individuals” web pages.

#### *Taxpayer and Stakeholder Outreach*

This past year, the Taxpayer Education & Communication (TEC) component of SB/SE prepared and disseminated “toolkits” to our external stakeholders on abusive scams and schemes. We now have “counter-marketing” education programs in place to combat: (1) abusive offshore tax avoidance schemes, (2) anti-tax law evasion schemes (e.g. frivolous arguments that the 16th Amendment was not properly ratified), (3) abusive tax evasion schemes (abusive domestic and foreign trusts), and (4) the misuse of disabled access credits. Typically, the tool kit contains sections on the facts about the schemes, the law, relevant arguments to refute the scheme, and talking points.

Last year’s Nationwide Tax Forums, the IRS’ preeminent outreach event that attracted almost 15,000 practitioners in six cities, also took on abusive schemes. We offered a new and well-attended seminar called, “Tax Scams, Schemes and Cons” and in his keynote address, the Commissioner described our efforts and encouraged

practitioners to report suspected scams and schemes to the IRS by calling or e-mailing us.

IRS Criminal Investigation and SB/SE also identified six occupational areas on which to concentrate educational and outreach materials. This unified approach focuses on noncompliance trends identified by both CI and SB/SE within specific occupations or industries. They are: Construction, Restaurants, Practitioners, Medical, Automotive, and Real Estate. To date, CI has prepared fact sheets, speeches, articles and conducted media interviews for the construction, restaurants, practitioners, and the medical profession market segments. So far in FY 2003, CI agents and managers have met with over 11,000 individuals during face-to-face outreach to local associations and practitioner groups.

Deflating slavery reparations schemes has been an enormous outreach success story. Indeed, as previously discussed, we launched a massive information and outreach campaign on slavery reparation claims. Materials were distributed nationally and locally to African American churches and religious coalitions, fraternities, sororities, and associations, including the NAACP and Urban League. In one year, the number of receipts fell from 80,000 to 2,246—a 97 percent drop.

We are continuing our efforts to tamp down this scheme. For example, last month, Representatives of SPEC's New York Territory addressed the Tenant Association Presidents in New York City Housing Authority properties on a variety of issues, including slavery reparations. Also in March, the Indianapolis Territory's Local Stakeholder Relationship Management Council conducted a "Super Saturday" at a large mall on the same date as the Territory's "Scam Jam." The topics covered included: slavery reparations, predatory lending, scams targeted to the elderly, preventing identity thief, avoiding mail fraud, keeping your mail safe, protecting your Social Security number, investment and sweepstakes scams, and work-at-home schemes. There was heavy media coverage.

We are also excited about the efforts made in the QW-4 arena over the past few months. A recent W-4 Summit held in February 2003 in Atlanta brought together all of our Stakeholders, Education and Communication (SPEC), Wage and Investment, SB/SE, and LMSB executives and resulted in their commitment to work as partners in improving our effectiveness in this important area of tax administration.

We have already begun looking into the establishment of a web site designed to assist employers and answer many questions on-line. We are also reviewing the Form W-4 for possible revisions designed to assist both the employee and the employer.

All VITA (Volunteer Income Tax Assistance) training materials now include a section on W-4 issues to ensure that all VITA and Tax Counseling for the Elderly (TCE) volunteers know how to educate taxpayers and properly complete a Form W-4. SPEC also developed a product for use in outreach to those entering the workforce. This brochure includes information on Form W-4 for new workers.

The SPEC Greensboro Territory is developing a W-4 outreach strategy and will be meeting with the North Carolina Department of Revenue after April 15 to coordinate efforts. The plan includes the development of a simple document in Spanish to distribute through many partners who reach the Spanish-speaking community. SPEC's Indianapolis Territory has already addressed W-4 outreach to multiple audiences, including all their coalition VITA sites and partners reaching Hispanic populations.

#### IDENTIFYING PROMOTERS AND PARTICIPANTS

##### *Lead Development Center*

Key to the fight against abusive scams and schemes is better identifying their promoters. To succeed, we must go the source and cut off the supply. To this end, SB/SE established a Lead Development Center (LDC) in April 2002. Its purpose is threefold:

- Centralize the receipt and development of leads on promoters of abusive tax schemes;
- Authorize and monitor on a national level abusive tax promoter investigations (also called 6700 investigations) assigned to the field; and
- Promote and effect the coordination of parallel investigation with IRS Criminal Investigation.

Let me explain how the LDC works. The Center receives leads from both internal and external sources, such as practitioners and taxpayers. For example, as I will discuss later in my testimony, the OVCI is producing leads from taxpayers coming clean. We will make excellent use of them at the LDC. LDC personnel also conduct Internet and other public database searches to develop facts about promoters or the promotion of schemes.

The lead is then classified, prioritized and eventually assigned to LDC agents for development and potential referral to the field. We also coordinate with the IRS' Office of Chief Counsel, Criminal Investigation, and other departments and functions for input on approval of the lead. If approved, the promoter is then referred to the field for case development.

Because of the LDC, we now also have a much better handle on the universe of the problem. Since its formation in April 2002, approximately 1,100 leads have been received by the LDC. The current receipt of new leads is averaging approximately 70–80 per month. As of March 1, 2003, we have 267 investigation referrals being worked in the field, with the remaining being evaluated in the LDC for further action. The leads can also be broken down into promoter brackets or “buckets,” with domestic trusts, offshore transactions and frivolous constitutional arguments being the largest.

I also want to point out an interesting pattern that is starting to emerge from our investigations. We are not seeing many new promoters. Rather, it is the same promoters selling a number of new schemes. If one scheme gets too hot, they drop it and move on to sell a different one, and so on and so forth. This is a hallmark of the huckster and confidence man.

Mr. Chairman, critical to our efforts are new expedited procedures developed with the Justice Department to obtain timely injunctions. In the past, many of the scams and schemes continued to operate even when we had identified them as being abusive. In a very real sense, we were fighting with one hand tied behind our back. However, with these new procedures in place, we and our partners at the Justice Department are in a much better position to shut these scams down before they can do any more harm.

As a result of referrals made to the Department of Justice, 22 injunctions were granted. The streamlined procedure for obtaining civil injunctions is markedly faster. Indeed, in the case of Section 861 scams, we have gone from months to weeks after identifying the scheme.

Let me also note that for this fiscal year, we have scheduled three classes to train approximately 100 additional personnel nationwide in promoter investigations. Our regular classroom training program related to scams and schemes for FY 2003 includes: abusive tax promotions (95 revenue agents), abusive schemes/passthroughs (125 managers), John Doe/Offshore cases (1,400 revenue agents), anti-money laundering (240 revenue agents), advanced collection techniques for schemes (120 revenue officers); foreign trust and other offshore (240 revenue agents), Casino Bank Secrecy Act (96 revenue agents), special enforcement training (75 revenue agents), OVCI training (700 revenue agents), and advanced fraud referral specialist (80 agents) and abusive tax scheme coordinators (50 special agents).

#### *Credit Card Summonses*

Since October 2000, the IRS has issued a series of summonses to a variety of financial and commercial businesses to obtain information on U.S. residents who held credit, debit, or other payment cards issued by offshore banks. We are identifying promoters and participants. The following is a chronology of our actions, according to public records:

- On October 30, 2000, a federal judge in Miami issued an order authorizing the IRS to serve John Doe summonses on American Express and MasterCard. These summonses were designed to obtain limited information for 1998 and 1999, revealing U.S. participants in offshore arrangements who hold credit cards issued by banks from Antigua and Barbuda, the Bahamas, and the Cayman Islands.
- On March 27, 2002, a federal judge in San Francisco issued an order authorizing the IRS to serve a John Doe summons on VISA International seeking records on transactions for 1999–2001 using cards issued by banks in over 30 tax haven countries.
- On August 21, 2002, a federal judge in Miami issued an order authorizing the IRS to serve a John Doe summons on MasterCard for records on transactions for 1999–2001 using credit cards issued by banks in over 30 tax haven countries.
- In August and October 2002, federal judges in 18 district courts across the nation gave permission to the IRS to serve John Doe summonses on over 120 businesses to assist in the identification of credit card owners.

The results of the investigations have been promising. The first summons alone yielded data from MasterCard on 237,000 cards issued through 28 banks in three countries.

Investigators have been using records from these summonses to trace the identities of those whose use of these payment cards may be related to hiding taxable in-

come. We identified thousands of offshore payment card holders for potential examination and dozens of cases have already been referred to Criminal Investigation for possible action. The investigation itself has entailed combing through data on millions of transactions.

An early estimate suggested that 1–2 million cardholders could be involved. However, after reviewing records in recent months obtained from the “John Doe” effort, we reduced our estimate of the number of abusive cardholders. This re-estimate is based on information we culled on duplicate cards issued to the same individual, inactive or small-dollar accounts, people using the cards because of bad credit, persons traveling abroad, and a wide range of other non-tax reasons for holding the cards. While an exact figure of taxpayers involved remains uncertain, we now believe the use of offshore credit, debit, and charge cards to evade payment of U.S. taxes involves hundreds of thousands of taxpayers.

Once taxpayers are identified from cards, case building begins. The IRS already has developed over a thousand cases for civil audits or potential criminal investigations. The IRS is increasing resources in Fiscal Years 2003–2004 devoted to working these cases.

Access to information is also critical to ensuring the full and fair enforcement of the tax laws. In addition to techniques, such as the use of these John Doe summonses, the United States has a broad network of bilateral treaties and agreements with countries throughout the world that allow the IRS to obtain information relevant to the tax liabilities of U.S. taxpayers. Information requested from other countries under these treaties and agreements is an important means by which the IRS identifies taxpayers who attempt to hide income offshore to avoid their tax obligations.

#### *The Offshore Voluntary Compliance Initiative*

In January 2003, we launched an initiative aimed at bringing taxpayers who used “offshore” payment cards or other offshore financial arrangements to hide their income back into compliance with tax law. The Offshore Voluntary Compliance Initiative (OVCI) grows out of the two-year-old “John Doe” summons investigation described above in my testimony.

Under the OVCI, eligible taxpayers who step forward will not face civil fraud and information return penalties. However, taxpayers will still have to pay back taxes, interest, and certain accuracy or delinquency penalties. The last day a taxpayer can apply is two weeks away—April 15, 2003.

Eligible taxpayers who come forward will also avoid criminal prosecution based upon application of the revised voluntary disclosure practice. A taxpayer who does not come forward now, however, will be subject to payment of taxes, interest, penalties, and potential criminal prosecution.

The Voluntary Compliance Initiative reflects an attempt to bring taxpayers back into compliance quickly while simultaneously gathering more information about the promoters of these offshore schemes. Mr. Chairman, I fully concur with your statement that “while taxpayers will be getting a fresh start, IRS plans on making it the end of the line for crooked perpetrators.”

As part of the request to participate, the taxpayer must provide full details on those who promoted or solicited the offshore financial arrangement.

The IRS will use this information to pursue promoters and to obtain information about taxpayers who have avoided tax through the use of offshore payment cards or other offshore financial arrangements and who do not come forward under the OVCI.

We are striking the proper balance with this initiative. It is sound tax administration, and it will help root out tax evasion. Those who misused offshore credit and other payment cards will be able to pay their fair share. Just as importantly, it will help the IRS get the people promoting these deals.

In addition to the names of those who promoted these offshore financial arrangements, taxpayers deemed eligible to participate in the Voluntary Compliance Initiative must provide the details on all aspects of the scheme used to avoid paying the proper tax liability.

Those who promoted or solicited others to avoid tax by using offshore payment cards and other domestic and offshore abusive schemes are not eligible to participate in the OVCI. Also prohibited is anyone who has illegal source income, such as a drug dealer. Complete details on this initiative and eligibility can be found in Revenue Procedure 2003–11.

Under the OVCI, eligible taxpayers will have to file or amend their returns and pay interest and certain civil penalties, as well as the tax. The interest and penalties depend on the amount of the unpaid tax liability, the years involved, whether a return was inaccurate or if a return should have been filed and was not.

For example, a taxpayer who understated his income to avoid \$100,000 in taxes in 1999 would wind up paying \$149,319 to the government. This includes the tax liability plus \$29,319 in interest and an additional accuracy-related penalty of \$20,000.

If a taxpayer did not step forward, his or her tax liability generally would include the civil fraud penalty of \$75,000, and therefore higher interest of \$42,758. The total amount due would be \$217,758, without considering probable additional civil penalties for failure to file certain information returns.

The accuracy-related penalty, cited in the above examples, is equal to 20 percent of the tax underpayment. The civil fraud penalty is up to 75 percent of the unpaid tax liability attributable to fraud.

To apply for the OVCI, taxpayers must notify the IRS in writing and provide their name, taxpayer identification number, current address, daytime phone number, and certain promoter information as specified in the Revenue Procedure.

As part of the OVCI, the IRS will also be closely monitoring the filing of amended returns. If, in order to circumvent this initiative, taxpayers simply file an amended return without complying with the other required provisions, they run the risk of having the civil fraud penalty and other information return penalties applied. As Senator Baucus rightly observed, "The IRS' message to tax evaders is clear—either come forward and pay what is owed to the country today, or find the IRS knocking on your door with jail time and high financial penalties tomorrow."

People interested in participating in the Offshore Voluntary Compliance Initiative can contact the IRS by calling 215-516-3537 (not toll-free), or visit our web site.

OVCI results to date are promising and we expect more taxpayers to take advantage of the initiative in its final two weeks. We will provide the Committee with an update after the close of the program.

Anecdotally, there are excellent examples of the results we are receiving. The OVCI unit is also receiving promoter and other fraud related information from taxpayers who have seen the OVCI media coverage, but who are not involved in offshore activities. These promotional materials and leads are being referred to the SB/SE and CI Lead Development Centers.

#### *Earned Income Tax Credit (EITC) Initiative*

Mr. Chairman, although not the focus of today's hearing, let me briefly comment on the EITC program that benefits millions of low-income workers. The current error rate for the EITC program is too high. In 1999, between 27 and 32 percent of EITC claims—or between \$8.5 billion and \$9.9 billion—were paid in error. EITC has been consistently listed among highrisk federal programs. Congress has recognized this by providing a separate appropriation that has been used for EITC compliance enforcement.

The FY 2004 Budget requests an additional \$100 million to begin a new strategy for improving the EITC program. This approach, suggested by the Department of Treasury EITC Task Force, concludes that the IRS must obtain additional information on certain EITC eligibility criteria before payment of the EITC-portion of refunds. A major portion of the request will be used to invest in suitable information technology and develop business processes.

The IRS will begin to use an integrated approach to address potential erroneous claims by identifying cases that have the highest likelihood of error before they are accepted for processing and before any EITC benefits are paid.

A key part of this strategy is to begin certifying taxpayers who claim qualifying children on the relationship and residency requirements. In addition, the IRS will use limited additional taxpayer information, in combination with taxpayer-specific IRS historical data, third party data and error detection systems to detect and freeze the EITC-portion of refunds that pose a high risk or filing status errors or income misreporting. The IRS will seek to minimize the burdens on taxpayers by using existing databases and other sources of information to verify eligibility in advance. This integrated approach is designed to provide far greater assurance that EITC payments go to the individuals who qualify for the credit, without sacrificing the goals of the EITC program.

#### ENFORCEMENT ACTION AGAINST PROMOTERS AND PARTICIPANTS

In conjunction with the Justice Department, the IRS continues to mount civil and criminal actions to combat the many tax-avoidance schemes, ranging from cases involving frivolous arguments to slavery reparations to credit cards issued by offshore banks.

Our new emphasis against promoters of abusive tax devices has shown results. As of March 19, 2003, the IRS had 22 promoter injunctions granted, 13 promoter injunctions pending in District Court and 2-3 pending at the Department of Justice,

216 promoter exams and information requests underway, and 464 ongoing criminal investigations of promoters of various tax schemes.

Mr. Chairman, of great interest to the Committee is our effort to shut down web sites that promote schemes. When a temporary injunction is ordered, all promoters running web sites are ordered to keep them running and post the injunction to the site to notify future visitors of the government's actions. A list of these web sites is found below. If the promoter does not comply, the Justice Department will and has pursued contempt.

The following are some of the representative actions broken down by civil and criminal actions. The information comes from DOJ press releases and publicly-filed court documents

#### CIVIL ACTIONS

##### *Offshore Credit Cards*

On March 13, the IRS announced that summons enforcement petitions have been filed by the Justice Department in seven U.S. District Courts against individual taxpayers related to the Offshore Credit Card Project. This marks the first time in the Offshore Project that the IRS has taken this step; previous court efforts centered on credit card companies and businesses. These actions are against individual participants.

According to publicly-filed court documents:

- The IRS took these steps based on information gathered in the Offshore Project—an on-going effort to identify persons who hide taxable income by transferring funds to offshore jurisdictions and then use payment cards to access these funds in the United States.
- The summons enforcement petitions were filed against individuals who used a MasterCard payment card issued by the Leadenhall Bank & Trust Company in Nassau, Bahamas. The enforcement petitions were filed after the individuals did not produce for examination the books or records requested in earlier IRS summonses.
- The IRS and Justice Department filed the petitions in U.S. District Courts in the Eastern District of California, the Middle District of Florida, the Southern District of Florida, the District of Maryland, the District of Nevada, the District of North Dakota, and the Western District of Tennessee.

Treasury Assistant Secretary for Tax Policy Pam Olson stated that “the IRS has focused resources on identifying and weeding out the threats to our tax system posed by tax avoidance activities, such as hiding income offshore. The Treasury Department is supporting the IRS initiatives by putting sunlight on the offshore sector. The Treasury and the IRS will continue to use all of the tools available to ensure that every taxpayer pays what it owes to support this great country.”

##### *Slavery Reparations*

According to a October 3, 2002 DOJ press release, the Department filed two lawsuits in Georgia federal courts to stop three different people from preparing clients' tax returns which claim bogus tax credits for slavery reparations. In one of the lawsuits, filed in Macon, Ga., the government alleged that Willie Haugabook of Montezuma, Ga., prepared more than 350 tax returns which claimed an estimated \$18 million in slavery reparations. In the other lawsuit, filed in Augusta, Ga., the government stated that Eddie and Erma Mims of Sylvania, Ga., prepared more than 70 tax returns which claimed almost \$3 million in slavery reparations.

##### *Tax Avoidance Schemes*

According to a March 20, 2003 DOJ press release, a federal court in Las Vegas issued a temporary restraining order barring Irwin Schiff and two associates, Cynthia Neun and Lawrence N. Cohen, from promoting their tax scams. The order prohibits the trio from holding any seminars to promote or sell Schiff's fraudulent “zero tax” plan or “any other false, fraudulent, or frivolous tax schemes or arguments.”

The order also prohibits Schiff and his associates from selling or advertising taxscam books, audiotapes and other tax-related products and services, and from preparing any federal income tax returns for others. Within 10 days, Schiff, Neun, and Cohen must provide a copy of the order to their current customers and former customers with whom they have done business since January 1, 1999.

According to court papers filed by the Justice Department, Schiff, Neun, and Cohen conduct seminars and sell audiotapes and other products designed to help customers evade federal taxes, primarily by filing income-tax returns falsely listing no income and no tax due. The Justice Department has alleged that customers of Schiff and his associates attempted to evade an estimated \$56 million in income taxes from 1999 through 2001.



This is the latest in a series of actions brought by the Justice Department in recent years against alleged tax scam promoters across the country. In the past two years, the Department has filed suits asking for injunction orders against 35 promoters and has prevailed in every case decided so far.

Also, according to a February 28, 2003 DOJ press release, a federal court in Tampa ordered David Bosset of Spring Hill, Fla., to stop promoting a fraudulent tax scheme. The permanent injunction bars Bosset from promoting the frivolous "Section 861" argument. Bosset had falsely claimed that Section 861 of the Internal Revenue Code exempted from federal income taxes persons with U.S.-source income. Bosset also must contact clients and inform them of the injunction.

In the permanent injunction order, the court stated that in promoting the scheme Bosset made "false or fraudulent statements." The court last March had entered a preliminary injunction against Bosset. Federal courts have enjoined five other "Section 861" tax scam promoters in other cases.

#### *Web Site Actions*

As of March 16, 2003, the following web sites were shut down or had injunctions posted on them:

- Al Abdo, *www.amtaxplan.com*, preliminary injunction entered and website shut down 5/25/01. (This was the first site shut down by means of an IRS/DOJ injunction suit.)
- Joy Foundation & Jack Malone, *www.joyfoundation.com*, permanent injunction on 10/21/02 and injunction posted on website within a week thereafter. Government moved for contempt because posting was not sufficiently prominent; thereafter the posting was made more prominent.
- Michael Richmond & Rex Black, *www.meep.com*; *www.libertyinstitute.com* & *www.nationaCEP.com*, permanent injunction against Rex Black on 6/14/02. Black served 3 months in prison and incurred substantial fines for civil contempt for failing to post the injunction on the sites. Injunction was finally posted in February.
- Thurston Bell, *www.nite.org*, Preliminary injunction entered 1/10/03; injunction posted on website a few days later.

Suit has been filed and is pending against:

- Chad Prater, *www.taxinformer.com*, preliminary injunction entered December 19, 2002. Court declined to order posting of injunction order on website, but did order Prater to remove false statements from the site. Prater has not complied with the injunction. DOJ moved for contempt on 3/10/03, and again asked the court to order Prater to post the injunction. A hearing on the contempt motion is scheduled for April 2, 2003.
- Irwin Schiff, *www.paynoincometax.com*, *www.ischiff.com*, suit filed 3/12/03 seeking temporary restraining order (TRO) to remove false statements from websites. TRO granted on March 20, 2003

Three additional suits have been referred to DOJ in which we requested DOJ to enjoin false statements on websites.

#### CRIMINAL ACTIONS

##### *Shift to Tax Administration*

With the IRS' major compliance initiatives now revolving around promoters and abusive scams and schemes, CI developed a comprehensive compliance strategy that incorporates all IRS operating divisions and their taxpayer bases. To begin the process, CI worked particularly closely with the other divisions to develop a strong fraud referral program.

##### *Fraud Referrals from other IRS Operating Divisions*

CI works closely with SB/SE, LMSB and W&I operating divisions to improve the fraud referral process. SB/SE established the position of "fraud referral specialists" to aid employees in identifying matters suitable for referral for criminal investigation. CI's lead development managers also work closely with SB/SE's fraud specialists to monitor the process. This has complemented CI's efforts to re-focus its investigative resources on legal source income cases. The acceptance rate for fraud referrals from other IRS operating divisions was 63 percent for FY2002—a 10 percent jump from the previous fiscal year.

##### *Refund Fraud Program*

Over the past four years, CI identified a significant increase in fraud and abuse in refund claims. For example, in calendar year 2002, the CI fraud detection centers prevented \$350,000,000 of more than \$470,000,000 in fraudulent refund claims from going out.

Criminal Investigation continues to work with W&I to ensure there is an effective program to deal with refund-related crimes. Fraud and abuse related to both the Questionable Refund Program (QRP) and the Return Preparer Program (RPP) is increasing. This increase applies to both the filing of paper returns and in electronically filed personal and business returns.

One of the contributing factors to the increase is identity theft and their use to file fraudulent returns. By employing our Electronic Fraud Detection System and the enhanced analytical skills of the redesigned Fraud Detection Centers, CI and W&I developed an effective deterrent in both QRP and RPP. This is a continuing process wherein our Fraud Detection Centers work with IRS submission processing to evaluate its effectiveness in identifying fraud.

#### *Non-filer Program*

Non-filers were a key area of emphasis for CI again this year. Of the 503 nonfiler investigations conducted in FY 2002, 224 prosecutions were recommended with 233 indictments and 227 convictions received.

#### *Employment Tax*

The proper withholding and payment of income taxes and employment taxes is an important compliance issue. CI made this too an emphasis area. For FY 2002, we initiated 92 investigations; 56 prosecutions were recommended and we received 55 indictments and 41 convictions. These represent as much as a 40 percent growth over the previous fiscal year.

#### *Abusive Trusts*

In FY 2002, CI initiated 108 investigations compared to 79 in FY 2001, recommended 55 prosecutions as compared to 30 in FY 2001, received 44 indictments as compared to 32 the previous year and won 26 convictions compared to 45 in FY 2001. The incarceration rate was 88.2 percent and average months served in prison was 32 months.

For the Anderson Ark & Associates abusive scheme, 79 investigations were initiated and 23 prosecutions were recommended. There were also 20 indictments and 10 convictions. Two individuals were sentenced and incarcerated with an average of 18 month to serve in prison.

#### *Electronic Crimes and Technology Based Tax Crimes and the Internet*

Computers are increasingly used to facilitate and commit sophisticated financial crimes. The records of financial transactions are moving from the paper ledger to the computer to off-site, online storage, and we are developing the tools and techniques to follow and find those records, wherever they may be.

CI has the capability to investigate Internet based schemes utilizing its computer crime development center that was established this year. The Center provides an expanded capability to trace the online activities of subjects of investigation. It also serves as a collection point of electronic data gathered through court-ordered wire-taps and trap and trace devices and as the delivery point for subpoenaed evidence that is submitted in electronic form.

#### *Preparer Fraud*

The IRS continues to investigate promoters of frivolous arguments and to refer cases to the Department of Justice for criminal prosecution. Taxpayers who file frivolous income tax returns face a \$500 penalty, and may be subject to civil penalties of 20 or 75 percent of the underpaid tax. Those who pursue frivolous tax cases in the courts may face a penalty of up to \$25,000, in addition to the taxes, interest and civil penalties that they may owe.

We have more than doubled the number of criminal investigations of preparers of federal tax returns in 2002 compared to the previous fiscal year. In FY 2002, 254 investigations were initiated, compared to 116 the year before. More cases were referred to the Department of Justice for prosecution—89 in FY 2002, up from 73 the year before. Preparers convicted of tax crimes received longer average prison terms—27 months in FY 2002, up from 20 months the year before.

Additionally, there has been a significant increase during the first quarter of FY 2003 in the number of criminal investigations referred to the Department of Justice for prosecution regarding individuals whose occupation includes accountant, electronic return originator and return preparer.

Return preparer fraud generally involves the preparation and filing of false income tax returns (in either paper or electronic form) by preparers who claim inflated personal or business expenses, false deductions, unallowable credits or excessive exemptions on returns prepared for their clients. Abusive preparers may also manipulate income figures to obtain fraudulent tax credits, such as the EITC.

*Voluntary Disclosure*

Outside of the on-going Offshore Voluntary Compliance Initiative, as of February 28, 2003, Criminal Investigation has received a total of 30 voluntary disclosure requests, 16 have been approved, five declined and nine are still pending.

*Offshore—Abusive Trust Guilty Plea Victory*

In a March 5, 2003 press release, the Department of Justice announced that two former administrators of the Institute of Global Prosperity (IGP) admitted in federal court in Charleston, S.C., that they used a foreign bank account to commit tax evasion. Shoshana B. Szuch, former Director of Operations of IGP, and her husband, Jeffrey S. Szuch, a former IGP conference planner, each entered a guilty plea before U.S. District Judge David C. Morton.

According to the charging document filed in court, the Szuchs were administrators of the Institute of Global Prosperity (IGP), an organization that hosted offshore seminars for promoters of abusive trusts and anti-tax schemes. IGP was also known by other names, including Global Prosperity Marketing Group (GPMG) and Global Prosperity Group (GPG). Members of IGP marketed and sold various IGP products, including an "education course" named "Global 1" priced at \$1,250; a ticket to a three-day offshore seminar named "Global 2" priced at \$6,250; and a ticket to a five-day offshore seminar named "Global 3" priced at \$18,750. The Global 2 and Global 3 seminars brought together portions of the IGP membership to hear, among other things, presentations by individuals and organizations involved in the sale and operation of foreign trusts designed in part to conceal income from the IRS.

Shoshana Szuch marketed and sold IGP products from the fall of 1996 until the fall of 1997 and was the Director of Operations of IGP from the fall of 1997 through February 2001, according to documents filed in court. Her husband, Jeffrey Szuch, assisted her in selling IGP products and planning offshore conferences hosted by IGP.

On or about Sept. 4, 1997, Shoshana Szuch and Jeffrey Szuch purchased an International Business Corporation (IBC) and related offshore bank account in the name of Oro Blanco, Ltd. This bank account, located in Antigua, was used by the Szuchs to conceal the income paid to Shoshana Szuch by IGP and the income earned from the sale of IGP products. Shoshana and Jeffrey Szuch failed to file a 1997 tax return despite having approximately \$62,540 in taxable income from IGP-related activities, upon which they owed approximately \$21,051 in income tax.

The plea agreement requires the Szuchs to cooperate fully with the government regarding their involvement and the involvement of others with IGP and to cooperate with the IRS in the ascertainment, computation, and payment of their correct federal income tax liability for 1997 through 1999. The maximum statutory penalties for tax evasion are imprisonment for five years, release under court supervision for three years and a fine of \$250,000. No sentencing date has been set for the Szuchs.

A member of IGP, Margo E. Jordan, pled guilty to tax evasion regarding her 1997 income taxes in the District of Maine on Feb. 28, 2003.

## CONCLUSION

Mr. Chairman, combating these abusive scams and schemes is our number one compliance priority. More than sapping the government of badly needed revenues, they undermine the confidence of honest taxpayers in the fairness of our time-honored system of voluntary compliance. I am pleased to report the progress we have made over the past year to identify the promoters and participants and to shut some schemes down. Clearly, we have a much better grip on the situation than we did a year ago. But clearly too, we still have much work to do. Yet I am convinced that if we stay the course we are on today, we can succeed.

## PREPARED STATEMENT OF NINA E. OLSON

Mr. Chairman and Distinguished Members of the Committee:

Thank you for inviting me to testify today about consumer issues relating to tax return preparation and filing. As you know, in my 2002 Annual Report to Congress I made a detailed proposal for the registration, examination, and certification of unenrolled federal tax return preparers. These are return preparers who are not certified to practice before the IRS as attorneys, certified public accountants, or enrolled agents. We estimate that unenrolled preparers constitute more than 50 percent of all preparers. Both the National Commission on Restructuring the Internal Revenue Service and the Commissioner's Advisory Group examined this subject. Re-

cently, members of the Senate and this Committee have introduced bills proposing registration of return preparers.

I should state at the outset that I began my tax career in 1975 as an unenrolled return preparer and maintained a tax preparation practice for sixteen years before I became an attorney. I know first hand the important assistance these professionals provide to taxpayers nationwide. If unenrolled preparers did not exist, many taxpayers would be unable to afford professional advice and assistance in preparing their tax returns. It is clearly in the best interests of taxpayers and the tax system that unenrolled preparers continue to flourish.

However, the importance of unenrolled preparers should not mask legitimate concerns about the quality of their services or abusive practices. Returns prepared by unqualified or unscrupulous preparers have negative effects for both the taxpayer and the IRS. For taxpayers, inaccurate returns mean overclaims as well as underclaims—either they pay more taxes than they should or their returns may be examined. For the IRS, these returns consume valuable resources, both in terms of processing original and amended returns or claims, and in the areas of examination and collection.

I first became concerned about the quality of return preparation by unenrolled preparers several years ago. During filing season, I was driving down a main street in the city in which I ran a low income taxpayer clinic. I noticed a sign in front of a used car dealer whose “mascot” was a duck. The sign read, “File your taxes with the Duck, use your refund for a truck!” It seemed rather unlikely to me that this car dealer possessed much tax law expertise; his obvious motivation for filing tax returns was to generate new car sales. And not incidentally, the dealer had a strong incentive to maximize the taxpayer’s refund, since that would have resulted in a larger down payment toward a more expensive vehicle.

I began to wonder about the long-term effects on taxpayer compliance of commingling such mercantilism with tax filing. My concern turned into alarm when I learned from clinics in other parts of the country about car dealers using refunds as down payments—through the device of a refund anticipation loan—toward the purchase of an automobile. If the refund is denied, the automobile is repossessed, and the taxpayer ends up with no refund in one year, no automobile, and a tax bill for the next year from cancellation of indebtedness income.

It is the linkage between these types of transactions and the IRS that causes me concern. I don’t want taxpayers to say: “I filed my taxes, and look what happened to me.” No tax agency can afford this type of “guilt by association.” The federal government, through its federal tax administrator, has an interest in protecting the integrity of the tax administration system. I believe that taxpayer willingness to participate in the tax system is bound to suffer over time if the taxpayer feels that

- (1) he can’t file without assistance;
- (2) that assistance is delivered by someone who is not well versed in tax; and
- (3) the entity that is providing the assistance is also trying to sell the taxpayer an unrelated product.

Thus, the federal government has an interest in ensuring that products and services offered in conjunction with the taxpayer’s filing, reporting, and payment obligations do not operate in such a way as to undermine the taxpayer’s faith and participation in the tax system.

Our legislative proposal for regulating tax return preparers addresses this concern. We approached this issue from three different perspectives—first, by reviewing the most serious problems experienced by taxpayers; second, by consulting Taxpayer Advocate Service and IRS employees as well as tax practitioners and low income taxpayer clinics; and finally, through our overriding focus on taxpayer rights. The term “taxpayer rights,” as used in this context, refers to more than the legal rights accorded to a taxpayer under the Constitution or the internal revenue laws or regulations. This broader interpretation can best be summed up by the question: “What do taxpayers have a right to expect from their government/tax administrator in a voluntary tax system?”

Clearly, taxpayers who are asked to voluntarily file, report, and pay their taxes have a right to expect that the process of doing so will not be unnecessarily burdensome or complicated. Unfortunately, the complexity of the tax laws applicable to even low or middle income taxpayers prevents many taxpayers from feeling confident and comfortable in preparing their own taxes.<sup>1</sup> In fact, 53 percent of individual taxpayers today utilize the services of paid tax return preparers. In tax year

<sup>1</sup> See National Taxpayer Advocate’s FY 2001 Annual Report to Congress, Pub. 2104 (rev. 12–2001), pages 78–100 (uniform definition of a qualifying child) and pages 166–177 (alternative minimum tax); National Taxpayer Advocate’s FY 2002 Annual Report to Congress, Pub. 2104 (rev. 12–2002), pages 231–242 (children’s income).

2000, nearly five percent of individuals used paid preparers to complete Form 1040EZ—the simplest version of the individual income tax return. Taxpayers filing individual returns with non-farm sole proprietorship schedules employed preparers 68 percent of the time. Do taxpayers have the right to expect these preparers to be competent and professional? If so, how can a taxpayer tell whether a preparer possesses the requisite skills and ethics? Simply asking a friend for a recommendation is not sufficient—the basis for the recommendation may be that the preparer got the friend a large refund, or helped him get a large down payment for his truck. It may have nothing to do with the preparer's tax expertise.

While it is difficult to obtain precise figures in the current unregulated environment, we estimate that there are between 700,000 and 1.2 million persons preparing taxes for a fee. Of these paid preparers, we estimate that more than half are subject to some form of examination, oversight, or discipline. The remaining 300,000 to 600,000, which I refer to as “unenrolled preparers,” are not regulated, except in a few states.<sup>2</sup>

In light of the current complexity of the tax laws, many taxpayers require assistance in fulfilling their obligation to voluntarily report their taxable income to the federal government's tax administrator. There are many valid reasons why taxpayers may seek tax assistance from someone other than the government—not the least of which is that the government and the taxpayer may legitimately disagree about the correct amount of tax to be reported. Our tax system contemplates the possibility of such disagreement and provides various mechanisms to resolve it.

The fact that taxpayers have legitimate reasons for utilizing private tax return preparers does not mean that the government has no interest in the commercial tax return preparation industry. To the contrary, the very existence of regulatory schemes in other areas where the public seeks advice and assistance with respect to basic governmental functions—for example, law and accounting—indicates that government has an interest in ensuring that people who hold themselves out as an interface between the public and the government should be held to some minimum level of competency, performance, and integrity.

In the tax world currently, this regulation applies to attorneys, certified public accountants, and enrolled agents, who represent the taxpayer before the IRS in collection, examination, appeals, and other matters. Historically, tax return preparation has been considered a largely ministerial act and therefore has not been regulated. However, with today's complex tax code, return preparation involves significant substantive decisions that can have serious downstream consequences for taxpayers. Simply determining a taxpayer's filing status—single, head of household, married filing separately or jointly—is often a complex and confusing exercise.

In the Taxpayer Advocate Service, we have seen numerous instances of paid preparers who have caused problems for the taxpayers whose returns they prepare because they have not kept current with the ever-changing tax laws or have not received formal training about return preparation. Consider one example I described in my 2002 Annual Report to Congress: A taxpayer relied on the advice of a tax preparer to determine his tax home for employee business expenses. The preparer relied on an outdated provision of the tax home rules that had been in effect more than 15 years earlier when preparing four consecutive years of income tax returns. The corrected tax bill ultimately exceeded \$40,000, and the taxpayer had to arrange for an installment agreement to pay it.<sup>3</sup>

There is, of course, a whole other category of return preparers who intentionally “broker” improper entries. These preparers may or may not appear as signatories on the tax return, even though they are required to sign the return since they receive a fee for preparation.<sup>4</sup> The Taxpayer Advocate Service has witnessed several such schemes over the years, including inflated casualty losses in disaster areas and claims for fuel taxes. Recently, one of our Local Taxpayer Advocates was standing in line at a store and heard two clerks discussing a local tax return preparation business that was advertising to low income taxpayers. The clerks said that the business was encouraging low income taxpayers to come in for tax preparation and was providing clients with additional social security numbers to claim “dependents” in order to generate larger refunds and the earned income tax credit.

Then there are preparers who are too clever by half. We are seeing in this filing season certain unenrolled preparers who know that their clients have been examined and/or denied the EITC in previous years. These preparers are filing returns without such claims in order to offer Refund Anticipation Loans for the non-EITC

<sup>2</sup>See Cal. Bus. & Prof. Code §22250–22259; Or. Admin. R. 800–25–0020.

<sup>3</sup>National Taxpayer Advocate's FY 2002 Annual Report to Congress, Pub. 2104 (rev. 12–2002) page 216.

<sup>4</sup>IRC §§6061 & 6695(b).

portion of the refund. They later prepare amended returns for the EITC portion of the refund, knowing it will take a while and most likely will be subject to review. Not only does the taxpayer incur costs for the preparation of two returns (the original and the amended return) along with the RAL charge (and a fee for direct deposit and check cashing if the taxpayer doesn't have a bank account), but the IRS must process two returns.

All of these activities cost the government—and the taxpayers, directly and indirectly—in terms of increased examinations, litigation, processing, and collection. This represents time and money for both parties that could be better spent elsewhere.

So, what do we do about this? Even if we agree that commercial tax return preparers—unenrolled preparers—should be subject to some level of oversight, we must ask whether the federal government should be the overseer. Or should this regulation be left to the states?

In my annual report this year, I describe in detail two state regulatory schemes—California and Oregon—which seem to have some effect on the quality of return preparation in these states.<sup>5</sup> Having studied these programs, we concluded that from the *federal* perspective, they impose a greater burden on the regulated party than is necessary to accomplish the *federal* purposes. Further, the fact that some states may seek to regulate federal return preparers while others do not creates a disparate, uneven and anti-competitive environment, and does not provide a nationwide solution to the problems I've outlined above.

However, we can learn from the states. We can take the key elements of their programs and devise a nationwide program that establishes some level of proficiency in tax as the norm for return preparation. Here is how it would work. The central components are registration, examination, and certification. Persons who prepare more than five federal income tax returns for a fee would be required to meet each of these components.

*Registration.* Let's get preparers into the system. An estimated seven percent of individual returns are prepared by a third party for a fee and are not signed by that paid preparer.<sup>6</sup>

*Examination.* We propose two levels of examination so that unenrolled preparers must demonstrate some minimum level of competency in federal return preparation. This is not an exam to qualify preparers to represent clients before the IRS. Rather, the examination would be based on the tax return itself—line by line, with questions geared to show that the preparer has a basic understanding of what is being asked for on that return line and some of the most common intricacies that arise with that type of income or deduction.<sup>7</sup>

The initial examination would test a preparer's knowledge in either individual tax return preparation (including simple sole proprietorship schedules) or business return preparation. An annual refresher exam would enable the IRS to test preparers on recent tax law changes and the most common errors from the previous filing season. These exams could be completed on-line, or at annual Tax Forums for practitioners. Private entities could develop training and exam preparation classes.

In fact, many unenrolled preparers in large tax preparation firms or who are members of professional associations already attend trainings. We do not believe our proposed testing regimen will impose a significant burden on them. But the bottom line is that unenrolled preparers will have to demonstrate some level of competence before they receive their certification.<sup>8</sup>

*Certification.* Once a preparer has passed the examination, he or she will receive a certification card. The certification card would show that the preparer is authorized to prepare federal tax returns for the period covered by the certification. To enforce this program, we propose a multi-year campaign, which would include paid advertising, education and outreach and be operated cooperatively with community and professional groups, in which taxpayers are advised of two simple concepts—

- If you pay for tax preparation, ask to see the preparer's certification.
- If you pay for tax preparation, don't pay until you see the preparer's name, address, and certification number on the tax return and on your copy.

<sup>5</sup>National Taxpayer Advocate's FY 2002 Annual Report to Congress, Pub. 2104 (rev. 12–2002), pages 222224.

<sup>6</sup>This estimate is based on a study of taxpayers claiming the Earned Income Tax Credit and therefore is not necessarily representative of all returns.

<sup>7</sup>The return preparer exam will be less rigorous than the IRS examination for enrolled agent status, which tests tax law and tax procedure knowledge.

<sup>8</sup>H&R Block reports that it has approximately 90,000 active preparers, and Jackson-Hewitt reports that it has approximately 25,000 active preparers. See Internal Revenue Service, Task 124: Market Research for e-file Options: Tax Preparer Research & Analysis of Available Data (March 2001).

This message, reinforced from year-to-year, will eventually become an axiom in the tax consumer's consciousness, much like the EITC campaign has contributed to the high participation rate for that credit. The benefits of this consumer-driven approach include:

- Through the certification card, consumers will know that their preparer is in the system and possesses some competency in tax return preparation.
- The IRS will have the preparer's name, address, and certification number for oversight purposes.
- Preparers who are not willing to meet these minimum professional standards or who are unscrupulous will become apparent.

It is true that some preparers may choose to "opt out" of certification by going underground. The registration/certification regimen draws a bright line—being qualified is now measured, and if a preparer chooses not to meet those standards or a taxpayer chooses to employ a preparer who does not meet those standards, then the preparer and the taxpayer will know that that choice has consequences.

If the IRS, through return processing and computer matching, determines that a preparer was not certified, or had not taken the exam, it could send a notice to the preparer advising him or her to take the exam within a specified period of time and to cease return preparation until the exam is passed. If the preparer does not respond, the IRS could, perhaps after another contact, send a letter to the taxpayer stating that the taxpayer's return preparer is not certified. Taxpayers will thus enforce the regulatory scheme with their feet!

Ultimately the IRS could trace frequent offenders or careless preparers and even decertify them. Where enforcement actions are necessary, the regulatory program sets forth clear expectations and standards against which to measure behavior.<sup>9</sup>

We believe our proposal is administrable and efficient. While it will require resources to collect and input data, develop and update examinations, and maintain the preparer database, a portion, if not all, of these costs can be offset by user fees on the regulated population.<sup>10</sup> Ultimately, more accurate returns will reduce the resources the IRS must devote to examining incorrect returns and collecting the resulting tax. A lynchpin of this proposal, however, is that it will *not* require an army of agents on the street to enforce the provisions. The taxpayers themselves, through a quality consumer education campaign, will enforce these provisions through their market behavior. This is a narrowly crafted mechanism to address the government's legitimate interest in maintaining the integrity of the federal tax administration system.

Before closing, I would like to comment on a related issue. The Internal Revenue Service's legitimate need to have returns filed electronically has had some unintended consequences. The emphasis on electronic filing has opened up the tax preparation field to entities that historically did not prepare returns and whose interest in doing so is driven by the desire to sell ancillary products and services.

We note that Section 2001 of the Internal Revenue Service Restructuring and Reform Act of 1998 established a Congressional policy that "the Internal Revenue Service should cooperate with and encourage the private sector by encouraging competition to increase electronic filing of [tax] returns." The Conference Report states that the IRS and Treasury should "press for robust private sector competition." The conferees acknowledged that disputes would arise between the IRS and the private sector about whether IRS-offered services inhibited competition. In such instances, the conferees requested that the Electronic Commerce Advisory Group (now called the Electronic Tax Administration Advisory Committee or ETAAC) recommend an "appropriate course of action" to the Commissioner. The conferees also stated that, notwithstanding the goal of fostering private sector competition, the "IRS should continue to offer and improve its Telefile program and make available a comparable program on the internet." H.R. Conf. Rep. No. 105-599.

I believe that Section 2001 of this Act has had the unfortunate effect of inhibiting the IRS from undertaking a rigorous analysis of the products being offered in connection with tax return preparation, including electronic filing, or proposing guidelines or standards for these products and services. This vacuum of leadership has led to a proliferation of non-tax goods and services associated with return preparation, particularly electronic return preparation and filing, which raises the types of

<sup>9</sup>In addition to registering and thus "surfacing" return preparers, the IRS needs to step up its application and enforcement of current preparer penalties. For example, Section 6694 of the Internal Revenue Code authorizes the IRS to impose penalties on tax preparers for understating a taxpayer's tax liability, yet for 2001, the IRS has imposed penalties under this authority totaling merely \$250.

<sup>10</sup>The fee for taking the enrolled agent exam is \$55. See IRS Form 2587. The fee for applying for enrolled agent status is \$80. See IRS Form 23.

problems I described in the car dealer example at the beginning of my testimony. I believe this issue is one that the Committee should also address.

Thank you for the opportunity to appear before you today to discuss these important issues.

PREPARED STATEMENT OF JAMES R. WHITE

April 1, 2003

**PAID TAX PREPARERS**

**Most Taxpayers Believe They Benefit, but Some Are Poorly Served**



Highlights of GAO-03-610T, a testimony before the Senate Finance Committee.

**Why GAO Did This Study**

In tax year 2000, over half of individual filers paid someone to prepare their tax return. These taxpayers paid an estimated \$14.7 billion for individual return preparation. Despite the importance of paid preparers' role in the tax system, little data exist on the quality of the services they provide. In light of this, GAO surveyed and interviewed taxpayers and gathered examples of the range of outcomes experienced by taxpayers who used paid tax preparers.

**What GAO Recommends**

GAO is not recommending executive action. However, GAO identified guidance from various sources suggesting common sense steps taxpayers can take when choosing or working with a paid tax preparer, such as:

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

[www.gao.gov/cgi-bin/getrpt?GAO-03-610T](http://www.gao.gov/cgi-bin/getrpt?GAO-03-610T).

To view the full testimony, including the scope and methodology, click on the link above. For more information, contact Jim White at (202) 512-5594 or [WhiteJ@gao.gov](mailto:WhiteJ@gao.gov).

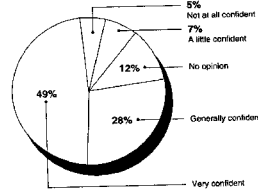
**What GAO Found**

Based on our on-going work, most taxpayers believe they benefit by using a paid tax preparer. According to the results of our nationwide survey, 77 percent of taxpayers said they were very or generally confident that their preparer completed a tax return that allowed them to pay no more in taxes than was legally required. In addition, the survey showed that 87 percent of taxpayers would use a paid preparer in the future. Despite these facts, taxpayers may not understand the tax laws well enough to assess the accuracy of their preparers' performance. To provide quality service, paid preparers must probe the personal circumstances that could affect the amount of tax their clients owe, such as whether the taxpayers have dependents. For example, one taxpayer took 3 years of prior returns prepared by a friend to a tax preparer. The preparer found that the taxpayer had overpaid his taxes by more than \$6,200 because he had overlooked earned income and child tax credits.

While most taxpayers expressed confidence in their paid preparers, our survey, studies of filed returns, and interviews with knowledgeable observers suggest that a small percent of taxpayers are poorly served due to problem performance by preparers. For example, GAO's survey results indicated that 5 percent of all taxpayers had no confidence that they had not overpaid their taxes. However, even a small percentage of the more than 71 million users of paid preparers in 2000 can translate into millions of affected taxpayers. Preparers who fail to adequately probe, provide questionable advice, or engage in fraudulent practices can cause serious consequences for their clients. For example, one taxpayer overpaid his taxes for several years by about \$3,500 to \$5,000, despite receiving notices from the Internal Revenue Service that he may be eligible for the earned income tax credit. When he showed these notices to his paid preparer, the preparer took no action.

Paid preparers are not always the cause of problems—taxpayers can provide preparers inaccurate or incomplete information. Despite using a preparer, taxpayers are still ultimately responsible for the accuracy of their return.

**Paid Preparer Users' Confidence That They Did Not Overpay Their Taxes**



Source: GAO's nationwide survey of taxpayers.



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Mr. Chairman and Members of the Committee:

I am pleased to be here today to discuss our on-going study of paid tax preparers. The Internal Revenue Service (IRS) estimates that there were up to 1.2 million paid tax preparers in 1999. These paid preparers are important to taxpayers, as underscored by the fact that in tax year 2000, over half of the 130 million individual filers paid someone to prepare their tax return. Taxpayers paid an estimated \$14.7 billion for individual return preparation. Numbers like these suggest that taxpayers believe that paid preparers provide a valuable service.

Given the complexity of the tax code, it is easy to understand why so many taxpayers depend on the assistance of a paid preparer. The need for the assistance of a paid preparer, combined with the fact that our tax system relies on taxpayers accurately completing and filing their returns, means that paid preparers play a critical role in the functioning of the nation's tax system.

Despite the importance of paid preparers, minimal data exist on the quality of services they provide. However, there are indications that some preparers make errors on taxpayers' returns that can result in taxpayers overpaying or underpaying their taxes. For example, last year we estimated that over 2 million taxpayers overpaid their 1998 taxes by \$945 million because they claimed the standard deduction when it would have been more beneficial to itemize.<sup>1</sup> Half of these taxpayers used a paid preparer. While taxpayers undoubtedly contributed to some of these errors, these data raise questions about the extent of errors caused by paid preparers.

In light of the importance of paid preparers to the functioning of our tax system and the lack of information about the quality of service they provide, you asked us to (1) obtain the views of taxpayers who used paid preparers and provide examples of paid preparer performance, including the type and what is known about the extent of problems caused by paid preparers and (2) identify common sense steps taxpayers can take to help ensure that they benefit from using a paid preparer.

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<sup>1</sup>*Tax Deductions: Further Estimates of Taxpayers Who May Have Overpaid Federal Taxes by Not Itemizing* (GAO-02-508, March 29, 2002).

My statement today is based primarily on a nationwide representative survey of taxpayers; in-depth interviews with a judgmental sample of taxpayers regarding their experiences with paid preparers; phone calls to a limited number of preparers in which we posed as potential clients asking about services and fees; interviews with large and small tax preparation firms, IRS's National Taxpayer Advocate, IRS officials, and several tax clinics offering tax help to low income taxpayers; and a review of IRS's closed case files on preparers investigated for fraud or other misconduct.

Anyone can be a paid tax preparer. No laws or regulations limit who can sell tax preparation services. The types and training of paid preparers vary widely. They range from attorneys and certified public accountants (CPA) to preparers who are not licensed and have no formal training. Commercial preparers may hire any of these and may also provide their own training. However, IRS does place limits on paid preparers who can represent taxpayers in matters before IRS. Those representing taxpayers are collectively referred to as practioners and can be attorneys, CPAs, enrolled agents—that is, former IRS employees or individuals tested in tax laws. All others are referred to as “unenrolled agents.” Practioners are governed by IRS Circular 230 regulations that prescribe standards of conduct and sanctions for violating the standards.

In summary, our work to date shows a range of paid preparer performance:

- Most taxpayers who used a paid preparer believe they benefit by doing so. In addition, most taxpayers reported that they did not pay more in taxes than was legally due and that their preparer knew enough about their personal tax situations to accurately prepare their returns. Paid preparers told us that asking probing questions about their clients' personal circumstances or seeing documentation of income and potential deductions were important components of providing quality services.
- However, some taxpayers using a paid preparer end up overpaying their taxes or preparer or underpaying their tax liability because some preparers did not adequately probe into or pay attention to taxpayers' personal circumstances, made computational errors, provided questionable advice, or, in rare cases, engaged in fraudulent activities.

Our work also shows that despite the use of paid preparers, taxpayers are ultimately responsible for the accuracy of their tax returns. Taxpayers can take some common sense steps to ensure they benefit from using a paid

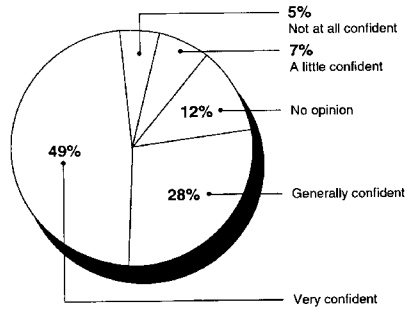
preparer, including providing complete and accurate information to their paid preparers.

**Most Taxpayers Are Confident They Benefit from Using Paid Preparers**

Taxpayers choose to use paid preparers for a variety of reasons. Many of the taxpayers we spoke to told us they used a paid preparer because they did not understand the tax laws. One taxpayer, for example, said she began using a paid preparer 9 years ago to help her with estate tax issues following the death of her father. Other taxpayers said they lacked the time or patience to complete their return on their own. For example, a mother of four who operates her own business part-time and is finishing her degree at night said she simply does not have the time to do her own taxes. Other taxpayers stated that they paid someone to prepare their taxes in hopes of obtaining a larger and/or quicker refund.

Most taxpayers who used a paid preparer believe they benefit from doing so. We estimate, based on our representative sample of taxpayers, that 77 percent of taxpayers who used a paid preparer are very or generally confident that they did not pay more in taxes than was legally required, as shown in figure 1. In addition, based on our survey results, we estimate that 87 percent of taxpayers would use a paid preparer in the future.

**Figure 1: Paid Preparer Users' Confidence That They Did Not Overpay Their Taxes**



Source: GAO Nationwide Survey of Taxpayers.  
 Note: The estimates have a 95 percent confidence interval of plus or minus 5.23 percent or less.

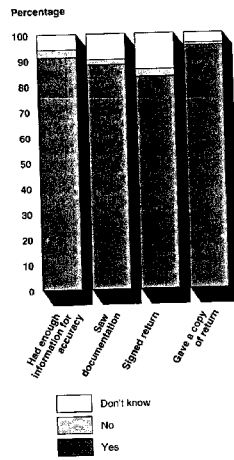
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A word of caution about our survey: it reflects taxpayers' perceptions and may overstate the quality of service paid preparers are providing. Most of the taxpayers we talked to in-depth said they used a paid preparer because they found IRS tax forms and documents too complicated or they were confronting an unusually complicated tax situation. Thus, the taxpayers in our survey may not understand the tax laws well enough to evaluate the performance of their paid preparers. Evidence that some taxpayers who used preparers overpaid or underpaid their taxes also suggests that taxpayers confronted by complicated IRS forms and a confusing tax code may be unable to identify errors made by preparers. For these reasons, the percentage of taxpayers who were confident they did not overpay their taxes may be overstated. There are no reliable data on the extent of the overstatement.

Despite this caveat, paid preparers can benefit their clients in several ways. First, probing about taxpayers' personal circumstances can help paid preparers ensure their clients do not overpay or underpay their taxes. Paid preparers told us they use a variety of techniques, including personal interviews and questionnaires, to get information about their clients' dependents, mortgages, other deductible expenses, or asset sales. Some paid preparers maintained contact with their clients during the year, allowing them to become intimately aware of the financial issues facing their clients and to make meaningful suggestions to reduce future liabilities. Based on our survey results, taxpayers were very confident that their preparer did sufficient probing or took other steps to ensure an accurate return. We estimate that about 91 percent of taxpayers believe their preparers had enough information about their personal circumstances to accurately prepare their tax returns, as shown in figure 2.

Paid preparers also can benefit their clients by reviewing income and expense documentation. To do this, most of the preparers we talked to said they ask their clients to provide documentation to support claimed income, deductions, and credits, such as W-2 forms from employers or 1099 forms from financial institutions. Taxpayers in our survey confirmed that this is a common practice. We estimate that 88 percent of paid preparer users were asked for supporting documentation, as shown in figure 2.

Figure 2: Client Perceptions on Aspects of Paid Preparer Performance



Source: GAO nationwide survey of taxpayers who filed in 2002.

Note: The estimates have a 66 percent confidence interval of plus or minus 5.23 percent or less.

Another way paid preparers can benefit their clients is educating them about the tax laws. Such efforts can help ensure taxpayers neither overpay nor underpay their taxes and may promote overall compliance. For example, one preparer who works primarily with immigrants said he and his staff spend considerable time explaining to their clients that paying taxes is part of the civic responsibilities they assumed in immigrating to this country. Other preparers told us they often have to educate taxpayers on more complex concepts, such as computing the basis, or the investment made in a property for tax purposes, to determine how much of a real estate sale would be taxable. Another preparer told us he found that a taxpayer had overpaid his taxes by more than \$6,200 over a 3-year period because the taxpayer had overlooked earned income and child tax credits. Still, another preparer told us he helped a taxpayer receive a

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refund in excess of \$19,000 when he found out that the taxpayer, who had moved twice in less than 2 years, had missed out on deductions for moving expenses due to job relocations.

Paid preparers are also required by law to take certain steps when filling out returns for their clients, including signing the return and giving their clients copies of the completed returns. We estimate that a vast majority of paid preparers signed and provided their clients a copy of their return, as shown in figure 2.

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### Evidence Suggests That a Small Percentage of Taxpayers Are Poorly Served Because of Problematic Preparer Performance

A variety of evidence shows that some taxpayers are poorly served by their paid preparers. The available evidence does not allow a precise estimate of the percentage of taxpayers affected, but none of it suggests that the percentage is large. However, even a small percentage of the over 71 million users of paid preparers in 2000 can translate into millions of affected taxpayers. Furthermore, the consequences for these taxpayers may be significant. They may overpay their taxes, overpay their preparers, or underpay their taxes and be subject to penalties and interest.

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### A Variety of Evidence Suggests That a Small Percent of Taxpayers Are Poorly Served by Their Preparer

Surveys of taxpayers, studies of filed returns, and interviews with knowledgeable observers all show that some taxpayers are poorly served by their paid preparer. We estimate that 5 percent of paid preparer users had no confidence that they had not overpaid their taxes, and another 7 percent had little confidence, as shown in figure 1. These results echo a 1997 Consumer Reports nonrandom survey of 26,000 of its readers, in which 6 percent said they discovered an error made by their preparers. Because these surveys are based on taxpayers' perceptions and ability to identify preparer errors, they may underestimate the extent of the problem. However, there is no evidence about the size of the underestimate.

Studies of filed returns also suggest that a small percentage of paid preparer users are poorly served. For example, we estimate that over 2 million of about 67 million taxpayers who used a paid preparer in 1998 may have overpaid their taxes by claiming the standard deduction when they would have been better off itemizing. Similarly, a January 2003 report by the Treasury Inspector General for Tax Administration estimated that there were approximately 230,000 returns filed by paid preparers in tax year 2001 where taxpayers appeared eligible for but did not claim the

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additional child tax credit. In addition, a 2002 IRS study of earned income tax credit returns for tax year 1999 estimated over- and under-claims of \$11 billion and \$710 million, respectively. IRS reported that paid preparers filed more than 65 percent of all earned income credit returns. It is not clear how many of the over- or underpayments in these examples are the fault of the preparer and how many are the fault of the taxpayer. It seems likely that preparers bear responsibility for at least some of the over- or underpayments. But, taxpayers could be at fault if they provide the preparer with incorrect or incomplete information.

Knowledgeable observers confirmed that some taxpayers are poorly served by paid preparers. For example, in the fiscal year 2002 annual report, IRS's National Taxpayer Advocate recommended requiring minimal levels of competency for paid preparers in order to better serve taxpayers and improve compliance. In another example, an IRS official responsible for overseeing the local paid preparer penalty program told us that based on the problems that he has seen and the amount of penalties he has issued, he believes poor service is more common among unlicensed preparers.

Overall, the evidence from taxpayer surveys, studies of filed returns, and knowledgeable observers demonstrates that some taxpayers are poorly served by their preparers. The evidence does not allow a precise estimate of this problem. The only representative information available—from taxpayer surveys—suggests that a small percentage of taxpayers perceive problems with their preparers. However, even a small percentage of all taxpayers who use preparers equates to millions of people.

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#### Problematic Preparer Actions and Inactions Result in Poor Service to Taxpayers

Paid preparers can poorly serve taxpayers through a variety of problematic actions and inactions. For example, preparers may fail to adequately probe and understand taxpayers' personal circumstances. We estimate that 3 percent of users did not believe that their preparer had enough information to accurately complete their return. Such lack of probing could explain the examples of taxpayers overpaying or underpaying their taxes.

A more egregious example is ignoring known information about a taxpayer's personal circumstances. In one instance, a paid preparer told us of a disabled taxpayer with limited English skills who overpaid his taxes by about \$3,500 to \$5,000. The taxpayer had received notices for several years from IRS stating he might be eligible for the earned income tax credit. Each year, he took the notices to his preparer but the preparer

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took no action. Eventually he changed preparers and his new preparer is working to amend the returns.

Other lapses are less severe because they are caught and corrected by IRS and account for a small percentage of returns completed by paid preparers. For example, in tax year 2000, IRS identified 357,000 computational errors on returns filed by paid preparers.

Some preparers provide questionable advice, which could contribute to taxpayers owing additional taxes, interest, and penalties. For example, one paid preparer told us of another preparer who set up certain trusts, claiming that the trusts were legitimate tax shelters. IRS later determined that the shelters were not legitimate. We do not know whether the taxpayer was complicit with this scheme; however, the taxpayer, a successful businesswoman, now owes a large amount of tax. In a related example, another paid preparer advised a married couple with two children that it was appropriate to file two tax returns with each claiming the head of household status, claiming one child, and receiving the earned income tax credit. The adjustments made to the taxpayers' accounts in subsequent examinations resulted in a bill in excess of \$4,000, which the taxpayers have no means to pay.

In extreme cases, some preparers engage in clear-cut fraud. Identified instances of fraud are rare—IRS recommended prosecution on 162 cases in calendar years 2001 and 2002. However, the consequences for taxpayers and the government can be severe. For example, one preparer, who was a former police officer, cost the Treasury about \$1.1 million. After providing clients with copies of their tax returns, this preparer altered the returns, adding fraudulent dependents, child credits, and earned income credits. The preparer filed all returns electronically, keeping part of the refunds as a fee, unbeknownst to some clients. The clients received the remainder of their refunds, which were inflated by an average of \$1,860. The IRS audited almost 700 of this preparer's returns, with many clients owing additional taxes and interest for multiple years. The preparer was ordered to pay \$342,446 in restitution to the IRS, but this did not help clients pay their back taxes. Eventually, this preparer was sentenced to 51 months in prison.

In another example, one paid preparer told his elderly client to provide him with the checks to make her quarterly estimated payments. Although he claimed these payments on the client's tax return, he never gave the checks to IRS—he kept them for himself. After receiving notices from IRS,



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the taxpayer visited the paid preparer who told her that IRS must have made a mistake. The preparer is now in jail.

Problematic preparer behavior may not always result in taxpayers over- or underpaying their taxes, it may also result in taxpayers overpaying for services they do not understand. Preparers offer packages of services geared toward accelerating the receipt of refunds, a service that can be particularly appealing to low income taxpayers who often want or need their refunds quickly. These packages typically include electronic filing and Refund Anticipation Loans (RAL). RALs are short-term loans arranged by preparers, issued by financial institutions, and secured by a taxpayer's refund. After the return is filed electronically, the preparer is notified by IRS whether or not the taxpayer has outstanding tax debts or selected other debts (e.g., student loans, child support). If the RAL is approved, the taxpayer receives the loan and his or her refund is directly deposited into the preparer bank account. Taxpayers who buy these services can get a loan on their refund in 0 to 2 days, while taxpayers who file electronically receive their refund in 10 days. Although some people are willing to pay for the faster services, advertisements that promote RALs or large refunds, such as those excerpted in figure 3, may leave taxpayers confused about the benefits of the services they are purchasing.

Figure 3: Excerpts of Preparer Advertisements for Large or Accelerated Refunds

**REFUND/24hr** Tax Prep Tax Loans  
**Fast loans on refunds**  
 Get Your Money Back in 24 Hours  
**No More Audit Worries**  
**24 hours**  
 Get FREE "101 hot tax tips"  
 and save \$3000 or more on  
**your taxes**  
 It's tax time again and you may be expecting  
 a refund. Why wait 6-8 weeks to receive it?

Tax Cash in 24-48 Hours  
**Lots' of Cash Back**

Source: Various Paid Preparer Advertisements.

These advertisements were not selected to represent the entire industry. However, two tax clinic directors told us that some preparers do not always explain the full costs of the services. Specifically, some taxpayers are confused about the cost associated with RALs, alternatives to using RALs, and the related interest costs. Consequently, taxpayers cannot weigh the cost of the service against the benefits that they might receive.

Based on information we gathered, fees for these packages vary widely. For example, while some preparers charge nothing for e-filing services, one preparer we spoke to (while we were posing as a potential client) said he would charge us between \$210 and \$250 to file electronically. Another preparer said he would charge \$130 for a RAL on a \$1,200 refund due, which equates to an annual interest rate of about 400 percent. In another example, one preparer said he would charge \$174 for a RAL on a \$700 refund due, which equates to an annual interest rate of over 900 percent. These examples are not representative of all preparer fees; the exact amounts of preparer fees for accelerated refunds depend on various

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individual circumstances, such as the financial institution the preparer uses to finance the loan and the amount of refund due.

Yet, such fees can significantly reduce the refund a taxpayer receives. One tax clinic director informed us of a disabled taxpayer who was due a refund of \$1,230 on a simple return. After paying various fees, such as return preparation and a RAL, she received a check from her preparer for \$414—about 34 percent of her expected refund. Taxpayers are using these refund acceleration services in increasing numbers. Based on IRS data, the National Consumer Law Center estimates that 12.1 million people received a RAL in 2001, up from 10.8 million in 2000. Taxpayers paid 907 million for these services in 2001, up from 810 million in 2000.

Another form of overpayment is purchasing services that may not be needed. In an interview with an IRS employee, we learned of a taxpayer who, for 2 years, went to a large tax preparer and paid about \$200 for returns that were not required to be filed. The elderly taxpayer's sole income came from Social Security and a small pension—about \$6,000 per year—and was below filing thresholds.

Although IRS is not responsible for ensuring the quality of service paid preparers provide, it does have the authority to monitor and take action against paid preparer misconduct. Specifically, there are three key offices with a responsibility for detecting and taking action against cases of paid preparers misconduct: (1) the Office of Professional Responsibility, which sanctions attorneys, CPAs, and enrolled agents for ethical or conduct violations; (2) Examination, which assesses penalties to any paid preparer for violations discovered during an audit; and (3) Criminal Investigations, which prosecutes preparers for fraudulent or other criminal activities. IRS has taken action against some preparers. For example, according to IRS, Examination issued 987 penalties totaling over \$4 million in fiscal years 2000 and 2001. Additional information on programs administered by these offices will be included in our follow-up report, which is planned for issuance this summer.

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### Taxpayers Can Take Steps to Help Ensure They Benefit from Using a Paid Preparer

Without paid preparers' expertise, many taxpayers would be unable to submit accurate tax returns. However, taxpayers who use a paid tax preparer are still responsible for the accuracy of their return. According to the law, taxpayers take responsibility for the accuracy of their returns when they sign them. Even if the preparer is at fault, it is the taxpayer who is ultimately responsible for any additional tax, interest, and/or penalties.

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Paid preparers are not always the cause of the problems discussed in this statement. Taxpayers can contribute to these problems in several ways. Paid preparers told us that they rely heavily on their clients' oral statements and documentation to complete tax returns. Paid preparers take various steps to ensure that the tax returns they complete are accurate, such as probing about personal circumstances and reviewing income and expense documentation. However, the effectiveness of such steps depends, in part, on the taxpayer. If taxpayers provide inaccurate or incomplete information about, for example, their social security or if they do not keep tax documents, such as wage or interest statements, preparers cannot complete an accurate return. Also, some taxpayers wait until the last minute to have their taxes prepared, which may limit the preparers' opportunity to probe.

IRS and other organizations, such as the American Bar Association and the Better Business Bureau, have produced guidance for taxpayers for selecting and working with paid preparers. Some of the most common advice from these organizations is shown in figure 4.

**Figure 4: Precautions to Take When Using a Paid Tax Preparer**

- When searching for a preparer, get recommendations from friends, co-workers, or other trusted people. Find out if you qualify for free services.
- Interview the preparer before hiring to check out qualifications, experience, discipline problems, and any history of complaints.
- Be sure you understand other services you will be getting, such as electronic filing or Refund Anticipation Loans. Find out whether these services are optional, what they will cost, and how they will benefit you.
- Don't hire a preparer who guarantees a refund before seeing your tax documents or whose fee is a percentage of your refund.
- Make sure your preparer understands your personal circumstances, income, and expenses. Show your official tax documents to your preparer, including W-2's and 1099s.
- Review your completed return before you sign it. Check that your tax information is correct. Even though someone else completed it, you are responsible for the accuracy of every item on your return.
- Don't sign a blank return and don't sign in pencil.
- Make sure your preparer's signature and tax identification number are on the return before you submit it. Keep a copy of the final return.
- Don't make checks for taxes due payable to preparers. Checks should be made payable to the United States Treasury.

Source: Internal Revenue Service, Tax Topic 254 - How to Choose a Paid Tax Preparer (Washington, D.C.); American Bar Association Section of Taxation, Tax for Filing Your Return with a Tax Preparer (Washington, D.C.); Better Business Bureau, Tax Preparers, (Arlington, VA); and Internal Revenue Service, 1040 Instructions (Washington, D.C., 2009).

These precautions can help taxpayers avoid some of the problems we identified, such as overpaying their taxes or other more serious consequences, such as delinquent taxes, interest, and penalties owed to the Treasury.

Mr. Chairman, this completes my prepared statement. At this time, I would be happy to address any questions the Committee may have.

#### GAO Contacts

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#### Acknowledgments

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Peter Rumble, and Kathleen Seymour contributed to this report.


**H&R BLOCK**

**STATEMENT OF JEFFREY W. YABUKI  
EXECUTIVE VICE PRESIDENT AND CHIEF OPERATING OFFICER  
H&R BLOCK  
BEFORE THE SENATE FINANCE COMMITTEE  
ON TAX RETURN PREPARERS  
APRIL 1, 2003**

Thank you for the opportunity to present our views on how to assure that taxpayers receive competent and honest preparation of their returns when they use a professional return preparer.

Thirty years ago, Henry Bloch testified on tax preparer integrity and quality. He addressed issues such as competence, confidentiality, advertising practices, and the stability of tax preparation firms. Many reforms he proposed were enacted. But additional reforms may still be needed.

Today, I'd like to discuss the tax preparation field generally and describe some of the things we do to ensure quality and integrity.

**Taxpayers Need Help**

Good tax preparers help millions of Americans comply with a complex and dynamic tax system and ease the burden and anxiety most Americans feel at tax time. Studies show many Americans inadvertently overpay their taxes. Varying levels of knowledge and skill – theirs or their return preparers – are one reason.

- A GAO report done for Senator Grassley showed missed deductions and credits alone may have caused over 2 million Americans to overpay their Federal taxes by an average of over \$400 each.
- A Treasury report found 600,000 low-income taxpayers didn't claim the refundable portion of the child credit, costing them an average of \$390 each.

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- H&R Block found that one out of 20 of the half-million taxpayers who took our "Double Check Challenge" allowing us to review past tax returns, was able to file an amended return recovering an average tax refund of \$1,300 each.
- And our studies show that 83 percent of Americans have never heard of the Saver's Credit. It can be worth up to \$1,000 for low- to middle-income taxpayers who contribute to a qualified retirement account before April 15, 2003. This year, we've helped more than 1 million clients save an average of \$169 each with the credit.

#### **Better Regulation and Enforcement**

The IRS has said, "The vast majority of return preparers are honest and reputable." We agree. We do not have good measurements of the degree to which incompetence or fraud afflicts the field. But consumers who pay for help deserve some assurance of competence, which is why we support meaningful minimum standards for tax return preparers.

Thirty years ago, Henry Bloch proposed IRS registration of paid tax preparers. We renew that call today and go further. We believe IRS certification of paid tax return preparers – which would require validation of applicable tax knowledge, criminal and tax-filing background checks, and minimum levels of continuing tax education – would benefit the public.

To succeed, however, this or any program depends on preliminary studies to carefully define problems, and on public education, industry cooperation, adequate funding, and effective enforcement.

The new program would join with existing regulation. All preparers today are subject to laws covering fraud, negligence, diligence, misrepresentation, and unauthorized disclosure, and can be enjoined from misconduct. And practitioners who represent taxpayers before the IRS on post-filing issues – attorneys, CPAs, and Enrolled Agents – are regulated by IRS Circular 230. There are also additional rules to cover Electronic Return Originators including background checks and tax filing verifications.

Enforcement is needed, though a clear challenge. Over 70 million taxpayers pay for help from an estimated million tax practitioners in a compact 10 week period. We applaud the IRS's recently doubling of investigations of return preparers and upgrading the Office of Professional Responsibility. But the overall record in recent years shows much room for improvement. We strongly recommend stepped-up IRS enforcement.

#### **Consumer Diligence Still Essential**

Even the best regulatory "Good Housekeeping Seal," however, is no substitute for consumers exercising basic diligence and being alert to red flags. Some common-sense consumer "Do's and Don'ts" include:

- Checking a preparer's training, experience, reputation, and references, and expecting clear disclosure of all fees and services.

- Avoiding preparers promising the biggest refund, charging fees on the basis of a specific tax result, asking you to sign a blank return, failing to sign the return himself, asking that the refund be mailed directly to him, or being vague about his availability in case of follow-up IRS notices or audit.

#### **H&R Block Training and Quality Control**

Let me say a word about our own training, self-regulation, and quality control. Today, 100,000 H&R Block employees and franchisees prepare 1 in 7 of individual tax returns filed with the IRS, or 17 million, at 9,300 U.S. offices including 43 in Montana and 137 in Iowa – where our RSM McGladrey subsidiary is also the largest accounting firm.

Through our tax schools, we are one of the largest adult educators in the country, training 250,000 students annually in a variety of tax classes and seminars, including 84,000 that enroll in our basic tax course with 66 hours of classroom instruction and homework generally requiring at least another 66 hours.

Our tax professionals, at a minimum, must take our basic tax course and receive a passing test grade to be eligible for hiring. To be rehired, our professionals take at least 24 hours of continuing education each year and are also trained on systems, products, policies, and procedures, which requires an additional 20-35 hours in class. About 5,000 are Enrolled Agents or CPAs.

Advanced training is tied in stages to an internal certification program as our tax preparers move up the ladder from Tax Associates to Master Tax Advisors, who must also meet the rigorous IRS exam to become an Enrolled Agent.

Our professionals work with a state-of-the-art computer program that checks and double checks calculations, theory, and accuracy. There are approximately 10,000 diagnostics in our software that warn tax professionals that there may be something to review, error diagnostics that won't let the user file unless they are corrected, and other diagnostics that check all of the IRS error codes. We also utilize a second review by another professional for many of our tax returns. Nearly 90% of our returns are electronically filed.

Information Technology, Tax Research, and Training groups at our headquarters provide support to the tax professionals including on-demand help for clients and customized research of complex tax questions.

#### **Work Guaranteed**

For clients who are audited, we help to prepare them and, if they so choose, will accompany them as a witness to explain how the return was prepared, but do not act as their representative. For all clients, we guarantee that we will pay any interest or penalties in the event we have made an error on their tax return. For those who want more, we allow them to purchase a Peace of Mind extended guarantee in which we will also pay any additional tax liability up to \$5,000 in the event that we make an error on their tax return.

Our training and culture are clear on one critical point: We play it straight. Our interpretations of the tax code are grounded in consistent interpretation and solid



research. We assist our clients in determining their correct tax liability to pay precisely what they owe, no more and no less.

Mr. Chairman, for nearly a half-century, H&R Block has built its reputation as the trusted tax advisor to Middle-America, and, more recently, as a tax and financial partner to our clients. Our practices and Code of Ethics reflect a longstanding commitment to integrity and professionalism.

Let me highlight, finally, four aspects of the current tax season that reflect our commitment to quality tax services.

#### **Financial Planning and Federal Benefits Alerts**

First, we are providing more tax and financial planning advice to our clients. Many of them see the tax filing experience as a once-a-year financial check-up.

For low- and moderate-income clients, we alert them not only to tax benefits like the EITC or child credit, but also to their eligibility for--

- state-sponsored health insurance programs (like Iowa's *hawk-i*);
- Food Stamps;
- Women, Infants, and Children Nutrition Programs;
- School Lunches; and
- for seniors, private-sector prescription drug discounts.

In Des Moines, we refer eligible unbanked clients to the Institute for Social and Economic Development's "Bank On It" program, funded by the Treasury's First Accounts Program, to open low-cost checking or savings accounts and strengthen credit and family finances while taking a course in personal finance.

#### **Helping America Save**

Second, we are showing taxpayers how to use tax-advantaged savings opportunities Congress enacts but that are still poorly understood by taxpayers.

Many Americans have never heard of the new Saver's Tax Credit or other tax-advantaged savings opportunities in the Tax Code. The Saver's Credit can be worth up to \$1,000 for low- to middle-income taxpayers who contribute to a qualified retirement account before April 15, 2003.

In some cases, there can be a triple benefit to opening an IRA, thereby increasing EITC eligibility, and getting the Saver's Credit too. This year, we've helped more than one million clients save an average of \$169 each with the credit and helped many others start savings programs for retirement, education, or buying a first home.

#### **Free File Alliance**

Third, our focus on preparers shouldn't obscure the growth of tax software and online filing that millions of taxpayers are using, such as our own TaxCut® software. We're one of 17 firms participating with the IRS in an innovative public-private Free File Alliance

this year. It permits 60% of taxpayers and all EITC recipients to file free securely online through the Internet. It's been successful for the IRS and for 2.5 million taxpayers who will file free this year.

The partnership approach avoided a government-only plan that could have put the IRS into competition with the software industry despite the stated desire of IRS leaders not to enter the software business. These issues will continue to be discussed during the three-year term of the agreement.

**EITC Concerns**

Finally, since two-thirds of EITC returns are completed by paid preparers, they have an important role to play in reducing unacceptably high non-compliance rates.

More can be done and should be done. But we are concerned about the IRS plan to require 45,000 recipients this year, and eventually several million, to pre-qualify by securing affidavits to verify relationships or residence in advance of the tax-filing season (starting from July to December 2003). As initially outlined, the plan is likely to create confusion, administrative logjams, and delayed refunds. We hope the IRS will work with others to improve the program before it is launched and to consider alternatives to ensure efficient administration.

**Submissions for the Record**

For the record, Mr. Chairman, I'd like to submit some material on-- tax preparer regulation, our training programs, our special efforts to link low-income clients with government benefits, and our annual top 10 tax simplification recommendations.

We appreciate the chance to testify, Mr. Chairman, and would be happy to respond to your questions.

##



## H&R BLOCK

### Help for Low- and Moderate-Income Clients in 2003

During the 2003 tax season, H&R Block will notify low- and moderate-income clients when they qualify for underutilized government benefit programs, prescription drug discounts, key tax credits and savings opportunities.

These benefits can be worth thousands of dollars to families with incomes of up to \$63,350.

#### **Block Advantage**

The benefits alert is part of *Block Advantage*, tips and advice tailored to the circumstances of each tax client and delivered as a customized print-out with the final tax return at Block's 9,000 U.S. locations. *There's no additional charge for this service, which is focused on objective advice, not sales.*

#### **Financial Education**

In addition, Block will test a program of more complete, enriched financial and tax planning advice and education for clients at 130 offices. This enriched help, delivered with workbooks by specially trained professionals, will cover over 30 government benefit programs.

The aim is to customize advice for clients as they move up the financial scale from concern about cash flow and basic needs, to budgeting, to saving for emergencies, to saving for goals, to investing and, finally, to building wealth.

H&R Block's mortgage subsidiaries already support homeownership financial literacy programs like *Borrow Smart* and *Don't Borrow Trouble*.

#### **Government Benefits Alert**

The four government programs covered in the national alert are aimed at health and nutrition assistance. For a family of four, they are:

■ **Health Insurance for Children.** Free or low-cost health insurance worth about \$1,500 per child yearly is available for families with incomes up to about \$36,000 through State Children's Health Insurance Programs (SCHIP) and Medicaid.

Standards, which vary by state, may be more generous than expected. In New Jersey, for example, families with incomes up to \$63,350 may be eligible (350% of the federal poverty line).

Nearly five million eligible children are still not enrolled in such programs. Over 15% of eligible children in Alaska, Arizona, Idaho, Louisiana, Montana, Nevada, New Mexico, Oklahoma, and Texas don't participate. Overall, more than 4.6 million children now receive health insurance under SCHIP and over 20 million children receive health insurance under Medicaid.

■ **Food Stamps.** Free assistance purchasing food of up to \$452 a month, or \$5,424 yearly, is available for families with incomes up to \$23,500 through the Food Stamp Program. Eligibility and benefits vary by family size.

Over two million working American families—57% of those eligible—don't receive food benefits to which they're entitled. Less than half of eligible individuals in Colorado, California, Arizona, Wisconsin, Texas, New Hampshire, Idaho, Massachusetts, Kansas, and Nevada receive benefits. Overall, more than 19 million Americans now receive food stamp benefits.

■ **Nutrition Aid for Women, Infants and Children.** Free assistance purchasing food averaging \$70 monthly, or \$840 yearly, is available to at-risk pregnant or postpartum women, infants and children up to age five in families with incomes of up to \$33,500 through the Women, Infants and Children Program.

As many as 1.5 million families may be missing benefits, although estimates vary. Overall, about 7.5 million women, infants and children now receive WIC benefits. One in four new mothers participates in WIC, and a third of WIC participants receive no other federal aid. WIC reduces infant mortality, develops healthier babies, and reduces later health care costs.

■ **School Lunches.** Free or reduced-price meals are available for children whose families have incomes up to \$33,500 through the National School Lunch Program. Many schools also provide breakfast and after-school snacks. Half of all elementary and secondary students in the United States—27 million children—now participate in the program.

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#### Tax Credit Alerts

H&R Block already notifies its clients of their eligibility for two important tax programs that aid low- and moderate-income families: the Earned Income Tax Credit and the Child Tax Credit.

- **The Earned Income Tax Credit.** The Earned Income Tax Credit (EITC) is a refundable credit that provides as much as \$4,140 yearly for working families with incomes up to \$34,178. The average EITC is \$1,650.

About a quarter of eligible taxpayers don't get EITC benefits to which they are entitled—4.3 million Americans lose \$2.7 billion in benefits annually. About 38% of households with three or more qualifying children failed to claim the credit in 1998, according to a recent government study. The program provides more than \$31 billion in benefits to 20 million working households annually. Sixteen states have state EITCs based on the federal credit.

- **Child Tax Credit.** The Child Tax Credit, worth up to \$600 for each dependent child under age 17, was expanded in 2001 to provide an additional refund to taxpayers who earn over \$10,350 in 2002 but who have little or no income tax liability.

Many low-income parents who claim children as dependents but who don't qualify for the EITC may not realize they can qualify for the Child Tax Credit. The Treasury Department reports that 611,560 eligible families lost an average of \$390 each, or \$238 million, by not claiming the credit for 2001. Of them, 74% had incomes of less than \$25,000.

#### Drug Discounts for Seniors

H&R Block will also alert low-income clients over age 65 or disabled to private-sector discounts on prescription drugs.

- **Prescription-Drug Discounts.** Cards offering discounts of 10%-40% on prescription drugs are available for seniors or those disabled from health-care providers, chain drug stores, and groups such as AARP. One program, for example, covers those with annual incomes under \$28,000 for individuals and \$38,000 for couples. Eligibility and cost vary by program; some offer free cards.

Health officials estimate that almost 10 million out of the 40 million seniors covered by Medicare could save as much as \$600 a year through such cards. About a third of Americans over age 65 have no prescription drug coverage. The average senior obtains 30 prescription drugs annually. Average retail prescription prices have doubled in the last decade. Medicines are for conditions such as diabetes, hypertension, high cholesterol, cancer, arthritis, and depression.

#### Incentives to Save

A 2001 Consumer Federation report found that the typical low- to moderate-income household has net financial assets of less than \$1,000. About 64% of moderate-income households (\$20,000-\$50,000) and 79% of low-income households (under \$20,000) live paycheck to paycheck.

Since millions of Americans are in debt or don't save enough, clients will receive information on debt management and

opportunities to build assets through saving for education, homeownership, retirement and other goals.

- **Education Savings.** H&R Block helps eligible clients use Education Savings Accounts, Qualified State Tuition Programs, and the Hope and Lifetime Learning Credits.

- **Retirement Savings.** In 2002, H&R Block clients in 14 states used their tax refunds to open 130,000 Individual Retirement Accounts. These *Express IRAs* are invested in a FDIC-insured money-market account provided through H&R Block Financial Advisors. That test will be broadened in 2003. Clients also receive help with Keogh, SEP, and SIMPLE retirement plans, as well as 401(k) and other employer plans.

- **Savers Credits.** H&R Block will help eligible taxpayers claim a nonrefundable credit for up to \$1,000 in annual contributions to IRAs or other retirement plans. Credits for tax years 2002-6 are available to joint filers with up to \$50,000 adjusted gross income (AGI), head of household filers with up to \$37,500 AGI, and other filers with up to \$25,000 AGI; the credit phases down near the top income ranges. The 2002 credit, available until April 15, 2003, strengthens incentives to start or expand an IRA. H&R Block supports making the credit refundable so more low-income taxpayers will be eligible.

- **Individual Development Accounts.** H&R Block has joined with nonprofit groups in urging passage of legislation for Individual Development Accounts to provide financial education and matching federal funds of up to \$500 yearly to help millions of low-income Americans save. About 20,000 IDA accounts have already been established through local programs in 350 communities with 100 more starting.

- **Access to Banks.** Over 10% of Americans do not have a bank account, making savings and borrowing difficult. In May, 2002, the U.S. Treasury's First Accounts Program awarded \$8.4 million in grants to 15 nonprofit groups to subsidize basic bank accounts and provide financial education for 35,445 "unbanked" low- and moderate-income citizens. H&R Block is cooperating with the Institute for Social and Economic Development in Des Moines (which received a Treasury grant) by referring eligible clients, who are interested in starting bank accounts, to the *Bank On It* program.

#### Free Online Tax Preparation and Filing

In 2003, H&R Block will participate in a unique public-private partnership to reduce the cost and burden of tax preparation on many low- and moderate-income taxpayers and to help the IRS achieve its goal of 80% of all tax returns filed electronically by 2007. An IRS-industry alliance will offer 60% of taxpayers, including most EITC recipients, free online tax preparation and filing through [www.irs.gov](http://www.irs.gov). H&R Block's *Online Tax Program* is among the programs featured.

*These initiatives in 2003 reflect H&R Block's continuing efforts to fulfill our mission to help our clients achieve their financial objectives by serving as their tax and financial partner.*



## TAX SIMPLIFICATION PROPOSALS: 2003

Since 1997, H&R Block has annually sent lawmakers, Treasury and IRS officials 10 suggestions for federal tax simplification. The recommendations were developed by H&R Block's Training and Research Department which serves more than 80,000 H&R Block tax professionals who assist over 16 million clients at 9,000 U.S. offices. The proposals, distilled from over a million inquiries, are illustrative, not comprehensive. They complement those of the AICPA, ABA, and TEI, as well as those in annual reports of the IRS's Taxpayer Advocate, and those in the three-volume study by the staff of Congress' Joint Committee on Taxation (2001).

Many of our past recommendations have been adopted. In deference to the excellent work of the JCT and the Taxpayer Advocate, our 2003 proposals support many of their recommendations as well as express independent views. Our focus is on problems faced by average taxpayers.

To help ease tax burdens, we have also testified before Congress on simplification and tax reform, proposed legislation to restructure payroll taxes, helped the IRS develop simpler forms and clearer instructions, led efforts to increase the number of electronically-filed returns, and suggested improvements in earned income tax credit compliance.

Several points help keep the issue of tax code simplification in perspective<sup>1</sup>:

- The burden of complexity falls most sharply on about 20% of taxpayers, the small but significant fraction with higher incomes and more complicated financial lives—the self-employed, small business owners, those with income from passive activities or in the form of capital gains, rent, and pension or annuity disbursements. Low-income taxpayers who claim an earned income tax credit (16%) also face unusual complexity.
- For many other Americans, the tax system is relatively simple. Over 80% of tax code provisions relate to business, not individual tax returns. Two-thirds of individual filers take a standard deduction and do not itemize. About 40% of individual filers are able to use simplified, 1-2 page, short forms—1040EZs and 1040As.
- The main reasons for complexity arise from defining income, rewarding favored activities, and meeting budget needs, not from multiple progressive tax brackets.
- Much complexity stems from the legislative process which involves compromise, pressured last-minute drafting, and tailoring tax provisions to fit the funds available, resulting in phase-ins, sunsets, eligibility restrictions, etc. Simplification usually loses out to competing political needs as many voices press for complicating adjustments while there is little constituency for simplification.
- Some complexity makes the tax code fairer by finely tuning laws to individual circumstances and avoiding a one-size-fits-all model. Some complexity comes from using the code to advance non-tax social or economic policies, encouraging activities like education, retirement savings, child care, home ownership, charity, etc. Some complexity helps reduce the taxes we pay.
- The IRS is easing complexity administratively by revising forms, notices, and instructions.
- Technology and tax software dramatically reduce the burden of complexity. Over half of tax filers use professional tax preparers who use computers. Millions of other returns are prepared using online services or software like H&R Block's *TaxCut®*. Reasons include convenience, faster refunds, and financial planning, as well as complexity.
- Through a private-sector partnership with the IRS, over 60% of taxpayers are eligible for free tax preparation and e-filing online. The Free File Alliance expects to file 2.5 million returns in 2003.
- Through the IRS, 15 million taxpayers are eligible to file 1040EZ returns free by telephone and aid is available at 400 IRS sites. Volunteer groups assist another 4 million low-income or elderly taxpayers.

## EXECUTIVE SUMMARY

### **Family Issues**

1. Definition of Qualifying Child. Unify the definition of qualifying child for the dependency exemption, head of household filing status, and applicable credits.
2. Child Tax Credit. Make the child tax credit fully refundable.

### **Education Issues**

3. Qualified Education Expenses. Unify the definition of qualified education expenses.
4. Education credits. Combine the Hope and Lifetime Learning credits.
5. Higher Education Deduction. Eliminate the Higher Education deduction.

### **Investments and Retirement Savings**

6. Long-term Capital Gains. Simplify the calculation of tax on long-term capital gains by reducing the number of tax rates or replacing the various tax rates with a capital gain deduction.
7. Home mortgage interest. Allow points paid to refinance a home to be deducted in the year paid.
8. Deductible IRA Contributions. Eliminate income phaseouts that restrict the number of taxpayers who can make deductible contributions to an IRA.
9. Early Withdrawal Penalties. Unify the exceptions to the penalties for early withdrawals from IRAs and employer retirement plans.

### **Alternative Minimum Tax**

10. AMT. Reform the alternative minimum tax by increasing the exemption amount and/or by repealing adjustment for common deductions.

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## H&R BLOCK'S 2003 TAX LAW SIMPLIFICATION PROPOSALS

### 1. Simplify the Definition of a Qualifying Child

**Proposal:** Conform age, relationship, and member of household tests for all definitions of qualifying child. Change the definition of custodial parent to mean the parent with whom the child resided for the greatest period of time during the year. Retain the provision that allows the custodial parent to waive the right to claim a qualifying child's dependency exemption.

**Current law:** Five commonly-used provisions benefit taxpayers with children, but each has its own definition of qualifying child:

- The dependency exemption.
- The child tax credit.
- The earned income credit.
- The dependent care credit.
- Head of household filing status.

**Discussion:** A common definition of qualifying child would greatly simplify the application. Certain exceptions to the uniform definition will still be required, such as age limitations for the various credits.

Unifying the various definitions of qualifying child has been suggested by many commentators. For example, the JCT staff recommended a uniform definition of qualifying child that would eliminate several tests such as the joint return test and the gross income test that appear in only one or two definitions of qualifying child. The JCT staff recommended that any child below a specified age that has a specified relationship to the taxpayer and lives with the taxpayer more than one half of the taxable year is a qualifying child for each of these five benefits.

### 2. Simplify the Child Tax Credit Calculation

**Proposal:** Make the child tax credit fully refundable. Use a phase-in and/or phase-out rule to minimize the revenue effect.

**Current law:** Current law provides for a \$600 per child nonrefundable credit for eligible dependents under age 17 (gradually increasing to \$1,000 per child by 2010). For 2002, the credit is phased out at modified AGI of \$75,000 for singles, heads of household, and qualifying widowers, \$110,000 for joint filers, and \$55,000 for married taxpayers filing separately.

The child tax credit is a nonrefundable credit. However, some or all of the child tax credit may be refundable to taxpayers whose tax liability is too low to use the full amount of the otherwise allowable credit.

For tax years beginning after December 31, 2000 as much as 10% of earned income in excess of \$10,350 is refundable. The refundable amount is limited to the excess of the tentative credit (\$600 x number of qualified children) less the amount allowed as a nonrefundable credit. Families with 3 or more qualifying children may use this calculation or an alternate calculation involving the excess of social security taxes over the EITC.

**Discussion:** The basic idea of the child tax credit is simple – allow a credit of \$600 per qualifying child. Making part of the credit refundable adds an incredible amount of complexity. The current rules require the nonrefundable credits to be taken in a certain order when none of the child tax credit is refundable and most situations where a portion of the credit is refundable. However, a different order applies if a portion of the child tax credit is refundable and the taxpayer is eligible for the adoption credit, the mortgage interest credit, or the D.C. first-time homebuyers credit.

Taxpayers who are eligible for one or more of the adoption credit, the mortgage interest credit, or the DC first-time homebuyer's credit must complete an additional worksheet to determine the amount of their refundable credit. This worksheet is extremely complex. The Treasury Inspector General reported that 700,000 eligible families failed to claim the refundable child credit because they did not complete the worksheet.

At first glance, this appears to be a very expensive proposal. However, it should be possible to limit the revenue cost with appropriate phase-in or -out rules.

#### 4. Establish a Single Definition for Qualified Education Expenses

**Proposal:** Adopt a uniform definition of qualified higher education expenses for all education incentives. The uniform definition would include expenses for tuition, books, fees, supplies, and equipment required for enrollment or attendance, and room and board for students who are attending school at least half-time. Qualified expenses would not include expenses with respect to any course or other education relating to sports, games, or hobbies other than as part of a degree program.

**Current law:** Several provisions of the Internal Revenue Code refer to "higher education expenses." These provisions include the Hope and Lifetime Learning credits, Coverdell education savings accounts, qualified tuition programs, the exclusion from income for interest on EE bonds, the student loan interest deduction, the exception to the early withdrawal penalty for distributions from IRAs, and the new tuition and fees deduction.

Incentive	Tuition/Fees	Room/Board	Books	Other
Hope Credit	X*			
Lifetime Learning Credit	X			
Education Savings Account	X	X	X	Primary/secondary expenses, Internet connection computers, etc.
Section 529 Plan/ "QTP"	X	X	X	
EE Bond Interest Exclusion	X			ESA and QTP contributions
Student Loan Interest Deduction	X	X	X	



IRA – exception to early withdrawal penalty	X	X **	X	
Tuition and Fees Deduction	X			

\*Degree requirement  
 \*\*Provided student is enrolled at least half-time

**Discussion:** Establishing a single definition for qualified education expenses reduces confusion because taxpayers will no longer have to decipher differences in the tax treatment of various expenses. Eliminating multiple definitions reduces the possibility of inadvertent errors by taxpayers and tax professionals.

**5. Hope and Lifetime Learning Credits**

**Proposal:** Combine the Hope and Lifetime Learning credits into one education credit. The new credit would be 20% of qualified education expenses (using a proposed uniform definition). The maximum credit would be \$2,000 *per-student*, based on maximum eligible expenses of \$10,000.

**Current Law:** The Hope Credit is a nonrefundable credit against Federal income taxes. The maximum credit amount is \$1,500 per student, representing 100% of the first \$1,000 of qualified tuition and related expenses and 50% of the next \$1,000 of qualified expenses. The credit is phased-out for modified adjusted gross incomes above \$40,000 (\$80,000 for joint returns). The credit is available for two taxable years, provided that the student has not completed the first two years of post-secondary education before the beginning of the second taxable year. The student must be enrolled at least half-time in a degree, certificate, or other program leading to a recognized educational credential at an eligible educational institution.

The Lifetime Learning credit is also a nonrefundable credit but it varies in several ways from the Hope credit. The Lifetime Learning credit is equal to 20% of qualified tuition and related expenses. The maximum credit is \$1,000 *per return* (\$2,000 for expenses paid after Dec. 31, 2002). The educational expenses must be paid to an eligible educational institution. The Lifetime Learning credit is not based on a student's workload and there is no limit as to the number of years for which the credit can be taken. The credit is phased out over the same range as the Hope credit. The Hope and Lifetime Learning credits cannot be taken in the same year for the same student.

**Discussion:** The education credits serve similar purposes, but they apply different percentages to different base amounts. The Hope credit can be taken for no more than two years. In addition, the Hope credit is available on a per-student basis and the Lifetime Learning credit on a per-return basis. Currently, a student eligible for the Hope credit will always receive a larger credit under the Hope provisions. However, because the Hope credit may only be claimed for two years, taxpayers must often make a choice whether to claim the credit for the first year (which often includes only one semester of expenses) or wait and take the credit for the following two years. After 2002, when the amount of qualifying expenses for the Lifetime Learning credit increases to \$10,000, many families will need to calculate both credits to determine which is more advantageous. Combining the credits will eliminate all of these issues. Families with two or more qualifying students could benefit substantially.

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**6. Higher Education Deduction.**

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**Proposal:** Eliminate the higher education deduction, and increase the phase-out range for the unified education credit to include those taxpayers who are currently eligible for the higher education deduction.

**Current Law:** The higher education deduction, a provision included in EGTRRA, first became effective in 2002. This deduction primarily benefits taxpayers who are in or beyond the phase-out limits for the education credits. Current law allows a deduction of up to \$3,000 for qualified tuition and fees for taxpayers with a modified AGI of \$65,000 or below (\$130,000 or below for MFJ filers).

**Discussion:** The tuition and fees deduction allows more taxpayers to claim a benefit for their higher education expenses. It also introduced yet another choice that taxpayers must make concerning incentives intended to provide similar benefits. Eliminating the deduction and expanding the eligibility for a unified education credit eliminates the need to make the choice while providing a comparable benefit.

This deduction is scheduled to expire after 2005.

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**6. Simplify the Treatment of Long-term Capital Gains**

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**Proposal:** Replace multiple capital gains rates with a deduction.

**Current Law:** In 2001, long-term capital gains may be taxed at a maximum rate of 8, 10, 20, 25, or 28% depending on the holding period and the type of investment. A taxpayer could have gains on a single year's return taxed at several of these rates. In addition, an 18% rate will be available in 2006.

**Discussion:** Calculation of the tax on capital gains required 36 lines on the tax year 2000 Schedule D. As a result of the addition of the 8% rate for tax year 2001, the IRS has moved several pieces of the calculation to separate worksheets. Thus, the tax calculation on the 2002 Schedule D requires only 22 lines, but several additional worksheets may be required. If the various capital gains rates are replaced with a capital gains deduction, Schedule D will be much shorter. A capital gains deduction would also simplify the foreign tax credit calculation.

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**7. Simplify the Home Mortgage Interest Deduction**

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**Proposal:** Allow a deduction for all home mortgage points in the year paid.

**Current law:** Points paid to buy, build or improve a personal residence are deductible in the year paid. Points paid to refinance a mortgage on a personal home must be amortized over the life of the new mortgage.

**Discussion:** Taxpayers, and even some tax professionals, are not aware of the limitation on deducting points for refinanced loans. This change is particularly relevant in light of the current level of refinancing.

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**8. Eliminate Phaseouts for Deductible IRA Contributions**

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**Proposal:** Remove income limitations for contributions to IRAs.

**Current law:** The allowable deduction for contributions to an IRA is limited for "active participants" in a qualified retirement plan. The deduction is also limited for individuals who are not active participants but who are married to active participants. Individuals who are not active participants and who are not married to active participants do not have an income limitation. The chart below summarizes the 2002 limitations (based on modified adjusted gross income) that apply depending on filing status and which spouse is an active participant.

Filing Status	Phaseout Range Active Participant	Phaseout Range: Nonactive Participant
Single/Head of Household	\$34,000 - \$44,000	N/A
Married Filing Jointly	\$54,000 - \$64,000	\$150,000 - \$160,000
Married Filing Separately – spouses lived together at any time during the year	\$0 - \$10,000	\$0 - \$10,000
Married Filing Separately – spouses lived apart all year	\$34,000 - \$44,000	N/A

**Discussion:** The rules are extremely complex. The definition of active participant can be confusing. The phaseout limits generally begin at relatively low incomes. Keeping track of nondeductible basis is also a burden that could be eliminated for future contributions.

#### **9. Unify Exceptions to the Penalties for Early Retirement Plan Distributions**

**Proposal:** Unify the exceptions to the penalties for early withdrawals from IRAs and employer retirement plans.

**Current law:** Taxable distributions from IRAs and from qualified retirement plans made before age 59½ are subject to an additional 10% tax unless they qualify for an exception. Some exceptions, such as distributions on account of death or disability, apply to all tax-favored retirement plans. However, the exceptions for distributions for higher education expenses and for first-time homebuyers apply only to IRAs. The exception for distributions made after separation from service after age 55 applies only to pension plans.

**Discussion:** Eliminates a source of confusion and frustration which traps unwary taxpayers. For example, if an individual retires under a qualified retirement plan at age 55, distributions from that plan are not subject to the early withdrawal penalty. If that individual rolls his money into an IRA and then begins taking distributions before age 59½, the distributions are subject to an early withdrawal penalty (unless another exception applies).

#### **10. Reform the Alternative Minimum Tax**

**Proposal:** Reform the alternative minimum tax increasing the exemption amount and simplifying the rules.

**Current Law:** The minimum tax — a separate, alternative tax system within the income tax code — is a major source of complexity. The current version was designed to ensure that “no taxpayer with substantial economic income should be able to avoid all tax liability by using exclusions, deductions and credits.”<sup>2</sup> The AMT is imposed to the extent that a taxpayer’s tentative minimum tax exceeds his or her regular tax liability. AMT income is the taxpayer’s taxable income increased by certain adjustments and preference items. Adjustments include disallowance of such mundane tax benefits as the standard deduction and personal exemptions. Preference items include such things as accelerated depreciation and gain on incentive stock options. The tentative minimum tax is computed using the amount of alternative minimum taxable income in excess of a phased-out exemption amount. The exemption amount has been slightly increased for tax years 2001 – 2004, but otherwise has remained unchanged since 1993.

The AMT was originally intended to ensure that high-income individuals do not unduly benefit from tax breaks not available to the average taxpayer such as deductions from passive investments. Under current law, however, families whose only “undue tax benefit” is the fact that they have several dependent children can be hit with AMT.

**Discussion:** Repeal of the individual AMT system would remove a major source of complexity but be very costly. Increasing the exemption amount, indexing it for inflation, simplifying the rules, and allowing personal credits to offset regular tax liability would eliminate some of the problems associated with the current system—complex calculations, definitional problems, unintended results, and a perception that the system is both unfair and irrational—while minimizing revenue loss and maintaining the goal of ensuring that taxpayers with substantial economic income incur some tax liability.

One problem that has caused a great deal of concern in the last year is taxation of unrealized gains associated with incentive stock options. Although these gains are exactly the kinds of “substantial economic gains” the current AMT regime is intended to tax, many taxpayers suffered unintended hardships because they were unable to convert their paper economic gains into realized gains.

Some modification is needed to halt expected sharp increases in the number of affected taxpayers over the next decade. Increasing the AMT floor and /or allowing common deductions for AMT purposes would reduce the number of taxpayers affected by AMT and refocus the tax on the higher-income individuals it was originally intended to affect.

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<sup>1</sup> For earlier H&R Block views on tax code simplification, see “Statement of Robert A. Weinberger, Vice President, Government Relations, H&R Block, on Tax Code Simplification,” before the Subcommittee on Oversight of the House Committee on Ways & Means, including H&R Block’s 1998 simplification proposals, June 23, 1998 [Serial 105-46]; and “Statement of Kathy T. Burlison, Tax Research and Training Associate, H&R Block, on Complexity of the Individual Income Tax,” before the Senate Committee on Finance, April 15, 1999.

<sup>2</sup> Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982* (JCS-38-83), December 31, 1982, at 17-18.



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Jeffery W. Yabuki  
Executive Vice President  
Chief Operating Officer

May 12, 2003

The Honorable Charles Grassley  
Chairman, Senate Finance Committee  
219 Dirksen Senate Office Building  
Washington, DC 20510

Sen. Max Baucus  
Senate Finance Committee  
219 Dirksen SOB  
Washington, DC 20510

Dear Chairman Grassley and Senator Baucus:

I appreciated the opportunity to testify before the committee at its April 1 hearing on tax preparers. This is to clarify for the record one issue that came up.

In the course of questioning by Sen. Bingaman about the Free File Alliance and the appropriateness of the participating companies offering add-on products and services for a fee, Taxpayer Advocate Olson shared her experience in going to the IRS Free File Web site and using an H&R Block product.

Her response implied that the product she used was identical to the one offered to Free File online users except for the cost. In fact, because she did not qualify for Free File, she apparently downloaded H&R Block's fee-based TaxCut® software rather than H&R Block's fee-based Online Tax Program. The difference is significant because the programs have different features. Her comments may have inadvertently confused listeners.

To clarify:

- Ms. Olson did not use our Free File online program. She instead used our fee-based TaxCut® software, an entirely separate product.
- Free File users must consent in advance in order to receive any non-tax-related commercial message. They must reaffirm their interest before any follow-up contact is initiated. In addition, clients may change their mind and opt out of any solicitations they have requested by contacting H&R Block.
- No H&R Block Free File online customer is prevented from filing his return free if he declines to receive commercial messages or buy added products or services. Ms. Olson's difficulties related to rejecting the interview format that is a critical part of TaxCut®'s software design and attempting to override program diagnostics. Declining to receive added information or purchase additional products and services never prevents free online filing.
- H&R Block fully respects and protects taxpayer privacy throughout the tax filing process and complies with all applicable laws and privacy and security provisions in the Free File Alliance agreement. Tax return information is never used without permission.

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- We believe the opportunity for added tax or financial products or services enhances our Free File offer and has been welcomed as valuable by many consumers.

About 2.7 million filers were able to prepare and file a free return through the Free File program in 2003, including all Earned Income Tax Credit applicants, a solid plus for consumers. Tax and non-tax product add-ons were available (e.g., state tax return) but free filing was explicitly not conditioned on anyone using them.

We are available to answer any questions on our products and the Free File Alliance and hope you will contact us if you would like any additional information.

Very truly yours,



Jeffery W. Yabuki  
Executive Vice President and  
Chief Operating Officer

