

Statement of

John A. Barrick, Jr., Ph.D, CPA

**Associate Professor of Accounting
Marriott School of Management, Brigham Young University**

**Before the
Senate Committee on Finance**

Protecting Taxpayers from Incompetent and Unethical Return Preparers

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Chairman Wyden, Ranking Member Hatch, and Members of the Committee: Thank you for inviting me to participate in this hearing. I appreciate this opportunity to address this important topic: protecting taxpayers from incompetent and unethical tax return preparers. My name is John Barrick. I am an Associate Professor of Accounting at Brigham Young University in Provo, Utah. In addition, I was an Accountant on the staff of the Joint Committee on Taxation during the 110th and 111th Congresses. I am a member of the American Taxation Association and a Certified Public Accountant (“CPA”). I am a sole proprietor and return preparer for two S-corporations and their primary shareholders. I am speaking for myself alone. My views should not be attributed to any of the organizations with which I am affiliated.

As a CPA and return preparer, I am affected by the preparer tax identification number (PTIN) program. There are financial and administrative costs that I bear from this new program.¹ As a CPA, I am exempt from the federal return preparer regulations because I am already subject to Circular 230 and a continuing education requirement. I am unaware of any benefits that my clients or I receive through these programs.

¹ The financial burden includes the \$64.25 initial fee and a \$63.00 recurring annual fee. The administrative burden includes time to register, maintenance of a PTIN personal identification number (PIN), and the inconvenience of junk mail and email as a result of my registration (due to the IRS distributing/posting the information provided from all PTIN users). The IRS website discloses that PTIN holders are subject to the Freedom of Information Act (FOIA). <http://www.irs.gov/Tax-Professionals/PTIN-Information-and-the-Freedom-of-Information-Act> (accessed April 1, 2014).

Protecting Taxpayers from Unscrupulous and Unethical Return Preparers

I would like to share one taxpayer's recent experience with an unscrupulous and unethical return preparer that will clearly illustrate the problem we are trying to prevent today:

A new client comes to visit a CPA, who is a former colleague and classmate of mine. The client indicates that he has a tax problem. By way of background, the client is a high-school graduate who never attended college, is a lower income, single father with custody of two young boys, and is currently facing tough economic times. During the previous year he engaged a tax return preparer, at the cost of \$800, who helped him prepare a return that claimed an \$8,000 tax refund. The return preparer did not sign the return, did not provide the client with a copy of the return, nor provide reliable preparer-contact information. The client received a check for the \$8,000, and began spending it. A short time later the client received a notice from the IRS denying the three American Opportunity Credits claimed (one for himself and each of his two young boys). The money has to be returned. Who is to blame? Both the client and tax preparer knowingly submitted a return that claimed false information. The client is now worse off than before filing the false return: he owes the full amount of the refund (\$8,000) plus the \$800 fee to the unscrupulous tax preparer. The tax preparer is not to be found, \$800 richer than before.

All of us at this hearing would like to prevent this type of behavior from happening. Return preparer regulation should be allowed if we can protect taxpayers from incompetent and unethical return preparers, and if the benefits of regulation outweigh the costs.² However, if regulation cannot protect taxpayers from these types of incompetent and unethical preparers, or if the costs of regulation exceed the benefits received, then you must find alternatives. I firmly believe that the regulatory framework in this case is insufficient to protect these taxpayers, and I will make several recommendations that Congress and the IRS could follow to better protect these taxpayers.

Why is this question important?

"Taxes are the price we pay for a civilized society" — Oliver Wendell Holmes

The U.S. tax system is designed to: 1) finance public projects; 2) redistribute wealth; and (3) encourage a variety of economic activities that are deemed to be in the public interest (Scholes and Wolfson, 1992). Because of these competing interests and the technical nature of the tax law the Internal Revenue Code (Code) is complex. Besides, the U.S. income tax system is a voluntary system, taxpayers' attitudes and perceptions of the tax system affect compliance. Yin (2012) stated that: "In the United States, the principal goal of (*personal income tax*) PIT administration has been to promote true, *voluntary* compliance on the part of taxpayers, where

² According to Temple-West (2014), the Obama administration has asked Congress to empower the IRS with authority to regulate federal return preparers.

they internalize their societal obligations to report accurately and pay their full tax liabilities.” The Tax Foundation (2009) asked taxpayers the question: “Do you consider the amount of federal income tax you have to pay as...?” In 2009, fifty-six percent (56%) of taxpayers felt the amount federal income tax was “too high” while only two percent (2%) felt the amount was “too low” (see Figure 1). This attitude likely reflects the 2006 estimated tax gap of \$385 billion (IRS 2012).

Figure 1

Q600 Do you consider the amount of federal income tax you have to pay as...?				
	2009	2007	2006	2005
Unweighted Base	2,002	2,012	2,017	2,013
Too high	56%	58%	59%	55%
About right	33%	31%	30%	33%
Too low	2%	2%	1%	2%
Not sure	10%	10%	9%	10%

“The hardest thing in the world to understand is the income tax” — Albert Einstein³

The Taxpayer Advocate (2012) reported that taxpayers spent 6.1 billion hours complying with the law. The Code is over 4 million words long, and contains 4,680 changes since 2001. This complexity often leads to taxpayer dissatisfaction. For example, the Tax Foundation (2009) asked taxpayers the following question: “How complex do you think the federal income tax is”? Eighty-five percent (85%) of taxpayers felt the federal income tax was either “very complex” or “somewhat complex” (see Figure 2).

Figure 2

Q630 How complex do you think the current federal income tax is?				
	2009	2007	2006	2005
Unweighted Base	2,002	2,012	2,017	2,013
TOP 2 BOX (NET)	85%	83%	80%	81%
(4) Very complex	52%	50%	48%	46%
(3) Somewhat complex	32%	33%	32%	35%
BOTTOM 2 BOX (NET)	9%	11%	10%	11%
(2) Not too complex	8%	10%	9%	9%
(1) Not complex at all	1%	2%	1%	2%
Not sure	6%	5%	10%	8%

³ This quote was attributed to Leo Mattersdorf, who was Mr. Einstein’s tax preparer. <http://quoteinvestigator.com/2011/03/07/einstein-income-taxes/> (last accessed April 1, 2014).

Because of this complexity, taxpayers hire return preparers to reduce the informational asymmetry between them and tax administrators. The GAO (2011) has said that paid return preparers are a cornerstone of our tax system — this is due to the oft-cited statistics that they help about sixty percent (60%) of taxpayers to file their returns. Higher-income taxpayers typically hire attorneys or CPAs to help them minimize taxes and meet their compliance obligations. “Over and over again courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced exactions, not voluntary contributions.” *Commissioner v. Newman*, 159 F.2d 848, 851 (2d Cir. 1947). Lower-income taxpayers often hire less-sophisticated or less-educated preparers and are more likely to be served by incompetent or unethical return preparers.

Regulation

Are there problems with income tax compliance? Yes. Are there some return preparers that lack the requisite knowledge and skills needed for compliance? Yes. Are there some unscrupulous and unethical return preparers? Yes. Are there some unscrupulous and unethical taxpayers? Yes. Are there some taxpayers that lack the requisite knowledge and skills needed for compliance? Yes. There has been a substantial amount of academic research on the topics of taxpayer compliance and effects of tax professionals on the tax compliance process.⁴

There are three primary problems that lead to tax compliance errors: 1) lack of knowledge, 2) lapses in ethical judgment, and 3) inadequate review processes or supervision. Preparer knowledge is addressed by the regulations through a certification examination and continuing professional education. Ethics are addressed through the application of Circular 230 to registered preparers. Review processes and supervision are areas where a diversity of practice exists and there are varying levels of quality as a result.

“The classical theory of government regulation is that society has problems and the government through reason can thoughtfully address them. But what is the problem the IRS is trying to solve with the regulations? There is no indication that paid preparers are incompetent, certainly not on a scale that would require government intervention. Why not let the market solve the competency issue? A crooked return preparer will be penalized by the IRS. But a preparer who leads his clients to audit will be out of business. And, to the extent it matters, there is no indication that paid preparers are less ethical than anyone else” (Brunori 2012).

⁴ Academics have done numerous studies exploring taxpayer behavior and tax professionals' roles in that process. For a review of taxpayer compliance literature see Taxpayer Advocate (2007), a commissioned study by M. Kornhauser. For a review of tax professional judgment and decision making see Roberts (1998). Additionally, the lack of tax compliance data from the IRS and made available to researchers has hampered tax compliance research in the United States relative to similar research being done in countries like Germany and Sweden. While there are concerns about taxpayer privacy, the IRS could make data available that would facilitate a better understanding to today's environment rather than drawing inferences that may be unlikely to generalize to the current environment.

Problems with Regulation

There are three main problems associated with or limits on regulation: 1) the inability to regulate the most unscrupulous and unethical preparers, 2) inability to impose ethics on either registered or unregistered preparers, and 3) the creation of winners and losers in the return preparation industry.

Ghost preparers

I will use the term “ghost preparers” to refer to the most unscrupulous and unethical return preparers. Ghost preparers prepare, but do not sign returns. The preparer I referred to in my earlier story is a good example of a ghost preparer. Ghost preparers don’t sign returns to avoid the unethical behavior being traced to him or her. These preparers charge inordinately large fees, often based on a percentage of the client’s fraudulent refund, quickly collect their fee, and then disappear before they are caught. These ghost preparers refuse to register because they want to hide in the shadows. How many ghost preparers are there? Tolan (2012) estimates there are between 88,000 and 388,000 paid preparers that failed to register. However, this presupposes that ghost preparers previously signed a tax return. The true number of ghost preparers is unknown, but this preparer group imposes the highest cost on taxpayers and is the least likely to be regulated. The only way to deal with ghost preparers is through the Criminal Investigation division of the IRS or other law enforcement methods. Regulation imposes costs on registered tax preparers and their clients without affecting ghost preparers who are outside the law.

Ethical Judgments

There are two small-sample studies that find errors made by return preparers. The first was conducted by the GAO (2009). In tests of chain preparers, the GAO found that 10 of 19 preparers failed to report business income. They excluded income that was not subject to the IRS matching program. Additionally, these same preparers claimed the Earned Income Tax Credit (EITC) for an ineligible child in five out of 10 applicable cases. These errors occurred by not asking about where a child lived or by ignoring the GAO’s answer to the question. In both situations, the preparers made ethical lapses. The second study was conducted by Treasury Inspector General for Tax Administration (TIGTA) in 2008. The TIGTA study examined 28 unenrolled preparers: 12 from commercial chains and 16 from smaller independent firms. The study found that 17 preparers calculated the wrong tax and six of these preparers acted willfully or negligently — demonstrated lapses in ethical judgment. While information is illuminating, the study doesn’t provide information on the distribution of these ethical lapses between the chain preparers and independent firms. How did the regulations improve the behavior of these previously unregulated preparers? Is there any evidence that these preparers’ ethical lapses would be improved by being subject to Circular 230?

Bauman and Mantzke (2004, 54-55) state that: “By all indications, it appears that [the] U.S. tax system is at least somewhat impaired by problems caused by (*federal tax return preparers*) FTRPs. However, evaluating proposals for increased regulation is hampered by the lack of

systematic evidence of the extent of the problem and the effectiveness of existing regulation. As such, it is not clear that increased regulation is the answer.”

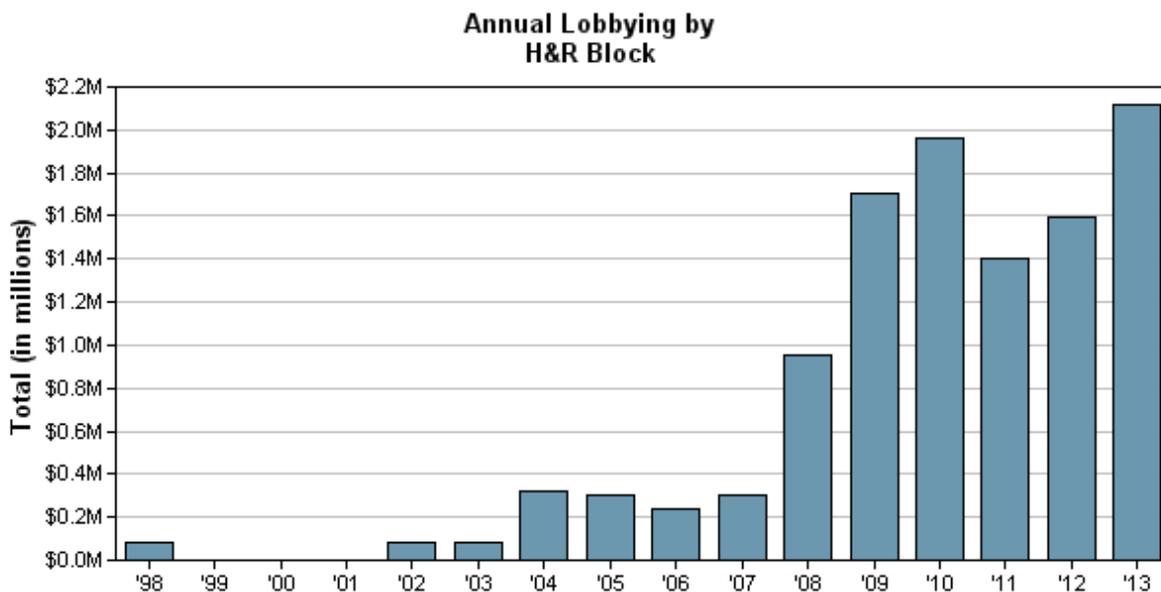
My personal interaction with return preparers from all levels of the industry, particularly those return preparers directly affected by the regulations, indicates that they are generally competent and conscientious. My intuition tells me that the regulations are unlikely to eliminate or deter unscrupulous and unethical preparers who aren't competent and conscientious.

Winners and Losers

Regulation clearly creates winners and losers among the previously unenrolled portion of the return preparation industry. A host of commentators have rightly pointed out that many of the small independent return preparers are disadvantaged. For example, Brunori (2014) states that: “The big proponents of regulating preparers are H&R Block, Jackson Hewitt, and the other large tax return preparation services. No one will ever convince me that big preparers have the public’s interest at heart. They merely want to limit or eliminate all the competition.”

The Lobbying Disclosure Act data bears this assertion out. Figure 3 was obtained from the Center for Responsive Politics’ Opensecrets.org database. The large increase in lobbying expenditures coincides with the government interest and discussion of return preparer regulation.

Figure 3



While I do not fully understand the economics of the large-scale commercial return preparation businesses, many of these businesses are presumed to make significant profits off of ancillary services, such as refund anticipation loans, which are now referred to as “refund anticipation checks.”

Alternatives to Regulation

I would like to thank Nina Olson, the National Taxpayer Advocate, for her and her staff's tireless efforts to help taxpayers. In the 2013 Taxpayer Advocate Report she recommends a six-part strategy. I highly recommend the first five points and urge you to carefully consider the sixth item:

Accordingly, the National Taxpayer Advocate urges the IRS to develop a six-part strategy to protect taxpayers in the event that *Loving* is upheld on appeal. Specifically, the strategy should include the following components:

1. Offer unenrolled preparers the opportunity to earn a voluntary examination and continuing education certificate.
2. Restrict the ability of unenrolled preparers to represent taxpayers in audits of returns they prepared unless they earn the voluntary examination and continuing education certificate.
3. Restrict the ability to name an unenrolled preparer as a Third Party Designee on Form 1040.
4. Mount a consumer protection campaign that educates taxpayers about the need to select competent preparers who can demonstrate competency.
5. Develop a research driven and Service-wide preparer compliance strategy similar in nature to the EITC preparer compliance strategy.
6. Recommend that Congress revise 31 U.S.C. § 330(a)(2) to clarify that the IRS has the authority to regulate unenrolled preparers.

Building off of her work, I suggest four strategies that I believe will improve the protections afforded to taxpayers from incompetent and unethical return preparers: 1) voluntary disclosure, 2) eliminate or limit refundable credits, 3) enforce existing return preparer laws, and 4) educate taxpayers.

Voluntary disclosure

We live in a free society; let the markets decide whether return preparer certification is a good thing. Licensed attorneys and CPAs are gainfully employed because their professional designations are valued by taxpayers. I recommend combining the Taxpayer Advocate's items one through three. Create incentives for return preparers to voluntarily register. Allow them to represent taxpayers before the IRS in audits and be designated on a taxpayer's Form 1040. These are items that taxpayers value. Also educate taxpayers about the advantages of using a registered return preparer.

Eliminate or Limit Refundable Credits

The growth of refundable credits in the income tax system encourages unscrupulous and unethical behavior by taxpayers, ghost preparers, and others wishing to defraud the federal government. "The availability of e-filing and the magnitude and frequency of claims for refundable tax credits have combined to make tax return preparation a lucrative business for many" (Olson, p 769). The former Commissioners make this point in the amicus brief: "Most

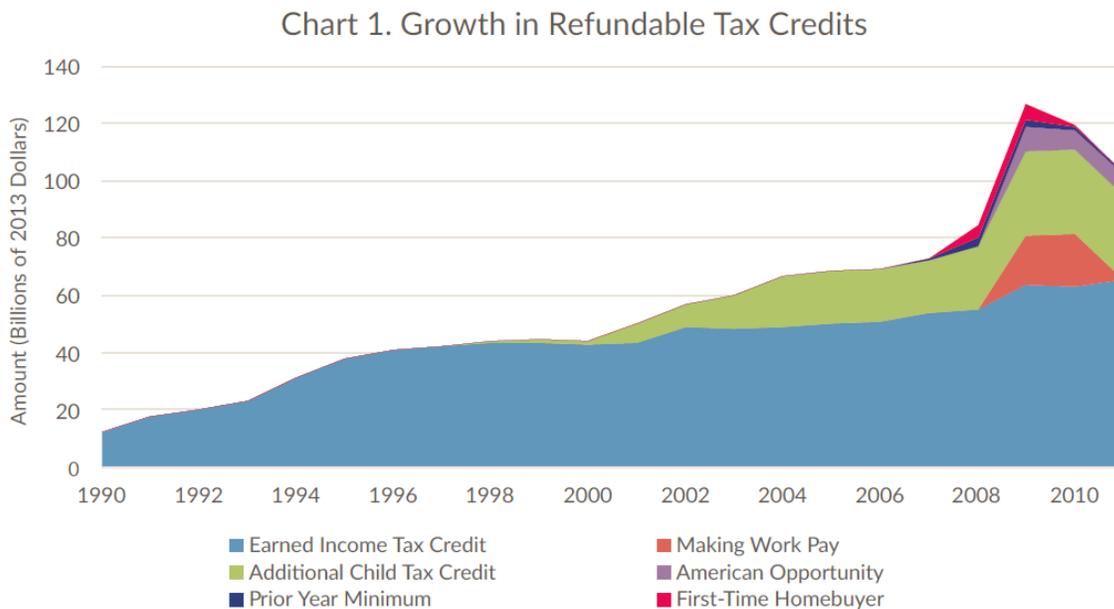
significantly, Congress has decided to administer an increasingly wide variety of government assistance programs through the federal income tax system, including assistance for low income families, health care, education, and homebuyers. In each instance, preparing and filing a tax return is the sole means by which taxpayers are able to present to Treasury their qualification for these programs and to obtain the financial assistance intended by Congress.”

Currently, the Internal Revenue Code includes the following refundable credits:

- earned income credit (§ 32);
- child tax credit (made partially refundable under § 24(d)(1));
- education credits (made partially refundable under § 25(i)(5));
- health insurance cost credit (§ 35);
- first-time homebuyer credit (§ 36) available from 2008-2011;
- making work pay credit (§ 36A) available in 2009 and 2010; and
- adoption expense credit (§ 36C, re-codified as § 23).

Figure 4 illustrates the historical growth of refundable credits claimed by taxpayers (Tax Foundation 2014).

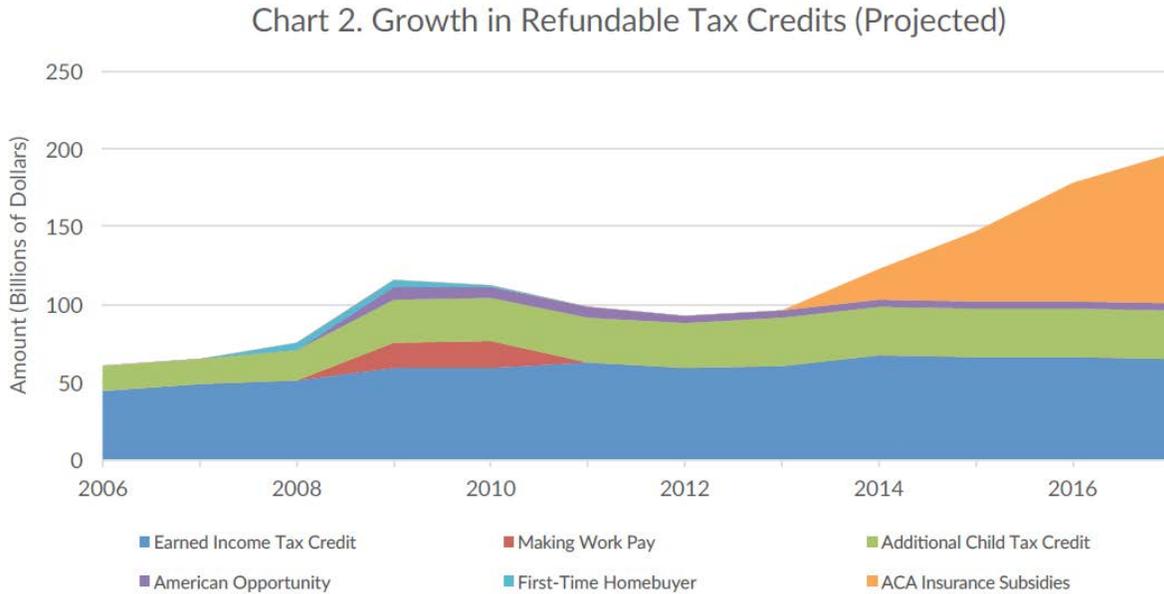
Figure 4



Source: IRS Statistics of Income, 1990-2011

Figure 5 projects the future growth of refundable credits (Tax Foundation 2014).

Figure 5



“The primary purpose of the Internal Revenue Service is to collect revenue. Refundable tax credits represent a form of mission creep, in which the IRS dispenses revenue instead of collecting it. Recent acts of Congress, particularly ARRA and the ACA, have dramatically increased the scope and breadth of these credits. As the ACA subsidies come online, the total expenditures associated with refundable tax credits will surpass \$200 billion” (Tax Foundation, 2014).

Outside of Washington there is very little understanding of why the Code is used for programs such as EITC, Low Income Housing Credit, etc. Congress can both authorize and fund a program through the Code with the single stroke of a pen, while doing so outside of the Code requires both an authorization to create the program as well as an appropriation bill to fund the program. This legislative loophole has led to a significant increase in refundable credits, and resulting opportunities for abuse.

The Joint Committee on Taxation (2013) shows the distribution of these refundable credits across taxpayers. Figure 6 indicates that taxpayers with taxable income below \$30,000 have a negative tax liability (refunds) created through refundable credits.

Figure 6

Table 2.—Distribution by Income Class of All Returns, Taxable Returns, Itemized Returns, and Tax Liability at 2012 Rates, 2012 Law, and 2012 Income Levels [1]

[Money amounts in millions of dollars, returns in thousands]

Income Class [2]	All Returns [3]	Taxable Returns	Itemized Returns	Tax Liability
Below \$10,000	17,878	12	418	-\$8,110
\$10,000 to \$20,000	17,418	4,168	760	-24,672
\$20,000 to \$30,000	18,526	6,328	1,360	-14,085
\$30,000 to \$40,000	15,862	7,928	2,310	144
\$40,000 to \$50,000	14,182	9,051	3,230	13,582
\$50,000 to \$75,000	26,339	20,123	8,583	72,802
\$75,000 to \$100,000	16,618	15,414	7,860	91,859
\$100,000 to \$200,000	22,735	22,412	16,522	293,676
\$200,000 and over	6,321	6,281	5,882	561,492
Total	155,879	91,717	46,925	\$986,688

[1] Tax law as in effect on December 31, 2011, is applied to the 2011 level and sources of income and their distribution among taxpayers.

[2] The income concept used to place tax returns into classes is adjusted gross income ("AGI") plus: (a) tax-exempt interest, (b) employer contributions for health plans and life insurance, (c) employer share of FICA tax, (d) workers' compensation, (e) nontaxable Social Security benefits, (f) insurance value of Medicare benefits, (g) alternative minimum tax preference items, and (h) excluded income of U.S. citizens living abroad.

[3] Includes filing and non-filing units. Filing units include all taxable and nontaxable returns. Non-filing units include individuals with income that is exempt from Federal income taxation (e.g., transfer payments, interest from tax-exempt bonds, etc.). Excludes individuals who are dependents of other taxpayers and taxpayers with negative income.

NOTE--Details may not add to totals due to rounding.

Source: Joint Committee on Taxation

Financial incentives do matter; the current tax law creates incentives for fraud. To the unscrupulous and unethical this is easy money.

Enforce Existing Return Preparer Laws

The Taxpayer Advocate finds the IRS negligent for its failure to take action against return preparers. This is echoed by an earlier testimony from the Chief of the Criminal Investigation Division: "The IRS currently has numerous tools available to address return preparer fraud and to educate the public. Effective application of these tools requires strong support of the IRS enforcement mission during this critical building stage. Some of the key tools include the Criminal Investigation Fraud Detection Centers, which deploy expert intelligence analysts who look at sophisticated data mining and data analysis tools and identify unscrupulous return preparers as well as defining the scope of their schemes. Numerous civil and criminal penalties can be deployed once return preparer schemes are identified and examined. The parallel investigative process permits a civil injunction to be issued, which allows us to stop fraudulent conduct in its tracks. Finally, we have no aggressive education and outreach program geared specifically to this problem which targets both law-abiding taxpayers and the preparer community. (IRS 2005)"

The IRS has seldom made use of its existing statutorily authorized tools for regulating tax return preparers, such as the tax return preparer penalty.

The IRS already has ample statutorily-authorized tools to apply against incompetent or unethical tax-return preparers. Furthermore, the regulations will be ineffective in eliminating the most incompetent and unethical return preparers.

Educate Taxpayers

Taxpayers are ultimately responsible for their own tax return. They have an obligation to put forth a good faith effort. If something promised you by anyone sounds too good to be true, it usually is; buyers beware. Taxpayer education can be an effective tool. Previously, the IRS has used taxpayer education favorably:

The IRS indicated that more than 80,000 tax returns were filed in 2001 seeking fictitious slavery tax credits totaling \$2.7 billion. The IRS estimated that \$30 million was mistakenly paid out in slave reparations in 2000 and part of 2001. However, the Service reports a significant drop in reparation claims attributable to stepped-up scrutiny of tax returns and an aggressive media campaign targeting scam artists promising to secure these phony tax credits for taxpayers. (Bauman and Mantzke, 2004, p. 58).

In addition to educating taxpayers about their own responsibility, you should recommend that the IRS follow the Taxpayer Advocate's item 4: "Mount a consumer protection campaign that educates taxpayers about the need to select competent preparers who can demonstrate competency."

Final Recommendations

"Licensing is effective only if accompanied by strictly enforced standards of performance and integrity. We see no realistic way of IRS's doing this. It has been estimated that there are over 200,000 preparers. Actually, no one knows. In any case, the administration of examinations and the conduct of character investigations for such a large number of individuals is beyond any resources we are likely to get for the job." . . . Statement made by former IRS Commissioner Johnnie M. Walters before the Legal and Monetary Affairs Subcommittee of the House Committee on Government Operations on April 13, 1972.

The tax law is large and complex. For these reasons, the majority of taxpayers seek the help of return providers. Regulation will not deter the most unscrupulous and unethical return providers. They are ghost preparers that attempt to defraud the income tax system. Nor will regulation increase return preparers' ethics without enforcement. Regulation clearly creates winners and losers; those who lobby for rent-seeking activities.

Don't allow states to regulate out-of-state tax return preparers. There are enough taxpayers that are required to file in multiple jurisdictions that it makes it difficult, if not impossible, for return preparers to provide the help they require.

Rather than regulate, please take steps to protect taxpayers from unscrupulous and unethical taxpayers: encourage voluntary disclosure, eliminate refundable credits, enforce existing return preparer laws, and educate taxpayers. However, if you must regulate, exclude those who are

already regulated, including attorneys, CPAs, and enrolled agents. If you must regulate, in addition to knowledge you must make sure that ethics are in place. In training future CPAs, we always start with a foundation of ethics.

Thank you for giving me the opportunity to think about how to help protect taxpayers from unscrupulous and unethical return preparers. I will be happy to answer your questions. I would also be happy to continue this discussion with you or your staffs on tax return preparer regulation, tax reform, or any other topic that you or they might request.

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