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IRS Commissioner's Return Preparer Review Forum
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Comments

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Introduction

The annual tax return preparation and filing requirement for Americans results in both an important marketplace transaction when consumers pay commercial outlets to prepare and file their tax returns and an exposure to high cost financial products when preparers partner with banks to sell high cost refund anticipation loans and other financial products and services.

Since 2002, the National Consumer Law Center (NCLC) and the Consumer Federation of America (CFA) have issued annual reports on refund anticipation loans and related tax preparation and filing issues.[1] We appreciate the opportunity to share some of this information with the IRS as the Commissioner develops his proposals to improve tax filing for American consumers.

A. Tax Preparers Should be Regulated to Protect Taxpayers.

A tax return is probably the most critical financial interaction that a consumer has with the federal government during the year. A wrongly or fraudulently prepared return can lead to dire economic consequences or even criminal sanctions for taxpayers. Yet there is no licensing requirement or supervision for the industry personnel that actually fills out the tax returns of tens of millions of consumers. Anyone can charge the public to prepare tax returns for whose accuracy the taxpayer is responsible. Large national chain tax preparers – H&R Block, Jackson

[1] Chi Chi Wu and Jean Ann Fox, National Consumer Law Center and Consumer Federation of America, *Big Business, Big Bucks: Quickie Tax Loans Generate Profits for Banks and Tax Preparers While Putting Low-Income Taxpayers at Risk,* February 2009. Available at www.consumerfed.org/pdfs/2009_RAL_Report.pdf

Hewitt, and Liberty Tax -- prepared about 20 million returns in 2007 while independent preparers prepared nearly 59 million tax returns. The independent preparers range from licensed professionals, such as attorneys and certified public accountants, to any person who wishes to make money preparing taxes and selling the extras, such as refund anticipation loans (RALs) and refund anticipation checks (RACs). Too often consumers get poor value for their tax preparation dollars.

In 2008, several significant studies on tax preparation and the sale of RALs were released by consumer groups and government investigators which illustrate a shocking lack of quality control or accuracy in tax preparation.

a. The Community Reinvestment Association of North Carolina (CRA-NC) in Durham and Community Legal Services of Philadelphia (CLS) and the Philadelphia Campaign for Working Families conducted 17 "mystery shopper" tests of paid tax preparers, with results analyzed by the National Consumer Law Center.

   Several preparers made serious errors that significantly affected tax liability. Two testers were required to file amended returns to fix errors. One tester withdrew after the preparer advised him not to include investment income on a return, essentially recommending tax fraud. This tester told coordinators "My experience with [the independent preparer] has been a scary one. I say that mainly because of the lack of confidence in the preparer's ability to competently complete our return …."[2]

b. Impact Alabama conducted mystery shopper tests of 13 tax preparers. Testers described themselves to preparers as parents with one or two children who lived with them less than six months of the year, which would not make them eligible for the EITC. Impact Alabama found that 11 of the 13 preparers incorrectly claimed the EITC. In addition, ten preparers did not report income from other jobs such as babysitting, nine preparers did not report interest income, and eleven allowed testers to claim "head of household" status without being qualified for it.

   All of the testers should not have qualified for refunds, but each preparer figured a refund ranging from $65 to $6,247. Five preparers figured a refund of $6,247 for a taxpayer who actually owed $112 to the IRS. These five preparers included a fringe preparer, Columbus Finance Company, a "Mo' Money Taxes" outlet, and three other independent preparers.[3]

c. A Treasury Inspector General for Tax Administration (TIGTA) Preparer Testing Report[4] in 2008 focused on the accuracy of returns prepared by paid preparers. TIGTA auditors tested 28 preparers (12 commercial chains and 16 independent preparers) and found that only 11

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[2] *Tax Preparers Take a Bite out of Refunds: Mystery Shopper Test Exposes Refund Anticipation Loan Abuses in Durham and Philadelphia*, is available at http://www.nclc.org/issues/refund_anticipation/content/shopper_report.pdf.

[3] Steve Doyle, *Group Uncovers Tax Cheaters*, Huntsville Times, Jan. 23, 2009.

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

(39 percent) of the 28 storefronts prepared an accurate tax return. The other 17 preparers (61 percent) prepared the returns incorrectly.

- 11 (65 percent) of the 17 contained mistakes and omissions that TIGTA considered to have been caused by human error and/or misinterpretation of the tax laws.
- 6 (35 percent) of the 17 contained misstatements and omissions TIGTA considered to have been willful or reckless.

Recommendations: The IRS should register or license preparers, including testing and educational requirements. At a minimum, any tax preparer selling additional products or services, such as refund anticipation loans or checks, should be required to be licensed and meet qualification standards. Tax preparers should be prohibited from charging taxpayers a fee for selling or brokering a tax financial product and should be prohibited from making referrals to check cashers that charge a fee to cash tax return or refund anticipation loan checks.

B. One of the Key Reforms to Prevent Abuses by Tax Preparers is to Ban Refund Anticipation Loans

Refund anticipation loans are very short term loans made by banks and facilitated by tax preparers, secured by the taxpayer's expected tax refund. In 2007, 8.7 million taxpayers paid to borrow against the refund they expected to receive from the IRS, paying $833 million in RAL fees plus $68 million in "add-on" fees, often called "application," "e-filing" or "service bureau" fees. For a typical $3,000 RAL, consumers pay finance charges that range from $62 to $110. If all fees are used to compute the cost of this ten day loan, the annual percentage rate ranges from 50 to nearly 500%, depending on the size of the loan.

<u>Low Income Workers Buy RALs and RACs</u>

Tax refund loans are marketed mostly to low-income taxpayers. IRS data indicates that 85 percent of taxpayers who applied for a RAL in 2007 had adjusted gross incomes of $38,348 or less. In 2007 nearly two-thirds of RAL borrowers (5.44 million families) received the Earned Income Tax Credit, the nation's largest anti-poverty program. About half of EITC recipients pay part of their publicly funded benefits to a bank to buy a tax-related financial product, including refund anticipation checks and loans.

Refund anticipation checks (RACs) are a non-loan payment device offered by RAL banks. With RACs, the bank opens a temporary bank account into which the IRS direct deposits the refund check. After the refund is deposited, the bank issues the consumer a paper check or prepaid debit card with the RAC proceeds and closes the temporary account. RACs generally cost around $30. In 2007, the IRS reports that nearly 11.2 million taxpayers received a RAC,[5] at a cost of about $336 million.

<u>RALs and RACs Permit Tax Preparers to Hide the Cost of Tax Preparation</u>

The ability to deduct tax preparation fees from a refund anticipation check – or a RAL – enables commercial preparers to withhold information on the price of tax preparation. They also make

[5] Data from IRS SPEC, Return Information Database for Tax Year 2006 (Returns Filed in 2007), Jan. 2009.

taxpayers less sensitive to the price of preparation. Since the fee is deducted from the RAL or RAC, consumers may not be as sensitive to this lack of pricing information.

The ability to deduct fees from a RAL or RAC also enables independent preparers to pad the price with add-on fees. Our research has found add-on fees from $25 to over $300. As a trade newsletter published by a software provider for independent preparers bluntly advised:[6]

> The most successful e-file shops in the U.S. do not use price lists and they "lowball" their tax preparation charges to get the customer in the door. (Note: In some markets it's customary to throw in free e-file and charge a higher price for the tax return preparation). ***They then charge more for e-filing and bank products to make up for the "lowball" price.*** For instance, if the going price for 1040EZ's in your area is $49 you might want to charge $29. Advertise the $29 price with a note at the bottom (the fine print) that says "1040EZ's". Get the customer in the door. Then charge more for the e-file and bank products to make up for the discounted $29 price.

RALs Contribute to Fraud and Aggressive Tax Positions by Preparers

Mixing tax preparation with refund anticipation loans has a negative impact on the integrity of tax administration. This promotes tax fraud by preparers, which the IRS recognized in opening a rule-making proceeding in 2008, asking whether the agency should write rules to restrict the sharing of tax return information to market RALs, RACs, audit insurance and other financial products.[7] A key question was whether RALs and other tax financial products provide preparers with a financial incentive to inflate refund claims inappropriately.

NCLC, CFA and other consumer groups submitted extensive evidence indicating that RALs do provide tax preparers with an incentive to inflate refunds and cited statements by fraud experts and IRS criminal enforcers that RALs aid thieves in commission of tax fraud.[8] The IRS has not issued any proposals as a result of this open docket.

The RAL contribution to tax fraud is no secret to the IRS. In 2004, then Director of the IRS Criminal Investigation Division's Refund Crimes Unit reported that 80 percent of fraudulent e-filed returns were tied to a RAL or other refund financial product.[9] In 2005, the Chief of the Criminal Investigations Division told Congress that 75 percent of tax returns identified as questionable and/or fraudulent were associated with a RAL.[10]

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[6] WorldWideWeb Tax, *Tax Return Pricing*, The Tax Time News, Oct. 2008, on file with NCLC.
[7] 73 Fed. Reg. 1131 (Jan. 7, 2008)
[8] Comments of National Consumer Law Center, Consumer Federation of America, et al. regarding Advance Notice of Proposed Rulemaking – Guidance Regarding Marketing of Refund Anticipation Loans (RALs) and Certain Other Products, April 7, 2008, available at http://www.consumerlaw.org/issues/refund_anticipation/content/comments_040708.pdf
[9] Allen Kenney, *IRS Official Shines Spotlight on E-Filing Fraud,* 2004 Tax Notes Today 130-4, July 6, 2004.
[10] Statement of Nancy J. Jardini, Chief, Criminal Investigation, Internal Revenue Service, *Testimony before the Subcommittee on Oversight of the House Committee on Ways and Means,* June 29, 2005, available at http://waysandmeans.house.gov/hearings.asp"formmode=view&id=2875.

RALs are the tool of choice for identity thieves. A March 2008 Wall Street Journal article about the growing problem of tax ID theft featured several cases in which RALs were used to perpetrate that crime.[11]

The U.S. Department of Justice (DOJ) civil action charged five Jackson Hewitt franchisees operating 125 offices with tax fraud for preparing fraudulent tax returns falsely claiming $70 million in tax refunds. DOJ alleged that these preparers filed false returns claiming refunds based on phony W-2 forms; fabricated businesses and business expenses on returns to claim bogus deductions; and massive fraud related to Earned Income Tax Credit claims. RALs were heavily involved in the fraud committed by these Jackson Hewitt franchisees, according to the DOJ complaints.[12]

Others have documented fraudulent tax preparation in connection with RALs. A 2008 sting operation by the New York Department of Taxation and Finance found evidence of fraud among about 40 percent of the 85 tax preparers they visited.[13] The National Taxpayer Advocate's 2007 Report to Congress noted that when IRS audited EITC tax returns associated with RALs, they found errors in 87 percent of the cases versus 73 percent of cases without RALs – a 14 percent difference.[14] The Treasury Department's Financial Crimes Enforcement Network (FinCEN) issued a warning to banks in 2004 on the fraud potential of RALs: "To make this type of loan appealing to the public, funds are made immediately available, leaving little time for the lender to perform due diligence to prevent fraud."[15]

Mystery shopper testing by consumer and advocacy groups have found repeated instances of inflated refunds and fraud, linked to RALs. Mystery shopper testing by consumer groups in Durham and Philadelphia found multiple instances of tax preparation that would have led to inflated refunds.[16] An advocacy group in Alabama conducted mystery shopper tests finding that 11 of the 13 preparers incorrectly claimed the EITC; 10 preparers did not report income from other jobs such as babysitting; 8 did not report interest income; and 12 allowed testers to claim "head of household" status without being qualified for it.[17]

The IRS's own research has confirmed the link to RALs and tax fraud. Last year the IRS examined different sets of tax returns that had been audited, some with RALs or RACs and others without. They found that "propensity scoring methods indicate that there is a significant correlation between taxpayers who use RALs and noncompliance. RAL users are 27 percent -

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[11] Tom Herman, *Identity Thieves Target Tax Refunds,* Wall Street Journal, March 12, 2008.
[12] Complaint, United States v. Smart Tax of Georgia, Inc., 1:07CV-0747 (N.D. Ga. Apr. 2, 2007); Complaint, United States v. Smart Tax Inc., 07C-1802 (N.D. Ill. Apr. 2, 2007); Complaint, United States v. Sofar, Inc., Civ. No. 2:07-cv-11460 (E.D. Mich. Apr. 2, 2007); Complaint, United States v. Smart Tax of North Carolina, Inc., Civ. No. 5:07-cv-00125-FL (E.D.N.C. Apr. 2, 2007). Complaints at http://www.usdoj.gov/tax/txdv07215.htm.
[13] Tom Herman, *New York Sting Nabs Tax Preparers,* Wall Street Journal, Nov. 26, 2008.
[14] National Taxpayer Advocate, *FY 2007 Annual Report to Congress,* December 31, 2007, at 88.
[15] FinCEN, SAR Activity Review, Issue 7, August 2004, at 15-17.
[16] Chi Chi Wu, Kerry Smith, Peter Skillern, Adam Rust, and Stella Adams, *Tax Preparers Take a Bite Out of Refunds: Mystery Shopper Test Exposes Refund Anticipation Loan Abuses in Durham and Philadelphia*, National Consumer Law Center, Community Reinvestment Association of North Carolina, Community Legal Services of Philadelphia, April 2008, ("Durham/Philadelphia Mystery Shopper Report")
[17] Impact Alabama, *Impact Alabama Undercover Investigation of Commercial Tax Preparers in Alabama Results and Analysis*, Jan. 2009, on file with authors.

36 percent more noncompliant than taxpayers who do not use a bank product."[18] The researchers cautioned that the higher rate of noncompliance by RAL users does not prove that RALs cause tax fraud.

RALs Provide Preparers with Financial Incentives to Inflate Refunds

Financial incentives provided to tax preparers who sell refund anticipation loans encourage preparers to sell and promote RALs and can lead to preparers sometimes inflating a taxpayer's refund. Incentives include kickbacks per RAL, a 49.9 percent participation share in every RAL facilitated by Block for HSBC, and a lump sum from RAL lenders to Jackson Hewitt plus payment for reaching growth thresholds. Independent preparers can tack on a multiplicity of add-on fees on top of the RAL loan fee charged by the bank, ranging from $25 to several hundred dollars. Despite IRS rules prohibiting preparers from basing their fees on the refund amount, RAL compensation structures undermine this protection by compensating preparers for generating loans. We suspect that some preparers may even be inflating refunds to attract customers, then taking out a "cut" of the inflated refund in the form of high add-on fees – exactly the abuse that the IRS rules were designed to prevent.

Retailers who offer tax preparation and RALs want bigger refunds so they can sell a more expensive product to be paid for by the RAL. A bigger refund means a bigger check cashing fee for the check casher who prepares tax returns, or more money to pay off a loan for payday lenders and pawn shop operators who offer tax preparation and RALs to their customers.

RALs Attract Fringe Financial Outlets to Tax Preparation

RALs entice a particularly troubling type of tax preparer – the fringe financial preparer. Fringe preparers include businesses that are historically associated with the exploitation of consumers, such as payday loan stores, check cashers, and used car dealers, as well as retailers and businesses that target immigrant communities.

Government research reports confirm the prevalence of fringe preparers. In June 2008, the GAO released a report based on its mystery shopper testing of tax preparers in several states.[19] The investigation was limited to identifying types of businesses where RALs are marketed, and the information preparers disclosed to RAL applicants. Of 27 preparers open only during tax season, 13 were located in businesses that target low-income customers, such as check cashers, payday loan vendors, rent-to-own stores, and pawn shops.

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

[18] Karen Masken, Mark Mazur, Joanne Meikle, and Roy Nord, *Do Products Offering Expedited Refunds Increase Income Tax Non-Compliance*, Office of Research, Analysis and Statistics, Internal Revenue Service, 2008, at 15, on file with authors..

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

A fundamental problem with fringe preparers is the questionable quality of tax preparation. While software providers and remote tax preparation locations do offer back office support, often the retail salesperson at the fringe preparer is actively engaged in the preparation. The testing conducted in Durham and Philadelphia found several instances of incompetent tax preparation, including by one fringe preparer who essentially advised the tester to commit tax fraud. Testing conducted in Alabama found even more instances of incompetent or fraudulent tax preparation, including a small loan company that prepared a tester's return to show a $6,247 refund when the tester actually owed $112 to the IRS.[20]

Recommendations: The IRS should amend its regulations under Section 7216 to prohibit the sharing and/or use of tax return information for purposes of selling or arranging financial products. This proposal is to remove the "with consent" exception to the ban on secondary use of tax return information and is the position taken by consumer groups in prior comments to the IRS. The IRS should stop providing the debt indicator service which makes it possible for RAL banks to learn about other claims on applicants' expected tax refunds before deciding whether to extend credit. The federal government should not be sharing this personal information with banks and should not be operating what is essentially a free credit reporting service for banks. The IRS should support legislation to ban the sale of loans secured by tax refunds or at least based on the Earned Income Tax Credit and other benefits distributed through the tax system. IRS tax refund checks should only be direct deposited by the IRS into a bank account owned by and controlled by the taxpayer.

C. The IRS Should Improve Speed and Access to Tax Filing and Refunds

IRS Should Speed Up Delivery of Tax Refunds

One of the most critical reforms that will reduce or eliminate RALs is to speed the issuance of refunds from the current 8 to 15 days to a few days. The IRS CADE system will allow it to do so, but the GAO reported earlier this summer that the CADE program was being reevaluated.[21] The IRS should resume work on CADE or make other upgrades to speed up delivery of tax refunds. Faster delivery makes RALs less attractive, saving taxpayers hundreds of millions in RAL fees each year.

IRS Should Provide Free Electronic Tax Return Filing

Although the IRS provides Free File through a business consortium and encouraged a reduction in their electronic filing fees, the longer term solution is to make it possible for taxpayers to use tax return templates provided on the IRS website to prepare and electronically file their own tax returns for free without going through a third party intermediary. Permitting direct e-filing by consumers who have prepared their own tax returns using IRS templates available on the IRS website or using commercial software programs is not the same as "letting the IRS prepare your

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[20] Impact Alabama, *Impact Alabama Undercover Investigation of Commercial Tax Preparers in Alabama Results and Analysis*, Jan. 2009, on file with authors.

[21] Government Accountability Office, GAO-09-640, *Tax Administration - Interim Results of IRS's 2009 Filing Season*, June 2009.

taxes." Conflating these two concepts is deliberate obfuscation by those who wish to preserve the complete control of commercial preparers over electronic filing.

Enabling taxpayers to file electronically for free directly with the Internal Revenue Service will benefit taxpayers tremendously. It will save taxpayers the fees charged by some commercial preparers for electronic filing. It will permit electronic return filing without the opportunity for commercial marketing of extraneous products and services. By allowing free direct electronic filing with the IRS, taxpayers would be able to bypass commercial preparers that might exploit or share their personal, confidential tax information for non-tax purposes.

A free direct electronic filing program at www.irs.gov is long overdue. Americans have been able for years to apply for federal student financial aid on www.fafsa.ed.gov and for Social Security benefits at www.ssa.gov. Many states make it possible for citizens to file state tax returns electronically for free. The IRS even discontinued its Telefile program a few years ago, which was used by over three million taxpayers in 2005 to file their simple tax returns for free by calling the IRS with the necessary information.

Recommendations: Speed up delivery of tax refunds to make loans based on refunds less attractive and to better serve Americans. Provide a free electronic form and delivery system through IRS.gov so that consumers can complete their tax returns and file electronically directly with the IRS without making their information available to commercial providers.

Conclusion

The IRS should ban loans secured by expected tax refunds and institute licensing and supervision of tax preparers in order to safeguard consumers and the tax system. In addition the IRS should speed up the processing of tax refunds and make direct free electronic return filing available for taxpayers.