

# Practice

*By Charles P. Rettig and Kathryn Keneally*

## IRS Return Preparer Strategy: Leveraging Limited Tax Enforcement Resources Through the Registration and Education of the Return Preparer Community

Congress has historically kept the IRS somewhat confused and under funded while requiring it to “do more with less.” Practitioners roundly support the IRS efforts with respect to responsible enforcement and efficient tax administration. From 1997 to 1998, the Senate Finance Committee held hearings on perceived abuses by IRS employees (discredited by a subsequent GAO Report) that led to the IRS Restructuring and Reform Act of 1998 (“RRA ‘98”). RRA ‘98 substantially shut down ongoing tax enforcement efforts by, in part, threatening career IRS employees with termination if they committed any of the “10 deadly sins”<sup>1</sup> (by simply attempting to assess and collect what they believed to be the proper amount of tax due). RRA ‘98 changed the mission of the IRS on the theory that a better educated taxpayer would somehow become more tax compliant. Some have suggested that these enforcement lapses merely increased the ability of a better educated taxpaying public to become more tax noncompliant. The continued inability of Congress to simplify the tax code only serves to exacerbate an extremely sensitive situation.

Appropriately funding IRS enforcement efforts is a sound investment that Congress should not ignore but which will not appear on the horizon for the foreseeable future. The IRS must leverage its limited enforcement resources to remain a viable threat to those who believe that tax returns merely represent an initial offer to negotiate with the government. Total IRS enforcement revenue increased from \$33.8 billion in FY2000 to \$48.9 billion in FY2009. This increase in enforcement revenue was achieved with a substantially similar number of IRS enforcement personnel (20,832 in FY 2000 and 21,059 in FY2009). Audits of individual returns increased from 366,657 to 1,099,639



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between FY2000 and FY2009 (with a corresponding increase in the audit coverage rate from 0.49 percent to 1.03 percent). Audit coverage for individuals with income over \$1 million increased from 5.03 percent in FY 2000 to 6.42 percent in FY 2009. With the number of individual return filings increasing from 124 million in FY2000 to over 138 million in FY2009 (coupled with a corresponding increase in the filings of nonindividual returns), the IRS must remain vigilant in its enforcement efforts regardless of budget constraints.

If Congress will not radically increase the budget for IRS enforcement personnel operating with an increasingly more complex tax code, other methods must be pursued to improve tax compliance. Congress and the IRS have been attempting to leverage limited tax enforcement resources through an enhanced focus on tax practitioners. Modifications to the return preparer penalty provisions set forth in Code Sec. 6694 (and the regulations there under) and creating a more stringent IRS Office of Professional Responsibility (OPR) overseeing perceived violations of Circular 230 (“Cir 230”)<sup>2</sup> have received the attention of the practitioner community. OPR, formerly known as the Director of Practice, enforces the Cir. 230 regulations governing the practice of specified practitioners—attorneys, CPAs, enrolled agents, enrolled actuaries and appraisers—before the IRS. OPR also reviews applications from individuals who wish to become an enrolled agent or enrolled actuary.

OPR has the authority to impose suspension, disbarment or significant monetary fines on federally authorized tax practitioners, firms and other entities. Karen Hawkins, the Director of OPR, understands the tax profession. She has spent many years in the proverbial “tax trenches” living through the difficulties of “tax season” encountered by many preparers as well as the representation of clients who have been less-than-forthcoming with information responsive to valid IRS inquiries. She has a strong sense of “right and wrong” and can be expected to appropriately exercise her authority on behalf of OPR with respect to alleged Cir 230 violations by practitioners. However, Cir 230 has not historically governed the actions of all paid return preparers. As such, OPR has not had

any authority to possibly sanction the inappropriate behavior of many paid preparers who fall outside the purview of Cir 230.

## Paid Preparers

For 2007 and 2008, more than 80 percent of all federal individual income tax returns were prepared by paid preparers or by taxpayers using consumer tax preparation software resulting in approximately 86.6 million federal individual income tax returns being prepared by paid tax return preparers.<sup>3</sup> The actual number of paid preparers is difficult to determine without some type of registration process, but the IRS estimates that there are between 900,000 and 1.2 million individual paid preparers of tax returns.<sup>4</sup> Recent studies show that 94 percent of taxpayers who use paid preparers generally follow their advice.<sup>5</sup>

**A survey of the preparer community might find that many taxpayers fail to fully disclose all relevant facts to their preparer, but that survey will have to wait.**

Sixty-two percent of taxpayers said they follow their preparer’s advice all the time.<sup>6</sup> When facing potential penalties for their errant behavior, it is not surprising that most taxpayers would indicate that they were merely following the advice and recommendations of their preparer. A survey of the preparer community might find that many taxpayers fail to fully disclose all relevant facts to their preparer, but that survey will have to wait.

Preparers are generally subject to some degree of oversight, but the level of oversight depends on whether the preparer holds a professional license (attorney, certified public accountants, etc.), has been enrolled to practice before the IRS, chooses to file returns electronically and the jurisdiction where the returns are prepared.<sup>7</sup> Although many preparers are licensed by their states (e.g., attorneys and certified public accountants) and others are enrolled to practice by the IRS, many are not required to pass any government or professionally mandated competency requirements before preparing a tax return. They have no minimum requirements for education, knowledge training or skill before they prepare a return for a fee. Paid preparers are subject to civil penalties for actions ranging from knowingly preparing a return that understates the taxpayer’s liability to failing to sign or provide an identification number on a return

they prepare. Preparers who demonstrate a pattern of misconduct may be enjoined from preparing further returns. Additionally, the IRS may pursue and impose criminal penalties against a preparer.

## **Undercover Visits to Preparers**

The Government Accountability Office (GAO), the Treasury Inspector General for Tax Administration (TIGTA) and other organizations have conducted undercover visits to tax preparers in recent years and discovered extremely high rates of error and misconduct.<sup>8</sup> Using two fairly straightforward tax patterns, GAO found that preparers computed the wrong tax amount in 17 of 19 visits, with five returns showing unwarranted excess refunds of nearly \$2,000 and two returns requiring the GAO “taxpayer” to pay over \$1,500 more in tax than actually owed. In 10 cases, the preparers failed to report side income, and in several cases, they explicitly advised the GAO “taxpayer” that reporting the side income was unnecessary because the IRS would have no way to discover it. The results of the TIGTA study are substantially similar.<sup>9</sup> Years ago, IRS Criminal Investigation ran several undercover operations around the country focusing on practitioners focusing on offers in compromise. Several practitioners were later indicted for the “advice” they provided to IRS undercover agents on tape.

## **Recommendations by the National Taxpayer Advocate**

Since 2002, the National Taxpayer Advocate has recommended that the IRS develop a strategy to improve preparer competence, visibility, and accountability.<sup>10</sup> In her 2009 Annual Report to Congress, National Taxpayer Advocate Nina Olson recommended that the IRS develop a comprehensive return preparer strategy that includes (1) a requirement that all persons who prepare tax returns and interact with taxpayers obtain and use a unique identifying number (known as a PTIN); (2) a requirement that all unenrolled preparers pass an examination that tests basic return preparation knowledge and thereafter complete periodic continuing education courses; (3) a public awareness campaign to inform taxpayers of preparer requirements; (4) creation of a publicly available database listing all certified preparers; (5) a large-scale program of IRS preparer visits; and (6) due diligence requirements covering areas of significant noncompliance.

Similar recommendations have been postured by various IRS Advisory Organizations including the Taxpayer Advocacy Panel, the IRS Advisory Council, and the Electronic Tax Administration Advisory Committee.<sup>11</sup>

## **IRS Return Preparer Review**

During 2009, the IRS actively solicited public comments regarding the potential oversight of paid preparers from tax return preparers, the return preparation industry, other federal and state government officials, consumer advocacy groups and members of the public. The IRS sought to have the preparer review process be an open discussion of the issues with the return preparer community, the industry, consumer advocacy groups and the public. Three public forums were held and more than 500 individuals and groups provided written comments.

Comments received by the IRS overwhelmingly supported increased oversight of paid preparers, particularly for those who are not attorneys, certified public accountants or other individuals authorized to practice before the IRS. An IRS analysis of the comments received demonstrated that:

- 98 percent of the comments favored increased oversight and enforcement for paid preparers;
- 88 percent of those who expressed an opinion on registering paid preparers favored registration;
- 90 percent of the comments on education and testing favored minimum education or testing requirements for paid preparers;
- 98 percent of the comments on quality and ethics favored establishment of quality and ethics standards for paid preparers;
- 99 percent of the comments favored increased efforts regarding outreach and communication for paid preparers.<sup>12</sup>

The IRS Return Preparer Review analyzed the information received from the public forums and comments and made the following recommendations to improve preparer competence and oversight:

**A. Mandatory Registration for Preparers.** It is important for the IRS to be able to identify returns prepared by a specific preparer when attempting to determine whether the preparer may have engaged in a pattern of errant behavior. The IRS will require all individuals who are required to sign a federal tax return as a paid preparer to register and obtain a preparer tax identification number

(PTIN). Registration will make it easier for the IRS to locate and review the returns prepared by a tax return preparer when instances of misconduct are detected. All paid preparers are required to furnish an identifying number on any return that they are required to sign as a paid tax return preparer. Currently, the signing preparer may provide either a social security number or a preparer tax identification number that the IRS will issue to the tax return preparer on application. The use of more than one number by any signing preparer, however, makes it difficult for the IRS to collect accurate preparer data and to identify any specific individual tax return preparer.

The IRS may charge a reasonable, nonrefundable fee to register as a preparer. The preparer tax identification number will be the exclusive number used to identify any tax return preparer submitting returns to the IRS. The IRS intends to study the impact and necessity of expanding this registration requirement to nonsigning preparers in the future. Registration will be phased in and will be effective for three-year periods and require preparers to renew their registration every three years. Preparers also will be subject to a tax compliance check at the time of each renewal.<sup>13</sup>

**B. Competency Examination Requirement.** The IRS will establish competency testing for all paid preparers required to register with the IRS who are not attorneys, certified public accountants or enrolled agents. The IRS will assess the quality of return preparation by those exempted from testing (e.g. attorneys, certified public accountants, enrolled agents) to later determine whether there is a need to expand competency testing to include these individuals in the future. The IRS will perform suitability checks on paid preparers required to complete competency testing.<sup>14</sup> There will not be any “grandfathering” from these testing requirements based upon past preparation experience.

Initially, the IRS will offer two competency examinations: One examination will cover wage and nonbusiness income Form 1040 series returns; another examination will cover wage and small business income Form 1040 series returns. The IRS plans to add a third test to address the competency of the preparer with regard to business tax

rules after the three-year implementation phase is completed. The IRS will develop transition rules to avoid significant interruption of services to taxpayers during the initial testing period. The preliminary approach will require that competency testing requirements be met no later than the required renewal date for tax return preparer registration. Return preparers will be given three years from the initial implementation date of testing to pass the required examination(s).<sup>15</sup> Also, preparers testing during this initial implementation period may attempt to pass the examination as often as the examination is offered provided the applicable fee is paid for each attempt.

**C. Continuing Professional Education.** Most practitioners attend conferences and seminars to receive the latest information regarding tax law changes for the upcoming filing season. The IRS will require 15 hours of annual continuing professional education, including three hours of federal tax law updates, two hours of tax preparer ethics and 10 hours of federal tax law topics, for preparers who are required to register. The continuing professional education requirements will not apply to attorneys, certified public accountants, enrolled agents or others enrolled to practice before the IRS because these individuals generally must complete continuing education requirements to retain their professional credentials. Existing continuing education requirements for: (i) attorneys vary by State but average 10 to 15 hours per year; (ii) certified public accountants vary by state but range from 120 hours over 3 years to 20 hours per year; (iii) Enrolled Agents are 72 hours over 3 years with 16 hours minimum per year including 2 hours ethics/professional conduct. California registered preparers are required to have 20 hours of continuing education per year while registered preparers in Oregon are required to have 30 hours of continuing education per year.

The IRS will assess the quality of return preparation by those exempted from continuing professional education (e.g. attorneys, certified public accountants, etc.) to determine whether there is a need to expand continuing professional education to include these individuals in the future. The IRS will reach out to the various licensing authorities for attorneys, certified

public accountants and other tax professionals to encourage them to support annual continuing professional education that includes federal tax law topics and updates and ethics for those individuals who are licensed by them and who prepare federal tax returns. Preparers will be required to self-certify the completion of continuing professional education at the time of registration renewal. The IRS will perform random checks to verify compliance.

**D. Ethical Standards.** All signing and nonsigning preparers will ultimately be subject to the Cir 230. The authority granted to those individuals who do not have professional licenses and who are not enrolled agents, enrolled actuaries or enrolled retirement plan agents will be limited to preparing and representing their clients as currently permitted during an examination of any return prepared by the preparer. The authority of attorneys, certified public accountants, enrolled agents, enrolled actuaries and enrolled retirement plan agents to practice before the IRS will not change from the authority they have under current Cir 230.

The remaining preparers will be authorized to prepare returns and to represent a client before the IRS during an examination of any return that the preparer prepared for the client as they are currently permitted under the limited practice provisions in Section 10.7(viii) of Cir 230. The conduct of the preparer in connection with the preparation of the return and any representation of the client during an examination will be subject to standard of conduct in Cir 230. Further, inquiries into possible misconduct and disciplinary proceedings relating to tax return preparer misconduct will be conducted under Cir 230.

**F. Tax Return Preparer Enforcement.** The IRS will develop a comprehensive, service-wide enforcement strategy that utilizes data gathered through registration and other means to address individuals who fail to comply with the new IRS paid preparer regulations. This strategy will include the issuance of new policy guidance that applies significant examination and collection resources to preparer compliance. Additionally, the IRS intends to strengthen the relationships and coordination among its business units relating

to preparer compliance issues. The strategy will also include the IRS looking at ways to enhance the effectiveness of its traditional enforcement tools against preparers (e.g., tax return preparer and promoter penalties, program action cases, and injunctions). For example, the IRS intends to elevate the priority of preparer penalties in Collection. Further, the IRS proposes to recommend that the period of limitations under IRC §6696(d) for assessing a penalty under IRC §§6694(a), 6695 and 6695A be extended. The IRS is not recommending any new penalties or an increase in any penalty amounts currently, but will continue to study whether a recommendation might be appropriate in the future.

The IRS will study how to enhance the effectiveness of traditional enforcement tools and incorporate new non-traditional enforcement tools (e.g., directed notices and preparer visits) into the enforcement activities directed at preparers. The IRS will study the impact an enhanced return preparer enforcement strategy has on taxpayer compliance and consider further changes to the IRS enforcement strategy dependent on the outcomes realized. The IRS will increase the coordination among its operating divisions and increase the staffing of OPR to allow for increased investigations of practitioners, including preparer misconduct.

**G. Tax Return Preparation Software.** The IRS will establish a task force that will seek the input of the tax preparation software industry, state government representatives, and other relevant stakeholders to address identified risks associated with the dependence of tax administration on consumer and commercial tax preparation software, and discuss the possibility of establishing industry standards.

**H. Refund Settlement Products.** The IRS will convene a working group to review the refund settlement product industry. Part of this review will include analyzing opportunities to improve refund delivery options. The IRS will assess the effectiveness of its provision of the debt indicator on reduction of costs and improvements in service to taxpayers

**I. Public Awareness and Service Enhancements.** The IRS will develop a public awareness

campaign to educate taxpayers, paid tax return preparers, and IRS employees about the new standards and requirements for tax return preparers. The IRS will develop a searchable database of tax return preparers who have registered and passed the competency examination.

The foregoing IRS recommendations will take several years to implement fully and will not be in effect for the current 2010 tax season. However, the IRS is taking immediate action to increase their oversight of preparers for the 2010 filing season. The IRS is immediately beginning to send letters to approximately 10,000 paid preparers nationwide. These preparers are among those with large volumes of specific tax returns where the IRS has historically discovered frequent errors. The letters are intended to remind preparers to be vigilant in areas where the errors are frequently found, including Schedule C income and expenses, Schedule A deductions, the Earned Income Tax Credit and the First Time Homebuyer Credit. Thousands of preparers who receive these letters will also be visited by IRS Revenue Agents in the coming weeks to discuss their obligations and responsibilities to prepare accurate tax returns. Separately, the IRS will be conducting other compliance and education visits with return preparers on a variety of issues. In addition, the IRS will more widely use investigative tools during this filing season aimed at determining tax return preparer noncompliance. One of those tools will include visits to return preparers by IRS agents posing as a taxpayer. During this effort, the IRS has indicated that it intends to work closely with the Department of Justice to pursue civil or criminal action as appropriate.

## Summary

The IRS is to be commended for its efforts leading to the Return Preparer Review. These efforts will allow the IRS to locate and consider appropriate enforcement action against preparers who are most deserving. Responsible preparers may also receive an unwanted focus but should, hopefully, be able to explain their actions. Mainstream preparers should not be concerned about being accountable for efforts leading to the preparation and filing of tax returns. Accountability is good. Hopefully the IRS will similarly focus on educating their enforcement personnel about when consideration of preparer penalties would be inappropriate and when a referral to

OPR would be inappropriate. The IRS has the tools to determine which preparers may be deserving of a hard look and which may have, at most, committed a foot-fault.

The comment process was open and all were invited to express their views. Many longtime preparers will be disappointed at having to take a competency examination following years of diligent efforts preparing returns. However, many returns are received by the IRS each year that do not reflect a basic level of preparer competence. Improving the efficiency of the IRS in identifying returns having patterns of errors will improve compliance for those contacted by the IRS. It is difficult to argue against minimal continuing education requirements for preparers of returns in an ever-changing world of complex tax issues. Most preparers likely far exceed the minimal continuing education requirements set forth in the Return Preparer Review.

Our system of tax administration will, overall, be significantly improved by the new preparer registration and continuing education requirements. Competent preparers will hopefully not be greatly impacted by the new requirements once fully implemented. Less-than-competent preparers will become more competent or, at least, better educated. Preparers who attempt to circumvent the system or play some form of audit lottery will have a better chance of meeting Karen Hawkins, the Director of OPR!

Overall, the registration and education of the return preparer community combined with a continued strong focus on the preparer penalty provisions, should improve compliance while preserving limited tax enforcement resources. Preparers will likely tighten their focus and continue their diligent efforts to “do the right thing” in preparation for any later IRS inquiries. However, it should be remembered that preparers are not “tax cops” assisting the IRS in the administration of our system of taxation. Not yet...but we are getting closer. Also, as long as we have a federal judicial system, the IRS is not the ultimate decision-maker on what preparer conduct is subject to discipline. Not yet ...

## ENDNOTES

- <sup>1</sup> See Act Sec. 1203(b) of the IRS Restructuring and Reform Act of 1998 (P.L. 105-206).
- <sup>2</sup> Regulations governing practice before the IRS, are forth in Title 31, Code of Federal Regulations, Part 10, and are published in pamphlet form as Treasury Department Circular 230. The regulations prescribe the duties and restrictions relating to that practice and the disciplinary sanctions for violating the regulations. A copy of Circular 230 is available at [www.irs.gov](http://www.irs.gov).
- <sup>3</sup> Internal Revenue Service Office of Research.

- <sup>4</sup> IRS Office of Program Evaluation and Risk Analysis, Paid Preparer Review for National Public Liaison (Sept. 2007). The return preparer population is believed to consist of approximately 42,896 active Enrolled Agents; 646,520 certified public accountants (as of 2006); 1,180,386 attorneys; 123 enrolled retirement plan agents; and 82,653 volunteers. The number of unenrolled return preparers is unknown.
- <sup>5</sup> IRS, AES2 Taxpayer Survey, Question 13 (2009); IRS, Taxpayer Assistance Blueprint, Phase 2 (2007); Barr, Dokko, Tax Filing Experiences and Withholding Preferences of Low- and Moderate-Income Households: Preliminary Evidence from a New Survey (2006).
- <sup>6</sup> *Id.*
- <sup>7</sup> All states license attorneys and certified public accountants and four states have enacted legislation regulating return preparers generally. Oregon and California have been regulating return preparers since the 1970s. Maryland and New York have recently passed legislation and will begin regulating return preparers in the near future.
- <sup>8</sup> Government Accountability Office, Paid Tax Return Preparers: In a limited Study, Chain Prepares Made Serious Errors, GAO-06-563T (Apr. 4, 2006).
- <sup>9</sup> Treasury Inspector General for Tax Administration, Most Tax Returns Prepared by a Limited Sample of Unenrolled Preparers Contained Significant Errors, Rept. #2008-40-171 (Sept. 3, 2008).
- <sup>10</sup> The National Taxpayer Advocate's Annual Reports to Congress are available on the IRS Web site at [www.irs.gov/advocate/article/0,,id=97404,00.html](http://www.irs.gov/advocate/article/0,,id=97404,00.html).
- <sup>11</sup> Taxpayer Advocacy Panel, 2006 Annual Report, Appendix E (2006); Internal Revenue Service Advisory Council, General Report (2008), [www.irs.gov/taxpros/article/0,,id=188469,00.html](http://www.irs.gov/taxpros/article/0,,id=188469,00.html); Electronic Tax Administration Advisory Committee, Annual Report to Congress (June 2009), [www.irs.gov/pub/irs-pdf/p3415.pdf](http://www.irs.gov/pub/irs-pdf/p3415.pdf).
- <sup>12</sup> IRS Return Preparer Review (Dec. 2009).
- <sup>13</sup> For renewal of registration purposes, a tax compliance check is a limited review of the tax return preparer's filing and payment compliance history (*i.e.*, the IRS will ensure that the tax return preparer has filed his or her federal personal and business tax returns and that the tax due on those returns has been paid or the tax return preparer has reached an acceptable agreement with the IRS to satisfy any outstanding liabilities). Return preparers who are not in compliance will be referred to the OPR for possible disciplinary action.
- <sup>14</sup> Suitability checks may include criminal background checks and tax compliance checks. For purposes of a suitability check, a tax compliance check is a limited review of the tax return preparer's filing and payment compliance history.
- <sup>15</sup> Individuals required to pass the examination(s) will be permitted to register as tax return preparers and receive a preparer tax identification number during this initial implementation even if they have not passed the examination(s).

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