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Relation to Taxpayer Compliance with
Internal Revenue Laws

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STUDY OF THE ROLE OF PREPARERS IN RELATION TO TAXPAYER COMPLIANCE WITH INTERNAL REVENUE LAWS

Leslie Book*

I. Introduction

The use of paid tax return preparers has grown steadily.¹ Recent estimates indicate that 65 percent of all individuals use some type of paid tax return preparer.² No formal requirements or educational background are needed to either prepare a return or offer advice in connection with the preparation of a tax return, and there are many types of tax return preparers.³ Recent estimates indicate that there are around 1.2 million preparers, many of whom are accountants, attorneys, or enrolled agents (EAs), that is practitioners who are subject to their respective professions' standards for professionalism and conduct.⁴ Other preparers have no connection to formal professions, and are thus not subject to the professional standards for conduct or Treasury Circular 230's potential disciplinary proceedings for misconduct.⁵ Many of

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¹ See Michael Albert, Kim Bloomquist & Ron Edgerton, *Evaluating Preparation Accuracy of Tax Practitioners: A Bootstrap Approach*, 2007 IRS RESEARCH CONFERENCE 1 (2007). From 1996 to 2005, the number of individual income tax returns prepared by paid practitioners increased from 63 million to 80 million. The total number of tax returns prepared by paid preparers rose to 74 percent of total reported taxes. "This trend indicates the growing dependency of our nation's tax system on the tax preparation industry and it underscores the need for the Internal Revenue Service to better understand how commercial tax preparation influences reporting behavior." *Id.*

² Michael Albert, Kim Bloomquist & Ron Edgerton, *Evaluating Preparation Accuracy of Tax Practitioners: A Bootstrap Approach*, 2007 IRS RESEARCH CONFERENCE 1 (2007).

³ IRC § 7701(a)(36). The Internal Revenue Code defines an income tax return preparer as "any person who prepares for compensation, or who employs one or more persons to prepare for compensation, any return of tax imposed by subtitle A or any claim for refund of tax imposed by subtitle A. For purposes of the preceding sentence, the preparation of a substantial portion of a return or claim for refund shall be treated as if it were the preparation of such return or claim for refund." *Id.*

⁴ These categories of practitioners are all generally subject to examination, continuing education and ethics requirements. See National Taxpayer Advocate 2002 Annual Report 219-20; AICPA Code of Professional Conduct available at <http://www.aicpa.org/about/code/index.htm> (2006) (giving standards of conduct for all CPAs); ABA Model Rules of Professional Conduct available at http://abanet.org/cpr/mrpc/mrpc_toc.html (giving standards of conduct for all attorneys).

⁵ See 31 CFR §§ 10.1-10.93 (2005) (reproduced in Circular 230). Treasury Circular 230 sets forth standards for tax practice and establishes a series of potential disciplinary actions against those practitioners who violate those standards. See Treasury Inspector General for Tax Administration, *The Office of Professional Responsibility Can Do More to Effectively Identify and Act Against Incompetent and Disreputable Tax Practitioners*, No. 2006-10-066 (March 2006). The IRS is aware of approximately 800,000 people who are unenrolled tax preparers. Employees of large national return preparation chains undergo some training are subject to internal quality reviews. Some of these employees are subject to Treasury Circular 230 due to their status as CPAs, enrolled agents, or attorneys. See Robert Weinberger, *Comments on Treasury/IRS Notice of Proposed Rulemaking Modifying Regulations to Circular 230 Standards of Practice Before the Internal Revenue Service*, 2007 TNT 215-35 (Nov. 6, 2007) (stating that approximately five percent of HR Block's practitioners are "licensed under Circular 230"). Currently, California and Oregon are the only two states requiring enrollment and certification of all tax

those preparers file fewer than ten tax returns, and it seems likely that a large percentage of those preparers are employed in other activities and are unlikely to have significant experience or exposure to substantive tax law.⁶ All paid return preparers, including those who are not regulated by any licensing entity or subject to competency or continuing education requirements, must comply with certain requirements in connection with the preparation of a tax return, including signing the return⁷ and providing a copy of the return to taxpayers.⁸ Preparers are also subject to civil⁹ and

preparers. See Oregon Board of Tax Practitioners, http://egov.oregon.gov/OTPB/about_us.shtml (last visited Oct. 4, 2007); Certification and Licensing Requirements, http://egov.oregon.gov/OTPB/Certification_and_licensing_requirements.shtml; (California Tax Preparer Code of Conduct, <http://www.ctec.org/index.asp?pid=7> (presenting California's Code of Conduct for Tax Preparers which requires registration for a "person who, for a fee or other consideration, assists with or prepares tax returns"). While the states' requirements and obligations differ in both California and Oregon there is an exception for CPAs who hold a valid license from the State Board of Accountancy and attorneys who are active members of their respective state Bar Associations. In California, there is also an exception for enrolled agents who are enrolled to practice before the IRS. For a summary of the requirements necessary to become an enrolled agent. See Enrolled Agent Information, IRS Website, <http://www.irs.gov/taxpros/agents/article/0,,id=100710,00.html>. There have been legislative proposals to impose federal regulation of return preparers. See e.g., S. 882, The Tax Administration Good Government Act (based on recommendations made by the National Taxpayer Advocate in her 2002 Annual Report to Congress at 216-230).

⁶ National Taxpayer Advocate 2002 Annual Report to Congress 225 (looking at IRS 1999 filing year data).

⁷ IRC § 6695(b) (imposing penalties on tax preparers who do not sign returns). The Temp. Regs. Sec. 1.6695-1T(b) also requires that a return preparer sign each return he or she prepares after completing it and before presenting it to the taxpayer. In Notice 2004-54, the IRS authorizes return preparers to sign original returns, amended returns, and extension requests by rubber stamp, mechanical device or computer software program. These signing methods must include either a facsimile of the preparer's signature or his or her printed name. Return preparers using one of these alternative means are personally responsible for affixing their signatures to returns or extension requests. If they use an alternative signing method, they must provide all of the other preparer information required on returns and extensions, such as (1) name, address and relevant employer identification number (EIN), (2) individual ID number (Social Security number or preparer tax ID number) and (3) telephone number. For an overview of return preparer standards see Terri Guitierrez, *Return Preparer Penalties: A Comprehensive Review*, The CPA Journal; available at <http://www.nysscpa.org/cpajournal/2001/0600/features/f063401.htm>.

⁸ IRC § 6107(b) (requiring furnishing copy of tax return to taxpayer).

⁹ A summary of some of the applicable penalties follows:

Code Section (§)	Description	Penalty
6694(a)	Understatement of taxpayer's liability due to an unrealistic position (unrealistic position redefined in 2007)	An amount equal to the greater of: a) \$1,000 or 50% of the income derived (or to be derived)
6694(b)	Understatement of taxpayer's liability due to willful or reckless conduct (willful or reckless conduct redefined in 2007)	An amount equal to the greater of: a) \$5,000 or 50% of the income derived (or to be derived)
6695(a)	Failure to provide a copy of return to taxpayer	\$50 per failure
6695(b)	Failure to sign return	\$50 per failure
6695(c)	Failure to furnish identifying number	\$50 per failure
6695(d)	Failure to retain a copy or list of returns filed	\$50 per failure

even criminal¹⁰ penalties for improper conduct and the Code provides that the United States may bring a civil action to enjoin tax preparers if preparers engage in certain types of impermissible conduct.¹¹

Practitioners of all types can alleviate barriers to compliance, including computational difficulty and legal complexity. They can help ensure that taxpayers take advantage of benefits administered through the tax system, such as the earned income tax credit (EITC), and help the government with its objective of increasing electronic filing.¹² Yet, they also can contribute to taxpayers failing to comply with the internal revenue laws in a number of ways, including actively facilitating taxpayer intentional misconduct, failing to apply the law to a client's circumstances, misunderstanding the law (including overstating a taxpayer's liability), or failing to obtain relevant facts from clients.

6695(e)	Failure of employers to file correct information on each tax preparer employed	\$50 per failure
6695(f)	Negotiation of taxpayer's refund check	\$500 per check
6695(g)	Failure to be diligent in determining earned income tax credit eligibility	\$100 per failure
6701	Aiding and abetting understatement of tax liability	\$1,000
6713	Improper disclosure or use of return information	\$250 per disclosure up to a maximum of \$10,000
7206	Willful preparation of false or fraudulent return or other document	Up to \$100,000, 3 years imprisonment, or both
7207	Knowingly providing fraudulent returns or other documents to IRS	Up to \$10,000, 1 year imprisonment, or both
7216	Knowingly or recklessly disclosing or using return information	Up to \$1,000, 1 year imprisonment, or both
7407	Authority to enjoin income tax preparers*	

* For a summary of the IRS's current civil and criminal legal actions against preparers, see *Tax Return Preparer Fraud*, (Jan. 2007) available at <http://www.irs.gov/newsroom/article/0,,id=167391,00.html>.

¹⁰ See e.g. IRC §§ 7201, 7206, 7207 and 7216. Return preparers can be subject to criminal penalties for fraudulently preparing returns or other documents. The possible deterrent effect of criminal sanctions against preparers is limited by the difficulty associated with establishing the proof of mental state of the preparer, i.e., that the preparer knew the return was false as filed. Stuart Karlinksky & Joseph Bankman, *Developing a Theory of Cash Businesses Tax Evasion Behavior and the Role of their Tax Preparers*, 5TH INT'L CONFERENCE ON TAX ADMIN. 164 (2002).

¹¹ In April of 2007, Jackson Hewitt franchisees were served injunction suits in four different states. The complaints in the injunction suits can be found at <http://www.usdoj.gov/tax/txdv07215.htm>; *United States v. Smart Tax Inc.*, No. 07C-1802 (N.D. Ill. Apr. 2, 2007); *United States v. Smart Tax of Georgia Inc.*, No. 07CV-0747 (N.D. Ga Apr. 2, 2007); *United States v. Smart Tax of North Carolina*, No. 5:07-cv-00125-FL (E.D. N.C. Apr. 2, 2007); *United States v. So Far Inc.*, No. 2:07-cv-11470 (E.D. Mich. Apr. 2, 2007). The cases were recently settled. See Department of Justice, *Corporations That Owned Jackson Hewitt Franchises in Three States Agree to Be Barred From Tax Return Preparation*, (September 28, 2007), www.usdoj.gov/opa/pr/2007/September/07_tax_779.html.

¹² See U.S. Gov't Accountability Office, *Tax Administration: Most Taxpayers Believe They Benefit from Paid Tax Preparers, But Oversight For IRS is a Challenge* 7-8, GAO-04-70 (2003); Lin Mei Tan, *Research on the Role of Tax Practitioners in Taxpayer Compliance: Identifying Some of the Gaps*, TAXATION ISSUES IN THE TWENTY-FIRST CENTURY 15 (2006). Electronic filing significantly reduces IRS processing costs. See U.S. Gov't Accountability Office, *Most Filing Season Services Continue to Improve, But Opportunities Exist for Additional Savings* 7, GAO-07-27 (2006).

As discussed in this article, the research to date regarding how paid preparers affect tax compliance is inconclusive. Some research suggests that practitioners can use their expertise to exploit legal ambiguities.¹³ Research also suggests that practitioners in effect play a dual role; that is they serve to exploit ambiguity, but also tend to serve as enforcers of the law when the law is relatively clear.¹⁴ Reflecting, in part, this research, policymakers and academics alike have emphasized practitioners' role in noncompliance when there is the opportunity to take advantage of legally ambiguous issues. For example, in *Markets in Vice Markets in Virtue*, interviewing advisors in New York and Australia, John Braithwaite studied the rapid growth in tax shelters in the late 20th century. Braithwaite's study emphasized the role that tax advisors have played in the growth of tax shelters, and noted the contagion effect that supply-driven shelter advice can have on taxpayer norms¹⁵ and expectations.¹⁶ Likewise, in proposing solutions to compliance problems, many commentators have emphasized the practitioners' role in connection with positions characterized by legal ambiguity.¹⁷

Much of the compliance literature and a great deal of governmental efforts directed at return preparers are aimed at tempering practitioner's appetites for exploiting ambiguity. For example, Eric Toder notes that much of "the popular perception of the tax gap comes from articles and books that publicize how corporations and wealthy individual taxpayers use highly-paid tax lawyers and accountants to devise sophisticated schemes to reduce their tax liability to a small fraction of their economic income."¹⁸ Notwithstanding the importance of understanding and reducing the gap that is associated with practitioners' role in exploiting ambiguities, a significant amount of the tax gap relates to items that are not characterized by legal ambiguities. The tax gap data shows that a large portion of the underpayment rate relates to issues where there is not the same opportunity for creative tax advice to exploit ambiguities through engineering artificial losses or deferring the receipt of income.¹⁹ Changing the penalty

¹³ See Steven Klepper, Mark Mazur and Daniel Nagin, *Expert Intermediaries and Legal Compliance: The case of tax preparers*, 34 *Journal of Law and Economics* 205 (1991).

¹⁴ See *Id.*

¹⁵ For further discussion of tax norms in areas where advisors can exploit ambiguity or take advantage of literal interpretations to achieve large tax benefits, see Alex Raskolnikov, *The Cost of Norms: The Tax Effects of Tacit Understandings*, 74 *U. Chi. L. Rev.* 601 (2007) (discussing, for example, the hedging strategy of variable delivery prepaid forward contracts) available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=939174. Raskolnikov has also discussed the manner in which the penalty regime might better influence advisors and taxpayers, especially in areas of legal complexity and ambiguity. Alex Raskolnikov, *Crime and Punishment in Taxation*, 106 *Colum. L. Rev.* 569 (2006).

¹⁶ John Braithwaite, *MARKETS IN VICE MARKETS IN VIRTUE* (Oxford Univ. Press 2005) (2005).

¹⁷ See e.g. Linda Beale, *Tax Advice Before the Return: The Case for Raising Standards and Denying Evidentiary Privileges*, 25 *Va. Tax Rev.* 583, 587 (2006).

¹⁸ Eric Toder, *What is the Tax Gap?*, 117 *Tax Notes* 367 (Oct. 22 2007).

¹⁹ See *Id.* ("Sophisticated avoidance techniques may be thought of as coming in two general forms. The first involves the use of devices to hide income or transactions that if detected would clearly trigger increased tax liability. . . . [The] "second set of transactions straddle the boundary between tax avoidance (legal) and tax evasion (illegal). Often these consist of a series of separate transactions, all of them within the letter of the tax law, that reduces tax liability, but produce no expectation for pretax economic gain."). The literature surrounding the rise in tax shelters is voluminous. See also Sagit Leviner, *A New*

regime to impose greater requirements of legal certainty on positions²⁰ or changing Treasury Circular 230 requirements to encourage practitioners to temper aggressive tax reporting positions will not have much effect when the noncompliance does not relate to aggressive interpretations of the law, but rather relates to, for example, relatively unambiguous legal matters dependent on the accurate presentation of essential facts and practitioner understanding of complex but fairly unambiguous legal rules.

Recent tax gap data suggests that this duality approach is not nuanced enough to capture the true dynamics between taxpayers and practitioners, especially when one views the significant tax gap figures associated with relatively unambiguous areas of the law. The gross tax gap is the shortfall after the true tax liability has been paid voluntarily and on time, and the net tax gap is the shortfall less the amount paid late or collected through enforcement activities or through voluntary payments made after the original due date.²¹ Both gross and net tax gaps can be subdivided into three main components: the non-filing gap, the underreporting gap, and the underpayment gap.²² The underreporting aspect of the tax gap itself is divided into three elements: underreported income, overstated offsets, and net arithmetical mistakes.²³ The 2001 estimate of the underreporting tax gap amounts to approximately \$285 billion,²⁴ and the

Era of Tax Enforcement: From Big Stick to Responsive Regulation, University of Michigan John M. Olin Center for Law & Economics 1 (Updated Feb. 2007). See e.g. Linda Beale, *Tax Advice Before the Return: The Case for Raising Standards and Denying Evidentiary Privileges*, 25 Va. Tax Rev. 583, 587 (2006).

²⁰ Joint Committee on Taxation, Technical Explanation of the "Small Business And Work Opportunity Tax Act Of 2007" And Pension Related Provisions Contained in H.R. 2206 as Considered by the House of Representatives on May 24, 2007, JCX-29-07 (May 2007). For example, the Small Business and Work Opportunity Tax Act (SBWOTA) broadens the definition of tax return preparer to also include persons preparing estate and gift tax returns, excise tax returns, and employment tax returns; previously the definition centered on income tax return preparers. I.R.C. § 6694, PL 110-113. For tax return preparers, SBWOTA also replaces the realistic possibility standard for undisclosed positions with the requirement that there be a reasonable belief that the tax treatment was more likely than not the proper treatment. The non-frivolous standard is also replaced by the requirement that there be a reasonable basis for the tax treatment when accompanied by a disclosure. SBWOTA also increases penalties for the undisclosed positions as well as for willful or reckless positions. For a scathing criticism of these changes see Richard Lipton, *What Hath Congress Wrought? Amended Section 6694 Will Cause Problems for Everyone*, 107 Journal of Tax (forthcoming 2007) (noting the challenges that practitioner face in determining whether a position is more likely than not correct).

²¹ Eric Toder, *What is the Tax Gap?*, 117 Tax Notes 367 (Oct. 22, 2007).

²² James et al., *Role of Tax Agencies in Influencing Taxpayer Compliance*, 5th Int'l Conference on Tax Admin 168 (2004). For a discussion and summary of the 2001 tax gap estimates, see IRS, *Reducing the Federal Tax Gap* (Aug. 7, 2007). The IRS's 2001 estimates are as follows: the gross tax gap is at \$345 billion, and the net tax gap (that is payments that come in late, either through voluntary payments or enforced collection) is \$290 billion.

²³ James et al., *Role of Tax Agencies in Influencing Taxpayer Compliance*, 5th Int'l Conference on Tax Admin 168 (2004) The above definitions suggest a certainty, which may not exist depending on the questions of interpretation regarding the tax law. Often, tax compliance literature considers this from the perspective of what the state assumes is legally owed by taxpayers, but there are situations where the state and taxpayers do not share the same definition. Marcelo Bergman, *Criminal Law and Tax Compliance in Argentina: Testing the Limits of Deterrence*, 26 International Journal of the Sociology of Law 55-74 (1998).

²⁴ Eric Toder, *What is the Tax Gap?*, 117 Tax Notes 369 (Oct. 22, 2007). The underpayment gap is estimated at \$33.5 billion and the non-filing gap is estimated at 27 billion.

individual income tax amounts to about 69 percent of the gross underreporting tax gap. Of that portion of the gross tax gap, the underreporting of business income is by far the most significant, with 2001 estimates suggesting that sole-proprietor underreporting accounts for an enormous \$68 billion. While not as significant in terms of dollars, the tax gap associated with overstated credits, and the Earned Income Tax Credit (EITC) in particular, is likewise very important for policymakers. The EITC, which has become the nation's largest anti-poverty program, has been in the crosshairs²⁵ repeatedly over its thirty-plus year history as data suggests that close to one-third of the amount claimed is in fact claimed in error.²⁶ This report will focus on the reporting of sole proprietor income and the proper claiming of the EITC, two areas in the individual tax gap characterized by complicated but fairly straightforward rules.²⁷

Both EITC taxpayers and sole proprietors use practitioners to help complete and file their tax returns.²⁸ These returns often are characterized by error.²⁹ Some scholars are taking note of the differences associated with errors on practitioner-prepared returns that arise on issues that are not characterized by legal ambiguity. In a recent paper, authors Tackett, Antenucci, and Wolf³⁰ discussed the impact of client honesty and the role of preparers. The authors perceptively noted that while Circular 230 maintains that practitioners can be subject to sanction if they recommend a client take a position on a tax return that does not have a realistic possibility (a one in three chance) that the position would prevail in court, "there is no probabilistic standard for establishing when

²⁵ See Lawrence Zelenak, *Tax or Welfare? The Administration of the Earned Income Credit*, 52 UCLA L. Rev. 1867 (2005) (summarizing the administrative and legal efforts and noting over-weighted efforts at compliance directed at EITC); but see Dennis Ventry, *Welfare by Another Name: How We Can Save EITC*, 114 Tax Notes 955 (2007) (explaining that EITC is on much safer ground and that advocates' overstate the compliance risks to the continued validity of the EITC).

²⁶ For a discussion of the substantive EITC eligibility rules, as well as a discussion of the breakdown of EITC errors, see Leslie Book, *Preventing the Hybrid from Backfiring*, 2006 Wisc. L. Rev. 1103, 1110-14 (2006).

²⁷ This is not to say that there is no complexity associated with the proper reporting of sole proprietor income or claiming the EITC. For example, in the recent legislative changes providing for uniform definition of claiming of qualifying child, there are significant ambiguities that likely perplex informed and conscientious return preparers. See Tom Daley, *Unintelligent Design*, 111 Tax Notes 813 (May 15, 2006). Nonetheless, while there are grey areas (e.g., the distinction between expenses that must be capitalized and those that can be deducted), the underreporting in these areas is largely related to the treatment of items not steeped in ambiguity or legal uncertainty. C.f. Joseph Bankman, *The Story of Indopco: What Went Wrong in the Capitalization v Deduction Debate*, TAX STORIES: AN IN-DEPTH LOOK AT TEN LEADING FEDERAL INCOME TAX CASES (Paul Caron, ed. 2003).

²⁸ Data on the use of commercial preparers among EITC claimants is found in Janet Holtzblatt & Janet McCubbin, *Issues Affecting Low-Income Filers*, THE CRISIS IN TAX ADMINISTRATION 148, 178-79 (Henry J. Aaron & Joel Slemrod eds., 2004). Researchers have likewise shown that sole proprietors are increasingly using paid preparers. Charles Christian, Sanjay Gupta, & Suming, 46 National Tax Journal 487-504 (1993).

²⁹ See Leslie Book, *Preventing the Hybrid from Backfiring: Delivery of Benefits to the Working Poor Through the Tax System*, 2006 Wis. L. Rev. 1103 (2006). "Recent studies indicate that a significant amount of EITC overclaims are associated with returns which commercial practitioners prepare. Of the approximately \$11 billion in upper-range estimated erroneous EITC claims made in 1999, approximately 57 percent of the overclaims were attributable to returns prepared by commercial return preparers." *Id.*

³⁰ James Tackett, Joe Antenucci, and Fran.Wolf, *Profiling Fictitious Tax Data*, 116 Tax Notes 953 (Sept. 10, 2007).

preparers should reject client tax data (or a client) because of integrity issues.”³¹ The authors also noted that preparers often give their clients the benefit of the doubt regarding the integrity of the data that clients provide, and consider the possibility that many preparers can be “unwitting participants in the filing of falsified tax returns.”³² At the same time, the authors acknowledge that some unscrupulous preparers are not just duped, but are active participants in the misstating of information on tax returns.³³

Analogizing return preparers to auditors, who because of Sarbanes-Oxley³⁴ have been charged with a greater responsibility in ensuring integrity of the financial data associated with public companies, Taxett, Antenucci, and Wolf suggest that Congress may up the ante on preparers, and expect them to play a stronger role in taxpayer compliance.³⁵ While no perfect fit exists in the preparer/auditor analogy,³⁶ Taxett, Antenucci, and Wolf

³¹ James Tackett, Joe Antenucci, and Fran Wolf, *Profiling Fictitious Tax Data*, 116 Tax Notes 953 (Sep. 10, 2007). Note that with the SBWOTA changes discussed above, the standard for sanction has changed, and the IRS will likely modify Treasury Circular 230 to reflect these changes. See Proposed Treas. Circ. 10.34(a).

³² James Tackett, Joe Antenucci, and Fran Wolf, *Profiling Fictitious Tax Data*, 116 Tax Notes 953 (Sep. 10, 2007). Due diligence is required under Circular 230 when practitioners are (1) preparing or assisting in the preparation of, approving, and filing tax returns, documents, affidavits, and other papers relating to IRS matters; (2) determining the correctness of oral or written representations made by the practitioner to the Department of Treasury; and (3) determining the correctness of oral or written representations made by the practitioner to clients with reference to any matter administered by the IRS. 31 CFR §§ 10.22 (2005). For CPAs, the Statement on Standards for Tax Services (STS) sets forth the role of the return preparer in relation to verifying facts essential for the completion of a tax return. STS No. 3 emphasizes that the ultimate responsibility for the accuracy of the return lies with the taxpayer, and that a return preparer “may in good faith rely, without verification, on information furnished by the taxpayer or by third parties.” In addition, STS No. 3 clarifies that the preparer does not generally have a duty to examine or verify supporting data; however, the standards also state that the preparer “should not ignore the implications of information furnished and should make reasonable inquiries if the information furnished appears to be incorrect, incomplete, or inconsistent either on its face or on the basis of other facts known to a member.” Statement on Standards for Tax Services No. 3, Certain Procedural Aspects of Preparing Returns; available at <http://ftp.aicpa.org/public/download/members/div/tax/ssts2.pdf>. Return preparers are subject to specific due diligence rules in connection to the preparing of tax returns in which an individual is claiming the EITC. The role of strengthening preparers’ due diligence requirements in connection with a broader discussion of self-regulation and enforced self-regulation will be discussed in upcoming research connected with this project.

³³ See James Tackett, Joe Antenucci, and Fran Wolf, *Profiling Fictitious Tax Data*, 116 Tax Notes 953 (Sept. 10, 2007).

³⁴ Pub. L. No. 107-204, 116 Stat. 745, 107th Congress – 2nd Session (2002). For a more general description of Sarbanes-Oxley legislation and its effect on lawyers and those practicing before the SEC, see Susan Saab Fortney, *National Symposium on the Role of a Corporate Lawyer: The Anticipated and Actual Effect of Sarbanes-Oxley on Corporate Lawyer’s Conduct*, 33 Cap. U.L. Rev. 61 (2004).

³⁵ James Tackett, Joe Antenucci, and Fran Wolf 116 Tax Notes 953 (Sep. 10, 2007). The authors suggest that return preparers can be better equipped to address errors that are tied to clients furnishing false numerical information through increasing the use of digital analysis, a fraud detection method used by forensic accountants and certified fraud examiners.

³⁶ Unlike in the corporate context, it is very difficult to costlessly rely on the public and class action bar to seek out and punish improper tax return preparers, whereas the gatekeeper function is more readily available when there is publicly available financial data and the mechanism of class action lawsuits can seek out and significantly punish improper auditor conduct. See Stuart Karlinsky, and Joseph Bankman, *Developing a Theory of Cash Businesses Tax Evasion Behavior and the Role of their Tax Preparers*, 5th

are on the right track with their exhortation that Congress and others consider that preparers may be in a position to ensure that clients behave better when it comes to more accurately reporting their tax liabilities.

This report will review the literature relating to the practitioners' influence on tax compliance. Rather than identify practitioners as exploiters or enforcers, this report will examine from a ground-up perspective the underlying causes of errors associated with two systemic issues that have had widely reported and studied noncompliance problems: the reporting of sole proprietors' income and the claiming of the earned income tax credit. Drawing on a wide range of sources, including existing third-party empirical, behavioral, and theoretical research, IRS studies, and my own experiences as a director of a Low Income Taxpayer Clinic (LITC), this report will consider in a more nuanced manner a typology of the practitioners' role in sole proprietor and EITC noncompliance. In a subsequent report, I will refine the typology further, postulate a theoretical context for legislative and administrative changes to assist in encouraging practitioners to act in a way that may possibly encourage taxpayers to file correct tax returns, and make specific proposals that policymakers may wish to adopt or study further to test effectiveness.

It is my intention that this report will help inspire discussion for an agenda for additional qualitative and quantitative research that may assist policymakers in designing and implementing proposed solutions that have, at their core, an assumption that practitioners can play an increasing role in creating taxpayer compliance norms, and assisting taxpayers in filing more accurate tax returns.³⁷ In particular, it is my hope that

Int'l Conference on Tax Admin. n.202 (2002). Cf. Dennis Ventry, *Whistleblowers and Qui Tam for Tax*, Tax Lawyer (forthcoming) (2007) (discussing the recently revamped tax whistleblowing program and suggesting that the tax system can improve on this model by adopting a whistleblowing program modeled on the False Claim Act).

³⁷ Professor Coffee suggests two core elements necessary for increased reliance on gatekeepers to help control the behavior of other actors:

1. The gatekeeper must have significant reputational capital, acquired over many years and many clients, which it pledges to assure accuracy of statements it makes or verifies; and
2. Relative to the principal, the gatekeeper receives a smaller payoff for its role as certifying, approving or verifying information.

See John Coffee, *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 BU L. Rev. 301 (2004). A problem in the tax law area is that many unenrolled return preparers have no or little reputational capital, and while the payoff individually is small, the preparers themselves make significant profits through mass return preparation. An additional problem with gatekeeper reliance, as Coffee notes, however, is there are also principal/agent problems, when "cowboys" within the agent's organization risk reputational capital to a degree that the firms would not. See *id.* at 310. This was in part the defense that Jackson Hewitt raised in connection with recent allegations of preparer misconduct at certain of its franchise operations, as it conducted an internal review of its operations and suspended the franchisees named in the civil lawsuits. See *Jackson Hewitt Launches Internal Review of Allegations Against Franchisee*, Jackson Hewitt Tax Services Inc., <http://ir.jacksonhewitt.com/phoenix.zhtml?c=177359&p=irol-newsArticle&ID=982454&highlight=>; *Jackson Hewitt Announce Temporary Suspension of Franchised Businesses Named in U.S. Lawsuits*, Jackson Hewitt Tax Services Inc., <http://ir.jacksonhewitt.com/phoenix.zhtml?c=177359&p=irol-newsArticle&ID=983018&highlight>. For a further discussion of the Jackson Hewitt lawsuits, see *infra* note 51.

a more complete understanding of the dynamics of noncompliance among practitioner-prepared returns will create opportunities for the IRS to rigorously test proposed solutions, with the additional use of pilot programs and use of control groups and field studies.³⁸

II. The Use of Preparers

Some preparers, such as attorneys, CPAs, and enrolled agents (EAs), have passed entrance examinations and are subject to continuing education requirements, and also subject to licensing requirements and disciplinary proceedings.³⁹ According to the Treasury Inspector General for Tax Administration (TIGTA), using data from 2005 tax account information, it is estimated that there are 137,928 attorneys, 181,237 CPAs, 25,610 EAs, and 62,397 representatives with multiple Circular 230 designations.⁴⁰ Yet, because anyone, regardless of education or training, can prepare federal income tax returns,⁴¹ the definition of preparer includes unlicensed preparers. Some are self-employed, though preparers can work for a variety of different types of enterprises, including law firms, CPA firms, and large national chains of return preparers such as H&R Block, Jackson Hewitt, and Liberty.⁴²

Governmental efforts that have the goal of changing the behavior of tax return preparers will only be effective if there is a causal connection between return preparer behavior and taxpayer compliance decisions. See Stuart Karlinsky & Joseph Bankman, *Developing a Theory of Cash Businesses Tax Evasion Behavior and the Role of their Tax Preparers*, 5th Int'l Conference on Tax Admin. n.162 (2002); see also Andrew D. Cuccia, *The Effects of Increased Sanctions on Paid Tax Preparers: Integrating Economic and Psychological Factors*, 16 the Journal of the American Taxation Association 42 (1994). The risk of any compliance strategy focusing on preparers gives rise to the possibility that taxpayers will seek out other preparers not affected by governmental actions, or self-prepare returns and continue to misreport. This risk is especially inherent if the noncompliance relates to issues in which the taxpayers do not feel they need assistance in misreporting, and if there are established taxpayer norms which suggest an acceptance of tax evasion. Nonetheless, this report takes as a starting assumption that at least some preparers do and can play a causal role in client decisions to comply, and that the government can play a stronger role in encouraging practitioners to positively influence taxpayer compliance decisions.

³⁸ See Ian Ayres, SUPER CRUNCHERS, WHY THINKING BY NUMBERS IS THE NEW WAY TO BE SMART *Batnam* 63-69 (2007) (discussing the successful government use of randomized testing and regression analysis to help determine the effectiveness of proposals to reduce various State's unemployment insurance payments). Ayres emphasizes that intuition and experience alone are insufficient as tools for predictive government and business policies, but notes the essential role that experience can play in helping consider the relevant variables that researchers should test. Ayres, at 124. In a sense, Ayres sets out the case for a deep human understanding of the dynamics of the problem at hand, but argues forcefully that the understanding should form the basis for rigorous statistical analysis, and cautions against "theorizing as an end in itself...." Ayres, at 125.

³⁹ For a summary of the myriad of ways such practitioners are registered, See National Taxpayer Advocate 2003 Annual Report to Congress 270. As mentioned above, two states, California and Oregon require return preparers to register with the state.

⁴⁰ Treasury Inspector General For Tax Administration, *The Office of Professional Responsibility Can Do More to Effectively Identify and Act Against Incompetent and Disreputable Tax Practitioners* 17, Table 4, 2006-10-066 (2006).

⁴¹ For a further discussion of estimates of the number of enrolled preparers see *supra* note 5; See 31 CFR § 10.7(e) (2005).

⁴² The three largest national chain return preparers are H&R Block, Jackson Hewitt, and Liberty. H&R Block is the largest, with Jackson Hewitt second, and Liberty the smallest of the three. H&R Block states that the "U.S. clients served constituted 16.1 percent of an IRS estimate of total individual income tax

The preparer's tasks consist of: 1) preparing the actual tax forms; 2) identifying items that may affect the taxpayer's liability; and 3) advising clients on resolving any uncertainty that may exist as to tax consequences of ambiguous items.⁴³ A significant amount of research exists surrounding why taxpayers seek preparers, including: the taxpayer's belief that he or she benefited from using a paid practitioner; the taxpayer did not understand the tax laws; the taxpayer lacked the time and patience to complete the returns on his or her own;⁴⁴ and the taxpayer's fear of audit, or a belief that the use of a preparer minimized audit risks.⁴⁵

In addition to completing and filing tax returns, preparers are often responsible for identifying items that affect tax liability and educating taxpayers about the tax law's application to the particular individual's circumstances. Preparers often, though not always, sell tax-related products or services to individuals seeking to have their returns completed,⁴⁶ especially with respect to the EITC. Preparers are required under internal revenue laws to identify themselves on the tax return, and are subject to due diligence requirements⁴⁷ and civil and criminal penalties for inappropriate conduct.⁴⁸ There are specific due diligence requirements that apply to practitioners preparing returns where the taxpayer files for the EITC.⁴⁹

returns filed as of April 30, 2007, compared to 15.7 percent in 2006 and 15.6 percent in 2005." The IRS estimates that 134.5 million individual income tax returns were prepared in 2005, and thus H&R Block prepared about 20 million of these. See Individual Income Tax Returns, Preliminary Numbers, <http://www.irs.gov/pub/irs-soi/05inplim.pdf>. Jackson Hewitt states, in its annual report, that it prepared 3.65 million individual tax returns in 2007 in the United States. See Jackson Hewitt Ann. Report, http://library.corporate-ir.net/library/17/177/177359/items/257860/JTX_2007AR.pdf (2007), (last visited Oct. 30, 2007). Liberty's Annual Report states that it prepared 1.5 million returns in the United States and Canada in 2007. See Liberty Annual Report, <http://www.libertytax.com/uploadedFiles/Files/2007%20Liberty%20Tax%20Annual%20Report.pdf> (2007).

⁴³ See Lin Mei Tan, *Research on the Role of Tax Practitioners in Taxpaying Compliance: Identifying Some the Gaps*, TAXATION ISSUES IN THE TWENTY-FIRST CENTURY 15 (ed. Sawyer) (2006); Andrew D. Cuccia, *The Effects of Increased Sanctions on Paid Tax Preparers: Integrating Economic and Psychological Factors*, 16 the Journal of the American Taxation Association 42 (1994). The Government Accountability Office, in a broad survey of taxpayers, noted that taxpayers chose to use preparers for a variety of reasons, including a lack of understanding of the laws, lack of time or patience to complete their own returns, and the belief that preparers would help facilitate the receipt of a larger or quicker refund. U.S. Government Accountability Office, *Tax Administration: Most Taxpayers Believe They Benefit From Paid Tax Preparers, But Oversight for IRS is a Challenge* 7-8, GAO-04-70 (2003).

⁴⁴ U.S. Government Accountability Office, *Tax Administration: Most Taxpayers Believe They Benefit From Paid Tax Preparers, But Oversight for IRS is a Challenge* 7-12, GAO-04-70 (2003).

⁴⁵ Lin Mei Tan, *Research on the Role of Tax Practitioners in Taxpaying Compliance: Identifying Some the Gaps*, TAXATION ISSUES IN THE TWENTY-FIRST CENTURY 17 (Sawyer ed. 2006).

⁴⁶ See *Tax Return Preparation Options for Taxpayers: Hearing Before the Senate Finance Committee 3-4 (Apr. 4, 2006)* (written statement of Nina E. Olson, National Taxpayer Advocate discussing how tax practitioners have become a place for the cross marketing of goods and services).

⁴⁷ I.R.C. § 6061. (discussing signing of returns and other documents). For a further discussion of requirements and related penalties see *supra* note 7.

⁴⁸ See *supra* note 9. I.R.C. §§ 6694(a)-(b), 6107(a)-(b), 6695(a)-(g), 6713(a), 7407(a), 7201, and 7206(1)-(2).

⁴⁹ I.R.C. § 6695(g) (imposing penalty for failure to comply with due diligence requirements with respect to EITC). Applicable regulations describe these requirements. Reg. § 1.6695-2, and the IRS summarizes these rules at: EITC Resources Online for Tax Professionals: Meeting Due Diligence Requirements

III. Errors

Recent GAO investigations of preparer errors,⁵⁰ widely publicized Department of Justice civil injunction proceedings highlighting franchisees of a national chain return preparer's active facilitation of bogus taxpayer refunds and overstated deductions,⁵¹ and Congressional testimony have focused on the role that preparers play in the tax gap.⁵² There is a growing sense that with the increased use of professional preparers in the tax system, the IRS would be better served to understand their role in taxpayers' decisions to comply with the tax laws.⁵³

For example, the recent Government Accountability Office (GAO) study that focused on the quality of returns prepared by preparers affiliated with national chains highlights the need for additional information to assist policymakers in understanding the dynamics of noncompliance. The GAO study was based upon investigators testing one of two scenarios at 19 outlets of several commercial preparers in a metropolitan area. The GAO study relied upon a mystery shopper approach, whereby GAO staff posed as taxpayers in one of two scenarios. In the first scenario, the staff member posed as a plumber who had most of his income reported, but who also had some side income that

available at <http://www.irs.gov/businesses/small/article/0,,id=168366,00.html> (describing due diligence requirements and applicable penalties for failing to meet requirements).

⁵⁰ See generally Government Accountability Office, *Paid Tax Return Preparers: In A Limited Study, Chain Preparers Made Serious Errors*, GAO-06-563T (2006). This study focused on tax returns prepared by paid tax return practitioners at nineteen different cites. GAO staff posed as taxpayers and had tax returns prepared by practitioners at the different cites. The results demonstrated issues with each of the returns ranging from small misstatements that had no effect on the tax, to large mistakes causing an effect on tax to be paid or the refund to be received.

⁵¹ For a discussion of the civil injunction proceedings, see David Ranni, *Jackson Hewitt Owners Deny Wrongdoing*, News & Observer (May 18, 2007), <http://newsobserver.com/business/v-print/story/575475.html>; *Jackson Hewitt Mess Hurts All Franchisees*. (Apr. 4, 2007), <http://www.franchisepick.com/jackson-hewitt-franchise-mess-hurts-all-franchisees>. The complaints in the injunction suits can be found at <http://www.usdoj.gov/tax/txdv07215.htm>; *United States v. Smart Tax Inc.*, No. 07C-1802 (N.D. Ill. Apr. 2, 2007); *United States v. Smart Tax of Georgia Inc.*, No. 07CV-0747 (N.D. Ga Apr. 2, 2007); *United States v. Smart Tax of North Carolina*, No. 5:07-cv-00125-FL (E.D. N.C. Apr. 2, 2007); *United States v. So Far Inc.*, No. 2:07-cv-11470 (E.D. Mich. Apr. 2, 2007). The cases were recently settled. The cases have been resolved. See Department of Justice, *Corporations That Owned Jackson Hewitt Franchises in Three States Agree to Be Barred From Tax Return Preparation*, (Sept. 28, 2007), www.usdoj.gov/opa/pr/2007/September/07_tax_779.html.

⁵² See GAO 2007 Tax Filing Season Interim Results and Updates of Previous Assessments of Paid Preparers and IRS Modernization and Compliance Research Efforts: Hearing Before Sen. Fin. Comm. 110th Cong. 2 (2007) (statement of James R. White, Dir. Strategic Issues and statement of David A. Powner, Dir. Information Technology Management Issues); *Filing Your Taxes: An Ounce of Prevention is Worth a Pound of Cure: Hearing Before the Senate Fin. Comm.*, 110th Cong. (2007) (statement submitted by AICPA); *Filing Your Taxes: An Ounce of Prevention is Worth a Pound of Cure: Hearing Before the Senate Fin. Comm.*, 110th Cong. (2007) (statement of Mark Everson, Commissioner of IRS); *Filing Your Taxes: An Ounce of Prevention is Worth a Pound of Cure: Hearing Before the Senate Fin. Comm.*, 110th Cong. (2007) (statement of Michael R. Phillips, Deputy Inspector Gen. for Audit Treasury Inspector Gen. for Tax Admin.).

⁵³ See Government Accountability Office, *Interim Results and Updates of Previous Assessments of Paid Preparers And IRS's Modernization and Compliance Research Efforts* 4-5, GAO-07-720T (2007) (noting GAO mystery study and commenting on the importance of research relative to the tax gap).

was not reflected on Forms W-2. He had enough deductions so that it was advantageous for him to itemize deductions. In the other scenario, the staff member posed as a single mother who worked as a retail sales clerk, but who also had income from babysitting. She had one child who lived with her, and one who did not.

The study found major errors, especially with respect to the EITC and the reporting of side income. In the GAO study the preparers did not report side income in ten of 19 cases, and the preparers did not ask about where a child lived or ignored answers to the question, and claimed an ineligible child for the EITC in five out of the ten applicable cases.⁵⁴ In cases where side income was an issue, preparers gave the mystery shoppers a variety of advice. Several mystery shoppers were informed that “such income was the decision of the taxpayer because the IRS would not know of it unless it was reported.”⁵⁵ Discussions of side income usually also ended up in advice of expenses to offset the income.⁵⁶

The GAO study caused quite a stir, inspiring, in part, congressional hearings⁵⁷ and garnering a fair bit of media attention.⁵⁸ While informative, the GAO test, at the same time as highlighting problems, raised some important overall questions of the role that preparers play, especially in connection with fairly straightforward tax rules. The GAO report indicated the possible factors behind the high error rates; namely, it referred to the broad range of experience and lack of training of national chain employees, and to different standards paid preparers are governed by.⁵⁹ The GAO recommended that the IRS conduct research into the extent that preparers are living up to their responsibilities, and asked the IRS to consider whether the GAO’s use of its mystery shopper

⁵⁴ Government Accountability Office, *Paid Tax Return Preparers: In A Limited Study, Chain Preparers Made Serious Errors*, GAO-06-563T, (2006).

⁵⁵ *Id.*

⁵⁶ *Id.*

⁵⁷ In 2007, the Senate Finance Committee held a hearing discussing many of the issues pointed out by the 2006 GAO study. The hearing included an update from the GAO on actions taken by the IRS in response to the 2006 study as well as statements from the Commissioner of the IRS. See generally *Filing Your Taxes: An Ounce of Prevention is Worth a Pound of Cure: Hearing Before the Senate Fin. Comm.*, 110th Cong. (2007) (statement of Mark Everson, Commissioner of IRS); *Filing Your Taxes: An Ounce of Prevention is Worth a Pound of Cure: Hearing Before the Senate Fin. Comm.*, 110th Cong. (2007) (statement of Michael R. Phillips, Deputy Inspector Gen. for Audit Treasury Inspector Gen. for Tax Admin.); *GAO 2007 Tax Filing Season Interim Results and Updates of Previous Assessments of Paid Preparers and IRS Modernization and Compliance Research Efforts: Hearing Before Sen. Fin. Comm.* 110th Cong. 2 n.3 (2007) (statement of James R. White, Dir. Strategic Issues and statement of David A. Powner, Dir. Information Technology Management Issues).

⁵⁸ See Albert Crenshaw, *Some Tax Preparers Don’t Add Up: Test of Commercial Firms Finds Errors in 19 of 19 Returns*, Washington Post (April 5, 2006) available at <http://www.washingtonpost.com/wp-dyn/content/article/2006/04/04/AR2006040401863.html> (detailing findings of GAO study).

⁵⁹ Different types of paid preparers (CPAs, attorneys, EAs, and unenrolled preparers) are subject to different governing standards. As discussed above, CPAs and attorneys may also be subject to different rules within the governing body of their professions. See Government Accountability Office, *Paid Tax Return Preparers: In A Limited Study, Chain Preparers Made Serious Errors*, GAO-06-563T, (2006).

methodology was something that the IRS should employ to better gauge the quality of services that return preparers provide.⁶⁰

IV. Theoretical Context of Tax Gap Research

A. Tax Compliance Generally

Before considering the literature surrounding practitioners' role in tax compliance, it is important to understand the broader tax compliance research context in which this literature exists.⁶¹ Over the past thirty years a significant amount of research from a variety of social science disciplines considered tax compliance. Economists, psychologists and sociologists have contributed to the discussion, offering research and at times conflicting explanations regarding the dependent variable of whether a person is likely to comply with his obligations to file an accurate tax return.⁶² In the jargon of social science research, the unifying theme among this research is a search for explanatory reasons, referred to as independent variables, to help explain the factors that lead to noncompliance. The disciplines' approach to research reflects differing approaches to how and why the variables might be related and the various disciplines' choice of which variables to focus on reflects, in part, their assumptions about what motivates human behavior.

In broad terms, the economic models of tax compliance assume rational behavior, and that people will coldly consider compliance from the perspective as to whether the expected utility to noncomply exceeds the utility from complying. To that end, researchers relying on the economic model looked to a variety of independent variables likely to affect the calculus, including penalty rates, the likelihood of audit, and the tax

⁶⁰ There has not been significant research into the quality of commercial return preparation, though the Casey Foundation has sponsored a limited research project. See Amy Brown for the Annie E. Casey Foundation, *Quality in Free and Commercial Tax Preparation: Results from the 2006 Tax Season* (June 2006). This study did a review of both free tax preparation sites as well as a small number of commercially prepared returns. The reviews looked at all aspects of each federal tax return. Seventy-three percent of all returns reviewed that had been prepared by paid practitioners had mistakes. Sixty-seven percent of returns prepared by tax practitioners contained material mistakes, *i.e.* those which changed the refund amount. By comparing the data of both the GAO and Casey Study, it can be seen that the mistakes found were similar. *Id.* The Casey Foundation and others have reviewed quality and error rates at various free return preparation sites, and similarly have found that many sites suffer from significant error rates. *Id.* See also Dustin Stamper, *IRS to Test Accuracy of Returns Prepared at Volunteer Income Tax Assistance Sites* 2007 TNT 222-6 (Nov. 15, 2007) (addressing IRS concerns for VITA sites having just over 50 percent accuracy in recent years); Treasury Inspector General for Tax Administration, *Accuracy of Volunteer Tax Returns Is Improving, but Procedures Are Often Not Followed*, 2007-40-137 (Aug. 29, 2007) (reviewing preparation of income tax returns at IRS volunteer sites).

⁶¹ This overview is similar to that I summarized in Leslie Book, *Freakonomics and the Tax Gap: An Applied Perspective*, 56 *Amer. L. Rev.* 1163 (2007).

⁶² I am indebted to the excellent theoretical overview of the respective social sciences approach to tax compliance research in Neil Brooks, *Challenge of Tax Compliance*, *TAX ADMINISTRATION: FACING THE CHALLENGE OF THE FUTURE* 19 (Eds. Evans and Greenbaum) (1998).

rate and income level.⁶³ This research has become quite sophisticated. There are numerous studies testing the variables that economists believe contribute to taxpayers' decisions to comply with the tax laws.⁶⁴

Psychologists and sociologists have rightly pointed out that the economic model is insufficient as an explanatory tool. Sociologists and psychologists alike argue that framing a taxpayer as an amoral utility maximizer fails to capture the complexities of human behavior and relationships, and fails to explain why compliance rates exceed what would otherwise be expected if people were solely evaluating compliance in terms of dollars and cents.⁶⁵ According to Erich Kirchler:

the financial self-interest model assumes that tax compliance and evasion are outcomes of rational decisions based on audit probability, detection probability and sanctions. On the other hand, the behavioural model of tax evasion includes economic, psychological and sociological variables such as demographic characteristics (e.g., education, income level, income source, occupation) social representations and attitudes (e.g., tax ethics, and social norms, fairness perceptions), and structural characteristics (e.g., complexity of the system, audit probability and detection probability, sanctions, and tax rates). Based on the rather small effects of variables considered in the neoclassical economic approach (i.e., audit probability, fines, marginal tax rate and income), several studies conclude that it is important to consider also citizens' acceptance of political and administrative actions and attitudinal, moral and justice issues as they are central to psychological and sociological approaches. Andreoni, Erard and Feinstien consider the development of purely economic models of tax compliance from a perspective of game theory and principal agent theory. However, they add, these models are rather poor descriptions of real-world tax systems.⁶⁶

The research provides little in the way of a united theory on tax compliance. As Professor Brooks aptly summarizes, in a perfect or even merely orderly world the research would lead to:

a theory about why people comply with the tax law from which an interested tax administration department could deduce a comprehensive compliance strategy. No such theory has emerged from the research. Like much empirical research, we end up learning how much we do not know. In some of the research, it is difficult to be sure which way causation runs...in more controlled experiments

⁶³ Erich Kirchler, *THE ECONOMIC PSYCHOLOGY OF TAX BEHAVIOUR* 160 (Cambridge University Press 2007) (2007).

⁶⁴ For an excellent summary of the empirical research implicating the rational model of tax compliance, see Erich Kirchler, *THE ECONOMIC PSYCHOLOGY OF TAX BEHAVIOUR* 107-18 (Cambridge University Press 2007) (2007).

⁶⁵ E.g., Cooter & Eisenberg, *Symposium Norms and Corporate Law: Fairness, Character, and Efficiency in Firms*, 149 U. Pa. L. Rev. 1717, 1725 (2001).

⁶⁶ Erich Kirchler, *THE ECONOMIC PSYCHOLOGY OF TAX BEHAVIOUR* 160 (Cambridge University Press 2007) (2007).

conducted to test for causation there are problems generalizing the results...and theories based on some research have become so complex that they explain everything, by tautology.⁶⁷

The tax compliance literature is often lacking the sweep of context, of true understanding of patterns of human behavior.⁶⁸ To date, the quantitative approach to tax compliance has failed to offer satisfactory predictive generalizations. One perceptive commentator, Margaret McKerchar, in addressing the shortfalls in the compliance literature, notes that research has been driven by the need to find a model fitting all possible types of compliance behavior with the goal of the research to allow predictions to be made about the taxpaying population in general. "In doing so, assumptions ...were often unrealistic and therefore reduced the usefulness of the model to policymakers and administrators. For example, it is unlikely that taxpayers are all utility maximizers, risk averse or rational decision makers. . . . [P]eople exist in a dynamic environment where there are a great deal of influences, of which some are inconstant and others may not yet been identified or studied by researchers."⁶⁹

Facing the inadequacy and shortfalls of the existing compliance literature, Professor McKerchar noted that researchers and policymakers would be better served by abandoning the search for a single model of taxpayer compliance, and considering the use of differing models "to explain differing types of compliance behaviour." McKerchar continued by emphasizing the importance of identifying the various typologies of noncompliance,⁷⁰ and urges that additional studies relate to actual observed taxpayer behavior and focus group study.⁷¹

B. Tax Practitioner Research

There is relatively little IRS data, publicly released, that identifies and compares errors between self-prepared and practitioner-prepared returns.⁷² Like the tax

⁶⁷ Neil Brooks, *Challenge of Tax Compliance*, TAX ADMINISTRATION: FACING THE CHALLENGE OF THE FUTURE 22 (Evans and Greenbaum, eds. 1998).

⁶⁸ See Pauline Niemiowski, Steve Baldwin and Alex Wearing, Thirty Years of Tax Compliance Research: of What Value Is It to the ATO, TAX ADMIN. IN THE 21ST CENTURY 211-12 (Walpole and Evans, Eds.) (2001). These authors note studies identifying 64 variables for noncompliance, and bemoan the contradictory and inconclusive research: "Beliefs, personality traits, demographic variables and tax rates, opportunity, propensity to evade, and various external variables have also contributed to understanding compliance behaviour. Yet despite the extensive research, there is still a paucity of consistent reliable predictors or explanations of causality." *Id.*

⁶⁹ Margaret McKerchar, *Why Do Taxpayers Comply*, TAX ADMIN. IN THE 21ST CENTURY 242 (Walpole & Evans, Eds.) (2001).

⁷⁰ I began this project of applying the useful Kidder/McEewn typology to low income taxpayers in 51 Kan Law Rev 1145 (2003) and continued it with a focus on commercial tax return preparers in my article in the Wisconsin Law Review, see generally Leslie Book, *Preventing the Hybrid from Backfiring: Delivery of Benefits to the Working Poor Through the Tax System*, 2006 Wis. L. Rev. 1103 (2006).

⁷¹ Margaret McKerchar, *Why Do Taxpayers Comply*, TAX ADMIN. IN THE 21ST CENTURY 242 (Walpole & Evans, Eds.) (2001).

⁷² See Eric Toder, *What is the Tax Gap?*, 117 Tax Notes 392 (Oct. 22, 2007) (stating that while the IRS has revitalized its tax gap research program since 2000, there are some measures of noncompliance

compliance literature generally, the literature regarding the role that practitioners play in compliance has been growing in recent years but also is inconclusive. In a recent sweeping review of the studies to date, Professor Lin Mei Tan, at Massey University in New Zealand, stated that “it is not clear whether the tax practitioner is part of the tax compliance problem. Neither is it clear as to how ethically sensitive they are. What is clear is that they can influence the taxpayers’ compliance behavior.”⁷³ This insight is crucial for it holds out the hope for governments that they can, in some way, influence practitioners to influence taxpayers to comply with the internal revenue laws.

Key questions involve to what extent practitioners influence compliance decision of their clients, and to what extent the government uses tools to help practitioners be agents for greater taxpayer compliance or influence taxpayers in a manner that contributes to less non compliance. Professor Tan wrote extensively on the issue, looking at studies that considered the reasons for using tax practitioners, the studies exploring preferences for types of advice, how taxpayers choose their practitioner, and how taxpayers evaluate the services they receive. Studies from the tax practitioner’s perspective considered whether the use of a tax practitioner would result in lower compliance, and analyzed the variables that are related to practitioners’ willingness to be aggressive. Studies that have considered practitioner aggressiveness fall within three main categories: 1) decision context features (*e.g.*, legal ambiguity, practitioner penalties, probability of audit, size of tax benefit); 2) client’s characteristics (*e.g.*, client importance, risk preferences, year-end financial condition of client) and practitioner characteristics (*e.g.*, practitioner demographics, including age, experience and education level; practitioner risk attitudes; type of practitioner; and size of establishment where practitioner works). Some of those studies are described below.

C. Who is the Real Instigator of Aggressive Advice?

Wading through the empirical evidence and studies leads to an inconclusive answer to the question as to who instigates noncompliant behavior, the taxpayer or the practitioner. The type of advice given by tax practitioners is usually classified as either “conservative” or “aggressive.” Hite and McGill defined aggressive as “taking a pro-taxpayer position on a questionable item.”⁷⁴ In their study, an aggressive position was “a situation where there is some reasonable probability that a particular tax return will not be upheld by an IRS review and subsequently legal challenge.”⁷⁵ They researched a random sample of U.S. residents with a hypothetical scenario.⁷⁶ The study showed taxpayers tended to agree with conservative advice from their practitioners but disagree

where there is a need for additional information, including “relative compliance rates among taxpayers who prepare returns by hand, prepare returns with software, and use paid preparers”). *Id.*

⁷³ Lin Mei Tan, *Research on the Role of Tax Practitioners in Taxpaying Compliance: Identifying Some the Gaps*, TAXATION ISSUES IN THE TWENTY-FIRST CENTURY 27 (Sawyer ed. 2006).

⁷⁴ Peggy Hite & Gary McGill, *An Examination of Taxpayer Preference for Aggressive Tax Advice*, 45 National Tax Journal 389, 390 (1992).

⁷⁵ *See Id.*

⁷⁶ *See Id* at 389, 392.

with aggressive advice.⁷⁷ This suggests taxpayers prefer to be on the “safe side.”⁷⁸ Hite and McGill found that taxpayers do not prefer aggressive advice, and therefore suggested that “professional experience and tax education inculcates potential tax advisors with a prevailing professional culture of aggressive tax planning.”⁷⁹

In a study discussing how professional standards of conduct mitigate aggressive reporting by tax professionals, Cuccia, Hackenbrack, and Nelson concluded that a professional “made an aggressive reporting decision if the practitioner selects the reporting position that portrays events favorably when that position is not indicated clearly by the facts and relevant professional literature.”⁸⁰ The study looked at practitioner’s actions when a standard is vague. The experiment provided subjects with “either an incentive to report aggressively or conservatively and a practice standard which employed a vague, verbal threshold.”⁸¹ Their results show that those who had an incentive to report aggressively made more liberal interpretations of the standard than those who had an incentive to report conservatively.⁸²

L. M. Tan conducted a study in New Zealand, based on the Hite and McGill study, on the taxpayer’s preference for the type of advice.⁸³ The group surveyed was a more focused group, using business taxpayers, most of whom engage tax practitioners to preparer their tax returns.⁸⁴ Tan found that most taxpayers tend to agree with advice, conservative or aggressive, given by their practitioner. This supports the notion presented by Hite and McGill that tax practitioners are the ones encouraging the aggressive positions as the taxpayers tend to agree with whatever advice is presented by their preparer.⁸⁵

While Hite and McGill and Tan’s studies proposed that the tax practitioner pushes aggressive advice on the taxpayer, Schisler’s study suggested that it is in fact the taxpayer who is the instigator of aggressive tax advice.⁸⁶ Schisler conducted an

⁷⁷ See Peggy Hite & Gary McGill, *An Examination of Taxpayer Preference for Aggressive Tax Advice*, 45 National Tax Journal 389, 398 (1992).

⁷⁸ *See Id.*

⁷⁹ *Id.*

⁸⁰ Andrew D. Cuccia, et al., *The Ability of Professional Standards to Mitigate Aggressive Reporting*, 70 Accounting Review (1995).

⁸¹ *Id.*

⁸² *Id.*

⁸³ Lin Mei Tan, *Research on the Role of Tax Practitioners in Taxpaying Compliance: Identifying Some the Gaps*, TAXATION ISSUES IN THE TWENTY-FIRST CENTURY (ed. Sawyer) (2006).

⁸⁴ *Id.*

⁸⁵ Peggy Hite & Gary McGill, *An Examination of Taxpayer Preference for Aggressive Tax Advice*, 45 National Tax Journal 398 (1992). A number of studies have likewise found that a majority of taxpayers want their tax return preparer to file accurate tax returns, with minimizing taxes not the primary taxpayer objective. *E.g.*, Collins, Milliron and Toy in Journal of the American Taxation Association (1990); Yuka Sakurai, and Valerie Braithwaite, *Taxpayer’s Perceptions of the Ideal Tax Adviser: Playing Safe or Saving Dollars?*, Centre for Tax System Integrity, Working Paper No. 5 (May 2001), available at <http://ctsi.anu.edu.au/publications/WP/5.pdf>.

⁸⁶ D.L. Schisler, *An Experimental Examination of Factors Affecting Tax Preparer’s Aggressive – A prospect theory approach*, 16 The Journal of American Taxation Association 124 (1994).

experimental study in the United States.⁸⁷ “As compared to tax practitioners, taxpayers are found to be more aggressive with tax due, to have lower equity perception of the tax system, and are more aggressive when ambiguous tax issues are involved.”⁸⁸ This is contrary to the findings of Hite and McGill and Tan. Klepper and Nagin, in their study, analyzing data from the TCMP and Pennsylvania Department of Revenue, found that practitioners tend to improve compliance on items that are clear, but tend to help taxpayers exploit ambiguity by taking aggressive positions on ambiguous items.⁸⁹

Some studies support the view that practitioners view taxpayers as instigators of aggressive advice, but also recognize that the search for a single model that explains the complex dynamics of practitioner/taxpayer interaction is likely inadequate. Sakurai and Braithwaite,⁹⁰ for example, classify practitioners into three distinct types: 1) honest and risk adverse, 2) cautious minimizers of tax, and 3) the creative and aggressive planner. Sakurai and Braithwaite concluded that the latter is the least popular in terms of taxpayer preference, but that this aggressive practitioner type is of particular concern. They suggested that taxpayers are inclined to seek out preparers who share their values.⁹¹ This insight is consistent with Karlinsky and Bankman’s study of sole proprietor noncompliance, where sole proprietors intent on minimizing income sought preparers they knew who would be comfortable with their approach.⁹² It is also consistent with Albert, Bloomquist and Edgerton’s study of underreporting, which suggests that a relatively small amount of practitioners are responsible for a disproportionate share of underreporting of certain types of income.⁹³ Likewise, Kidder, and McEwen, adapting a sociological approach, postulated that there are different types

⁸⁷ See D. L. Schisler, *An Experimental Examination of Factors Affecting Tax Preparer’s Aggressive – A prospect theory approach*, 16 *The Journal of American Taxation Association* 124 (1994).

⁸⁸ *Id.*

⁸⁹ See Steven Klepper & Daniel Nagin, *The Role of Tax Preparers in Compliance*, 22 *Policy Sciences* 167-94 (1989).

⁹⁰ Yuka Sakurai, and Valerie Braithwaite, *Taxpayer’s Perceptions of the Ideal Tax Adviser: Playing Safe or Saving Dollars?*, Centre for Tax System Integrity, Working Paper No. 5 (May 2001), available at <http://ctsi.anu.edu.au/publications/WP/5.pdf>.

⁹¹ *Id.* at 22.

⁹² See Stuart Karlinsky & Joseph Bankman, *Developing a Theory of Cash Businesses Tax Evasion Behavior and the Role of their Tax Preparers*, 5TH INT’L CONFERENCE ON TAX ADMIN. 164 (2002). Albert, Bloomquist, and Edgerton found that many errors were committed more frequently by self preparers, but that there was a higher incidence of potential Automatic Underreporting Program (AUR) misreporting (e.g. wages, mortgage interest, stock refunds and other items backstopped by third party information returns) among clients of paid practitioners. Albert, Bloomquist, and Edgerton found an inverse relationship between firm size and incidence of misreporting. In a case study focusing on Connecticut, the authors found that a small number of preparers was responsible for both a “significant percentage of potential AUR cases as well as the associated net underreporting amount” *Id.* at 14. For example, the top 10 firms in Connecticut, in terms of number of AUR cases, accounted for 2.6 percent of Connecticut filers with potential misreporting and 4.7 percent of the almost \$5.8 billion in net underreporting amount. *Id.* at 12-13 Table 5. The top 50 Connecticut filer accounted for 8.4 percent of all potential misreporting and a significant 11.4 percent of net potential underreporting amount. *Id.*

⁹³ See Michael Albert, Kim Bloomquist & Ron Edgerton, *Evaluating Preparation Accuracy of Tax Practitioners: A Bootstrap Approach*, 2007 IRS RESEARCH CONFERENCE (2007).

of practitioners, those that broker or facilitate compliant behavior, and those that facilitate noncompliant behavior.⁹⁴

As Professor Tan indicated in her Research in *The Role of Tax Practitioners in Taxpayer Compliance: Understanding the Gaps*,⁹⁵ there are significant shortfalls in the literature to date:

The literature to date is not clear as to whether taxpayers are instigators of aggressive advice or whether tax practitioners comply with such demands. It is also not clear whether it is in fact the practitioner who influences their clients' tax compliance behaviour. With their reliance on tax practitioners, it is possible that some clients who prefer conservative advice may also be convinced by their practitioners to accept aggressive advice. Furthermore, it is also possible that practitioners may have incorrectly inferred the preferences of their clients.

Most prior studies failed to take into account the interactions between the taxpayers and their practitioners. Most studies were conducted from either the perspective of the taxpayer only or the practitioner only. These two categories of studies therefore present only one side of the picture. There is certainly a lack of knowledge of how tax practitioners and their clients interact or what the practitioner-client relationship is. This is a potential area for future research.⁹⁶

Tan's perceptive critique focused largely on practitioners' influence with respect to positions that have at their core some degree of uncertainty. Yet, the literature has not focused on practitioner influence on items that are not characterized by ambiguity. For unambiguous items, individuals present themselves to practitioners in three broad ways: 1) they want help in preparing their tax returns correctly; 2) they want assistance in

⁹⁴ See Robert Kidder & Craig McEwen, *Taxpaying Behavior in Social Context: A Tentative Typology of Tax Compliance and Noncompliance*, in 2 TAXPAYER COMPLIANCE 47 (Jeffery Roth et al. eds., 1989).

⁹⁵ Lin Mei Tan, *Research on the Role of Tax Practitioners in Taxpayer Compliance: Identifying Some of the Gaps*, TAXATION ISSUES IN THE TWENTY-FIRST CENTURY (ed. Sawyer) (2006).

⁹⁶ Lin Mei Tan, *Research on the Role of Tax Practitioners in Taxpayer Compliance: Identifying Some of the Gaps*, TAXATION ISSUES IN THE TWENTY-FIRST CENTURY (ed. Sawyer) (2006) (citations omitted). Tan notes that there are a number of areas that are ripe for additional research, including the following:

- An interesting research area that could be further explored is to what extent practitioners are willing to give in to the demands of their clients or to what extent clients are willing to adopt practitioners' advice
- Who (the client or the practitioner) has the greater influence on tax decisions?
- Does the length of the working relationship between the client and practitioner have any effect on the tax decision making?
- What factors steer the working relationship between the practitioner and the client?
- Is tax practitioners' advice affected by the firm size of their clients or other factors?
- Are practitioners client-driven?
- How do practitioners balance the requirements of the tax law, their clients' interest, their professional responsibilities and the demands of the organization that they work in?

Lin Mei Tan, *Research on the Role of Tax Practitioners in Taxpayer Compliance: Identifying Some of the Gaps*, TAXATION ISSUES IN THE TWENTY-FIRST CENTURY (ed. Sawyer) (2006).

facilitating the taking of improper positions, with assistance taking a variety of different forms; or 3) they do not have a strong preference and look to their practitioners for guidance.

As Sakurai and Braithwaite suggested, some practitioners, regardless of client preference, will not knowingly facilitate underreporting of sole proprietor income, nor will they assist people in claiming an EITC incorrectly. When taxpayers intent on underreporting visit that group of practitioners, practitioners may be able to moderate taxpayer behavior, though more research is needed to examine this. For example, how moderating can practitioners be? Can Congress or the IRS encourage practitioners to assist in encouraging taxpayers toward compliance without alienating taxpayers or contributing to taxpayers' potential concerns that practitioners may not have sufficient loyalty to their clients? If practitioners can, at least at the margin, temper improper taxpayer behavior, what actions should the government take to encourage taxpayers to visit the "right" type of preparers and educate preparers on the actions they can take to become positive influences on compliance? What role does skills and ethics training play in practitioners' willingness to facilitate or tolerate noncompliance? Should the government require only certain types of preparers to prepare more complex returns, or returns that research indicates have a potential for misreporting or error? Do we know enough about the characteristics or identities of practitioners who facilitate noncompliance, or is more research needed so we can better identify those practitioners? Should the government provide incentives to taxpayers or practitioners to facilitate the use of better or perhaps regulated preparers, or impose additional burdens or costs on those who fail to use preparers that will have a tendency to facilitate compliance?

The above questions, McKerchar and Brooks' critique of tax compliance research generally, and Tan's critique of the tax compliance literature as it relates to practitioners, are all premised on a need for a deeper and layered approach to understanding the decision to comply with the tax laws. Researchers who seek deeper understanding have often turned to more qualitative approaches to problems. Few researchers have attempted to undertake a more qualitative analysis of tax noncompliance, which would allow for an inquiry that would include a search for contextualized findings.⁹⁷ There are varying definitions in the social science literature, but qualitative social science research methodology has at its core an "interpretive, naturalistic approach to its subject matter,"⁹⁸ and is an "inquiry process of understanding based on distinct methodological

⁹⁷ For a refreshing example of a qualitative approach to reviewing noncompliance, see Joseph Bankman & Stuart Karlinsky, *Tax Evasion Behaviour and the Role of Their Tax Preparers*, in 5TH INTERNATIONAL CONFERENCE ON TAX ADMINISTRATION 136 (Walpole and Fisher eds. 2002) . In their paper, the authors spoke with hundreds of independent contractors, business owners, information users and paid tax preparers, on conditions of confidentiality. Given the sensitive issues (including the possibility that the behavior of the subjects could give rise to civil and criminal sanction), the authors spoke on conditions of confidentiality, and some interviews were conducted on a web site that did not record the interviewee's IP address, and others were arranged over a web site and then conducted without the authors obtaining identification.

⁹⁸ THE HANDBOOK OF QUALITATIVE RESEARCH (Denzin & Lincoln, eds., Sage Publications) (1994).

traditions of inquiry that explore a social or human problem⁹⁹ involving the use and collection of a variety of empirical materials, including case studies, personal experience, focus groups, interviews, and participant observation. Unlike quantitative research, which seeks to generate data, and allow researchers to reach reliable and repeatable conclusions, qualitative research looks to collect data from the above methods, and generate ideas and hypotheses from these data largely through what is known as inductive reasoning.¹⁰⁰ The strength of good qualitative research is that it uses a variety of data collection methods, that should touch the core of what is going on rather than skimming the surface.¹⁰¹ The goal of this type of research is to build a complex picture that goes beyond a focus on causal relationships, and would allow policymakers and researchers to gain a nuanced understanding which would create opportunities for researchers to hypothesize and test solutions that could then be subjected to rigorous statistical analysis.¹⁰²

Kidder and McEwen likewise emphasized the importance of exploratory ethnographic research and interviews as a basis for understanding the role of practitioners, suggesting that the role of practitioners may best be learned by observing interactions between practitioners and taxpayers. Kidder and McEwen recommended the creation of standard tax scenarios, and recommended bringing those scenarios to different preparers to evaluate how they treat specific tax situations.¹⁰³

⁹⁹ THE HANDBOOK OF QUALITATIVE RESEARCH (Denzin & Lincoln, eds., Sage Publications) (1994).

¹⁰⁰ See Adri Labuschagne, *Qualitative Research - Airy Fairy or Fundamental?* 8 *The Qualitative Report* 1 (Mar. 1, 2003), available at <http://www.nova.edu/ssss/QR/QR8-1/>.html. See also Steven J. Taylor & Robert Bogdan, *Introduction to Qualitative Research Methods*, Wiley, (1998).

¹⁰¹ See Adri Labuschagne, *Qualitative Research - Airy Fairy or Fundamental?* 8 *The Qualitative Report* 1 (Mar. 1, 2003), available at <http://www.nova.edu/ssss/QR/QR8-1/>.html. See also Steven J. Taylor & Robert Bogdan, *Introduction to Qualitative Research Methods*, Wiley, (1998); Bent Flyvbjerg, *Five Misunderstandings About Case Study Research*, 12 *Qualitative Inquiry* 219, 244-45 (2006) (at 244-45) (stating that good social science research often combines qualitative and quantitative research methods).

¹⁰² See Margaret McKerchar, *Why Do Taxpayers Comply*, TAX ADMIN. IN THE 21ST CENTURY 242 (Walpole & Evans, Eds.) (2001) (suggesting that a theoretical base can arise from working “backward[s] from outcome to decision processes to influence” with the possibility of this understanding leading to an appreciation of predictors which can also be tested quantitatively). In his insightful book, *Super Crunchers*, Professor Ian Ayres, in extolling the virtues of statistical analysis, rather than intuitive based decision-making, likewise recognizes that intuition and hypothesizing are crucial first steps toward statistical testing of possible solutions to problems. See Ian Ayres, *SUPER CRUNCHERS*, *Batnam* 124-125 (2007). The approach I suggest here is not an end in and of itself, but will hopefully assist policymakers in designing potential administrative and legislative solutions that can be subjected to careful statistical analysis, including the possible use of randomized testing and demonstration projects. *Id.* at 64-80.

¹⁰³ See Robert Kidder & Craig McEwen, *Taxpaying Behavior in Social Context: A Tentative Typology of Tax Compliance and Noncompliance*, in 2 *TAXPAYER COMPLIANCE* 69-70 (Jeffery Roth et al. eds., 1989). Kidder and McEwen also suggest that researchers spend time as an assistant to the offices of practitioners or taking a temporary job at a national chain, with the purpose of understanding the role of practitioners through observation. *Id.* at 69.

V. Overview of the Role of the Practitioner in Sole Proprietor and EITC Noncompliance

The tax gap in 2001 attributable to the individual income tax was estimated at 245 billion¹⁰⁴ and accounted for 71 percent¹⁰⁵ of the total tax gap. The underreporting portion of the tax gap is the most significant of the overall gap. Individuals have increasingly turned to third parties, or tax return preparers, to prepare their tax returns. For example, in 2005, 80 million tax returns were prepared by paid practitioners, up from 63 million tax returns only nine years before.¹⁰⁶ In 2005, 62 percent of all tax returns were completed and signed by paid practitioners.¹⁰⁷

With the increased use of preparers it is becoming increasingly important to understand what role those preparers play in tax compliance. One interesting question is the role that practitioners play in facilitating the underreporting aspect of the tax gap, and, in particular, noncompliance among taxpayers who either overstate deductions or credits or who underreport income. The underreporting of the tax gap, and the way that the government can address the underreporting tax gap, has been the subject of increasing academic and governmental attention.¹⁰⁸ One area that has received relatively little attention is the role that practitioners play in tax noncompliance, especially in relation to items or taxpayers where there is little legal uncertainty.¹⁰⁹ This project is an attempt to raise questions and identify areas for future qualitative and quantitative research regarding the role of practitioners in tax compliance.

An important premise of this project is that there is not one particular compliance problem associated with the tax system, but rather many different compliance problems that vary greatly by issue and type of taxpayer. For example, the role of practitioners in noncompliance is different when one compares sophisticated high net worth individuals wishing to avoid or defer taxes from large gains associated with an entrepreneur's building and selling a high tech business to a small dry cleaner who comes to a self-employed public accountant and wants to file tax returns failing to show 100 percent of the business's gross receipts. Likewise, a low-wage single parent sharing custody of her child who wishes to get the maximum earned income tax credit generated-refund presents a different compliance picture than an upper middle class suburban woman who wants to sell her residence and has failed to maintain all records of home improvements to properly compute basis. There are many different types of taxpayers and practitioners, with noncompliance stemming from sophisticated tax shelters¹¹⁰ which may play on legal ambiguity, to relatively simple schemes based upon the

¹⁰⁴ See Eric Toder, *What is the Tax Gap?*, 117 Tax Notes 372 (Oct. 22, 2007).

¹⁰⁵ See *Id* at 373.

¹⁰⁶ See Michael Albert, Kim Bloomquist & Ron Edgerton, *Evaluating Preparation Accuracy of Tax Practitioners: A Bootstrap Approach*, 2007 IRS RESEARCH CONFERENCE 1 (2007).

¹⁰⁷ See Michael Albert, Kim Bloomquist & Ron Edgerton, *Evaluating Preparation Accuracy of Tax Practitioners: A Bootstrap Approach*, 2007 IRS RESEARCH CONFERENCE 1 (2007).

¹⁰⁸ 2007 TAX GAP CONFERENCE PAPERS (June 2007).

¹⁰⁹ Eric Toder, *What is the Tax Gap?*, 117 Tax Notes 392 (Oct. 2, 2007).

¹¹⁰ See Linda Beale, *Tax Advice Before the Return: The Case for Raising Standards and Denying Evidentiary Privileges*, 25 Va. Tax Rev. 583, 587 (2006).

straightforward and not too ambiguous decision to fail to report some percentage of income from a cash business.

In this project, I will look in depth at two areas of systemic individual noncompliance, the underreporting of income from the cash business sector, and the overstating of the earned income tax credit (EITC). Both represent significant areas of noncompliance. The underreporting of business income is the greatest component of the individual underreporting aspect of the tax gap, contributing to almost a third of the estimated tax gap.¹¹¹ The EITC is likewise important in that it has increasingly become the federal government's principal tool for addressing child poverty and rewarding low wage work.¹¹² The error rate in the EITC in 1999 was approximately 27 to 32 percent of all EITC payments,¹¹³ significantly higher than the overall tax compliance rate but lower than the estimated noncompliance rate among sole proprietors. Moreover, IRS, Congress, and GAO have highlighted EITC noncompliance over the past decade, and a series of IRS compliance studies focusing on the EITC, provides researchers with insights into the role that practitioners have played in its error rate.¹¹⁴

In recent years, there has been a significant amount of academic,¹¹⁵ administrative,¹¹⁶ and legislative¹¹⁷ attention on the errors associated with the EITC, with less focus on the tax gap associated with sole proprietors.¹¹⁸ That lack of attention is starting to change,

¹¹¹ Eric Toder, *What is the Tax Gap?*, 117 Tax Notes 370 (Oct. 22 2007).

¹¹² See Dennis Ventry, *From Competition to Cooperation: Imagining a New Tax Compliance Norm*, (draft 2007), Lawrence Zelenak, *Tax or Welfare? The Administration of the Earned Income Credit*, 52 UCLA L. Rev. 1867 (2005)

¹¹³ Earned Income Tax Credit Compliance, available at <http://www.whitehouse.gov/omb/budget/fy2004/pma/earnedincome.pdf>.

¹¹⁴ CRISIS IN THE TAX ADMINISTRATION (Henry & Slemrod, eds., year) Janet Holtzblatt & Janet McCubbin, *Complicated Lives: Tax Administration Issues Affecting Low-Income Filers*, CONFERENCE ON THE CRISIS IN TAX ADMINISTRATION (2003).

¹¹⁵ E.g., Steven Holt, *Keeping it in Context: Earned Income Tax Credit and Treatment of the Working Poor*, 6 Conn. Pub. Int. L. J.183 (Spring 2007); Lawrence Zelenak, *Tax or Welfare? The Administration of the Earned Income Credit*, 52 UCLA L. Rev. 1867 (2005).

¹¹⁶ See IRS, IRS EARNEDINCOME TAX CREDIT (EITC) INITIATIVE, at i-v (2005), http://www.irs.gov/pub/irsutl/irs_earned_income_tax_credit_initiative_final_report_to_congress_October_2005.pdf (discussing the results of the IRS's pilot program requiring 25,000 taxpayers to prove that children resided with the taxpayer for more than six months prior to a tax return being filed).

¹¹⁷ For a summary of the legislative efforts to resolve EITC noncompliance see Lawrence Zelenak, *Tax or Welfare? The Administration of the Earned Income Credit*, 52 UCLA L. Rev. 1867 (2005).

¹¹⁸ There are some notable exceptions to this. See Erich Kirchler, *THE ECONOMIC PSYCHOLOGY OF TAX BEHAVIOUR* 152-66 (Cambridge University Press 2007) (2007). Kirchler related sole proprietor noncompliance to broader research relating to the effects of external actions restricting choice. Kirchler, at p. 155. Kirchler suggested that in addition to sole proprietors' additional opportunities for noncompliance attributable to the lack of information reporting and withholding, sole proprietor noncompliance can be understood, in part, on an adverse reaction to the perceived and actual role that taxes (and out of pocket liabilities) play in restricting entrepreneurial freedom, especially at the beginning of sole proprietors' businesses, when risk of failure is high. See also Eliza Ahmed and Valerie Braithwaite, *Understanding Small Business Taxpayers*, 23 International Small Business Journal 539-568 (2005) (discussing the lack of academic attention to sole proprietors but mentioning exceptions). Recent promising research has looked at the relationship of sole proprietors and paid preparers James Hasseldine, Peggy Hite, S. James, and M. Toumi, *Persuasive Communications: Tax compliance enforcement strategies for sole proprietors*, 24 Contemporary Accounting Research 171-94 (2007) (in

especially in light of the National Research Program (NRP)¹¹⁹ data highlighting the high rate of noncompliance and the high relative amount of the tax gap associated with sole proprietors. Given the relative lack of attention to sole proprietors, this section contains a more robust discussion of sole proprietor noncompliance, looking at the data the IRS recently released, as well as a review of some of the research that sheds light on the underlying causes for the high error rate in this sector.

A. Sole Proprietor Noncompliance

As mentioned above, the numbers associated with sole proprietor noncompliance are startlingly high. Sole proprietors are a fairly diverse group, but their hallmark in IRS compiled tax gap data is that they own unincorporated businesses and report their business receipts and expenses on their Form 1040 through the completion of a Schedule C. Proprietors with receipts under \$5,000 are allowed to report all their results on a simplified form, Schedule C-EZ. For 2003, the most current year that data is available, about 20.6 million sole proprietors filed income tax returns, with sole proprietors accounting for approximately 72 percent of all businesses in the US.¹²⁰ The taxpayers in this segment are diverse, from physical trainers, house cleaners, architects and hairstylists selling services, to EBAY sellers, small grocers, and people who make their living selling small homemade crafts.

One of the key distinctions between sole proprietors and wage earners is that the compliance rate for wage earners is very high,¹²¹ while most sole proprietors (about 61 percent) understated income, and that there was misreporting of about 57 percent of the net business income.¹²² Perhaps most interesting was GAO's identification that a small

controlled field experiment, testing the result of sanction and normative communications among self-prepared and paid-preparer returns in the United Kingdom). Hasseldine, Hite, James and Toumi's study builds on past studies that have considered persuasive communications as a means encouraging tax compliance. For example, See Richard Schwartz and Sonya Orleans, *On Legal Sanctions*, 34 U. Chi. L. Rev. 274-300 (1967); Marsha Blumenthal, Charles Christian, & Joel Slemrod, *Do Normative Appeals Affect Tax Compliance? Evidence From A Controlled Experiment In Minnesota*, 54 National Tax Journal 125-136 (2001). Hasseldine et al note the inconclusive research to date regarding preparers' roles in relation to tax compliance. Hasseldine, at 175. I intend to discuss their research model in future research connected with this project.

¹¹⁹ National Research Program Overview, IRS, <http://www.irs.gov/privacy/article/0,,id=139179,00.html> (last visited Nov. 30, 2007); IRS Updates Tax Gap Estimates, IRS, <http://www.irs.gov/newsroom/article/0,,id154496,00.html>.

¹²⁰ See Government Accountability Office, *Tax Gap: A Strategy For Reducing The Gap Should Include Options For Addressing Sole Proprietor Non Compliance* 10, GAO-07-1014 (July 2007).

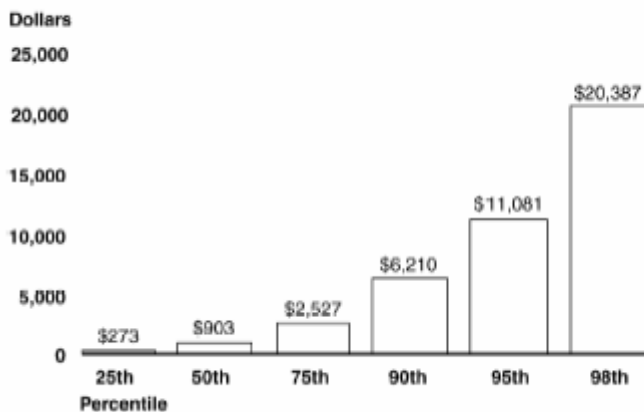
¹²¹ According to recent IRS estimates, amounts that are subject to substantial information reporting and withholding (like wages) account for only 1.2 percent of the net misreporting gap. IRS, Tax Year 2001 Individual Income Tax Underreporting Gap (Feb. 2007)

¹²² See Government Accountability Office, *Tax Gap: A Strategy For Reducing The Gap Should Include Options For Addressing Sole Proprietor Non Compliance* 17, GAO-07-1014 (July 2007). The distribution of noncompliance is further illustrated by this table the GAO compiled from IRS data:

percentage of the taxpayers are responsible for most of the misreporting. GAO estimates that about 1.25 million taxpayers accounted for the largest ten percent of understatements, where the mean understated amount was about \$18,000.¹²³

GAO recently reported that the reasons for the high rates of sole proprietor noncompliance are “well known,” focusing on the opportunity for concealment that is associated with the lack of third party reporting¹²⁴ and withholding on payments to proprietors.¹²⁵ The 2007 GAO report on identifying strategies to reduce sole proprietor noncompliance involved a broad approach, including providing additional educational outreach and assistance, especially to first-time filers, requiring separation of personal and business bank accounts, clarifying the rules distinguishing independent contractors and employees, imposing additional information reporting requirements, improving audit selection,¹²⁶ and enhancing the sharing of data with states. Interestingly despite data showing that approximately 73 percent of sole proprietors used paid practitioners in tax

Figure 4: Estimated Understated Tax Amounts by Percentile for Form 1040s with Schedule Cs Attached, Tax Year 2001



Source: GAO analysis of IRS data.

. Government Accountability Office, *Tax Gap: A Strategy For Reducing the Gap Should Include Options For Addressing Sole Proprietor Non Compliance* 10, GAO-07-1014 (July 2007). Another 9 percent overstated their income. *Id.*

¹²³ Government Accountability Office, *Tax Gap: A Strategy For Reducing the Gap Should Include Options For Addressing Sole Proprietor Non Compliance* 14, GAO-07-1014 (July 2007).

¹²⁴ For a discussion of the limited reporting obligations associated to payments to sole proprietors, see Government Accountability Office, *Tax Gap: A Strategy For Reducing the Gap Should Include Options For Addressing Sole Proprietor Non Compliance* 10, GAO-07-1014 (July 2007).

¹²⁵ See *Id.* at 1.

¹²⁶ As Professor Bankman notes, while increasing audits (and the implicit audit increase likely inherent in an increase in information reporting) may have significant effects on reducing the gap, there is little political support for such an increase. Joseph Bankman, *Eight Truths About Collecting Taxes from the Cash Economy*, 117 *Tax Notes* 506 (Oct. 29, 2007). Bankman perceptively notes that the average taxpayer would likely be skeptical of the IRS's ability to target audits to taxpayers likely to be evading, and he also notes the huge government and taxpayer resource issues associated with auditing sole proprietors. *Id.*

year 2005,¹²⁷ GAO does not discuss the role of practitioners, nor do any of the solutions highlight the important role that practitioners can play in this area.¹²⁸

B. EITC Noncompliance

A significant number of people who file returns purporting to be eligible for EITC benefits are not in fact eligible in whole or in part or are unable to demonstrate eligibility. A 1999 IRS study of EITC claims estimated that, of about 18.8 million tax returns (representing approximately \$31.3 billion in claims), between \$9.7 billion and \$11.1 billion of EITC claims were erroneous.¹²⁹ IRS enforcement activities prevented or recovered approximately \$1.2 billion in improper claims.¹³⁰ Thus, using upper range estimates, the IRS should not have paid approximately \$9.9 billion of the claims. More recent (2005) estimates of EITC noncompliance suggest that even after a number of legislative and administrative changes designed to improve the administration of the EITC, approximately 23 to 28 percent of EITC was paid or credited erroneously, with IRS enforcement preventing another \$2 billion in improper claims¹³¹

Analysis of tax-year compliance data from 1999 shows that 80 percent of the overclaims, and 75 percent of overclaim dollars stemming from those improper claims are attributable to three types of errors.¹³² These included: (1) approximately \$3 billion to qualifying child errors on 1.6 million returns; (2) approximately \$2 billion to filing status errors on 1.3 million returns; and (3) approximately \$1.9 billion to income misreporting errors on 3.6 million returns.¹³³ The most common qualifying child error involved claiming a child who did not live with the taxpayer for over half of the taxable year and therefore did not satisfy the EITC residency requirement.¹³⁴ Another common qualifying child error involved claiming a child who did not have the required relationship

¹²⁷ IRS data shows that 15,008,081 Schedule C filers used a paid preparer out of a total 20,596,287 Schedule C filers in tax year 2005. Tax Year 2005, *IRS Compliance Data Warehouse, Individual Returns Transaction File (IRTF)*.

¹²⁸ The National Taxpayer Advocate has pointed out that there is very little in the way of consistent data regarding the “number and types of errors on returns, tracked by type of return preparer.” National Taxpayer Advocate 2002 Annual Report to Congress 225.

¹²⁹ IRS, COMPLIANCE ESTIMATES FOR EARNED INCOME TAX CREDIT CLAIMED ON 1999 RETURNS 3, 11 tbl.1 (2002). The noncompliance range is attributable to differing assumptions for those claimants who did not respond to the IRS compliance study. See *id.* at 3; Janet Holtzblatt & Janet McCubbin, *Complicated Lives: Tax Administration Issues Affecting Low-Income Filers*, CONFERENCE ON THE CRISIS IN TAX ADMINISTRATION 163 (2003).

¹³⁰ IRS, COMPLIANCE ESTIMATES FOR EARNED INCOME TAX CREDIT CLAIMED ON 1999 RETURNS 3, 11 tbl.1 (2002).

¹³¹ This is based primarily on NRP data. *Filing Your Taxes: An Ounce of Prevention is Worth a Pound of Cure: Hearing Before the Senate Fin. Comm.*, 110th Cong. (2007) (statement of Mark Everson, Commissioner of IRS). Examinations accounted for \$1.34 billion and math error adjustments accounted for \$330 million. The balance is from document matching activities.

¹³² IRS, COMPLIANCE ESTIMATES FOR EARNED INCOME TAX CREDIT CLAIMED ON 1999 RETURNS 3, 13 tbl.2 (2002).

¹³³ *Id.*

¹³⁴ Administration of the Earned Income Credit, IRS Announcement 2003-40, at 1133 available at <http://www.irs.gov/newsroom/article/0,,id=110298,00.html>.

to the taxpayer.¹³⁵ The data shows much overlap among the common errors, as most children who did not meet the relationship requirement also did not meet the residency requirement.¹³⁶

Recent studies indicated that a significant amount of EITC overclaims were associated with returns that commercial preparers prepared. Of the approximately \$11 billion in upper-range estimated erroneous EITC claims made in 1999,¹³⁷ approximately 57 percent of the overclaims were attributable to returns prepared by commercial return preparers.¹³⁸ The overall error rate among taxpayers who reported using a preparer was 34.6 percent, compared with 37.8 percent among those who did not report using a paid preparer.

Also, there are significant variations in the error rate among the different type of preparers. In 1999, about 25 percent of the EITC was claimed in error. The 35.2 percent of the claimants using other commercial preparers had a much higher error rate of 36.2 percent.¹³⁹

TYPE OF PREPARATION	PERCENT OF RETURNS	AVERAGE EITC CLAIM	AVERAGE EITC OVERCLAIM	OVERCLAIM RATE	MARGIN OF ERROR
CPA/Attorney	5.0%	\$1,279.22	\$260.45	20.4%	8.43%
EA/HR/JH	26.4%	\$1,917.67	\$499.08	26.0%	5.47%
Other Professional	32.4%	\$1,755.53	\$603.00	34.3%	3.80%

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The presence of the EITC-generated refund and the ability to monetize the anticipated refund immediately (and thus pay the preparation and related costs) contribute to the presence of both the national marketplace leaders (like H & R Block), as well as local “mom and pop” storefront preparers (who often are not enrolled agents or accountants, but who are self-employed or working for smaller local firms).¹⁴¹ It is unclear whether the difference in error rates among classes of preparers is attributable to the preparers’ skills or scruples, or to the client characteristics of those using the different preparer types.¹⁴²

VI. A General Discussion of How Practitioners Facilitate Noncompliance

¹³⁵ Administration of the Earned Income Credit, IRS Announcement 2003-40, at 1133 available at http://www.irs.gov/newsroom/article/0,,id=11_0298,00.html.

¹³⁶ *Id.*

¹³⁷ Janet Holtzblatt & Janet McCubbin, *Complicated Lives: Tax Administration Issues Affecting Low-Income Filers*, CONFERENCE ON THE CRISIS IN TAX ADMINISTRATION 163 (2003).

¹³⁸ National Taxpayer Advocate 2003 Annual Report to Congress 270.

¹³⁹ Janet Holtzblatt and Janet McCubbin, *Issues Affecting Low-Income Filers*, in *The Crisis in Tax Administration* 170-171 (Brookings Institution Press 2004).

¹⁴⁰ National Taxpayer Advocate 2002 Annual Report to Congress.

¹⁴¹ National Taxpayer Advocate, 2003 Annual Report to Congress 170-71; Alan Berube *et al*, The Brookings Institution, *The Price of Paying Taxes: How Tax Preparation and Refund Loan Fees Erode the Benefits of the EITC*, p. 4 available at http://www.dlc.org/documents/Price_of_Paying_Taxes.pdf.

¹⁴² National Taxpayer Advocate 2003 Annual Report to Congress 171.

A. Introduction

Researchers recently emphasized the importance of understanding the practitioner's role in brokering or facilitating noncompliance,¹⁴³ based in part on the insights of sociologists Robert Kidder and Craig McEwen.¹⁴⁴ Writing about the benefits of setting out such a typology, Kidder and McEwen remind us that viewing compliance variables too narrowly has the effect of limiting understanding of the complexities underlying taxpayer decisions whether to comply or not to comply with the tax laws.¹⁴⁵ Thus, as I have written elsewhere, as a necessary prerequisite to understanding the causes of noncompliance and the potential policies to redress noncompliance, one must define noncompliance based upon the various reasons why people comply or fail to comply in different areas of the tax law.

While a typology in and of itself is unlikely to completely capture the complexities of human behavior, nor allow us to statistically measure possible administrative or legislative efforts directed at reducing errors on returns that practitioners prepare, it does allow us to think more precisely about why tax returns prepared by paid preparers may have a significant level of errors. Kidder and McEwen identify brokered noncompliance as taxpayer noncompliance that is undertaken upon the direction of a knowledgeable tax expert.¹⁴⁶ This is a useful first step, but it can be broken up further to help us better understand the practitioner's role in the tax gap. As Kidder and McEwen discussed, much tax compliance literature focuses too narrowly on intentional violations, and the original Kidder/McEwen discussion of brokered noncompliance too narrowly considers advisors in that capacity.

As indicated in the literature survey above, research to date is inconsistent or at least unclear in helping us understand the role that practitioners play in tax compliance.¹⁴⁷ In an attempt to better understand the potential sources of noncompliance, in this project I am refining this understanding of brokered noncompliance. Yet, the research literature, my experience working in a legal clinic for ten years where I saw hundreds of taxpayers who filed incorrect tax returns that were prepared by practitioners, and the initial results

¹⁴³ See Kristina Murphy, *Aggressive Tax Planning: Differentiating Those Playing the Game from Those Who Don't*, 25 *Journal of Economic Psychology* 307, 309 (2004) (noting that until recently compliance research failed to "consider the potential impact of tax agents in the compliance process.").

¹⁴⁴ See Robert Kidder & Craig McEwen, *Taxpaying Behavior in Social Context: A Tentative Typology of Tax Compliance and Noncompliance*, in 2 *TAXPAYER COMPLIANCE* (Jeffery Roth et al. eds., 1989); see also Margaret McKerchar, *Why Do Taxpayers Comply*, *TAX ADMIN. IN THE 21ST CENTURY* 242 (Walpole & Evans, Eds.) (2001). and Lin Mei Tan, *Research on the Role of Tax Practitioners in Taxpayer Compliance: Identifying Some of the Gaps*, *TAXATION ISSUES IN THE TWENTY-FIRST CENTURY* 15 (2006) (citing to the utility of adapting the approach of Kidder McEwen).

¹⁴⁵ See Robert Kidder & Craig McEwen, *Taxpaying Behavior in Social Context: A Tentative Typology of Tax Compliance and Noncompliance*, in 2 *TAXPAYER COMPLIANCE* 48 (Jeffery Roth et al. eds., 1989).

¹⁴⁶ See *Id.* at 62.

¹⁴⁷ See Kristina Murphy, *Aggressive Tax Planning: Differentiating Those Playing the Game from Those Who Don't*, 25 *Journal of Economic Psychology* 307, 310 (2004) (noting after reviewing the literature that studies exploring the question of who instigates aggressive tax reporting have yielded contradictory results).

of focus group studies that TAS and I have conducted,¹⁴⁸ suggested that crucial first steps in this inquiry include asking the fundamental question as to why a tax return that is prepared by a practitioner may be incorrect.¹⁴⁹

B. How Tax Return Preparers Can Contribute to Noncompliance

Preparers likely contribute to noncompliance in different ways. The following sets forth a listing of the number of ways practitioners likely contribute to returns that understate income or overstate applicable credits.

1. Ignorance or misunderstanding of the law—poor training or education, inadequate attention to changes in the law, or complexity of the law;
2. Misunderstanding or failing to understand or learn the facts—language or cultural barrier—can also be related to ignorance or misunderstanding of the law, as the practitioner may not know what information is relevant;¹⁵⁰
3. Unable or unwilling to detect false or incorrect information, though the unwillingness or inability is not reflective of failing to exercise due diligence;
4. Facilitate noncompliance by not exercising appropriate due diligence to verify facts or information;
5. Aid and abet in noncompliance by advising taxpayers how to misstate or omit income, or claim inappropriate or excessive deductions or credits;
6. Facilitate continued noncompliance by advising taxpayers how to arrange affairs to minimize chances of detection, including advising taxpayers on practices or positions that are likely to generate IRS attention;¹⁵¹
7. Directed noncompliance—working in an environment where there is a culture of noncompliance, either through insufficient quality control or active and affirmative exhortations to take affirmative steps which are meant to minimize liabilities or maximize refunds.¹⁵²

It is important to understand motivations for why brokers may intentionally or negligently facilitate taxpayer noncompliance. Items four through seven may arise from a perceived need to generate revenues from the activity (though taxpayers themselves get the lion's share of benefits), retain clients, attract new clients, and for some

¹⁴⁸ The focus groups were conducted through out the summer of 2007, and involved a series of questions asked to practitioners that were meant to solicit their ideas about the role of preparers in noncompliance. In a later report, I will summarize and discuss the insights gleaned from the focus group sessions.

¹⁴⁹ By incorrect, I mean that the return is different from what the IRS would be legally owed by a taxpayer, assuming that the IRS and taxpayers share the same definition Marcello Bergman, *Criminal Law and Tax Compliance in Argentina: Testing the Limits of Deterrence*, 26 *International Journal of the Sociology of Law* (1999).

¹⁵⁰ See A. Christensen, *Evaluation of Tax Services: A client and preparer perspective*, 14 *The Journal of the American Taxation Association* 60-87 (1992).

¹⁵¹ See Stuart Karlinsky & Joseph Bankman, *Developing a Theory of Cash Businesses Tax Evasion Behavior and the Role of their Tax Preparers*, 5TH INT'L CONFERENCE ON TAX ADMIN. 164 (2002).

¹⁵² A clear example of this is the type of activities the government has alleged in a series of related civil injunction suits brought in connection with activities undertaken by franchise offices of Jackson Hewitt. See *U.S. Government Sues Jackson Hewitt Tax Preparation Franchises in Four States Alleging Pervasive Fraud* (April 3, 2007), available at <http://www.usdoj.gov/tax/txdv07215.htm>.

taxpayers (especially those seeking the EITC) position the firm or a business partner to benefit from the sale of refund generated products or services.

C. Types of Preparers—how preparers interact with taxpayers intent on understating their tax liability

An essential part of my setting out a structure of noncompliance is a realization that some taxpayers come to practitioners with the intent of understating their taxes or maximizing their refunds. Part B, above, considers the broader issues of errors on returns that are prepared by professional preparers, but within that broad category there is the particularly challenging issue of how preparers intersect with taxpayers who seek out practitioners to prepare and file erroneous returns that are noncompliant because the client is providing incomplete or inaccurate factual information to the preparer.¹⁵³ An interesting area of study is how practitioners react to those taxpayers. It is my hypothesis that practitioners who interact with those taxpayers intent on understating their taxes react in one of six ways:

1. Refusing Practitioners: This preparer refuses to accept as clients those they know or suspect as dishonest or inappropriately aggressive (or terminate the relationship once they gain knowledge or reasonable belief);
2. Signaling Practitioners: This preparer signals a refusal to prepare returns among those that they know or suspect are dishonest, through requesting back-up documentation or making detailed inquiries that contribute to the taxpayer's understanding that the practitioner is unwilling to prepare such returns;
3. Facilitating Practitioners: This preparer knows or has a reasonable suspicion that the taxpayer is misstating facts but facilitates noncompliance by advising taxpayers how to conceal or misstate income, or overstate or improperly generate deductions or credits;
4. Indifferent practitioners: This preparer is indifferent to the taxpayer conduct but willing to follow taxpayer preference and overlook noncompliance in which the preparer knows or has a strong suspicion is present;
5. Incompetent or Unsophisticated Preparers: Based upon what we would reasonably expect the practitioner to know given the practitioner's due diligence requirements, this preparer should be able to understand that the taxpayer is more likely than not overstating his credits or understating his liability, but this preparer is unable to detect or suspect client misconduct for a variety of reasons, including a lack of training, education, or sophistication; and
6. Reasonably Unknowing Practitioners: Despite the client conduct, the practitioner does not know and does not have sufficient basis to believe that the facts the client provides are incorrect.

¹⁵³ As mentioned in the literature survey, some research suggests that taxpayers seek out practitioners with like values to themselves, especially when taxpayers are intent on minimizing taxes through underreporting of income. See Stuart Karlinsky & Joseph Bankman, *Developing a Theory of Cash Businesses Tax Evasion Behavior and the Role of their Tax Preparers*, 5TH INT'L CONFERENCE ON TAX ADMIN. 164 (2002), Yuka Sakurai & Valerie Braithwaite, *Taxpayer's Perceptions of the Ideal Tax Adviser: Playing Safe or Saving Dollars?*, Centre for Tax System Integrity, working Paper No. 5 (May 2001).

There are some important policy questions that spin from understanding the above typology. As some research indicates, there is some support for the notion that taxpayers will listen to practitioners' advice about whether to comply with the tax laws.¹⁵⁴ Likewise, there is evidence that suggested that taxpayers seek out tax advisors who generally match their attitudes towards tax compliance.¹⁵⁵ It is possible, of course, that at least some taxpayers intent on improperly understating their income will seek out practitioners who will not make it difficult for them to noncomply, or file returns without the benefit of a preparer. Yet, assuming that preparers have some gatekeeping¹⁵⁶ role in the system, what can be done to push practitioners to become either type 1 or type 2 practitioners and encourage taxpayers to visit type 1 or type 2 preparers?¹⁵⁷ In addition, there are ways that the government can shift preparers from type 5 or type 6 preparers and generate possibilities for those preparers to become agents of compliance.

D. EXAMPLE

The following example applies the categorizations in sections B and C above. The situation is complicated, of course, by the taxpayer's role in the noncompliance, and the variety of motivations and scenarios that taxpayers present, but it illustrates the challenges that researchers must confront in addressing the dynamics of noncompliance in this area.

Andrew, a 21 yr old single male lives in a one-bedroom apartment. He works on the evening shift at a warehouse, which starts at 6:00 p.m. His sister, Betty, is a single mom and has three kids: twin girls Debbie and Edna, age seven, and a three-year old boy, Frank. Betty lives with her mother Caroline, in a modest house Caroline owns. Betty has had a series of low-wage jobs, and has had substance

¹⁵⁴ See Peggy Hite & Gary McGill, *An Examination of Taxpayer Preference for Aggressive Tax Advice*, 45 National Tax Journal, 398 (1992).

¹⁵⁵ See Sakurai, Y., and V. Braithwaite, *Taxpayer's Perceptions of the Ideal Tax Adviser: Playing Safe or Saving Dollars?*, Centre for Tax System Integrity, working Paper No. 5 (May 2001).

¹⁵⁶ It is likely that any increased gatekeeper responsibility will be met by significant professional opposition. See John C. Coffee, *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U.L. Rev. 301 (2004) (noting the resistance that attorneys have raised in connection with post-Enron proposed increases in responsibilities and liabilities to the public, but emphasizing that in light of the social costs associated with misconduct it is increasingly unlikely that professions can maintain their guild-like self-governing role); R.H. Kraakman, *Gatekeepers: The Anatomy of Third-Party Enforcement Strategy*, 2 J.L. Econ. & Org., 53 (1986).

¹⁵⁷ Karlinsky and Bankman examine through field study interviews the role of the preparer with respect to cash business owners. In their study, Karlinsky and Bankman interview hundreds of people to, as the authors say, "get a feel" for what is happening in the world of small businesses, relative to the reporting of cash business income. To that end, the author, spoke with hundreds of business owners and various types of practitioners; including CPA, enrolled agents, bookkeeper, and accountants for the big five firms. In the study, Karlinsky and Bankman conclude that cash business owners rely on their own devices to significantly understate the income the business generates. In addition, the authors also conclude that there is a segmented market of practitioners, some of whom will tolerate not even a suspicion of client underreporting, with other practitioners turning a blind eye. Others provide active assistance in activities that will likely facilitate the taxpayer's behavior and make it more difficult for the government to detect. See Stuart Karlinsky & Joseph Bankman, *Developing a Theory of Cash Businesses Tax Evasion Behavior and the Role of their Tax Preparers*, 5TH INT'L CONFERENCE ON TAX ADMIN. 166 (2002).

abuse issues. In 2006 Betty and Andrew each earned \$12,000. Due to health issues, Caroline no longer works and receives Social Security disability income.

Andrew is especially fond of Frank, and cares for the boy, often at his house. He also has set up an area in his apartment where Frank can sleep over, which he often does on weekends.

Betty's friend Georgia is a hairdresser who also moonlights during tax season as a tax return preparer. She prepares about 18 tax returns a year for friends in the neighborhood. She charges \$50 per return, and she does not sign the return as a paid preparer. Georgia prepared Andrew's tax returns. 2006 is the first year that Andrew filed a tax return. Andrew filed as a head of household taxpayer, and claimed Frank as a dependent and qualifying child. Note also Georgia prepared Betty's return, and she filed as head of household, and claimed the twins as dependents and qualifying children for the EITC.

The effect of this is significant. If Andrew filed properly he would have taxable income of \$3,550 and a tax liability of \$358 (properly means filing single, without any dependents, qualifying children, or EITC). By claiming Frank as a qualifying child he reduced his tax liability to zero and qualified for a \$2,746 EITC, and \$105 Child Tax Credit. The decision to allow Andrew to claim Frank does not affect Betty's liability whatsoever, as with either two or three qualifying children she would be eligible for a \$4,536 EITC and \$105 Child Tax Credit. Thus, this results in a shortfall to the fisc, of \$3,209.¹⁵⁸

What We Know About Andrew

As a legal matter, Andrew's error as it relates to his ability to claim Frank as a qualifying child for the EITC is that he and the child flunk the residency test.¹⁵⁹ In light of the IRS's compliance studies, we know that failure to satisfy the residency test is the most common reason why people like Frank erroneously claim the EITC.¹⁶⁰ We can identify a number of variables that may or may not be significant insofar as demonstrating a tendency that people like Frank would erroneously claim the EITC. For example, we could examine his age and gender, his education, his use of an unenrolled preparer who prepared fewer than 25 returns; his sister's having more than two children, his financial circumstances, and even his identification with society at large or affection for the government.

¹⁵⁸ This is the sum of the understated tax liability and the overstated credits. For a discussion of how the structural incentives within the EITC and CTC may influence demand for non compliance See Leslie Book, *Freakonomics and the Tax Gap: An Applied Perspective*, 56 Amer. L. Rev. 1163, 1176-1177 (2007). See also Dorothy Brown, *The Tax Treatment of Children: Separate but Unequal*, 54 Emory L.J. 755, 789 (2005) (noting the unfairness of the CTC lower refundability for lower income individuals).

¹⁵⁹ To pass the residency test the two would have to share the same principal place of abode for greater than half the year. IRC §32(c)(3)(A) (referencing the definition of qualifying child under IRC §152(c)).

¹⁶⁰ IRS Announcement 2003-4, 2003-1 C.B. 1132 (discussing residence as the most common EITC error relating to qualifying child eligibility).

Assuming that we can identify variables that have a statistically significant relationship to the tendency of someone like Andrew to erroneously claim the EITC, consider, however, on reflection how difficult it is to identify the underlying reasons why Andrew improperly claimed Frank on his return. Here are some, and I suspect that there are more, given the complexities of human behavior:

Potential Reasons For Error

1. Georgia attempted to maximize the refund for Andrew, with Andrew assuming that Georgia prepared the return properly and genuinely not knowing that the return was incorrect;
2. Georgia attempted to maximize the refund for Andrew, with Andrew consenting to the approach after she explained what she was doing and why;
3. Georgia improperly applied the law and thought that Andrew could treat Frank as a qualifying child;
4. Georgia knew the law, but failed to or was not able to learn the appropriate facts so that she could properly prepare the tax return; and
5. Andrew misstated facts to Georgia.

From a researcher or policymaker's standpoint, it would be helpful to know why Andrew filed an incorrect return. What to do about the error should depend on whether the error was inadvertent or intentional. If intentional, it would be helpful to know whether the intent originated on the supply-side (*i.e.*, from the preparer), or on the demand-side, (*i.e.*, from the taxpayer). If inadvertent, a researcher would want to know what contributed to the mistake; for example, was it a cultural or language gap between the preparer and the taxpayer, or was it a lack of interviewing skills, or a shortfall in knowledge of the tax laws. Once a deeper understanding emerged, at that point more quantitative research might shed insight about what was effective in reducing that particular type of error.

Conclusion

This report is an invitation to additional research and a call for a deeper understanding of the sources of errors on commercially-prepared returns. With the growing importance and taxpayer use of practitioners, and continued interest in reducing the tax gap, it is inevitable that Congress and the IRS will look to practitioners' role in the tax gap, and consider their role in improving compliance.

In a subsequent report I will try to sharpen this focus and refine the practitioner-based typology further, postulate a theoretical context for legislative and administrative changes to assist in encouraging practitioners to act in a way that may encourage taxpayers to file correct tax returns, and make specific proposals that policymakers may wish to adopt or study further to test effectiveness. In addition, I will integrate qualitative research in the form of focus group sessions that I have conducted with a series of enrolled practitioners at various IRS-sponsored tax forums, and develop mystery shopper scenarios that can

better capture the dynamics between differing commercial preparers and common taxpayer scenarios.