

A Consumer Protection Rationale for Regulation of Tax Return Preparers

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A CONSUMER PROTECTION RATIONALE FOR REGULATION OF TAX RETURN PREPARERS

PIPPA BROWDE*

Of the 150 million tax returns filed each year, approximately fifty-six percent are prepared with the help of a paid preparer. Although state-licensed lawyers and certified public accountants may prepare tax returns for clients, the vast majority of paid tax return preparers are completely unregulated. For low-income taxpayers who are eligible for refundable tax credits, these unregulated tax return preparers do more than just fill out tax returns. Return preparers who serve low-income taxpayers often also market consumer credit products, such as refund anticipation loans or checks.

*Government agencies and consumer advocates have documented widespread problems with the tax return preparer industry. In 2011, the IRS promulgated regulations on tax return preparers by instituting minimum competency, background investigation, and continuing education requirements. But in *Loving v. Internal Revenue Service*, the Circuit Court of Appeals for the D.C. Circuit struck down the regulations on the grounds that they exceeded the scope of the enabling statute. The IRS indicated it would pursue a legislative fix. In the wake of the government's defeat in *Loving*, policy makers, scholars, and practitioners are weighing in on the question of how tax return preparers should be regulated. This Article addresses a more fundamental question: Why should tax return preparers be regulated?*

The calls for regulations and much of the existing literature on regulating tax return preparers explicitly stated or implicitly assumed that regulation would improve tax compliance. This Article contends that, while any improvement of compliance rates would be a benefit of regulation, the rationale for regulating tax return preparers who prepare tax returns for the working poor and sell consumer credit products should be to protect taxpayers as consumers. In support of this proposal, this Article first describes the myriad

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of services provided and products sold by tax return preparers to low-income taxpayers. Second, relying on empirical evidence on the relationship between tax return preparers and compliance, this Article challenges the rationale that regulation will improve compliance. Third, and finally, this Article re-frames regulation as a mode of consumer protection, supported by the relationship among low-income taxpayers, the government, and tax return preparers and as a check upon the market incentives that allow for exploitation of low-income taxpayers.

I. INTRODUCTION	529
II. THE TAX RETURN PREPARATION INDUSTRY, LOW-INCOME TAXPAYERS, COMPLIANCE, AND PRIOR REGULATIONS	533
A. Role of Tax Return Preparers in the Tax Administration System	533
1. Types of Tax Return Preparers and What They Do.....	534
2. Tax Return Preparers Facilitate Low- and Lower-Income Taxpayer's Access to the Earned Income Tax Credit (EITC)	538
3. Tax Return Preparers as Consumer Credit Providers	540
Refund Anticipated Loans	542
Refund Anticipation Checks	544
Use of Anticipated Refunds to Purchase Consumer Goods on Credit.....	545
4. Problems with Credit Products Facilitated by Tax Return Preparers and Existing Protections for Consumers.....	546
B. Compliance Problems Associated with the TRP Industry.....	547
1. Studies on Non-Compliance	548
2. The Costs of the Errors are Borne by Taxpayers, the Government and the Tax Administration System.....	549
C. History of Attempts to Regulate Tax Return Preparers.....	551
1. Lead-Up and 2011 Regulations	551
2. The Story of <i>Loving</i> and Its Aftermath	553
III. THE RATIONALE THAT REGULATION OF THE TAX RETURN PREPARATION INDUSTRY WILL IMPROVE EITC COMPLIANCE	554
A. The Relationship Between Regulation of Return Preparers and Tax Compliance.....	554
1. Voluntary Compliance and the Tax Gap	555
2. The Relationship Between Tax Return Preparer Non- Compliance and the Tax Gap.....	557
IV. REFRAMING THE RATIONALE FOR REGULATION OF TAX RETURN PREPARERS AS CONSUMER PROTECTION	558

A.	Existing Legal Mechanisms are Insufficient to Protect Taxpayers as Consumers	559
1.	Existing Penalties That Apply to Tax Return Preparers	559
2.	Existing Legal Mechanisms are Insufficient to Protect Low-Income Taxpayers from Bad Actors	561
B.	The Triangular Relationship Between the Government, Taxpayers, and Tax Return Preparers and Divergent Incentives for Tax Return Preparers.....	563
1.	The Interests of the Government, Low-Income Taxpayers, and Return Preparers, and Where They Overlap	563
2.	Where Incentives of Tax Return Preparers Diverge There is Potential for Harm.....	565
C.	Regulation for Consumer Protection Aligns with the Policies Underlying the EITC	570
V.	CONCLUSION	571

I. INTRODUCTION

In most states one must have a license to sell breakfast sandwiches at a weekend farmers' market or to cut hair.¹ Unlike the person cutting hair or making the egg sandwich, tax return preparers generally are allowed to prepare tax returns without satisfying any government regulatory requirements.² Many

1. For example, under state regulations in Montana, "mobile food establishments," which would include food prepared and sold, or both, from a moveable location such as a push cart or trailer, may not operate without a license. MONT. ADMIN. R. 37.110.238(1) (2015) (requiring a license to operate a food establishment); R. 37.110.261(15)(a) (defining mobile food establishment). For barber and cosmetology licensing requirements in Montana, see R. 24.121.601 (setting forth licensing requirements). In the hairstyling context, there has been considerable controversy about the scope of the licensing requirement. *See, e.g.,* Chi-Chi Zhang, *Hair Braider Says Utah Cosmetology Law is Unfair*, DESERET NEWS (Apr. 30, 2011), <http://www.deseretnews.com/article/700131619/Hair-braider-says-Utah-cosmetology-law-is-unfair.html> [<https://perma.cc/BDV8-T8BE>].

2. There are four states that regulate tax return preparers: Oregon, California, Maryland, and New York. *See* OR. REV. STAT. § 673.615 (2017); CAL. BUS. & PROF. CODE § 22253 (West 2017); MD. CODE ANN., BUS. OCC. & PROF. § 21-501 (LexisNexis 2017); N.Y. TAX LAW § 32(b)(1) (Consol. 2017); *see also* Megan L. Brackney, *State Regulation of Tax Return Preparers*, 94 PRAC. TAX STRATEGIES 208 (2015) (providing further analysis regarding the four states that regulate tax return preparers). Some professionals who prepare tax returns, such as certified public accountants (CPAs) and attorneys, must pass certification exams, obtain state licensing, satisfy continuing education requirements, and are subject to sanctions for unethical practices. *See* MONT. CODE ANN. § 37-50-302, 305 (2015); MONT. ADMIN. R. 24.201.501–503, 2106 (2016); N.M. CODE R. § 16.60 (LexisNexis 2016); OR. REV. STAT. § 673.010–075, 165 (2015); *In re* Petition to Adopt Amended Rules for Admission to the Bar of Montana, No. AF 11-0244 (Mont. Jan. 13, 2013); N.M.R.A. 15-101–406 (2013); SUPREME COURT OF THE STATE OF OR., RULES FOR ADMISSION OF ATTORNEYS (2017). An

of these return preparers also sell ancillary consumer credit products to the people whose tax returns they prepare. The ancillary credit products usually have high rates of interest or are of a predatory nature.³

Imagine a single mother who works a low-paying job and struggles to make ends meet.⁴ Assume she is eligible to receive \$5,500 in government subsidies via refundable tax credits, all administered through the tax system. She goes to an unlicensed tax return preparer. The fee structure for the return preparation is not transparent and she does not know what it will cost to have the return prepared. She does not have the money to pay for the return to be prepared, she is struggling to pay her bills and she needs a new car. With no money down, the return preparer calculates her expected refund and prepares the tax return. She enters an arrangement with the preparer for the fee to be taken out of her anticipated refund. The preparer might offer her a short-term loan with a high rate of interest to accelerate the receipt of the refund. The preparer might be a used-car dealership that offers tax services to its customers and the preparer encourages her to apply her anticipated tax refund to a used car. She can take the car today, and for a significant fee, use the potential refund as a down payment. Either way, she leaves the preparer's office having filed her tax return, forgoing a significant portion of the \$5,500 she is entitled to receive. Though nothing came out of her pocket, it may cost her \$750 or more in fees for deferred payment of the services, loan fees, and interest, reducing the amount of her tax refund.

Assume further that the return preparer made errors on the tax return resulting in too much money issued as a refund to the taxpayer. Whether the errors were intentional or not, a taxpayer bears the ultimate responsibility for the tax owed, including any amount erroneously issued to the taxpayer. If the IRS takes enforcement action to correct the errors, the taxpayer must repay the erroneously issued refund.⁵

obvious concern with tax return preparers is that they have access to sensitive information such as Social Security numbers, financial statements, and wage and tax statements belonging to their clients.

3. See *infra* Section II.A.3.

4. This example is fictitious, but it is based on the Author's experience working as a general tax attorney for the IRS Office of Chief Counsel in the Small Business/Self-Employed Division in New York, NY and Sacramento, CA from 2008–2012. In working on cases involving eligibility for refundable tax credits, the Author would routinely hear taxpayer stories regarding a taxpayer's interaction with a tax return preparer.

5. See *infra* Section II.B.2. This example assumes the IRS issues the refund. Some enforcement occurs before a refund is issued and the claimed refund is not issued. For example, to minimize or prevent identity theft-related fraud, the IRS utilizes strategies to engage in "pre-refund fraud detection." See IRS, INTERNAL REVENUE MANUAL § 25.25.1.1 [hereinafter I.R.M.]. The pre-refund detection is accomplished through collection and analysis of data. *Id.* § 25.25.1.2.

Most tax return preparers do not engage in predatory practices or intend to harm the customers they serve. The tax administration system, however, does not ensure that unscrupulous preparers will always face the penalties under the law, which allows preparers the latitude to engage in deceptive or unfair practices.⁶

Regulation of professionals is usually justified on grounds that it ensures public safety and protects consumers.⁷ For instance, the food worker selling breakfast sandwiches has to cook the food to established temperatures to ensure the customer eating the sandwich does not get sick, not in order to minimize costs to the medical system for treating food borne illness. By comparison, the discussion of regulating preparers has focused on how regulation might improve tax compliance, not how regulation might protect individual taxpayers who ultimately bear most of the risk with respect to bad actor preparers.⁸ The direct purpose of the regulation of the food preparation and haircutting industries is to protect consumers,⁹ though there may be indirect benefits to society of reduction of costs to the medical system.

6. See *infra* Section IV.A.2.

7. Marc T. Law & Sukkoo Kim, *Specialization and Regulation: The Rise of Professionals and the Emergence of Occupational Licensing Regulation*, 65 J. ECON. HIST. 723, 724–25 (2005). The civil justice system is also intended to protect consumers. See THOMAS O. MCGARITY, FREEDOM TO HARM: THE LASTING LEGACY OF THE LAISSEZ FAIRE REVIVAL 30–32 (2013) (explaining the tension between free market theorists and proponents of occupational regulation). Valid and effective occupational regulation ought to balance the need to protect consumers against potential negative consequences to the economic market because, often, regulation serves to create barriers to entry and protect existing industry players without a corresponding benefit that protects consumers from bad actors. An excellent recent example of the protectionist underpinnings of some professional service regulation is the case of the state of Utah denying an individual woman's request to operate an African-style hair braiding business without obtaining a cosmetology license that would require 2,000 hours of training, cost between \$9,000 and \$19,000, and teach little or nothing about African hair braiding. See Zhang, *supra* note 1; see also Jacob Goldstein, *So You Think You Can Be a Hair Braider?*, N.Y. TIMES MAG. (June 12, 2012), <http://www.nytimes.com/2012/06/17/magazine/so-you-think-you-can-be-a-hair-braider.html> [https://perma.cc/UF2Y-44V2].

8. See, e.g., Sagit Leviner, *The Role Tax Preparers Play in Taxpayer Compliance: An Empirical Investigation with Policy Implications*, 60 BUFF. L. REV. 1079 (2012); Jay A. Soled & Kathleen DeLaney Thomas, *Regulating Tax Return Preparation*, 58 B.C. L. REV. 151 (2017).

9. See, e.g., MONT. CODE ANN. § 50-50-103 (2015) (authorizing the MT Department of Labor and Industry to adopt rules relating to the licensing of retail food establishments for the purpose of protecting public health); *id.* § 37-31-103 (stating that the purpose of regulating the barber and cosmetology industry is to protect public health and safety from unqualified practitioners); Zhang, *supra* note 1.

While improving compliance in tax administration is a worthy goal, I suggest the problem should be re-framed.¹⁰ This Article makes the case that regulation of tax return preparers who prepare returns for the working poor is a matter of consumer protection. Return preparers who prepare returns for low-income taxpayers, and who often sell consumer credit products in conjunction with the return preparation, should be regulated. This Article makes three important contributions. First, it examines the full spectrum of services provided to low income taxpayers by return preparers. Second, this Article criticizes the traditional rationale for regulation of the return preparation industry to improve compliance. This critique is based on empirical work studying the connection between tax return preparers and compliance; the goal of regulation for compliance does not adequately address all of the potential harms that unscrupulous preparers may cause. Third, this Article re-frames the argument in favor of regulation as an issue of consumer protection. The rationale of consumer protection is based on the triangular relationship that exists between the taxpayer, the government, and the return preparers and the market incentives that allow for low-income taxpayers to be exploited by return preparers.

This Article proceeds in the following manner: Part II describes the role preparers have in the tax system with respect to the administration of refundable credits for the working poor and as providers of consumer credit products. Part II also examines the compliance problems associated with return preparers and the history of attempts to regulate the industry. Part III addresses the traditional premise that regulation of return preparers will improve compliance, in particular the assumption that regulation will reduce errors with respect to the refundable tax credits available to the working poor. In challenging the traditional rationale for regulation, this Article explains the concept of voluntary compliance, the tax gap, and considers data on the impact return preparers have on compliance and the tax gap. Part IV makes the positive contribution that the rationale for regulation of the return preparation industry should be reframed to be a matter of consumer protection; it also highlights the diverging incentives of tax return preparers by analyzing the triangular relationship between taxpayers, tax return preparers, and the government, and

10. Framing matters for two reasons. First, the objectives of regulation should be clear to carefully tailor the regulatory scheme itself, thus preventing overbroad regulations. Second, in the particular area of the administration of tax benefits to the working poor, framing is especially important because there are competing policy objectives. The prevailing view ought to be helping low-income taxpayers access benefits rather than enforcement of compliance. It is my hope that this argument in favor of reframing sparks further conversation as to how regulation of the tax return preparation industry can achieve the goals of protecting taxpayers as consumers.

the important informational asymmetries that contribute to market incentives to exploit taxpayers.

II. THE TAX RETURN PREPARATION INDUSTRY, LOW-INCOME TAXPAYERS, COMPLIANCE, AND PRIOR REGULATIONS

This Part provides the necessary background on the tax return preparer industry. In particular, it examines the role the tax return preparation industry has in the administration of refundable credits for the working poor and in the sale of consumer credit products to the taxpayers. This Part also describes widespread problems associated with the tax return preparation industry and the history of prior attempts to regulate the industry.

A. *Role of Tax Return Preparers in the Tax Administration System*

Tax return preparers are a critical player in the functioning of our tax administration system. The majority of taxpayers rely on tax return preparers to assist in return preparation, and taxpayers trust their preparers to be competent.¹¹ Use of return preparers is widespread among taxpayers of all income levels.¹² This Article focuses on the use of return preparers by low-income taxpayers who qualify for refundable credits intended to be anti-poverty measures. As shown below, many of these low-income taxpayers also purchase ancillary credit products from their tax return preparers.

11. See Nina E. Olson, *More Than a 'Mere' Preparer: Loving and Return Preparation*, 139 TAX ANALYSTS 767, 767, 770 (2013).

12. The role of tax return preparers depends in large part on the financial condition of the taxpayer the preparer serves. Some general literature on tax return preparers and the regulation of the industry focuses on the preparers role in reducing the amount of tax paid by taxpayers with higher income. See generally Patrick E. Tolan, Jr., *It's About Time: Registration and Regulation Will Boost Competence and Accountability of Paid Tax Preparers*, 31 VA. TAX REV. 471 (2012). Other scholarship addresses the role of tax return preparers with respect to low-income taxpayers claiming refundable credits. See, e.g., Leslie Book, *Study of the Role of Preparers in Relation to Taxpayer Compliance with Internal Revenue Laws*, in 2 NAT'L TAXPAYER ADVOCATE, 2007 ANNUAL REPORT TO CONGRESS 44 (2007) [hereinafter Book, *Study of the Role of Preparers*]; Leslie Book, *Refund Anticipation Loans & The Tax Gap*, 20 STAN. L. & POL'Y REV. 85 (2009) [hereinafter Book, *Refund Anticipation Loans & The Tax Gap*]; Leslie Book, *Preventing the Hybrid from Backfiring: Delivery of Benefits to the Working Poor Through the Tax System*, 2006 WIS. L. REV. 1103, 1115–17 (2006) [hereinafter Book, *Preventing the Hybrid from Backfiring*].

1. Types of Tax Return Preparers and What They Do

A common complaint of the United States tax system is that preparing one's tax return is too complicated.¹³ Tax return preparers assist American taxpayers by preparing and filing tax returns,¹⁴ and provide necessary assistance to individuals who either choose not to, or feel they cannot, navigate the complexities of the tax laws without help.¹⁵ Of the approximately 150 million individual income tax returns filed each year, roughly 80 million are prepared with the help of a paid tax return preparer.¹⁶ While low-income taxpayers are likely to use a preparer because they believe they lack the ability to prepare the return themselves, they also choose to pay a return preparer because they believe the preparer may increase the amount of refund or accelerate the refund through the sale of a credit product.¹⁷

13. JOEL SLEMROD AND JON BAKIJA, *TAXING OURSELVES: A CITIZEN'S GUIDE TO THE DEBATE OVER TAXES* 3 (4th ed. 2008) ("For many, complying with our labyrinthine tax regulations is frustrating, costly and intrusive."). Slemrod and Bakija debunk the notion that the tax code is too complex. Approximately 45 percent of all taxpayers, especially low-income taxpayers, "spend fewer than 10 hours per year on their taxes." *See id.* at 4.

14. *See* 26 C.F.R. § 301.7701-15 (2017) ("A *tax return preparer* is any person who prepares for compensation, or who employs one or more persons to prepare for compensation, all or a substantial portion of any return of tax or any claim for refund of tax under the Internal Revenue Code (Code).").

15. *See* Leviner, *supra* note 8, at 1087-88 (documenting reasons why taxpayers use return preparers, such as lack of taxpayer understanding of filing requirements; taxpayer lack of time and patience; belief that preparer can minimize tax liability and maximize refunds; and potentially reducing the probability of an audit); *see also* Olson, *supra* note 11, at 767, 770. According to the NCLC, filing a tax return is likely "the most critical financial interaction," an individual has with the government each year. Brief for Amici Curiae Nat'l Consumer Law Ctr. and Nat'l Cmty. Tax Coal. in Support of Defendants-Appellants and Arguing for Reversal of the District Court at 4, *Loving v. IRS*, 742 F.3d 1013 (2014) (No. 13-5061), 2013 WL 1386247, at *4 [hereinafter *Amici Curiae in Support of Defendants-Appellants, Loving v. IRS*].

16. *Protecting Taxpayers From Incompetent and Unethical Return Preparers: Hearing Before the S. Comm. on Fin.*, 113th Cong. 5, 7 (2014) [hereinafter *Koskinen, Protecting Taxpayers*] (statement of John A. Koskinen, Comm'r, IRS). Former IRS Commissioner Koskinen, in his written statement, wrote that "[e]ach year, paid preparers are called upon by taxpayers to complete about 80 million returns, or about 56 million of the total individual income tax returns filed, while another 34 percent of taxpayers use tax preparation software, for a total of 90 percent who seek some form of assistance." *Id.* at 131 (written testimony of John A. Koskinen, Comm'r, IRS). It was estimated that, in tax year 2011, 81.2 million (or 56 percent) of individual tax returns were filled out by a paid preparer. U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-06-563T, *PAID TAX RETURN PREPARERS: IN A LIMITED STUDY, PREPARERS MADE SIGNIFICANT ERRORS* 8 (2014).

17. *See* Book, *Preventing the Hybrid from Backfiring*, *supra* note 12, at 1115-16. Tax-time refund products have gone through a death and resurgence. *See* Leslie Book, *New Report Discusses the Rebirth of Refund Loans*, PROCEDURALLY TAXING BLOG (April 4, 2017) <http://procedurallytaxing.com/new-report-discusses-the-rebirth-of-refund-loans/> [<https://perma.cc/S49C-KAR6>] [hereinafter *Book, Rebirth of Refund Loans*].

Paid tax return preparers are categorized into three general groups of practitioners. The first group is comprised of professionals who are state licensed, such as certified public accountants (CPAs) and attorneys.¹⁸ CPAs and attorneys are licensed after meeting educational requirements and undergoing examination of both competency and character.¹⁹ The second group is comprised of so-called enrolled agents.²⁰ Enrolled agents, though not professionally licensed by any state, are regulated by the federal government and must demonstrate competency in tax matters, demonstrate compliance with the agent's tax obligations, and meet ethical standards and continuing education obligations.²¹ The third group of tax return preparers, "unregulated tax return preparers" or "unregulated preparers," unlike enrolled agents or CPAs and attorneys, are completely unregulated and encompass all remaining paid preparers.²² Unregulated preparers may prepare tax returns for a fee but are not required to have any minimum education or expertise and are not subject to background checks or ethical competencies.²³ Of the nearly 80 million returns prepared by preparers, over half are prepared by unregulated tax return preparers.²⁴ In 2009, the IRS estimated that there were approximately 43,000 enrolled agents, 650,000 CPAs (as of 2006), and 1.2 million attorneys who

18. 31 C.F.R. § 10.3(a) (2017) (attorneys); *id.* § 10.3(b) (certified public accountants).

19. *See, e.g.*, MONT. ADMIN R. 24.201.2106 (2016); N.M. CODE R. § 16.60.3.15 (LexisNexis 2016); OR. REV. STAT. § 673.165 (2015); MONT. SUPREME CT., RULES FOR CONTINUING LEGAL EDUCATION RULE 4 (2013); N.M. SUPREME CT., MCLE RULES ART. 2 § 18-201 (2011); SUPREME COURT OF THE STATE OF OR., RULES FOR ADMISSION OF ATTORNEYS 8.21 (2017).

20. 31 C.F.R. § 10.3(c) (enrolled agents).

21. *Id.* §§ 10.4(a) (eligibility to become enrolled agent), 10.5(d)(1) (compliance and suitability checks), 10.6 (renewal process for enrolled agent).

22. *See infra* Section II.C.1 (discussing the IRS's attempts to regulate the third group of preparers). Circular 230 still contains the regulations to that effect, 31 C.F.R. §§ 10.3(f), 10.4(c), 10.5, but the regulations have been struck down. *See Loving v. IRS*, 742 F.3d 1013, 1021–22 (D.C. Cir. 2014). There have been empirical studies on the quality of tax returns prepared by various paid (and unpaid) preparers. *See infra* at Sections II.B.1. *See generally infra* IV.B.2 (discussing informational asymmetries and its impact on quality of services).

23. IRS, RETURN PREPARER REVIEW 8, 35 (2009).

24. John A. Koskinen, *Regulation of Tax Return Preparers*, in 1 TAXPAYER ADVOCATE, ANNUAL REPORT TO CONGRESS 61, 61 (2013). Approximately 22 million individual tax returns are prepared by CPAs, another approximately 12 million are prepared by other state regulated preparers such as enrolled agents, actuaries and state regulated return preparers, and fewer than 900,000 are prepared by attorneys. *Id.* at 62.

prepared returns.²⁵ In the absence of official registries, the number of unregulated preparers is unknown.²⁶

Among unregulated tax return preparers there is tremendous variety in terms of sizes and types of businesses engaged in preparing returns. These businesses can be divided into two general categories: (1) Businesses whose primary purpose is to provide products and services related to the tax preparation industry and (2) Businesses where preparation of returns is ancillary to their primary business purpose.²⁷ Among the first category of businesses whose primary business is related to the preparation of tax returns, there is variety itself in terms of size of operation. Tax return businesses vary in size from solo practitioners to medium-size firms to large, national chains.²⁸

The second category of preparers, businesses in which return preparation is secondary or ancillary to the primary business, are often referred to as fringe return preparers. Fringe preparers are primarily engaged in the business of selling consumer products and they offer tax return preparation services as a way to entice customers.²⁹ Fringe preparers usually offer customers the option to finance the purchase of goods sold by the preparer by the anticipated tax refund.³⁰ Examples of fringe preparers include car dealerships; check cashing and payday lenders; pawnshops and rent-to-own stores; and other fee-based

25. IRS, *supra* note 23, at 9 fig.2.

26. *Id.* (unknown estimate); NAT'L TAXPAYER ADVOCATE, 2003 ANNUAL REPORT TO CONGRESS 270 (Dec. 31, 2003) (estimating the number from 300,000 to 600,000 for tax year 2001). Even if NTA's numbers were accurate, the increase in use of tax return preparers suggests the numbers must be adjusted upward. See Leviner, *supra* note 8, at 1090.

27. See *Regulation of Federal Tax Return Preparers: Hearing Before the H. Comm. on Ways and Means Subcomm. on Oversight*, 109th Cong. 2 (2005) [hereinafter Olson, *Tax Return Preparers*] (written statement of Nina E. Olson, National Taxpayer Advocate). The defining feature of fringe preparers is that they are "not engaged primarily in the business of preparing taxes." *Id.*

28. Three major national chains, Jackson Hewitt, H&R Block and Liberty Tax are the largest tax return preparer chains in the country. See CHI CHI WU & CHANTAL HERNANDEZ, NAT'L CONSUMER LAW CTR., MINEFIELD OF RISKS: TAXPAYERS FACE PERILS FROM UNREGULATED PREPARERS, LACK OF FEE DISCLOSURE, AND TAX-TIME FINANCIAL PRODUCTS 15–16 (2016); see also *Protecting Taxpayers From Incompetent and Unethical Return Preparers: Hearing Before the S. Comm. on Fin.*, 113th Cong. 49 (2014) [hereinafter Alban, *Protecting Taxpayers*] (written statement of Dan Alban, Attorney, Inst. for Justice). Size of return preparation business is relevant. Under the IRS's prior attempt to regulate the industry under the 2011 regulations, the larger chain operations did not oppose the regulations whereas smaller businesses, like the plaintiffs in the *Loving* case, argued they were less able to absorb the costs of regulation that the larger chains were more able to absorb. See *infra* notes 133–38 and accompanying text.

29. See WU & HERNANDEZ, *supra* note 28, at 18–19.

30. See, e.g., *id.* at 21.

providers.³¹ Taxpayers using a fringe preparer may be able to purchase goods, such as a used car or furniture, with no money down after assigning the customer's anticipated tax refund to the fringe preparer.³²

In addition to paid tax return preparers, some taxpayers rely on unpaid tax return preparers that have been exempt from prior attempts to regulate the industry. Free tax preparation services available to low-income taxpayers include the Volunteer Income Tax Assistance (VITA) program and the Tax Counseling for the Elderly (TCE) program.³³ Still other taxpayers rely on friends and family to prepare their returns for free.³⁴

31. *Id.* at 18–19 (providing examples of fringe preparers); *id.* at 21 (discussing “First Quarter Tax Max Marketing Program,” a program for auto dealers marketed by TRS Refund Services, which allows for car dealers to both boost auto sales by allowing customers to apply tax refunds toward the purchase of a vehicle and generate profits from the preparation of the return, plus interest and fees); *see infra* Section II.A.3 (discussing the financial products businesses use to encourage spending and fees generated on products themselves).

32. *See* WU & HERNANDEZ, *supra* note 28, at 1, 20–21.

33. *Free Tax Return Preparation for Qualifying Taxpayers*, IRS <https://www.irs.gov/individuals/free-tax-return-preparation-for-you-by-volunteers> [<https://perma.cc/NBA9-FK5V>] (last updated Oct. 30, 2017) (stating that TCE and VITA programs are offered nation-wide at community centers, libraries, and schools; both volunteer programs are funded by grants from the IRS budget). VITA offers free tax preparation services to taxpayers who earn \$54,000 or less, individuals with disabilities, and taxpayers who have limited English-speaking skills. *Id.* VITA is staffed by volunteers who receive training in basic income tax preparation from the IRS. *Id.* This raises the obvious question, if VITA requires training and annual re-certification for a volunteer to prepare tax returns for free, why does the system allow paid tax return preparers to do so without required training? TCE services are also offered to provide free tax help for all taxpayers, but particularly for those over the age of 60, with an emphasis on tax issues relating to pensions and retirement-related concerns, and TCE providers also receive training from the IRS. *See id.* “More than 90,000 volunteers at 12,057 Volunteer Income Tax Assistance and Tax Counseling for the Elderly sites assisted more than 3.6 million taxpayers during the 2015 Filing Season.” Karen Kraushaar, *The IRS Needs to Adhere to Procedures to Assess its Volunteer Tax Return Preparation Program Accurately*, U.S. TREASURY (June 29, 2016), https://www.treasury.gov/tigta/press/press_tigta-2016-18.htm [<https://perma.cc/5X4D-QGL4>]. *See generally* Ezra Levin & Shervan Sebastian, *Strengthening VITA to Boost Financial Security at Tax Time & Beyond*, PROSPERITY NOW (June 2016) https://prosperitynow.org/files/resources/06-2016_VITA_tax_policy_brief.pdf [<https://perma.cc/F2JE-TBSG>].

34. According to a survey of American taxpayers, roughly 10.9% of taxpayers get a friend or family member to help file their taxes. Elyssa Kirham, *43% of Americans File Taxes From the Comfort of Their Home, Survey Finds*, GO BANKING RATES (Jan. 25, 2016), <https://www.gobankingrates.com/personal-finance/43-percent-americans-file-taxes-comfort-home-survey-finds/> [<https://perma.cc/T4FG-5J33>]. One can also file for free by using “IRS Free File,” which “is a partnership between the IRS and the Free File Alliance, a group of industry-leading private-sector tax preparation companies that have agreed to provide free commercial online tax preparation and electronic filing.” *About the Free File Program*, IRS, <https://www.irs.gov/uac/about-the-free-file-program> [<https://perma.cc/9DD9-ZZ3H>] (last updated Nov. 29, 2017) (internal citation omitted). Free

2. Tax Return Preparers Facilitate Low- and Lower-Income Taxpayer's Access to the Earned Income Tax Credit (EITC)

Paid tax return preparers have a unique role in the tax administration system. Paid preparers, especially otherwise unregulated preparers, help low-income taxpayers access social welfare benefits administered through the tax system. Since the mid-1990s, a majority of federal social welfare benefits are administered through the tax system via refundable credits such as the Earned Income Tax Credit (EITC), and to a lesser degree child tax credits.³⁵ The EITC represents “the nation’s largest anti-poverty program.”³⁶ Taxpayers eligible for the EITC “are often the least educated and least financially sophisticated in the U.S. today.”³⁷

With the expansion of refundable tax credits aimed as anti-poverty measures, the relationship between the IRS and the intended recipients of government assistance has changed.³⁸ The expansion of tax-based welfare shifts from a government determined eligibility to a private, market driven industry, which acts as the intermediary to assist taxpayers to claim eligibility.³⁹ The shift in delivery of government benefits is perhaps one of the most significant factors driving demand for otherwise unregulated tax return

File Software is available to taxpayers with income equal to \$64,000 or less and Free File Fillable Forms if taxpayer’s income is greater than \$64,000. *See id.*

35. *See generally* Book, *Preventing the Hybrid from Backfiring*, *supra* note 12, at 1110 (providing background on the history of the EITC and the tax system).

36. Book, *Study of the Role of Preparers*, *supra* note 12, at 49. Despite the complexities detailed in this Article with respect to the proliferation of the tax return preparer industry and the credit products return preparers sell, there are some policy justifications for switching from means-based welfare to welfare distributed to low-income reporting workers. *See* Leslie Book, *Bureaucratic Oppression and the Tax System*, 69 *TAX LAW* 567, 573–74 (2016) [hereinafter Book, *Bureaucratic Oppression and the Tax System*]. Distribution of welfare through the tax system has support for two main reasons: (1) it lessens the stigma associated with means-based welfare and (2) it is administratively simpler for the government. *Id.* at 573; *see also* Anne Alstott, *The Earned Income Tax Credit and the Limitations of Tax-Based Welfare Reform*, 108 *HARV. L. REV.* 533, 533 (1995).

37. Olson, *supra* note 11, at 769.

38. Book, *Bureaucratic Oppression and the Tax System*, *supra* note 36, at 573. The U.S. tax law and administrative system has long played a role in social and economic goals. *See id.* at 573, 575. However, in describing barriers low income taxpayers face in obtaining government benefits to which they are entitled, Professor Book notes that “the advent of the use of refundable credits in the tax system has fundamentally changed the relationship between the Service and those who increasingly depend on the tax system to meet basic needs.” *Id.* at 573.

39. *See* Olson, *Tax Return Preparers*, *supra* note 27, at 2. The emergence of paid preparers other than CPAs and attorneys directly correlates with the expansion of the EITC. *See id.* The advent of electronic tax return filing, also in the early 1990s, triggered more demand for paid preparers as taxpayers without access to the internet could obtain their refunds more quickly. *See id.*

preparers.⁴⁰ With the increase in demand for return preparers by low-income taxpayers, a parallel market for consumer credit products has emerged.⁴¹

The majority of taxpayers claiming EITC benefits rely on the services of tax return preparers or use of commercial tax software and many purchase consumer credit products sold from their preparers.⁴² These taxpayers may perceive the fees paid for return preparation and credit products as a cost to access the government benefits to which they are entitled.⁴³ The cost of return preparation to EITC beneficiaries has been described as “a hidden administrative cost of the EITC program,” which reduces the net benefits received by low-income taxpayers.⁴⁴

While it is true that most tax return preparers do not engage in practices that hurt taxpayers, troubling statistics on fraudulent refund claims and the EITC call into doubt the accuracy and intentions of tax return preparers who serve the working poor.⁴⁵ Returns claiming the EITC are perhaps the single biggest

40. See Book, *Preventing the Hybrid from Backfiring*, *supra* note 12, at 1115–17, 1115 n.77, 1116 nn.78–79.

41. *Id.*

42. See CHI CHI WU, NAT’L CONSUMER LAW CTR., RIDDLED RETURNS: HOW ERRORS AND FRAUD BY PAID TAX PREPARERS PUT CONSUMERS AT RISK AND WHAT STATES CAN DO 3 & n.1, 5 (2014) [hereinafter WU, RIDDLED RETURNS]; Soled & Thomas, *supra* note 8, at 156 & n.29 (citing Koskinen, *Protecting Taxpayers*, *supra* note 16). About 21.6 million consumers obtained a refund anticipation check (“RAC”) in 2014, with the vast majority being “low-income,” CHI CHI WU & MICHAEL BEST, NAT’L CONSUMER LAW CTR., TAXPAYER BEWARE: UNREGULATED TAX PREPARERS AND TAX-TIME FINANCIAL PRODUCTS PUT TAXPAYERS AT RISK 4 (2015) [hereinafter WU & BEST, TAXPAYER BEWARE], paying a “minimum of \$648 million in RAC fees” and “another estimated \$200 million in add-on fees.” *Id.* at 1.

43. See Olson, *Tax Return Preparers*, *supra* note 27, at 2. According to a survey conducted by The National Society of Accountants in 2016 and 2017, “the average fee to prepare and file a simple Form 1040 (with no itemized deductions) and a state tax return is \$176.” Ray Martin, *A Taxpayer’s Guide to Tax-Prep Fees*, CBS NEWS (Feb. 1, 2017), <https://www.cbsnews.com/news/a-taxpayers-guide-to-tax-prep-fees/> [<https://perma.cc/4TFL-FLBD>].

44. See Alstott, *supra* note 36, at 590.

45. See IRS, *supra* note 23, at 6, 13–17. In 2009, the IRS estimated “that there are between 900,000 and 1.2 million paid return preparers,” including state regulated preparers such as attorneys and CPAs, but the number of otherwise unregulated return preparers is unknown. *Id.* at 8, 9 fig.2. Compliance studies show that when it comes to tax benefits for the working poor, unregulated return preparers incorrectly prepare returns. See *id.* at 13–17 (citing Government Accountability Office studies that a half of the return preparers in mystery shopper reviews incorrectly reported that the GAO’s shopper was entitled to two children for the EITC when the shopper was only entitled to the credit for one child). The *Return Preparer Review* also cited a Treasury Inspector General for Tax Administration study in which errors were documented on the EITC, child tax credit, filing status and dependency exemptions. *Id.* at 16 fig.5.

source of fraudulent refund claims.⁴⁶ Furthermore, “data suggests that close to one-third” of all claims for the EITC are claimed in error.⁴⁷ These statistics have sparked inquiry into the cause and nature of the errors. Researchers examine whether the high error rate is driven by return preparer misconduct, taxpayer misconduct, or a combination of both.⁴⁸ The answer remains unresolved, but the fact that the EITC has a much higher error rate than traditional means-based welfare programs where eligibility is determined by the government instead of claimed by a taxpayer on a return, has triggered political energy toward enforcement to reduce errors.⁴⁹

3. Tax Return Preparers as Consumer Credit Providers

For many taxpayers who seek the assistance of a tax return preparer to claim their EITC benefits, the filing of the return is the first of several possible financial services sought from a tax return preparer.⁵⁰ Some taxpayers who qualify for the EITC cannot afford to wait for their refund, and many do not have cash available to pay for the return preparation itself.⁵¹ Some taxpayers do not have access to the banking system in the first place.⁵² Tax return

46. WU, RIDDLED RETURNS, *supra* note 42, at 1. The NCLC estimates that approximately sixty percent of EITC claimants (16 million returns) use unregulated tax preparers. *Id.* at 2; see Book, *Preventing the Hybrid from Backfiring*, *supra* note 12, at 1117 (2006) (noting that approximately fifty-seven percent of erroneously claimed EITC credits were attributable to returns prepared by paid preparers).

47. Book, *Study of the Role of Preparers*, *supra* note 12, at 49.

48. *See id.*

49. See Lawrence Zelenak, *Tax or Welfare? The Administration of the Earned Income Tax Credit*, 52 UCLA L. REV. 1867, 1881 (2005). For error rates among lower-income taxpayers claiming the EITC, broken down by return preparers, see IRS, COMPLIANCE ESTIMATES FOR THE EARNED INCOME TAX CREDIT CLAIMED ON 2006–2008 RETURNS 26 (2014) [hereinafter IRS, COMPLIANCE ESTIMATES FOR EITC CLAIMED ON 2006–2008 RETURNS].

50. See Book, *Refund Anticipation Loans & The Tax Gap*, *supra* note 12, at 99 (“[T]he tax preparation industry as a whole has become . . . ‘a vehicle for cross-marketing of non-tax goods and services.’” (quoting *Tax Return Preparation Options for Taxpayers: Hearing Before the S. Finance Comm.*, 109th Cong. 149 (Apr. 4, 2006) (written statements of Nina E. Olson, National Taxpayer Advocate))).

51. See Andrew T. Hayashi, *The Effects of Refund Anticipation Loans on the Use of Paid Preparers and EITC Take-Up 9* (Virginia Law and Economics Research Paper No. 2016-9, 2016), <https://ssrn.com/abstract=2801591> [<https://perma.cc/PM5N-MSA4>], for a discussion of factors in triggering demand for refund loans, including allowing low-income taxpayers the ability to borrow the cost of tax preparation. Historical data shows that the majority of taxpayers who sought RALs are lower-income and claim the EITC. See Book, *Refund Anticipation Loans & The Tax Gap*, *supra* note 12, at 86.

52. See Michael S. Barr and Jane K. Dokko, *Third-Party Tax Administration: The Case of Low- and Moderate-Income Households*, 5 J. EMPIRICAL LEGAL STUD. 963, 964 (2009) (finding one reason

preparers often provide ancillary credit products to allow taxpayers quicker access to their anticipated refunds at high cost to the taxpayer.⁵³ These products include Refund Anticipation Loans (RALs) and Refund Anticipation Checks (RACs) and the ability to apply an anticipated refund to a host of consumer goods.⁵⁴ Preliminary reports indicate that more than 1.5 million RALs were issued by March 2017, and IRS data shows that 18.8 million taxpayers obtained RACs in 2015.⁵⁵

Many of these high-cost credit products have seemingly analogous non-tax counterparts such as payday loans.⁵⁶ The key distinction of these ancillary financial products is their connection to the tax system.⁵⁷ Repayment of these loans is achieved not by the taxpayer/debtor directly. Instead, the loans are repaid by the government, as a cut of the welfare benefits through the tax system.⁵⁸ This has distortive effects to the taxpayer as a consumer of these products.⁵⁹

Taxpayers who are at low or lower income levels are much more likely to rely on these ancillary financial products,⁶⁰ probably because they have no

for use of return preparers is lack of access to banking system); *see also* Hayashi, *supra* note 51, at 10–11.

53. *See* IRS, *supra* note 23, at 10.

54. *Id.* Fringe preparers can use return preparation as a tool to attract customers and allow customers to purchase goods on credit based on the anticipated refund. *See* WU & BEST, TAXPAYER BEWARE, *supra* note 42, at 17–18. For example, TRS Tax Max, self-proclaimed largest electronic filer for the retail industry, markets return preparation services to retailers to allow retailers to “receive a portion of [the] customer’s refund within 24 hours!” *See* Benefits, TRS TAX MAX, <https://www.taxmax.com/TRSTaxMax/Benefits.aspx> [<https://perma.cc/K4YY-E5YS>] (last visited Sept. 24, 2017). TRS Tax Max specifically markets to car dealers, allowing customers to have their tax return prepared at the dealership and the prospective refund to be applied to the purchase price of the vehicle. *See* WU & BEST, TAXPAYER BEWARE, *supra* note 42, at 18.

55. CHI CHI WU & MICHAEL BEST, NAT’L CONSUMER LAW CTR., BIG CHANGES BURDEN TAXPAYERS: NEW LAW DELAYS REFUNDS, DRIVES DEMAND FOR LOANS; IMMIGRANT TAXPAYERS FACE CHALLENGES 3, 5 (2017) [hereinafter WU & BEST, BIG CHANGES BURDEN TAXPAYERS].

56. *See* DEE PRIDGEN & RICHARD M. ALDERMAN, CONSUMER CREDIT AND THE LAW § 5:6, at 368 (2015–16 ed.).

57. *Compare* IRS, *supra* note 23, at 10 (discussing refund settlement products), *with* PRIDGEN & ALDERMAN, *supra* note 56, at 368 (discussing payday loans).

58. *See supra* note 57.

59. *See infra* Section IV.B.2, for a discussion of the behavioral economics literature on risk preferences.

60. *See, e.g.*, WU & HERNANDEZ, *supra* note 28, at 1; WU, RIDDLED RETURNS, *supra* note 42, at 3; CHI CHI WU, NAT’L CONSUMER LAW CTR., END OF THE RAPID RIP-OFF: AN EPILOGUE FOR QUICKIE TAX LOANS (2011) [hereinafter WU, END OF THE RAPID RIP-OFF: AN EPILOGUE FOR QUICKIE TAX LOANS]; CHI CHI WU ET AL., NAT’L CONSUMER LAW CTR., TAX PREPARERS TAKE A BITE OUT OF REFUNDS: MYSTERY SHOPPER TEST EXPOSES REFUND ANTICIPATION LOAN ABUSES IN

savings or cushion of resources. These financial products, while objectionable to consumer advocates because of the high rates of interest or usurious nature, exist because of market demand by consumers. Empirical research shows that taxpayers are more likely to file returns and claim refundable tax credits to which they are entitled when loan products are available to make refunds more quickly accessible.⁶¹ The following is a brief description of the most common products: RALs, RACs, and the application of the anticipated refund to consumer goods by fringe preparers, and the problems associated with those products.

Refund Anticipated Loans

RALs are short-term, high interest-rate loans issued from a financial institution and secured by the expected refund.⁶² RALs allow taxpayers to accelerate receipt of their refund and defer payment of the cost of return preparation.⁶³ A taxpayer borrows against the refund claimed on the return and is obligated to repay the loaned amount.⁶⁴ A RAL lender issues the anticipated refund amount, less tax return preparation fees and filing, finance, and processing charges.⁶⁵ Then, the IRS refund is directly transferred to the lender to repay the loan and any interest.⁶⁶ Regulations prohibit tax return preparers from actually issuing the loan directly, but the return preparers facilitate the loans by partnering with banks.⁶⁷ Preparers and lenders developed

DURHAM AND PHILADELPHIA (2008) [hereinafter WU ET AL., TAX PREPARERS TAKE A BITE OUT OF REFUNDS].

61. See Hayashi, *supra* note 51, at 3.

62. *Id.* at 6–7.

63. *Id.*

64. Book, *Refund Anticipation Loans & The Tax Gap*, *supra* note 12, at 99. Traditionally, RALs were recourse loans. See WU & HERNANDEZ, *supra* note 28, at 7 (explaining that taxpayers/debtors used to be personally liable for repayment of the loans). Current iterations of RAL products are non-recourse, though it is not clear whether all RALs are non-recourse. *Id.*

65. *Id.*

66. *Id.*

67. *Id.* at 99–100; see also Hayashi, *supra* note 51, at 6. The rules prohibiting tax preparers from issuing the loans (or being related to the institution issuing the loan) are found in the IRS's handbook for authorized e-File Providers. IRS, HANDBOOK FOR AUTHORIZED IRS E-FILE PROVIDERS OF INDIVIDUAL TAX RETURNS 44–45 (2004). The handbook also sets forth all of the disclosure requirements for preparers with respect to RALs. *Id.* One of these relationships is the “per-RAL compensation arrangement” under which “the preparer receives a flat fee from the lender, regardless of the size of the loan.” Book, *Refund Anticipation Loans & The Tax Gap*, *supra* note 12, at 100. Another type of relationship is a “participation arrangement,” whereby the preparer acquires a less than fifty percent share of the loan, based on an interpretation of Revenue Procedure 98-50, which allows

relationships that created an economic interest in the loans on the part of the preparer.⁶⁸ RALs are usually made for a duration of less than two weeks, or the time it takes the IRS to process and issue the tax refund.⁶⁹

Over the last eight years RALs have undergone a significant evolution. Historically, the loans were incredibly low risk to the lenders because the IRS provided a “debt indicator,” which revealed whether a taxpayer’s refund would likely be issued by the IRS or garnished by the IRS to satisfy other outstanding tax obligations or unpaid debts such as unpaid child support or federally funded student loans.⁷⁰

Bank lender-issued RALs were once prevalent and especially popular among low-income taxpayers.⁷¹ The loans were controversial because they carried high fees and high effective rates, in addition to concerns that the fees incentivized preparers and banks to inflate the claims for a refund.⁷² Between 2009 and 2012, banks left the RAL market or were forced out because of federal regulations.⁷³ In 2011, the IRS stopped providing the lenders a debt indicator.⁷⁴ So, with these regulations in place, banks have stopped issuing RALs.⁷⁵

for such an arrangement because “the preparer is not the lender so long as it does not own a majority share in the loan.” *Id.*

68. Book, *Refund Anticipation Loans & The Tax Gap*, *supra* note 12, at 100.

69. See Hayashi, *supra* note 51, at 7. Tax refunds are now usually issued within 21 days. IRS, IRS REFUND INFORMATION GUIDELINES FOR THE TAX PREPARATION COMMUNITY (2016), <https://www.irs.gov/pub/irs-pdf/p2043en.pdf> [<https://perma.cc/XW#8-4ZZA>]. Under some circumstances, the IRS may take additional time to review a claim for a refund. *Id.*

70. See Book, *Refund Anticipation Loans & The Tax Gap*, *supra* note 12, at 105–06 (explaining the IRS’s Debt Indicator program).

71. In year 2002, there were 14.1 million RAL applications. WU, END OF THE RAPID RIP-OFF: AN EPILOGUE FOR QUICKIE TAX LOANS, *supra* note 60, at 8. The popularity among lower income taxpayers, many who claim the EITC, is notable. In one study, the median adjusted gross income of RAL borrowers was less than \$20,000 and twenty-five percent of taxpayers with income between \$10,000 and \$25,000 used a RAL. *Id.* at 10.

72. Book, *Rebirth of Refund Loans*, *supra* note 17.

73. WU & BEST, BIG CHANGES BURDEN TAXPAYERS, *supra* note 55, at 3; see Hayashi, *supra* note 51, at 11.

74. Hayashi, *supra* note 51, at 11. In the absence of the IRS providing the lender with information on whether the taxpayer applying for a RAL was likely to receive the refund or not, the RAL market shriveled up. See *id.* RAL applications fell by 84.5% in 2011 and the FDIC “notified RAL lenders that making loans without the debt indicator was ‘unsafe and unsound.’” *Id.*

75. *Id.* at 11–12.

Payday lenders and other non-bank lenders started to offer RALs after 2012, but exponentially fewer taxpayers have applied for them since 2002.⁷⁶ The National Consumer Law Center claims the non-bank RALs are riskier than bank-issued RALs, citing an enforcement action against a non-bank RAL lender in which the Consumer Financial Protection Bureau (CFPB) alleged the non-bank-issued RAL had APRs of over 240 percent.⁷⁷

A market, however, continues to exist for so-called “no fee” RALs.⁷⁸ In 2016, a number of non-bank RAL lenders began issuing a purported “no-fee” RAL or an advance of up to \$750.⁷⁹ Although advertised as no-fee, preparers derive revenue through higher APRs, increased cost for tax preparation, or a kickback to the preparer on a charged fee.⁸⁰ The tax return preparation industry promotes new loans to attract customers; what drives this industry is a complicated matter because, for some players, it is not so much about the preparation of returns as it is about the fees generated from extending consumer credit,⁸¹ while for others the loan products are designed as a marketing tool to attract customers.⁸²

Refund Anticipation Checks

As the market for RALs evaporated, tax return preparers started marketing RACs. RACs are temporary bank accounts, created for a fee, for the taxpayer to receive his or her refund.⁸³ Unlike the RAL, a RAC does not facilitate immediate access to anticipated refunds, but it may accelerate a taxpayer’s

76. WU & HERNANDEZ, *supra* note 28, at 5. The IRS estimates that 12.7 million received RALs in 2002, while only 100,000 taxpayers applied for non-bank RALs in 2013 and only 34,000 applied in 2014. *Id.*

77. *Id.* at 5, 24.

78. *See id.* at 5–8. There are also paystub RALs or pre-tax filing season loans, made before taxpayers receive their IRS Form W-2s, which are lines of credit, not secured by refunds; they have annual fees and interest rates on the credit issued. *Id.* at 8.

79. *Id.* at 5. NCLC provides examples where non-bank lenders offer RALs through Jackson Hewitt and other tax preparation services. *Id.* 5–8.

80. *Id.* at 6.

81. *See* Stacy Cowley, *Tax Refund Loans Are Revamped and Resurrected*, N.Y. TIMES (Jan. 15, 2017), <https://www.nytimes.com/2017/01/15/business/tax-refund-loans-are-revamped-and-resurrected.html> [<https://perma.cc/ST2C-TPMN>].

82. *Id.*

83. *Id.*; WU & BEST, *BIG CHANGES BURDEN TAXPAYERS*, *supra* note 55, at 5.

access if the taxpayer does not have a bank account.⁸⁴ The RAC allows a taxpayer to have his or her tax preparation fees paid directly out of the refund.⁸⁵

RACs are dummy bank accounts that are created by a financial institution and await the refund deposit by the IRS.⁸⁶ Banks and tax preparers generate fees on RACs sold to taxpayers.⁸⁷ Data on the prevalence and cost of RACs to taxpayers indicates that approximately “21.6 million taxpayers obtained a RAC in 2014.”⁸⁸ RACs generally cost \$25–\$60 for a federal return plus \$10–\$13 for the state return, in addition to the cost of the return preparation.⁸⁹

For taxpayers with a bank account, RACs offer nothing more than a loan for the tax preparation fee.⁹⁰ A question exists as to whether the deferred payment of the tax preparation fee “make[s] taxpayers less sensitive to the price of tax preparation” (and the problems that come with lack of transparency in tax preparation fees).⁹¹

Use of Anticipated Refunds to Purchase Consumer Goods on Credit

In addition to RALs and RACs, fringe tax return preparers offer taxpayers the ability to apply the anticipated tax refund to the cost of return preparation itself or to other consumer products.⁹² Fringe preparers use tax preparation

84. See Hayashi, *supra* note 51, at 8. IRS regulations prohibit the deposit of a refund into the bank account of the tax preparer, regardless of whether a taxpayer has a bank account. 31 C.F.R. § 10.31(a) (“A practitioner may not endorse or otherwise negotiate any check (including directing or accepting payment by any means, electronic or otherwise, into an account owned or controlled by the practitioner or any firm or other entity with whom the practitioner is associated) issued to a client by the government in respect of a Federal tax liability.”).

85. Hayashi, *supra* note 51, at 8.

86. See *id.*

87. WU & HERNANDEZ, *supra* note 28, 3–4. According to the NCLC, fees for RAC products in 2016 by seven providers of federal RACs, ranged from \$25 to \$59.95. *Id.* The lowest price for a federal RAC was based on a preparer (Republic Bank & Trust) who chose to lower the price and receive no kickback. *Id.* at 4.

88. *Id.* at 3.

89. *Id.*

90. See WU & BEST, TAXPAYER BEWARE, *supra* note 42, at 2.

91. WU & HERNANDEZ, *supra* note 28, at 5. Prospect theory in behavioral economics would confirm this proposition because people are risk averse if the prospect is framed as potential loss (such as paying out of pocket for return preparation) versus risk-seeking if the prospect is framed as a potential gain (such as having the cost of return preparation taken out of the refund). See Amos Tversky and Daniel Kahneman, *Advances in Prospect Theory: Cumulative Representation of Uncertainty*, 5 J. RISK & UNCERTAINTY 297, 297–98 (1992). See *infra* Section IV.B.2, for further discussion.

92. See *supra* pp. 534–35 (discussing fringe return preparers).

services to attract potential customers and accelerate or increase the purchasing power of their customers.⁹³

Examples of fringe preparers are tax preparation services offered by “check cashers, payday lenders, rent-to-own stores, retailers, car dealers, and other fee-based providers.”⁹⁴ Fringe retailers or service providers seeking to capitalize on the potentially available funds generated by a tax refund may rely on third-party tax preparation companies to assist with the technical return preparation.⁹⁵ Fringe preparers also may offer sales during the fourth quarter of a tax year, deferring payment on the consumer goods, based on anticipated refunds to be applied following the filing of the customer’s tax return.⁹⁶

4. Problems with Credit Products Facilitated by Tax Return Preparers and Existing Protections for Consumers

The problems with refund-anticipated consumer credit products facilitated or provided by tax preparers are not dissimilar from general consumer credit products that are marketed to low-income individuals, such as payday loans or title loans.⁹⁷ The problems can be characterized as products the consumer does not need; credit products with high rates of interest; or products that are junk themselves.⁹⁸

Tax preparers will often charge additional fees that serve no purpose aside from increasing revenue to the preparer at the expense of reducing a taxpayer’s

93. See WU, RIDDLED RETURNS, *supra* note 42, at 5 (including examples of a car dealership offering to prepare returns for customers who lacked funds to make down payment and a shoe store offering a free pair of shoes with tax preparation).

94. WU & HERNANDEZ, *supra* note 28, at 18; WU, RIDDLED RETURNS, *supra* note 42, at 4–5.

95. WU & HERNANDEZ, *supra* note 28, at 19.

96. *Id.* at 20.

97. Payday loans are high-interest short-term loans. PRIDGEN & ALDERMAN, *supra* note 56, § 5:6, at 368. A post-dated check is usually written by the consumer in advance of the consumer’s anticipated pay check and the creditor promises not to cash the check. *Id.* The post-dated check includes the amount of the cash advance and service charges. *Id.* Payday loans are also referred to as cash advance loans or check advance loans. *Id.* They are very similar to the refund anticipatory loans in that they are advances of cash to the consumer based on anticipation of a payment. Compare IRS, *supra* note 23, at 10 (discussing refund settlement products), with PRIDGEN & ALDERMAN, *supra* note 56, at 368 (discussing payday loans, including RALs). A key difference is that payday loans are monetized directly by the consumer, whereas refund anticipatory loans are monetized by the federal government’s issuance of the consumer’s tax refund. See *infra* notes 212–214 and accompanying text, for an explanation of how the third-party monetization of the loan affects the incentives of return preparers and taxpayers.

98. See generally *supra* notes 30–32 and accompanying text (discussing the types of products provided).

refund,⁹⁹ and possibly from defrauding the federal government. Such additional or “add-on” fees may be labeled as: “Application fees; [d]ata and document storage fees; [d]ocument processing fees; [e]-filing fees; [s]ervice bureau fees; [t]ransmission/software fees; [and t]echnology fees.”¹⁰⁰ The add-on fees are not for additional services provided. For example, in a lawsuit brought by the federal government to permanently enjoin an individual from operating a tax return-preparation franchise business, the defendant business owner testified that such fees are “junk fees” and serve no purpose other than to generate additional revenue.¹⁰¹

Refund anticipation loans and most refund-anticipatory credit products are covered by the federal Truth in Lending Act (TILA) and the regulations thereunder.¹⁰² Essentially, the TILA requires disclosures regarding the terms and specifically prohibits misleading advertising of terms.¹⁰³ Critics of the TILA, however, dispute its efficacy in the high-cost credit arena.¹⁰⁴

B. Compliance Problems Associated with the TRP Industry

In an ideal world, return preparers would serve as the “key ally” to the IRS to fulfill the IRS’s “dual mission of providing taxpayer service and ensuring tax compliance.”¹⁰⁵ Unfortunately, the tax return preparation industry is blemished

99. See WU & HERNANDEZ, *supra* note 28, at 9.

100. *Id.*

101. United States v. ITS Fin., L.L.C., No. 3:12-CV-95, 2013 WL 5947222, ¶¶ 337, 358–67 (S.D. Ohio Nov. 6, 2013). For a discussion on the civil justice remedies of injunctive relief and other penalties against tax return preparers who perpetuate fraudulent or criminal schemes, see *infra* Section IV.A.

102. Truth in Lending Act (TILA), 15 U.S.C. § 1602 et seq. (2012). For a thorough discussion of the application of TILA to payday loans, see PRIDGEN & ALDERMAN, *supra* note 56, § 5:6, at 368–70.

103. See PRIDGEN & ALDERMAN, *supra* note 56, § 7.1, at 494–97.

104. Christopher L. Peterson, *Truth, Understanding, and High-Cost Consumer Credit: The Historical Context of the Truth in Lending Act*, 55 FLA. L. REV. 807, 890 (2003). Some critics dispute whether TILA has achieved the ultimate goal of protecting consumers by allowing them to make informed financial decisions:

[I]n the market for high-cost credit, [TILA] has failed almost entirely in promoting price informed borrowing decisions among the most vulnerable debtors. In the high-cost credit market, structural and market forces act, not to promote price competition, but to promote confusion and strategic lending behavior. High-cost lenders have a greater incentive to erect barriers to price shopping than moderate and low-priced lenders.

Id. (footnotes omitted).

105. Koskinen, *Protecting Taxpayers*, *supra* note 16, at 5; see Danshera Cords, *Paid Tax Preparers, Used Car Dealers, Refund Anticipation Loans, and the Earned Income Tax Credit: The*

with documented instances of negligence to intentional fraud.¹⁰⁶ Theoretically, the costs of errors made by tax return preparers should be borne by the taxpayer, the government, and the tax administration system as a whole. In reality, however, the burden for inaccurate returns is mostly borne by the taxpayer.

1. Studies on Non-Compliance

Compliance studies performed by the Government Accountability Office (GAO) and the Treasury Inspector General for Tax Administration (TIGTA), among many other consumer advocacy groups, have conducted mystery shopper tests of paid tax preparers serving recipients of the EITC nationwide.¹⁰⁷ The results of the mystery shopper tests highlight a culture of gross incompetence to outright fraud in return preparation and promotion of unconscionable financial products, with little or no regard for ethical standards.¹⁰⁸ The GAO and TIGTA both found that the majority of returns prepared were done so inaccurately.¹⁰⁹ For example, TIGTA found that only eleven of the twenty-eight return preparers tested by mystery shoppers were prepared correctly.¹¹⁰ Of the seventeen returns prepared with errors, six were

Need to Regulate Tax Return Preparers and Provide More Free Alternatives, 59 CASE W. RES. L. REV. 351, 382 (2009) (“[T]he relationship between the IRS, return preparers, and low-income taxpayers [is viewed as] a partnership . . . [in which] most, if not all, of the downside risk is borne by the taxpayer.”).

106. Amici Curiae in Support of Defendants-Appellants, *Loving v. IRS*, *supra* note 15, at 3. As Professor Book notes, there are a number of ways tax return preparers contribute to noncompliance in overstating credits or understating income, including, among other things:

- (1) Ignorance or misunderstanding of the law . . . ;
- (2) Misunderstanding or failing to understand or learn the facts . . . ;
- (3) [Being] unable or unwilling to detect false or incorrect information . . . ;
- (4) [N]ot exercising appropriate due diligence to verify facts or information; [and]
- (5) Aid[ing] and abet[ting] in noncompliance by advising taxpayers how to misstate or omit income, or claim inappropriate excessive deductions or credits[.]

Book, *Study of the Role of Preparers*, *supra* note 12, at 69–70.

107. U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-06-563T, PAID TAX RETURN PREPARERS: IN A LIMITED STUDY, CHAIN PREPARERS MADE SERIOUS ERRORS 3 (2006) [hereinafter GAO, PAID PREPARERS MADE SERIOUS ERRORS]; TREASURY INSPECTOR GEN. FOR TAX ADMIN., 2008-40-171, MOST TAX RETURNS PREPARED BY A LIMITED SAMPLE OF UNENROLLED PREPARERS CONTAINED SIGNIFICANT ERRORS 2 (2008) [hereinafter TIGTA, SIGNIFICANT ERRORS]; WU ET AL., TAX PREPARERS TAKE A BITE OUT OF REFUNDS, *supra* note 60, at 2 (uncovering repeated instances of serious tax errors and fraud in addition to disclosure violations with respect to RALs).

108. See Olson, *supra* note 11, at 768 (analyzing these studies); see also Amici Curiae in Support of Defendants-Appellants, *Loving v. IRS*, *supra* note 15, at 3.

109. See Olson, *supra* note 11, at 768.

110. TIGTA, SIGNIFICANT ERRORS, *supra* note 107, at 2.

considered to have misstatements or omissions that TIGTA considered to be willful or reckless.¹¹¹ The GAO report found errors in seventeen of the nineteen tests, including preparers advocating for claiming ineligible children for the EITC in five cases and inflating refunds by more than \$1,000 in six of the cases.¹¹²

By comparison, there are higher levels of compliance on returns prepared by volunteer preparers (such as IRS prepared, VITA, or TCE services) than by returns prepared by otherwise unregulated tax return preparers.¹¹³ That study notes, however, that its results do not reveal whether it is the taxpayer or return preparer who instigates the non-compliance.¹¹⁴

2. The Costs of the Errors are Borne by Taxpayers, the Government and the Tax Administration System

When a tax return preparer does cause a taxpayer to erroneously claim an EITC, the consequences of erroneously prepared tax returns are borne by the taxpayer, the government, and the tax system as a whole.¹¹⁵

Costs to the government of errors made by tax return preparers can be categorized in two ways: direct monetary costs and indirect monetary costs that exact a psychic toll on the entire tax administrative system. Direct monetary costs are lost revenue and increased enforcement costs to the IRS.¹¹⁶ Indirect monetary costs to the government are the immeasurable costs to the integrity

111. *Id.*

112. GAO, PAID PREPARERS MADE SERIOUS ERRORS, *supra* note 107, at 21–23.

113. Leviner, *supra* note 8, at 1120.

114. *Id.* at 1131. The inability to separate which of the two parties initiates the non-compliance is a challenge to determining the role tax preparers play in compliance, especially in light of research that suggests “taxpayers are inclined to seek out advisors who share their views of compliance.” *Id.* at 1132.

115. Not all erroneously claimed EITC dollars are done so by tax return preparers. *See supra* Section II.A.2.

116. *See* U.S. GOV’T ACCOUNTABILITY OFFICE, GAO-16-475, REFUNDABLE TAX CREDITS: COMPREHENSIVE COMPLIANCE STRATEGY AND EXPANDED USE OF DATA COULD STRENGTHEN IRS’S EFFORTS TO ADDRESS NONCOMPLIANCE 1–2 (2016). Data for 2011 show that the EITC had a 27.3 percent net overclaim rate. *Id.* at 69 tbl.5 (2016). Notably, the GAO report breaks down the estimates on the error rate on the EITC by preparer type with the highest rate, 33.6 percent, by unregulated preparers. *Id.* at 70 tbl.8. This error report translated into more than \$15 billion of improper payments. *Id.* at 1. Unfortunately, there is no way to separate the estimates for improper payments based on whether a return is prepared by an unregulated preparer or not.

of the tax administration system if compliant taxpayers perceive that other taxpayers are not complying.¹¹⁷

The direct monetary cost to the government of tax return preparer initiated non-compliance is complicated by the policy objectives of the EITC, namely to serve as an anti-poverty measure. If the erroneously paid refund serves to improve the well-being of a low-income taxpayer there may be no net detriment to the government.¹¹⁸

The harm to a taxpayer who relied on a bad return preparer is multi-faceted and can be devastating. First, a taxpayer may have paid inflated fees for the return preparation itself.¹¹⁹ As an initial matter, fees paid to tax return preparers can be extraordinarily high considering the relative simplicity of the returns of many low-income taxpayers. Second, there are costs for the additional fees and interest for refund-anticipated credit products.¹²⁰ If the IRS issues an erroneous refund, the taxpayer will owe the tax and may lose eligibility for the EITC in the future.¹²¹ Furthermore, studies show the government is not likely to enforce against tax return preparers, whereas the draconian penalties for the EITC that

117. Marjorie E. Kornhauser, *Normative and Cognitive Aspects of Tax Compliance: Literature Review and Recommendations for the IRS Regarding Individual Taxpayers*, in 2 NAT'L TAXPAYER ADVOCATE, ANNUAL REPORT TO CONGRESS 138, 138–40 (2007). Perceived cheating causes erosion of voluntary compliance. See *id.* See generally *infra* Section III.A.1, for a discussion on voluntary compliance.

118. Zelenak, *supra* note 49, at 1915.

119. *Protecting Taxpayers from Incompetent and Unethical Return Preparers: Hearing Before the S. Finance Comm.*, 113th Cong. 264 (2014) (written statement of Chi Chi Wu, Staff Attorney, National Consumer Law Center) (citing lack of transparency as the reason for “very high, and possibly inflated, tax preparation fees”). In a recent study of mystery shopper testing, fees ranged from \$37 to \$427 for return preparation. WU & HERNANDEZ, *supra* note 28, at 14; see also WU, RIDDLED RETURNS, *supra* note 42, at 18 (providing a table with examples of tax preparation fees determined by various mystery shopper studies).

120. See WU & HERNANDEZ, *supra* note 28, at 2–8.

121. See Michelle Lyon Drumbl, *Those Who Know, Those Who Don't, and Those Who Know Better: Balancing Complexity, Sophistication, and Accuracy on Tax Returns*, 11 PITT. TAX REV. 113, 133–34 (2013); Alex H. Levy, *Believing in Life After Loving: IRS Regulation of Tax Preparers*, 17 FLA. TAX REV. 437, 448 (2015). A taxpayer is always liable for the tax. A taxpayer may, however, escape accuracy related penalties, I.R.C. § 6662(a)–(b) (2012), but if the taxpayer erroneously claims the EITC, he will not be entitled to claim the credit for two or ten years, depending on whether the error was reckless or fraudulent. *Id.* § 32(k); see also Leslie Book, *The Ban on Claiming the EITC: A Problematic Penalty*, PROCEDURALLY TAXING BLOG (Jan. 23, 2014), <http://procedurallytaxing.com/the-ban-on-claiming-the-eitc-a-problematic-penalty/> [<https://perma.cc/8KQZ-FBV5>] (discussing the prospective ban on claiming EITC). The tax return preparer also bears the risk of exposure to civil and criminal penalties, and in egregious cases, the government may seek injunctive relief against the preparer. See *infra* notes 167–79 and accompanying text.

prohibit receipt of the credit in subsequent years have been enforced disproportionately as compared to other underreporting errors.¹²² In addition to these economic costs, there are additional costs to the taxpayer of the time and expense associated with responding to compliance audits and judicial review.¹²³

C. History of Attempts to Regulate Tax Return Preparers

This section explores the history of regulation of tax return preparation, documents the IRS's attempts to regulate preparers beginning in 2011, and reviews litigation challenging the regulations.

1. Lead-Up and 2011 Regulations

In the early 2000s, lawmakers introduced federal legislation to license and register paid preparers and RAL providers.¹²⁴ The legislation did not make it out of committee, and the IRS pursued an administrative solution through its authority to regulate tax return preparers.¹²⁵

Congress authorizes the Department of Treasury to regulate the practice of representatives of persons before it, allowing the IRS to require good character, reputation, necessary qualifications, and competence before admitting a representative to practice before the IRS.¹²⁶ Congress also grants the IRS

122. See Book, *The Ban on Claiming the EITC*, *supra* note 121.

123. Taxpayers who find themselves defending an audit or pursuing judicial remedies in cases where the IRS denies a claim for the EITC often must prove personal information, such as domestic living arrangements and child custody. See *Watch Out For These Common EITC Errors!*, IRS, <https://www.irs.gov/credits-deductions/individuals/earned-income-tax-credit/watch-out-for-these-common-eitc-errors> [<https://perma.cc/RCU4-M39D>]. The costs of responding to an audit or seeking judicial review include non-economic costs. For low income taxpayers, those costs include relinquishing privacy of domestic living arrangements. Hayes Holderness, *Taxing Privacy*, 21 GEO. J. ON POVERTY L. & POL'Y 1, 1–2 (2013) (comparing economic effects of requirements of disclosing private domestic information with privacy harms from disclosure).

124. See Low Income Taxpayer Protection Act of 2003, S. 685, 108th Cong. § 2 (2003). A similar bill was introduced in 2001, which also would have required paid preparers and RAL providers to be licensed and regulated. See Low Income Taxpayer Protection Act of 2001, S. 802, 107th Cong. § 2 (2001).

125. See IRS, *supra* note 23, at 32–33 (discussing IRS's findings before implementing regulations). See generally Bryan T. Camp, *'Loving' Return Preparer Regulation*, 140 TAX NOTES 457, 457–62 (July 29, 2013) (discussing the history of Circular 230 and lead up to the *Loving* case). The 2011 regulations were published at Regulations Governing Practice Before the Internal Revenue Service, 76 Fed. Reg. 32286 (June 3, 2011).

126. 31 U.S.C. § 330(a) (2012).

authority to discipline “incompetent” and “disreputable” persons subject to its regulation.¹²⁷

The IRS publishes rules regulating attorneys, accountants, and other tax professionals who practice before the IRS in what is known as Circular 230.¹²⁸ Historically, Circular 230 established standards of competence for individuals practicing before the IRS and contained methods and procedures for disciplining covered individuals who failed to meet those standards.¹²⁹ Generally speaking, the historic regulation of *practice before the IRS* applied to practitioners who engaged in adversarial proceedings and not to *mere return preparers*.¹³⁰

Based on a review of the return preparer industry and following the IRS’s strategic plan, the IRS attempted to expand its regulation of practitioners to include those tax return preparers previously not subject to Circular 230.¹³¹ The expansion of the regulations (referred to as the preparer regulations) imposed certification, registration, and continuing education requirements on any paid tax return preparer.¹³²

127. *Id.* § 330(c).

128. 31 C.F.R. § 10 (2010) (representing the pre-2011 Circ. 230).

129. *See id.* A covered practitioner who failed to comply was subject to censure, suspension or disbarment from practice before the IRS, and monetary sanctions. *Id.* § 10.50(a)–(c).

130. *See* Bryan T. Camp, *supra* note 125, at 457–62, for a thorough analysis of the history of Circular 230 from its inception through the return preparer regulations at issue in *Loving*.

131. In December 2009, the IRS published a report reviewing Return Preparers. *See* IRS, *supra* note 23. The IRS commissioned the review to follow objectives in its strategic plan for 2009–13 which were to “1) Strengthen partnerships with tax practitioners, tax return preparers, and all third parties in order to ensure effective tax administration; and 2) Ensure that all practitioners, tax return preparers and other third parties in the tax system adhere to professional standards and follow the law.” *Id.* at 1 (citing IRS, STRATEGIC PLAN 2009–2013 (April 2009), <http://www.unclefed.com/IRS-Forms/PubsForTaxPros/p3744.pdf> [<https://perma.cc/H9Y8-962E>]). Based on the review, the IRS took the position that taxpayers, tax administration, and the tax professional industry, would be better served through the regulation of the industry, including through registration, competency examination, ethical standards, and enforcement. *Id.* at 3–5. The IRS also took the position that, based on the shift toward reliance on tax return preparers and tax preparation software and based on studies conducted by GAO and TIGTA indicating that returns completed by some tax return preparers were inaccurate, *id.* at 5–6, and after surveying tax return preparers, the associated industry, federal and state government officials, consumer advocacy groups and the American public, *id.* at 6, “there [was] general agreement that tax return preparers and the associated industry play a pivotal role in our system of tax administration,” and there was widespread support to increase oversight. *Id.* at 32–33.

132. *See* 31 C.F.R. § 10.4(c) (2017) (requiring tax return preparer demonstrate competence on written exam); *id.* § 10.5(b) (requiring registered tax return preparer to pay fee to apply); *id.* § 10.5(d) (allowing the IRS to conduct tax compliance and suitability check on TRPs).

2. The Story of *Loving* and Its Aftermath

In *Loving v. IRS*, three independent tax return preparers successfully challenged the regulations as exceeding the scope of the enabling statute and sought an injunction against the IRS.¹³³ The D.C. Circuit held that the IRS impermissibly expanded its regulatory authority to encompass tax return preparers.¹³⁴ The court's holding was based on the premise that a tax return for a client does not rise to the level of engaging in practice before the IRS,¹³⁵ the *Loving* decision was not on the merits of regulation of return preparers.¹³⁶

In the wake of the D.C. Circuit's decision in *Loving*, policy makers and scholars have supported the need for federal regulation. The IRS has indicated that it is seeking a statutory fix to *Loving*.¹³⁷ But there is not uniform support for a single regulatory proposal. Recently, Karen Hawkins, the former director of the Office of Professional Responsibility (OPR), which oversees applying the standards of practice to tax professionals, opined that, given the variation in types of preparers and the roles those preparers play, a "one-size-fits-all" approach to regulating tax return preparers is untenable.¹³⁸ In the meantime, the IRS has adopted a voluntary continuing education program for tax return preparers called the Annual Filing Season Program as an interim measure, but it lacks any mechanism for competency testing.¹³⁹

133. 917 F. Supp. 2d 67, 72, 80–81 (D.D.C. 2013), *aff'd*, 742 F.3d 1013 (D.C. Cir. 2014) (upholding the injunction).

134. *Loving*, 742 F.3d at 1016.

135. *Id.* at 1017–18.

136. *Id.* at 1021–22.

137. See Koskinen, *Protecting Taxpayers*, *supra* note 16, at 6.

138. Karen L. Hawkins, *2017 Erwin N. Griswold Lecture Before the American College of Tax Counsel: A (Not So) Modest Proposal*, 70 TAX LAW. 647, 647–49, 654 (“I am less convinced that Circular 230 can serve as the guidance needed for the entire tax professional community. The disparities in education and sophistication levels among the practice groups are huge.”). Hawkins also addressed what she believes to be fatal flaws with Circular 230, *id.* at 652–54, and her recommendations for making the process more transparent, including giving the OPR more independence from the IRS. *Id.* at 658–59. This Article also highlights how tax return preparers for low-income taxpayers differ from those who prepare returns for taxpayers with greater income levels—the incentives are different and the role of the tax return preparer is different. Regulations of the industry should be tailored to fit those specific needs.

139. *New IRS Filing Season Program Unveiled for Tax Return Preparers: Voluntary Program to Focus on Continuing Education for Unenrolled Preparers*, IRS (June 30, 2014), <https://www.irs.gov/newsroom/new-irs-filing-season-program-unveiled-for-tax-return-preparers> [<https://perma.cc/6A2H-HLH7>]; see Koskinen, *Protecting Taxpayers*, *supra* note 16, at 6. The program allows preparers to voluntarily take continuing education, pass a competency examination and be bound by professional responsibility standards. 1 NAT'L TAXPAYER ADVOCATE, FISCAL YEAR 2015 OBJECTIVES: REPORT TO CONGRESS 71–78 (June 30, 2014). The IRS lists the preparers in a

III. THE RATIONALE THAT REGULATION OF THE TAX RETURN PREPARATION INDUSTRY WILL IMPROVE EITC COMPLIANCE

Most of the calls to regulate the tax return preparer industry are based on the premise that regulation will improve overall compliance with the tax laws, especially with respect to the EITC.¹⁴⁰ As explained below, the premise that regulation will have significant effects on overall compliance is imperfect.¹⁴¹ In challenging the regulation for compliance rationale, this Part explains the concept of voluntary compliance and the tax gap. It also considers existing research on the connection between the actions of tax return preparers and the tax gap.

A. *The Relationship Between Regulation of Return Preparers and Tax Compliance*

Many policy makers, scholars, and practitioners have advocated for regulation of tax return preparers, such as by requiring return preparers to certify, register, pass background investigations, and fulfill continuing education requirements, as the means to improve compliance.¹⁴² Indeed, the IRS's stated goal in promulgating the preparer regulations in 2011 was to do just that: improve compliance.¹⁴³

Some of these arguments for regulation to improve tax compliance have been based on assumptions that are not supported by empirical studies or evidence. For example, one legal scholar writes that tax return preparer regulation, "costs the government nothing, since higher collections from more accurate returns should more than make up for the costs of the regulations," but

database available to taxpayers seeking qualified preparers. *Id.* at 72. The National Taxpayer Advocate has criticized the voluntary program because it is insufficient to protect low income taxpayers, and the IRS has itself acknowledged the limitations of the program. *Id.* at 71–78.

140. See IRS, *supra* note 23, at 2, 6 ("After consideration . . . the IRS believes that taxpayers, tax administration and the tax professional industry and related service providers will be better served through [regulation].").

141. See *infra* Section III.A.2.

142. In addition to the IRS, many legal scholars advocate for regulation to improve compliance. See Soled & Thomas, *supra* note 8, at 171–73; Levy, *supra* note 121, at 469; Cords, *supra* note 105, at 355. The National Taxpayer Advocate has supported regulation of return preparers as a means to improve compliance. Olson, *Tax Return Preparers*, *supra* note 27, at 3–4. Consumer advocates have also touted improvements to tax compliance as the basis for recommending regulation of return preparers. See WU, RIDDLED RETURNS, *supra* note 42, at 4; WU & HERNANDEZ, *supra* note 28, at 1–2.

143. IRS, *supra* note 23, at 6.

provides no empirical evidence or data to support this claim.¹⁴⁴ The tax compliance problem at low-income taxpayer level is more nuanced. Professor Cords argues that reduction of EITC non-compliance requires, “consistent regulation of paid preparers and greater oversight of RALs, coupled with increased simplification.”¹⁴⁵

Admittedly, it is tempting to blame low tax compliance rates for taxpayers claiming the EITC on tax return preparers. It is hard, if not impossible, to prove causation. Tax return preparers are one of many variables in the tax compliance puzzle.¹⁴⁶ To understand the effect of regulation of the return preparation industry on tax compliance some general background on how tax compliance is encouraged and enforced in the United States is necessary.

1. Voluntary Compliance and the Tax Gap

The American tax system is based on voluntary compliance; taxpayers must calculate, report and pay their tax obligations.¹⁴⁷ Voluntary compliance is reinforced through withholding, third-party reporting, economic and criminal

144. See Levy, *supra* note 121, at 469. The context of this quote was to build bipartisan Congressional support for regulation. The author argued that regulation is a “rare Democratic priority” that should pay for itself, *id.*, and that “Republicans have long been tough on fraud in the EITC program; they should be drawn to an effort to crack down on abuse of the public fisc.” *Id.* Another article stated that the “entirely predictable” consequence of failure to regulate return preparers are the errors on returns that, as a result, cause “large numbers of taxpayers [to] pay less than they owe.” Soled & Thomas, *supra* note 8, at 171.

145. Cords, *supra* note 105, at 355.

146. As Professor Book has noted, EITC compliance is a complex and multi-faceted problem that includes the facilitation of brokered noncompliance by tax return preparers. Leslie Book, *Freakonomics and the Tax Gap: An Applied Perspective*, 56 AMER. L. REV. 1163, 1175 (2007). Additional problems with preparers are that return preparers are incentivized to sell goods and services “that are monetized by the very refunds that taxpayers claim on tax returns,” and that creates a “temptation for preparers to facilitate errors.” *Id.* Further complicating the compliance problem is the issue of selection bias. See Book, *Refund Anticipation Loans & the Tax Gap*, *supra* note 12, at 98; see also IRS, COMPLIANCE ESTIMATES FOR EITC CLAIMED ON 2006–2008 RETURNS, *supra* note 49, at 24 (highlighting that low overclaim percentages on returns prepared by trained volunteers may “reflect the effect of selection bias arising from taxpayers’ choice of preparer”). One part of the problem is that the IRS does not have full information regarding preparers. See Janet Holtzblatt & Janet McCubbin, *Issues Affecting Low-Income Filers*, in THE CRISIS IN TAX ADMINISTRATION 148, 170 & n.42 (Henry J. Aaron & Joel Slemrod eds., 2004).

147. The voluntary compliance-based system allows taxpayers to structure their transactions in a way to minimize tax liability, within the construct of the law, but taxpayers must report their taxes, report them accurately, and pay their taxes. See *Helvering v. Gregory*, 69 F.2d 809, 810–11 (2d Cir. 1934) (“Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one’s taxes.”).

sanctions, and social norms.¹⁴⁸ Voluntary compliance estimates for tax years 2008–2010 are approximately 82% meaning non-compliance overall hovers around 18%.¹⁴⁹ Rates of non-compliance for taxpayers claiming the EITC in 2011 are slightly higher, estimated between 21 and 26%.¹⁵⁰

Rates of non-compliance are measured by estimates of the tax gap, which represents the difference between estimated total revenue that should be reported and collected and the actual tax reported and paid.¹⁵¹ The gross tax gap of \$458 billion is based on three components: non-filing, underreporting, and underpayment.¹⁵² Relevant to the analysis here, \$387 billion is the estimated gross tax gap for underreporting, and that amount breaks down as follows: \$41 billion accounts for underreported corporate income tax, \$81 billion for underreported employment tax, and the remaining \$264 billion is from underreporting on individual income tax.¹⁵³

EITC errors generate estimated improper payments by the IRS of between \$11.6 and \$13.6 billion.¹⁵⁴ By comparison, filing status errors (such as selecting head of household as opposed to single) account for \$5 billion of the

148. See I.R.C. §§ 3401–3406 (2012) (requiring withholding of federal income tax); I.R.C. §§ 3101–3128 (mandating withholding of employment taxes); I.R.C. § 6041(a) (requiring third party reporting of payments in excess of \$600). Civil and criminal tax penalties are based on a traditional, economic or deterrence model; the penalties for non-compliance are essentially a carrot for complying taxpayers and a stick for noncompliant taxpayers. See I.R.M., *supra* note 5, § 1.2.20.1. There is much scholarship examining the roles social norms, signaling demographics play a role in a taxpayer's decision to comply. See generally Leandra Lederman, *The Interplay Between Norms and Enforcement in Tax Compliance*, 64 OHIO ST. L.J. 1453, 1459; Eric A. Posner, *Law and Social Norms: The Case of Tax Compliance*, 86 VA. L. REV. 1781 (2000); Dan M. Kahan, *Signaling or Reciprocating? A Response to Eric Posner's Law and Social Norms*, 36 U. RICH. L. REV. 367 (2002); Dan M. Kahan, *The Logic of Reciprocity: Trust, Collective Action, and Law*, 102 MICH. L. REV. 71 (2003).

149. See IRS, FEDERAL TAX COMPLIANCE RESEARCH: TAX GAP ESTIMATES FOR TAX YEARS 2008–2010, at 11 tbl.3 (May 2016) [hereinafter IRS, FEDERAL TAX COMPLIANCE RESEARCH].

150. TREASURY INSPECTOR GEN. FOR TAX ADMIN., 2012-4-028, THE INTERNAL REVENUE SERVICE IS NOT IN COMPLIANCE WITH ALL IMPROPER PAYMENTS ELIMINATION AND RECOVERY ACT REQUIREMENTS, at 5 fig.2 (2012).

151. IRS, FEDERAL TAX COMPLIANCE RESEARCH, *supra* note 149, at 3.

152. Estimated gross tax gaps for components are \$32 billion, \$387 billion, and \$39 billion, respectively. IRS, TAX GAP ESTIMATES FOR TAX YEARS 2008–2010, at 2 (April 2016), <https://www.irs.gov/pub/newsroom/tax%20gap%20estimates%20for%202008%20through%202010.pdf> [<https://perma.cc/B7XP-LXLY>].

153. *Id.* at 4 tbl.2.

154. These figures are estimates for improper EITC payments in 2012. TREASURY INSPECTOR GEN. FOR TAX ADMIN., 2012-40-028, *The Internal Revenue Service Was Not in Compliance with All Requirements of the Improper Payments Elimination and Recovery Act for Fiscal Year 2012*, fig.2 (Feb. 25, 2013), <https://www.treasury.gov/tigta/auditreports/2013reports/201340024fr.html#internal> [<https://perma.cc/32LZ-UFGD>].

underreporting estimated gross tax gap (for a total of 1% of the total gross tax gap), and tax credit underreporting errors, including but not limited to EITC errors, account for \$40 billion, or 9%, of the total gross tax gap.¹⁵⁵ Those figures are not as significant as the gross tax gap for underreporting of business income, which is estimated as \$125 billion, accounting for 27% of the gross tax gap.¹⁵⁶

2. The Relationship Between Tax Return Preparer Non-Compliance and the Tax Gap

There are two problems with the premise that regulation of preparers will improve compliance. First, because tax return preparers are not the cause (or sole cause) of high error rates in claiming the EITC, regulation of return preparers would not solve the non-compliance problem. With respect to the relationship between tax return preparers and compliance, studies by economists and legal scholars correlate regulation to minimizing the tax gap if the question is legally ambiguous.¹⁵⁷ EITC compliance is not an area of legal uncertainty,¹⁵⁸ and there is no concrete evidence correlating tax return preparer issuance of financial credit with tax compliance.¹⁵⁹

Furthermore, while there has been an assumption that regulation of preparers would address the underreporting tax gap, the role tax return preparers play in compliance is complex. As Professor Leslie Book concluded, “there is not one particular compliance problem associated with the tax system,

155. IRS, *supra* note 152, at 4 tbl.2.

156. *Id.*

157. Book, *Study of the Role of Preparers*, *supra* note 12, at 63–64; *see also* Steven Klepper, Mark Mazur, & Daniel Nagin, *Expert Intermediaries and Legal Compliance: The Case of Tax Preparers*, 34 J. L. & ECON. 205, 210 (1991) (finding the impact of preparers on compliance is “a decreasing function of legal ambiguity but an increasing function of the frequency of unequivocal legal breaches”).

158. EITC non-compliance is usually a matter of fact. *See* Book, *Study of the Role of Preparers*, *supra* note 12, at 67 (analyzing and categorizing EITC non-compliance as improper claiming of qualifying children, filing status errors, or misreporting income).

159. Book, *Refund Anticipation Loans & The Tax Gap*, *supra* note 12, at 109 (“Banks and preparers make money on this product [RALs]. Absent additional evidence, the fact that preparers and banks make money off the product does not necessarily create the kind of connection to noncompliance that warrants a banning of that product solely on the basis of the truism that people sometimes act improperly when they can earn money. Research is needed to specifically consider whether the added speed associated with RALs emboldens claimants to act inappropriately and boost demand driven noncompliance, or whether the additional profits associated with the facilitating of RALs encourages inappropriate preparer conduct.” (footnotes omitted)).

but rather many different compliance problems that vary greatly by issue and type of taxpayer.”¹⁶⁰

The second problem with the premise that regulation will improve compliance is that even assuming regulation will improve tax compliance, any improvement would be relatively small because EITC non-compliance does not significantly contribute to the tax gap. According to tax gap data for tax years 2008–2010, errors particular to the EITC, such as filing status, account for a small percentage of the gross tax gap. As previously mentioned, filing status errors accounted for \$5 billion of the underreporting estimated gross tax gap (for a total of 1% of the total gross tax gap), and tax credit underreporting errors accounted for \$40 billion, or 9%, of the total gross tax gap,¹⁶¹ so the dollars at stake with respect to EITC non-compliance do not justify the compliance efforts and enforcement resources dedicated.¹⁶² The tax gap associated with overstated claims for credits is not “as significant in terms of dollars,” but it has become a politically hot issue.¹⁶³

Because EITC errors are not as monetarily impactful as other errors to the tax gap,¹⁶⁴ if the real goal is to reduce the tax gap or increase compliance, the focus should be on the underreporting of business income.

Even assuming that regulation would have a positive impact on compliance (however small), the concerns about possible negative consequences on the industry of regulation of tax return preparers may not outweigh the benefits from a compliance perspective alone. Opponents to regulation argue that regulation will not work to improve compliance. Their central argument is that regulation of the industry is protectionist and anti-competitive and only serves to improve market shares for bigger players, such as H&R Block, Jackson Hewitt, and Liberty Tax.¹⁶⁵

IV. REFRAMING THE RATIONALE FOR REGULATION OF TAX RETURN PREPARERS AS CONSUMER PROTECTION

Part III refuted the traditional assumption that regulation of the return preparer industry would correlate to improving compliance with respect to the

160. Book, *Study of the Role of Preparers*, *supra* note 12, at 63.

161. IRS, *supra* note 152, at 4 tbl.2.

162. For instance, taxpayers claiming the EITC almost double their likelihood of audit. 1 NAT'L TAXPAYER ADVOCATE, 2011 ANNUAL REPORT TO CONGRESS 300 (December 31, 2011).

163. Book, *Study of the Role of Preparers*, *supra* note 12, at 49; Zelenak, *supra* note 49, at 1867–69, 1874 (noting that efforts of compliance directed at the EITC are not proportionate to dollars at stake).

164. Book, *Study of the Role of Preparers*, *supra* note 12, at 49; *see supra* note 161 and accompanying text.

165. *See Alban, Protecting Taxpayers*, *supra* note 28, at 49.

EITC. This Part shifts from critiquing the rationale of regulation for compliance to making a positive contribution. The rationale for regulation of the return preparer industry ought to be reframed as a consumer protection issue. In reframing the rationale, policy makers and scholars will be able to focus on low-income taxpayers as consumers of goods and services, and tailor regulatory regimes to achieve the goals of consumer protection.

In support of this thesis, this Part first addresses one main objection to regulation: that regulation is unnecessary because of existing applicable penalties. Finding existing applicable penalties insufficient to protect low-income taxpayers, this Part next examines the triangular relationship between taxpayers, the government, and return preparers, and how that relationship cultivates divergent incentives. Finally, it shows how regulation for consumer protection aligns with broader policies underlying the EITC and trends in issues that the working poor face in tax administration.

A. Existing Legal Mechanisms are Insufficient to Protect Taxpayers as Consumers

Opponents of regulating the return preparation industry make two main general arguments: first, regulation will not work; and second, regulation is not necessary. In Part III, this Article addressed the first anti-regulation argument, that regulation will not improve compliance.¹⁶⁶ To support the argument that regulation should be reframed as a matter of consumer protection, the following Sections respond to the second anti-regulation argument that regulation is not necessary.

1. Existing Penalties That Apply to Tax Return Preparers

In addition to civil and criminal penalties for noncompliant taxpayers,¹⁶⁷ existing penalties are intended to address deviations from standards of conduct by tax return preparers.¹⁶⁸ Tax return preparers are subject to civil and criminal tax penalties for any errors made, both negligently and fraudulently.¹⁶⁹ The government can also pursue injunctive relief against particularly bad

166. See *supra* Section III.A.2, notes 157–65 and accompanying text.

167. For example, penalties exist that the IRS can impose on taxpayers who fail to timely file tax returns or pay liabilities owed, I.R.C. § 6651 (2012), who negligently report understatements of tax, *id.* § 6662(a)–(c), and who fraudulently underreport income. *Id.* § 6663.

168. Opponents of regulation of return preparers also cite to the civil justice system as an alternative to regulation. See, e.g., MCGARITY, *supra* note 7, at 28–29; Wendy Wagner, *When All Else Fails: Regulating Risky Products Through Tort Litigation*, 95 GEO. L.J. 693, 694–95 (2007) (critiquing regulation through litigation).

169. See, e.g., I.R.C. §§ 6694, 6695.

preparers.¹⁷⁰ So, opponents of regulation point to the myriad of penalties that apply as an ex post regulatory regime.¹⁷¹

All tax return preparers, including unregulated preparers, are subject to civil and criminal penalties for improper conduct. For example, tax return preparers are subject to penalties of \$1,000 or \$5,000 per instance for understating a taxpayer's liability if the understatement is due to negligence or willful conduct, respectively.¹⁷² Civil penalties also apply if a return preparer fails to provide a copy of a return to a taxpayer, sign the return, furnish an identifying number, retain copies or a list of refunds filed, or file correct information about each tax preparer employed.¹⁷³ If a tax return preparer negotiates a taxpayer's refund check, the preparer is liable for a \$500-per-check penalty.¹⁷⁴ Special penalties also apply for errors with respect to failing to be diligent in determining EITC eligibility.¹⁷⁵

Tax return preparers are also subject to criminal penalties for aiding and abetting an understatement of tax liability, improperly disclosing or using return information, or willfully preparing false or fraudulent documents.¹⁷⁶ The criminal penalties range from \$1,000 for aiding and abetting to \$250 per improper disclosure of return information and up to \$100,000 or three years imprisonment (or both) for willful preparation of fraudulent returns.¹⁷⁷

The government can also seek injunctive relief against abusive tax return preparers. Federal law authorizes an injunction to prohibit a tax return preparer from engaging in return preparation in the future when the preparer understates a taxpayer's liability, commits any other action subject to penalty, or engages in "fraudulent or deceptive conduct which substantially interferes" with the

170. *See id.* § 7407 (government may seek injunctive relief against preparer to prevent future harm); *id.* § 7408 (civil action to enjoin specific conduct related to tax shelters and reportable transactions).

171. *See, e.g.,* MCGARITY, *supra* note 7, at 29.

172. I.R.C. § 6694(a)–(b).

173. *Id.* § 6695(a)–(e) (2012). A penalty of \$50 per failure applies, with a maximum of up to \$25,000. *Id.*

174. *Id.* § 6695(f).

175. *Id.* § 6695(f)–(g). If a preparer is not diligent in determining EITC eligibility, the preparer is liable for a \$500-per-failure penalty. *See id.* § 6695(g).

176. *Id.* § 6701 (aiding and abetting); *id.* § 6713 (improper disclosure or use of return information); *id.* § 7206 (willful preparation of false or fraudulent return or other document submitted to IRS).

177. *Id.* § 6701(b)(1) (aiding and abetting); *id.* § 6713(a) (improper disclosure or use of return information); *id.* § 7206 (willful preparation of false or fraudulent return or other document submitted to IRS).

administration of tax law.¹⁷⁸ Lawsuits to enjoin tax return preparers from preparing returns are expensive and time-consuming, and they are also an ex-post remedy that has little deterrent effect.¹⁷⁹

2. Existing Legal Mechanisms are Insufficient to Protect Low-Income Taxpayers from Bad Actors

Civil and criminal penalties and injunctive relief are intended to deter and punish wrongdoing by tax return preparers. In *Loving*, the court expressed concern that regulation of the industry was unnecessary because of specific penalty provisions in the tax code that apply to tax return preparers.¹⁸⁰ Monetary penalties and injunctive suits alone, however, are ineffective tools to address the widespread problem, and they do little to prevent harm to the taxpayer.¹⁸¹

It is unlikely that bad actors will suffer any consequence from the IRS. Enforcement rates for return preparer penalties are very low. Statistical data on abusive tax return preparers shows that in fiscal year 2015, 266 investigations were initiated and 238 prosecutions were recommended by the IRS Criminal Investigation division.¹⁸² Of those 238 cases in which prosecutions were recommended, 224 resulted in indictments, and 204 resulted in sentencing.¹⁸³ Compared to the estimated 300,000 to 600,000 unregulated preparers¹⁸⁴ and the results of the mystery shopper tests documenting widespread errors perpetuated by return preparers,¹⁸⁵ the low number of investigations shows that the

178. *Id.* § 7407(b).

179. *See infra* Section IV.A.2.

180. *Loving v. IRS*, 742 F.3d 1013, 1020 (D.C. Cir. 2014). As its fourth of six reasons for rejecting the IRS's argument that the IRS had authority to regulate tax return preparers, the court stated that allowing the IRS to regulate return preparers "would effectively gut Congress's carefully articulated existing system for regulating tax-return preparers." *Id.* For further analysis of the court's opinion in *Loving*, see Levy, *supra* note 121, at 459–62.

181. *See Amici Curiae in Support of Defendants-Appellants, Loving v. IRS*, *supra* note 15, at 30–31; Levy, *supra* note 121, at 459–62. With the exception of rules prohibiting a return preparer from negotiating a taxpayer's refund check, the existing legal mechanisms are not consumer protection oriented.

182. *Statistical Data—Abusive Return Preparers*, IRS, <https://www.irs.gov/uac/statistical-data-abusive-return-preparers> [<https://perma.cc/U8AG-P6XD>] (last updated Sept. 27, 2017).

183. *Id.*

184. *See NAT'L TAXPAYER ADVOCATE*, *supra* note 26, at 270 (estimating number of unregulated return preparers).

185. *See supra* Section II.B.1 (documenting pervasive errors by unregulated preparers).

likelihood of enforcement does not appropriately correlate to the rampant errors perpetuated by return preparers.¹⁸⁶

In addition to criminal prosecutions, court-ordered injunctions against abusive tax return preparers offer a strong solution to preventing the individual preparer from continuing to perpetrate fraud or deceptive practices. However, as with criminal prosecutions, the likelihood of the IRS pursuing injunctive relief against bad preparers is also small.¹⁸⁷ Injunctive actions are a highly resource intensive punishment for the IRS to pursue against a return preparer because such lawsuits require extensive evidence of the preparer's wrongdoing and multiple witnesses willing to testify against the preparer.¹⁸⁸ Existing penalties and injunctive suits are insufficient and ineffective at protecting taxpayers as consumers.

Even if the IRS were likely to enforce civil penalties on abusive preparers, the existing penalty regime ignores research on normative and cognitive aspects of tax compliance.¹⁸⁹ Importantly, in the context of the EITC and other refundable credits, penalties designed to deter preparers from exploiting legally ambiguous positions likely will not have a deterrent effect because the law is not legally ambiguous.¹⁹⁰ As Professor Book notes, EITC non-compliance relates to “relatively unambiguous legal matters dependent on accurate presentation of essential facts and practitioner understanding of complex but fairly unambiguous legal rules.”¹⁹¹ So, the existing penalties are not being enforced against abusive return preparers, and according to some scholars, would not work even if they were enforced.

186. See Book, *The Ban on Claiming the EITC*, *supra* note 121; see also Section II.B.2.

187. IRS data shows that from 2003–2007, the IRS obtained Court ordered injunctive relief against 175 return preparers. IRS, FS-2007-12, TAX RETURN PREPARER FRAUD 2–3 (Jan. 2007), <https://www.irs.gov/pub/irs-news/fs-07-12.pdf> [<https://perma.cc/W34Q-U8W9>].

188. See I.R.M., *supra* note 5, § 20.1.6, for IRS policy on initiating and developing cases to enjoin a tax return preparer from preparing returns.

189. See Kornhauser, *supra* note 117, at 138 (examining “tax morale” as affected by “procedural justice, trust, belief in the legitimacy of the government, reciprocity, altruism, and identification with the group”). See generally *supra* Section III.A.1 (discussing voluntary compliance).

190. See Book, *Study of the Role of Preparers*, *supra* note 12, at 48 (highlighting that differences may exist with respect to the efficacy of penalties for deterring tax planning versus errors by TRPs preparing returns for low-income taxpayers).

191. *Id.*

B. The Triangular Relationship Between the Government, Taxpayers, and Tax Return Preparers and Divergent Incentives for Tax Return Preparers

The government, low-income taxpayers, and tax return preparers have interests that overlap to some extent, but not completely. Where the three parties' interests diverge, market incentives exist for tax return preparers to exploit gaps in the law itself or the lack of enforcement of the law that would protect low-income taxpayers. In addition to divergent incentives of tax return preparers, important informational asymmetries particular to the system of tax administration exist between the tax return preparer and the taxpayer that contribute to the market incentives to exploit taxpayers.

1. The Interests of the Government, Low-Income Taxpayers, and Return Preparers, and Where They Overlap

The government's interest is in maintaining the integrity of the tax administration system. Because the American tax administrative system is built on voluntary compliance, erosion of compliance is a serious threat.¹⁹² Maintaining the integrity of the tax administration is no simple matter because the system itself has competing objectives.¹⁹³ On one hand the government is concerned with collection of revenue.¹⁹⁴ On the other, the government wants low-income taxpayers to claim social benefits for which they are eligible because the EITC serves important policy objectives of supporting working families, especially households with children.¹⁹⁵ The government has an interest in paying the correct amount of EITC to eligible American taxpayers.¹⁹⁶

Taxpayers are interested in maximizing their allowable tax benefits and obtaining those benefits as soon as possible.¹⁹⁷ Taxpayers are also interested in

192. See *supra* Section III.A.1.

193. The IRS Mission reflects this tension, which states the IRS must “[p]rovide America’s taxpayers top-quality service by helping them understand and meet their tax responsibilities and enforce the law with integrity and fairness to all.” I.R.M., *supra* note 5, § 1.1.1.2(1); see also Kristin E. Hickman, *Pursuing a Single Mission (or Something Closer to It) for the IRS*, 7 COLUM. J. TAX L. 169, 173–74 (2016) (arguing to separate the administration of welfare benefits from tax collection).

194. The IRS mission statement addresses this need to collect revenue indirectly, but states that “[t]he IRS’ role is to help the large majority of compliant taxpayers with the tax law, while ensuring that the minority who are unwilling to comply pay their fair share.” I.R.M., *supra* note 5, § 1.1.1.2 (2).

195. For a discussion of the EITC as an anti-poverty measure, see *supra* notes 35–44 and accompanying text, Drumbl, *supra* note 121, at 120–23, and Zelenak, *supra* note 49, at 1903.

196. With respect to individuals claiming eligibility for the EITC, the correct amount is not the smallest amount of tax, but rather the proper EITC to which a claimant is entitled. See I.R.M., *supra* note 5, § 1.1.1.2 (1).

197. See Hayashi, *supra* note 51, at 10.

minimizing their exposure to enforcement by the IRS.¹⁹⁸ A low-income taxpayer may be interested in obtaining a refund that exceeds the amount to which the taxpayer is legally entitled, to the extent such benefits outweigh the cost of enforcement.

Tax return preparers are primarily interested in maximizing profits and minimizing exposure to applicable penalties.¹⁹⁹ Some tax return preparers generate fees for preparing returns and fees or kickbacks from facilitating credit products.²⁰⁰ Fringe preparers also derive profit from applying a taxpayer's anticipated tax refund to the purchase price of a good or service that the preparer sells or provides.²⁰¹ While tax return preparers may have an interest in complying with standards of conduct in preparing returns so as to avoid civil or criminal penalties, tax return preparers ultimately have no risk as to the tax liability of the taxpayer.²⁰²

The three parties have somewhat overlapping interests, but for different reasons. All parties want the taxpayer to receive at least the benefits to which the taxpayer is legally entitled and all prefer minimal enforcement. The government depends on tax return preparers to assist low-income taxpayers in preparing returns and submitting those returns electronically.²⁰³ The government has an interest in the industry of tax return preparers to the extent return preparers (in preparation of the return or in providing credit products or both) incentivizes taxpayers to claim benefits for which the taxpayer is eligible. Similarly, low-income taxpayers depend on preparers to prepare their returns, and in many cases, accelerate the receipt of the refund.

198. If the taxpayer claims an amount exceeding the proper allowance, a taxpayer is only concerned about enforcement to the extent it will cause the taxpayer to have to repay the erroneously issued refund or prevent the taxpayer from seeking the tax benefit in the future. A taxpayer who relies on a tax return preparer generally will not be subject to civil penalties for the inaccurate return. *See* I.R.C. §§ 6662(a), 6664(c)(1) (2012) (relying on tax return preparer is defense to penalty).

199. *See* generally *supra* Section II.A, for a discussion on the role tax return preparers play in the tax administration system.

200. *See supra* Section II.A.3.

201. *See supra* Section II.A.3.

202. In other words, if a tax return preparer inflates a refund and the taxpayer is audited or otherwise detected by the IRS, the taxpayer and not the preparer is liable for the deficiency in tax. *See* Section IV.A.1 (discussing penalties applicable to return preparers). Experimental economics research shows that tax return preparers' behavior with respect to the positions taken on tax returns can be explained by prospect theory. Kaye J. Newberry et al., *An Examination of Tax Practitioner Decisions: The Role of Preparer Sanctions and Framing Effects Associated with Client Condition*, 14 J. ECON. PSYCH. 439, 440–41 (1992). Tax return preparers may be more likely to take a risky position on the tax return of a new client to attract the new client, but, with existing clients, tax return preparers may be less risk seeking because of the desire to retain them. *See id.* at 449.

203. *See* Book, *Study of the Role of Preparers*, *supra* note 12, at 46, 50.

2. Where Incentives of Tax Return Preparers Diverge There is Potential for Harm

The problems lie where tax return preparer interests do not overlap. Their desire to maximize profits may incentivize some preparers to inflate the amount of the refund claimed by a low-income taxpayer, either because it ensures repeat customers or because the tax return preparer's fee is tied to the amount of refund claimed.²⁰⁴ The latter is especially true with respect to fringe preparers who have a direct financial interest in the amount of refund generated by the return they prepare.²⁰⁵

Take the example of a fringe preparer who is primarily engaged in selling used cars but prepares tax returns for customers who wish to apply their potential tax refund to the purchase price of a car. The preparer has a direct financial incentive to inflate the amount of the refund, increasing the amount the customer has to spend on a car.²⁰⁶

The incentives of tax return preparers also diverge because the transactions between low-income taxpayers and fringe preparers are entirely monetized by a refund from a third party: the government.²⁰⁷ If the taxpayer is utilizing a RAC product, the taxpayer is not directly paying for the goods or services. For example, RACs allow low-income taxpayers to obtain a loan for the cost of return preparation.²⁰⁸ As explained above, the RAC is a bank product that creates a temporary bank account into which the IRS deposits the taxpayer's refund.²⁰⁹ Once the refund is deposited, the bank takes a fee for the use of the temporary account and a fee for the return preparation.²¹⁰ Then, "[t]he remainder is issued to the [taxpayer] in the form of a paper check, prepaid debit card, or a direct deposit to the [taxpayer's] own bank account."²¹¹

Fringe preparers and preparers who sell consumer credit products exploit the fact that humans behave irrationally. Behavioral economics teaches us that

204. See *supra* Section II.A.4, for a discussion of fee structures for refund anticipated credit products.

205. See *supra* Section II.A.4.

206. See WU, RIDDLED RETURNS, *supra* note 42, at 5. The NCLC documents that fringe preparers, in particular car dealers, are supported by companies such as Tax Max that provide software and support for "businesses that want to prepare taxes 'on the side' to boost sales in their primary line of business." *Id.*

207. See Book, *Freakonomics and the Tax Gap*, *supra* note 146, at 1175 (noting that this third-party payer structure "creates a strong temptation for preparers to facilitate errors").

208. See WU, RIDDLED RETURNS, *supra* note 42, at 6 n.16.

209. *Id.* See generally *infra* Section II.A.3 (discussing RACs).

210. WU, RIDDLED RETURNS, *supra* note 42, at 6 n.16.

211. *Id.*

taxpayers are willing to pay a higher fee for the same tax preparation services if that fee is not paid out of pocket and is instead monetized by the refund itself.²¹² If a taxpayer must pay return preparation fees out of her pocket, the taxpayer will not tolerate the higher cost that she would if the fees were taken out of the refund itself.²¹³ These preferences reflect the fact that taxpayers view the same dollar cost for the fee differently depending on whether they perceive the cost as a potential gain (paid out of the refund proceeds) or a potential loss (paid out of pocket).²¹⁴

The divergent incentives of tax return preparers arise because preparers have a financial interest in the refund amount and because the fees and products purchased by taxpayers are monetized by a third-party payor (the IRS), and these incentives create potential for harm. Regulation as a matter of consumer protection is necessary to mitigate that potential for harm.²¹⁵

Informational asymmetries particular to tax administration also require regulation to protect low-income taxpayers. Tax return preparers' divergent incentives foster manipulative and exploitative business practices that capitalize on the informational asymmetries between the taxpayer and the preparer.²¹⁶ These asymmetries reflect the fact that the provider of services has

212. This unique, third-party payer relationship creates heightened need for consumer protection based on what behavioral economics instructs with respect to human behavior and assumption of risk. See Tversky & Kahneman, *supra* note 91, at 297–98 (finding risk assumption varies when framing the transaction as potential gain rather than potential loss). “Two central assumptions in [cumulative prospect theory] are that individuals are risk-averse over gains and risk-seeking over losses, that they tend to overweight low-probability events while underweighting the likelihood of high-probability ones.” William T. Harbaugh et al., *The Fourfold Pattern of Risk Attitudes in Choice and Pricing Tasks*, 120 *ECON. J.* 595, 595 (2010).

213. See generally Tversky & Kahneman, *supra* note 91; Harbaugh et al., *supra* note 212, at 595.

214. See generally Tversky & Kahneman, *supra* note 91; Harbaugh et al., *supra* note 212, at 595.

215. Data, in fact, does not support the proposition that lower income taxpayers claiming the EITC who rely on unregulated return preparers, as opposed to self-preparing their returns, are more likely to overclaim the amount of the EITC. IRS, COMPLIANCE ESTIMATES FOR EITC CLAIMED ON 2006–2008 RETURNS, *supra* note 49, at 24. However, the nature of the relationship between a taxpayer and the preparer where the preparer's profits are directly tied to the amount of the refund justifies regulation because the taxpayer is uniquely unable to otherwise protect herself.

216. Book, *Bureaucratic Oppression and the Tax System*, *supra* note 36, at 587.

better information than the other party regarding the quality of the services.²¹⁷ This imbalance of information can create a market failure.²¹⁸

Informational asymmetries exist because providers of specialized services tend to have more information than consumers regarding the quality of the services.²¹⁹ The more an informational asymmetry exists between consumers and providers of services, the more likely that lower quality services will drive out those of higher quality from the market.²²⁰ Economic literature suggests that for the market of professional services, such as preparation of tax returns, occupational regulation may protect consumers from bad actors because of the potential informational asymmetries.²²¹

Like any consumer transaction involving specialized, technical services, tax return preparers have more information about the return preparation process than the taxpayers they serve. These informational asymmetries are basic informational shortfalls which arise because low-income taxpayers who seek EITC or other refundable credits are often vulnerable consumers.²²² Low-income taxpayers may have limited literacy skills or limited English language proficiency, lack sophistication with financial transactions, and lack knowledge of free or lower cost filing options.²²³ Furthermore, as the economic literature suggests, the demand by low-income taxpayers seeking refund anticipated credit products highlights the lack of bargaining power many low-income taxpayers have with respect to return preparation services.²²⁴

As vulnerable or unsophisticated consumers, low-income taxpayers are at a disadvantage because of the lack of transparency of fees for return preparation and costs associated with refund anticipated credit products. Traditionally, regulation has been used to address these types of informational asymmetries

217. See George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q. J. ECON. 488, 490 (1970); Kenneth J. Arrow, *Uncertainty and the Welfare Economics of Medical Care*, 53 AM. ECON. REV. 941, 946–47 (1963); Hayne E. Leland, *Quacks, Lemons, and Licensing: A Theory of Minimum Quality Standards*, 87 J. POL. ECON. 1328, 1329 (1979).

218. See *supra* note 217.

219. Law & Kim, *supra* note 7, at 724–25.

220. *Id.*

221. See, e.g., *id.* For its application in other areas of consumer protection law, see Wagner, *supra* note 168, at 695–96.

222. See NAT'L TAXPAYER ADVOCATE, *supra* note 162, at 301.

223. See *id.*; see also *supra* note 37 and accompanying text.

224. See Hayashi, *supra* note 51, at 9–10; see also WU, RIDDLED RETURNS, *supra* note 42, at 3 (noting that for many low-income taxpayers who claim the EITC, it represents “the single largest sum of money that they will receive during the entire year”).

with disclosure laws.²²⁵ But there are non-regulatory approaches to resolve informational asymmetries, such as educational outreach programs.²²⁶

In addition to the typical information shortfalls, the tax code itself actually serves to increase the informational asymmetries that allow tax return preparers to manipulate taxpayer decision making with respect to return preparation services and consumer credit products. Laws in the tax code intended to protect taxpayer privacy have the consequence of reducing information available to taxpayers. In particular, taxpayer privacy laws reduce the amount of information available regarding the likelihood of audit and enforcement by the IRS against particular return preparers.²²⁷

Laws prohibiting disclosure of taxpayer information prohibit disclosures by both the government and tax return preparers.²²⁸ First, with respect to prohibitions on disclosure by the government, the tax laws specifically prohibit disclosure of “return information” by any employee or officer of the United States.²²⁹ Return information includes any information relating to the taxpayer identity, the nature of a taxpayer’s income, any credits to which a taxpayer is entitled, and whether the taxpayer’s return is, was, or will be examined by the

225. Cass R. Sunstein, *Informational Regulation and Informational Standing: Akins and Beyond*, 147 U. PENN. L. REV. 613, 613 (1999) (“[M]andatory disclosure is an increasingly pervasive and important regulatory tool.”). But see *supra* note 104 and accompanying text, for a discussion of inadequacies of existing regulations for consumer lending.

226. See George B. Sproles et al., *Informational Inputs as Influences on Efficient Consumer Decision-Making*, 12 J. CONSUMER AFF. 88, 100–01 (1978) (measuring consumer perceptions based on varying amounts of consumer information). An example of an informational solution to the problem of expensive tax return preparers are the provisions of free tax preparation by VITA. For example, Alaska’s Business Development Center has established a Volunteer Tax and Loan Program designed to “provide[] tax assistance to underserved, hard-to-reach, low income rural residents of partner communities,” *Volunteer Tax & Loan Program*, ALASKA BUSINESS DEVELOPMENT CENTER, <http://www.abdc.org/program-vtlp-2> [<https://perma.cc/B9LV-V7TJ>] (last visited Sept. 24, 2017), and it does so with the help of sponsorship from the VITA and TCE programs. *Contributors*, ALASKA BUSINESS DEVELOPMENT CENTER, <http://www.abdc.org/contributors> [<https://perma.cc/JL65-4546>] (last visited Dec. 24, 2017). In 2017, the program prepared over 5,900 current-year tax returns, among many other accomplishments. *VITLP 2017 Program Results*, ALASKA BUSINESS DEVELOPMENT CENTER, <http://www.abdc.org/program-vtlp-2> [<https://perma.cc/W38Q-V8Q6>] (last visited Jan. 18, 2018).

227. See I.R.C. § 6103 (2012).

228. *Id.* § 6103(a) (prohibiting disclosure of tax return information by the government); *id.* § 6713 (imposing civil penalty for disclosures by tax return preparers); *id.* § 7216 (imposing criminal penalty for disclosures by tax return preparers).

229. *Id.* § 6103(a).

IRS.²³⁰ Parallel rules exist to prevent disclosure by tax return preparers of return information.²³¹

The consequence of these prohibitions is that the government and return preparers are restricted in disclosing qualitative and quantitative information regarding the returns actually prepared by the return preparers. The laws prohibiting disclosures are a double whammy against taxpayers as consumers. First, the rules prohibiting disclosures by tax return preparers prevent ethical preparers from signaling the high quality of their services to taxpayers.²³² Signaling itself is a non-regulatory tool that corrects informational asymmetries.²³³ An ethical preparer who could advertise specific information regarding the high quality and low-likelihood of adverse enforcement would signal to taxpayers that she is an ethical preparer. Second, the laws prohibiting disclosures protect abusive return preparers who can hide their malfeasance from taxpayer clients under the guise of mandatory non-disclosures.²³⁴

Compounding the problems of lack of disclosure by tax return preparers, the limitations on disclosure by the government mean that there is no mechanism to check or corroborate return preparer information. Because of these limitations, a taxpayer as a consumer is blind as to a tax return preparer's quality and competence.²³⁵

Treasury regulations provide some exceptions to the imposition of penalties against return preparers making disclosures in certain situations.²³⁶ For example, the regulations provide that return preparers can produce statistical

230. *Id.* § 6103(b)(2)(A) (defining “return information,” broadly to include “a taxpayer’s identity, the nature, source, or amount of his income, payments, receipts, deductions, exemptions, credits, assets, liabilities, net worth, tax liability, tax withheld, deficiencies, overassessments, or tax payments”).

231. *See id.* §§ 6713, 7216. Prohibition against disclosure by the return preparer is enforced via civil and criminal penalties, respectively. *Id.*

232. *See generally id.*

233. *See Akerlof, Market for Lemons, supra* note 217, at 499–500.

234. *See generally* I.R.C. §§ 6713, 7216.

235. This is particularly important because many audits are *infected audits* that stem from the IRS auditing all returns prepared by a tax return preparer who is being investigated or will be investigated for abusive behavior. *See* I.R.M., *supra* note 5, § 4.1.10.3 (providing procedures for initiating “Program Action Cases (PAC)”). The I.R.M. provides for the enforcement of return preparer penalties against preparers who have made errors on a number of returns. *See id.* § 4.1.10.7.1(2)(b). The IRS investigates such return preparers, initiating the PACs against preparers based on a number of factors, including widespread errors made on returns, the number of affected client/taxpayers, the dollar amounts of tax errors, and prior compliance problems of the return preparers. *Id.* § 4.1.10.3.2(2). These investigations will examine a sample of 30 client returns. *Id.* § 4.1.10.3.6. Taxpayers have no way to find out if their return preparer is subject to a PAC or other preparer investigation.

236. *See* 26 C.F.R. § 301.7216-2 (2017).

compilations of data for the purpose of supporting their return preparation business.²³⁷ Those statistical compilations can be used for marketing and advertising purposes, so long as the advertising is not false or misleading and does not contain average dollar amounts of tax refunds secured for clients.²³⁸ Return preparers can also disclose return information if the information is for peer or quality reviews undertaken to evaluate and improve the quality of the returns by the preparer by certain qualified practitioners.²³⁹ With these exceptions Treasury has created an opening for possibly expanding the exceptions to prohibitions of disclosure. Treasury could liberalize the exceptions further to make clear that ethical preparers can send signals to tax return preparers.

A regulatory fix will not completely resolve the issue. The regulations do not provide any obvious regulatory fix to the problem that abusive preparers can hide behind the non-disclosure rules as a shield. There are likewise no regulations or interpretations under the prohibitions against government disclosures that would allow for the government to confirm or negate a tax return preparer's assertions of quality.

A lack of transparency regarding the cost of return preparation and lack of consumer understanding of the services being provided are other informational asymmetries.²⁴⁰ Moreover, there is a lack of transparency with respect to refund-anticipated credit products, costs to the taxpayer, and other alternatives.²⁴¹ The domino effect is that, in addition to any compliance problems they might have, taxpayers are marketed exploitive loans and sold products they may not need.

C. Regulation for Consumer Protection Aligns with the Policies Underlying the EITC

Regulating return preparers as a matter of consumer protection aligns with the broader policies underlying refundable tax credits aimed at the working poor.²⁴² As the federal government moved away from traditional means based

237. *Id.* § 301.7216-2(o).

238. *Id.* § 301.7216-2(o)(1), (3).

239. *Id.* § 301.7216-2(p).

240. Circ. 230 prohibits preparation of a return on contingency fee basis. *See* 31 C.F.R. §§ 10.27(b)–(c) (2017).

241. *See* Cords, *supra* note 105, at 390 (arguing for more education of free options for return preparation and education on consumer credit products).

242. Other scholars have argued for similar policy alignments. *See generally* Drumbl, *supra* note 121 (arguing penalties for error on EITC should align with policies for the IRS administering social benefits through the tax code).

welfare in the early 1990s and toward a welfare-to-work model administered through the tax code, the government has moved private actors into the role of determining eligibility for government subsidies.²⁴³ The government relies on return preparers to serve as the intermediary and has essentially created a demand for return preparation services for the working poor, so it ought to protect those same taxpayers from the potential for abuse that exists by way of the divergent incentives. Absent regulation, the government is essentially setting up some of the most vulnerable members of society to be exploited by abusive return preparers.

V. CONCLUSION

Existing scholarship has long focused on how unregulated tax return preparers pose a threat to the tax administration system, specifically to tax compliance. Instead of focusing on regulation of the industry to improve tax compliance, tax return preparers should be regulated as a matter of consumer protection. The government has created the market for tax return preparers to assist low-income taxpayers in claiming government anti-poverty measures administered through the tax code. In doing so, tax return preparers have diverging incentives that foster abusive practices. Regulating for consumer protection benefits low-income taxpayers. It also achieves the policy reasons behind the EITC, and it may also benefit the government.

Re-framing the goal of regulation from improving tax compliance to protecting low-income taxpayers as consumers will change the types of regulations.²⁴⁴ Instead of focusing on the accuracy of the returns, regulations will need to address the full spectrum of services return preparers provide to low-income taxpayers. Regulations may need to be tailored to the types of return preparers. The incentives of fringe preparers are different from those of businesses primarily engaged in the return preparation business. Furthermore, a consumer protection focus will ensure that the regulations are holistic in approach, encompassing refund anticipatory credit products as well as return preparation.²⁴⁵

243. See Olson, *supra* note 11, at 770.

244. Scholars have noticed the connection to consumer protection. See Cords, *supra* note 105, at 353 (“[P]rimary oversight of [unregulated tax] return preparers is imposed by state consumer protection laws.”).

245. Interesting research on alternative regulatory regimes is already being done. Borrowing from research on responsive regulations, Professor Book argues that shifting the paradigm for regulation of preparers from enforcement to front-end efforts, including personal contact, will be more effective than existing penalties. Leslie Book, *The Need to Increase Preparer Responsibility, Visibility and Competence*, in 2 NAT’L TAXPAYER ADVOCATE, 2008 ANNUAL REPORT TO CONGRESS 74, 77 (December 31, 2008).